

A new era dawns

Our longstanding thesis of a market vulnerable to shocks has been confirmed, allowing us to take profits on several dynamic positions.

Markets have been a rollercoaster ride. The S&P 500 was down 20% from its recent peak to 8 April. But then President Trump announced a pause in the higher reciprocal tariffs, and the index rallied over 8% on the day and more than 11% intraday peak to trough, before selling off again¹. The speed of the market correction, which happened in just a few days, is seldom seen.

I have seen a selloff like this only twice during my career: the global financial crisis and COVID-19 (I was just starting at university when the 1987 crash happened). Importantly, US equities have greatly underperformed the European markets.

There are always multiple drivers in any market, but given the timing of the start of the correction it is fair to say that 'Liberation Day' tariffs and uncertainty around these policies made investors extremely nervous. The VIX, the market's best-known fear indicator, rose to around 50 in early April – a level that has previously only been reached in periods of severe risk aversion.

Case confirmed

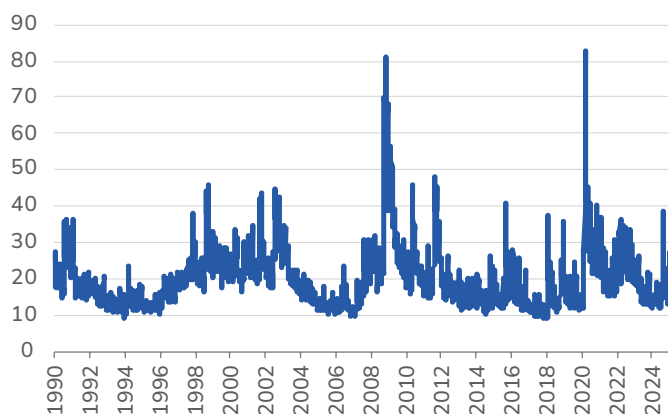
We believe this selloff is a clear expression of our thesis that the market was vulnerable going into this. A soft landing was priced, and investors collectively believed that US exceptionalism would continue in 2025.

A broadly held consensus makes the market vulnerable, and given this, our multi-asset portfolios were cautiously positioned from a dynamic perspective. At the end of February, we sold our long equity position to neutral. That trade made our portfolios overall underweight risky assets, given our longstanding short position in credit risk and our long duration position, which we see as a diversifier during recessions.



Emiel van den Heiligenberg
Head of Asset Allocation

VIX is back in the danger zone



Source: Bloomberg as at 8 April 2025.

Key risk

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1. Source: Bloomberg as at 10 April 2025.



As part of our investment beliefs we are also much more diversified in our long-term strategic allocation, with [less US equities](#) and more alternatives and duration than most of our competitors, who usually follow market cap indices.

Recent falls in US equities follow the worst quarter of [relative performance of US stocks versus the rest of the world](#) since 2002. Of course, it's too early to tell if these market moves spell the [end of US exceptionalism](#). But US equities did start the year as investors' favourite asset class, so some of the recent price action probably represents a clearing of very skewed investor positioning and relatively high starting valuations.

What's the economic impact?

[Tim Drayson was warning](#) of the potential strong negative impact of tariffs months before 2 April.

Although recession probability forecasts had risen in recent weeks, we believe they are now likely to be revised even higher, and recession is our base case at this point.

The headwinds to growth from trade disruption, uncertainty and reduced confidence could all potentially combine to have a much larger impact than that suggested by estimates based on the direct cost of tariffs alone.

Avoiding a US recession is now our alternative upside scenario, and could be achieved by a combination of tariff rollbacks, a limited response from trading partners, or domestic US fiscal stimulus that is passed quickly enough to mitigate the impact of the tariffs.

What are we doing in portfolios?

In the Asset Allocation team, we believe diversification² can help to act as risk management by design, ensuring we are not overly exposed to any one asset class, region or economic scenario. While in the past we have adjusted strategic asset allocations of the back of significant macro regime change (for example, post-Brexit), we don't see the uncertainty around future US policy as meeting the threshold for targeted changes yet.

Part of our more diversified approach extends to equity allocations, where we typically have a lower strategic allocation to US equities than concentrated market cap indices. The recent divergence in performance away from the US has therefore acted as a natural relative tailwind for our approach this year, though it follows a long period of US outperformance.

As mentioned, for portfolios with more dynamic positioning, we were positioned with a cautious bias ahead of the announcements. This was expressed with a negative view on credit, a positive view on sovereign bonds and a neutral view on equities. With credit spreads at historically tight levels earlier this year, we saw the return potential from the asset class as asymmetric, with little upside potential and more significant losses possible in risk-off scenarios.

In currency markets, we have been leaning against the strong US dollar narrative for several months, with a continued preference for the Canadian dollar and Mexican peso. At the start of the year, there was much love for the US dollar that we simply did not share.

In the immediate aftermath of the tariff announcement, when there was significant market stress, we took profit on several dynamic positions. First, with the brief rally in bonds around 'Liberation Day' we took profit on some of our government bond positions, our medium-term overweight in duration. Second, we have bought equities to take profit on our underweight risk assets, bringing us back to neutral. We are using equities for this move as they are the most liquid instrument, instead of buying back our underweight credits.

Following the market correction, we have seen a dramatic change in consensus expectations towards our recession view and extreme stress. This provides grounds for us to start buying the dips. To be clear, a full recession is not yet priced (35% equity correction would be required), but we think a more than 20% correction is enough to start building a long risk position. We expect to do this in three areas: buy more equities, close our credit underweight and possibly sell government bonds and build an underweight duration position.

Aiming to deliver long-term value

While the market landscape is shifting, we believe our diversified approach and strategic positioning could provide a robust framework to navigate the uncertainties.

We are committed to managing portfolios that aim to be well positioned for potential opportunities, regardless of the prevailing economic conditions.

As always, our focus remains on aiming to deliver long-term value for our investors through careful management and strategic agility.

Thinking, wide and deep

Our articles in this publication reflect the breadth of our thinking, and I am sure you will find plenty of food for thought in the coming pages. Start with Tim's detailed analysis of US tariffs, which will no doubt dictate the market mood in the months ahead.

Elsewhere, Rob Griffiths and Simon Bell revisit the prospects for the Magnificent Seven, US small caps and European equities following the European renaissance since the start of the year.

John Southall, meanwhile, turns his quantitative expertise to the subject of private markets, using a modelling framework to determine what level of allocation might be appropriate based on an investor's circumstances, beliefs and risk appetite.

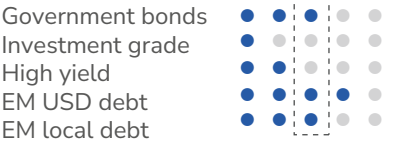
Finally, our regular CAMERA update will provide a summary of our long-term return expectations across a range of asset classes.

Our key asset class views

Overview



Fixed income



[Dashed box] = Strategic allocation

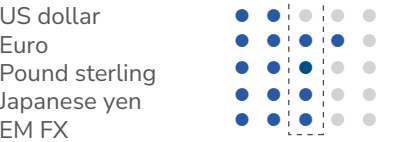
This schematic summarises the combined medium-term and tactical views of L&G's Asset Allocation team as of 22 April 2025. Asset allocation is subject to change. The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. Regional equity views should be read in conjunction with the overall equity view. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point.

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Equities (inter-region views)



Currencies



2. It should be noted that diversification is no guarantee against a loss in a declining market.





US tariffs: what happens next?

In a dramatic reversal of policy, President Trump has paused reciprocal tariffs. But uncertainty and the effective tariff rate remain high and the US is still likely heading for recession.



Tim Drayson
Head of Economics

President Trump’s 2 April Liberation Day shocked economists and markets by delivering large universal tariffs based on trade deficits rather than a more gradual and targeted approach to address US perceptions of unfair trade practices.

Economists responded with significant cuts to their forecasts, with many forecasting recession. A combination of factors, including market pressures, persuaded President Trump to pause the reciprocal tariffs for 90 days one week later. But 10% universal tariffs were still kept in place, and tariffs on China rose to at least 145%. The other tariffs introduced so far this remain. Policy reversal has probably reduced some of the risks of a more serious crisis, but betting markets are still suggesting a greater than 50% chance of a US recession this year.³

The huge tariffs on China mean these changes do not reduce the overall tariff rate based on current trade flows, though we expect a collapse in imports into the US from China if not quickly scaled back. This will reduce the effective tariff rate, but still leave it higher than most were expecting before Liberation Day. Furthermore, by entering into negotiations for 90 days, uncertainty is likely to remain high. It remains to be seen how quickly deals can be struck, but 10% tariffs now appear to be the floor.

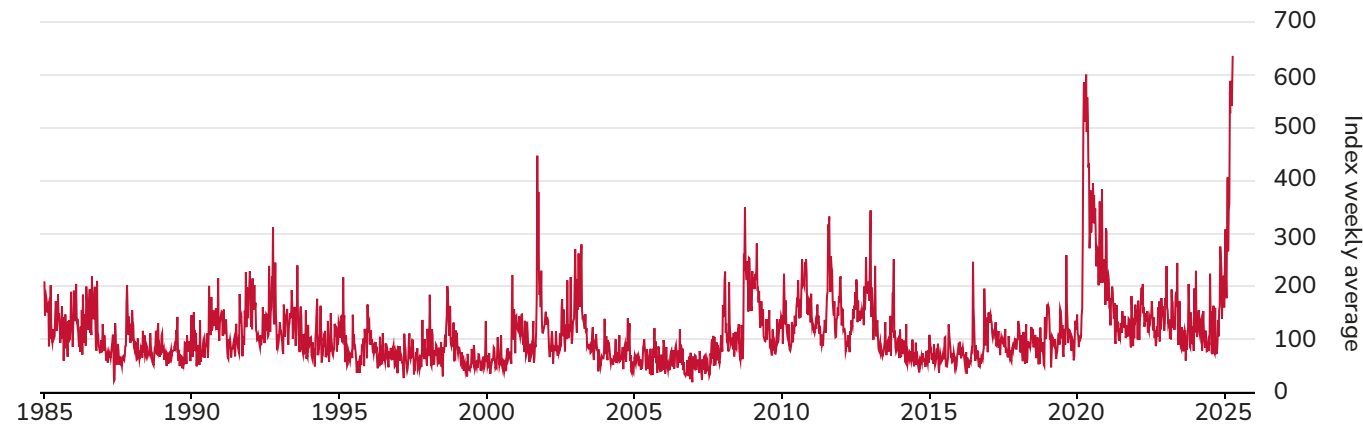
Negative feedback loops

While the gap between our long-held view and consensus is in the process of closing, we still worry about the fat tail of a deeper recession. This is a negative supply shock, alongside a policy of maximum trade uncertainty as every traded product and country is in scope and there is little visibility on where the tariffs will settle. The downside risk is further tariffs emerge in the weeks ahead, leading to retaliation and trade war escalation, amplified by negative feedback loops from persistent uncertainty, wealth effects and a tightening in financial conditions.

We expect this to have a chilling impact on US GDP. Business investment related to trade and new supply chains is likely to be placed on hold. Recent confidence surveys have begun to falter, and we expect a further deterioration.

But to the extent this is still perceived as a negotiating tactic, the most adverse economic effects won't be seen until after the tariffs have been in place for a while. So the deterioration in the economic data might not be fully apparent until the summer. The extent to which this reduces the US goods trade deficit is

US economic policy uncertainty



Source: [Economic Policy Uncertainty Index](#) as at 9 April.

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unclear. If the US goes into recession (the opposite intention of the policy) that would reduce imports and the trade deficit.

A more benign path

President Trump has shown some sensitivity to a deteriorating stock and bond market, and likely will be paying attention to polling numbers. At some point, this could trigger a combination of removing the Mexico and Canada tariffs, better engagement with the rest of the world and a lower level of tariffs. This sets up the prospect for more balanced bilateral negotiations (including a quick renegotiation of the United States-Mexico-Canada Agreement).

The Fed is in a tight spot from political pressure and tariff-induced inflation, which could push the core PCE deflator above 4% later this year, but rate cuts provide a backstop against a sharp rise in unemployment.. Congress is still debating fiscal policy.

Signs of economic weakness and tariff revenues could encourage tax cuts beyond merely extending those due to expire.

But ultimately any relief is likely to be modest. An effective tariff rate of-15-20% seems likely to persist all year. This is because reducing the trade deficit in an attempt to boost US manufacturing appears to be one of the key strategic objectives.

In the near term, retaliation could come not only from governments, but directly from consumers via a broader boycotting of US products and brands. We have seen a strong anti-America reaction in Canada and signs that tourism to the US is falling sharply. In any case, some damage is already done and uncertainty over tariffs and their impact is likely to remain high.

3. Polymarket as at 8 April 2025.

Where next for European equities?

Fiscal developments have galvanised the region's markets, but shareholder returns remain anything but certain.



Robert Griffiths
Global Equity Strategist



Simon Bell
Fund Manager

The prospects for European equities appeared particularly poor after the election of Donald Trump.

His assertive policy platform encompassing tariffs, a distinctly more sceptical approach to US security commitments to NATO, and vocal support for the leading American tech firms all appeared to pose profound challenges for European equities.

That left the region very cheap, especially when compared with the US, and deeply unloved by global investors. It seemed the election marked a new and reinvigorated phase of American exceptionalism, with assertive policy supercharging the case to be overweight US equities, and little else.

There was no alternative

It should be said, though, that the persistent outperformance of US equities over the past 15 years was as much about a lack of compelling alternative narratives as it was about the particular merits of the US market.

For much of the past decade, Europe has seen a mix of austerity, populism and war in Ukraine sap investor appetite. China has seen an equally lost decade as it has struggled under the weight of a persistent deflation of its housing and construction sector after years of overbuilding.

Investors expected, and were positioned for, more of the same, with momentum trades dominating as investors found little reason to do anything other than what had worked in recent years.

A shock to the system

Perhaps we should all have been more mindful of President Trump's self-professed status as a disruptor. In Europe's case, it's probably better to describe him as a defibrillator, shocking the region's politicians into the kind of decisive actions which seem beyond them in more normal, less challenging times.

Central to this has been Germany's decision to ease the rules surrounding its debt brake and to boost infrastructure spending, steps that together could lift spending by €1 trillion over the next 10 years, equivalent to c.23% of GDP.⁴

China, conscious of the challenge US tariffs could create for its export-driven growth model, has pursued increasingly assertive domestic stimulus policies aimed at reinvigorating consumption at home, rather than relying on it from abroad.

These developments have seen alternative narratives for investors explode into life, and left the only thing exceptional about US equities being their extended valuations relative to the rest of the world.

Can Europe walk the walk?

So, where are we now? This is an environment in which narratives, and investors, move fast. Since December, the DAX has outperformed the Nasdaq by around 20%⁵, Germany's valuation discount has closed by around 15 percentage points⁶, and survey data⁷ suggest one of the largest net overweights in European equities seen in the past decade.

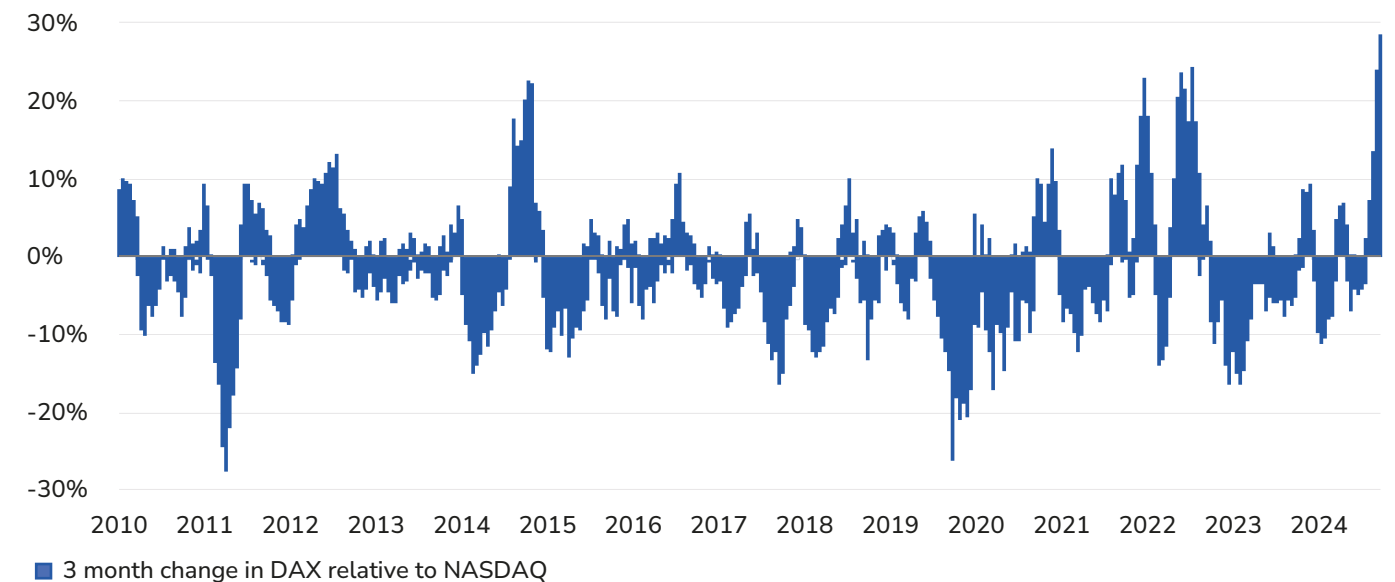
Even more strikingly, Rheinmetall*, Germany's leading defence firm, is now up over 2,700% over the past five years,⁸ making Nvidia*'s 1,900% gain over the same period⁹ appear quite pedestrian.

That puts European equities in a rare position where expectations are high, and ultimately earnings need to deliver.

Year to date, even as European equities have rallied 15%, 2025 earnings-per-share expectations have drifted lower.¹⁰ What has underpinned the US equity market in the past 15 years has been extraordinary profit delivery. This has been helped, it should be said, by substantial buybacks and tax cuts.

Yes, Europe's fiscal backdrop has changed markedly to one much more conducive of growth, but translating that into returns to shareholders will be far from straightforward.

A new chapter for Europe?



Source: Economic Policy Uncertainty Index as at 9 April 2025.

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4. Bloomberg as at 8 April 2025.

5. ibid.

6. ibid.

7. Bank of America's Fund Manager Survey.

8. Bloomberg as at 20 March 2025.

9. ibid.

10. ibid.

Sizing private markets

How much should investors put in illiquid assets? We use a modelling framework to provide some possible answers.



John Southall
Head of Strategic Research

There are two main reasons illiquid assets may deserve an allocation. First, diversification: they allow access to a broader opportunity set. The second is as a source of outsized returns. This could come from illiquidity premia or lower market efficiency, so increased scope for skilled managers to add value. Some investors have decades-long investment horizons. As such, they may be well placed to capture illiquidity-based returns.

There are also grounds for caution. Diversification is a free lunch, but outsized returns are not. Apart from reduced liquidity, private assets suffer from scant historic data, a lack of transparency, and challenges measuring returns. Rebalancing is constrained, costs higher and governance requirements more onerous.

This raises the question of how much it might make sense to invest. Modelling frameworks can help us reach an informed answer.

Market cap

A useful starting point for allocations is market capitalisation. Estimating the proportion of investible assets that are private is tricky, but studies suggest around 10%,¹¹ with the share predicted to grow rapidly.

Square one might therefore be to hold around 10% in private assets. However, an investor should adjust their strategy depending on their risk appetite, circumstances and beliefs.

But can we quantify this?

Sizing private assets

In setting expected net excess returns, our starting point is their risk contribution to the global investable universe.

The nice thing about this is that if an investor has the same circumstances, beliefs and risk appetite as an average investor then optimisation leads to 10% in private assets, neatly tying in with the idea above.

Of course, nobody is the average investor! As such we want to understand how their strategy should differ. To explore, I produced the efficient frontiers below, which blend five strategies:

On the left, the investor is average other than a potentially different risk appetite.

On the right, I've allowed for an additional 0.5% p.a. return on private assets. This addition could reflect a greater ability to harness illiquidity-based returns (perhaps thanks to a longer investment horizon), a stronger belief in the merits of private investing, or the ability to access private returns at lower costs.¹²

Depending on preferences, a modest (c.10%) up to a sizeable (c.30%) allocation to diversified private markets appears appropriate if the overall volatility target is 10% p.a. At lower volatilities private assets are squeezed out¹³ but at higher volatilities private equity kicks in as a way of accessing higher expected returns.

A deduction, rather than addition, of 0.5% p.a. on private assets could make sense for investors with shorter time horizons or reduced tolerance for illiquidity for other reasons. This eliminates private market exposure from the efficient frontier other than for very high return targets.

Wider benefits

Compelling narratives and the [potential wider societal benefits](#) of some private assets can help people remain invested and engage with their pension.

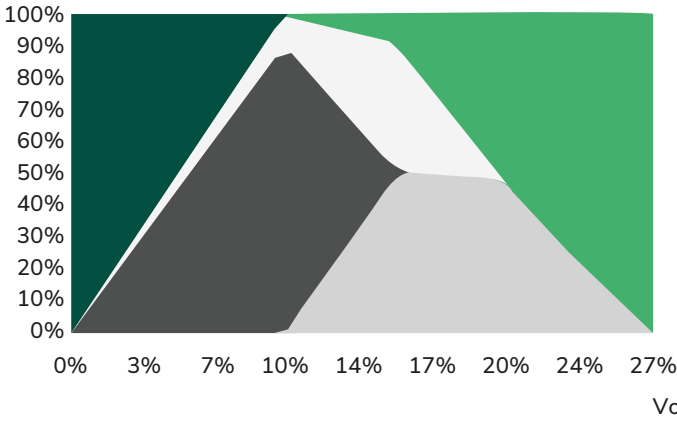
There may also be psychological benefits to private assets. Appraisal-based valuations are sometimes criticised as making private assets appear less risky than they really are. However, this feature has a positive dimension, as it could help investors avoid succumbing to [loss aversion](#).

Investors also [tend to perceive](#) tangible investments, such as property, as less risky.

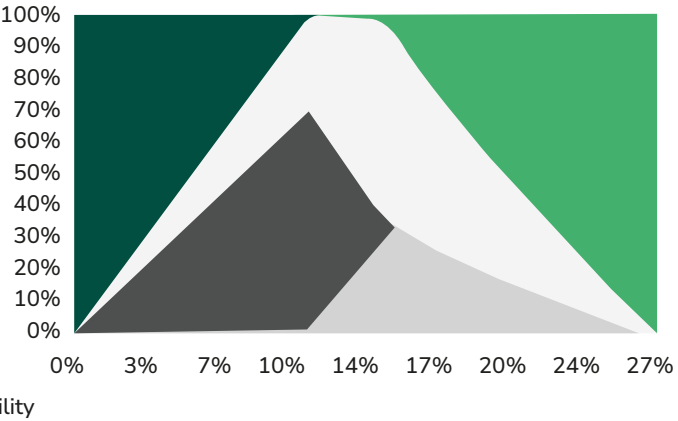
Broadening the opportunity set

No strategy is all things to all investors, and private markets are no different. However, we do think they can be a useful diversifier, at least in modest amounts. Although care is needed, it is also plausible that they offer illiquidity premia and alpha opportunities net of costs. The potential benefits of private assets are particularly useful where they align with the opportunities and goals of the investor, for example a long horizon, resource to do the necessary due diligence and scale to negotiate lower fees.

Efficient Frontier assumes no preference for private assets



Efficient Frontier assumes an 0.5% pa return on private assets



■ Low-risk (cash, gilts, linkers - depending of objectives) ■ Diversified private markets (including private equity)
■ Global listed equity ■ Private equity ■ Liquid multi-asset (including listed equity)

Source: L&G calculations as at December 2024. For simplicity we have used mean-variance optimisation to illustrate the potential impacts on asset allocation from including private markets. In general we also optimise using more sophisticated approaches but mean-variance is a useful starting point.

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11. For example, SSGA estimated 9.7% of the global investible universe of c\$175trn was in real estate, private equity and private debt as at June 2024.
12. Note it's not saying there is 'only' an illiquidity premium of 0.5% p.a. – rather it is saying that the benefits less the drawbacks of private assets are worth 0.5% p.a. more to this investor than the average investor.
13. But there could be a role for private credit, not split out here.

CAMERA: currency assumptions in focus

There’s no ‘right’ answer, but it’s important to understand the impact of different approaches on long-term return forecasts.



Patrick Greene
Strategist, Asset Allocation

Producing expected return models can reveal important assumptions that might otherwise be hidden. Here we want to shine a light on currency assumptions. Choosing between alternate but sensible currency assumptions can lead to big changes in expected returns.

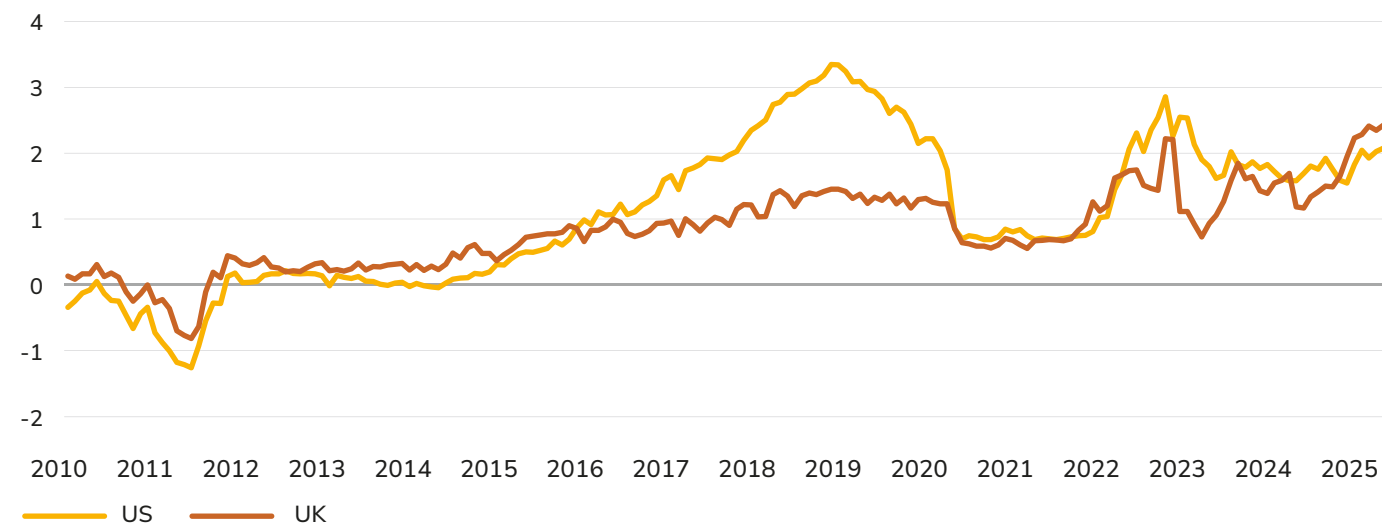
Interest rate differentials

Currency assumptions tend to come in a few different varieties. These assumptions frequently relate to interest rates, either explicitly or implicitly, through inflation differentials. Commonly used assumptions in expected return estimates include:

- **Uncovered Interest Rate Parity (UIP):** Expected currency movements will offset interest rate differentials
- **Relative Purchasing Power Parity (relative PPP):** Future currency movements will equal the inflation differentials between the two countries
- **Constant Spot Exchange Rates:** Hold the currency constant at the current level

When interest rate or inflation differentials are large, choosing between these assumptions can make a big difference. This is particularly true for euro-based investors today.

1-year interest rate differential with Germany



:Source: Bloomberg, as at April 2025.

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Picking the ‘right’ model

Unfortunately for investors, no assumption is definitively the best. Each assumption has some merit or some empirical evidence that you could interpret in its favour:

- **UIP** has a strong theoretical foundation and is consistent with it being hard to earn returns from simple carry trades. However, there is evidence that various risk premia are rewarded in FX markets, even if it is not always the case.
- **Relative PPP** is often used in economics, where it is based on the Law of One Price i.e. you shouldn’t be able to make a profit simply buying a good in one place and selling it somewhere else (within limits). But empirical evidence is mixed and if Relative PPP does hold, it is often not true over short periods.
- **Constant Spot Exchange Rates** are a sensible choice if you think the exchange rate is a random walk, and it is also easy to understand. The Bank of England uses this assumption in some of its projections. But it ignores all the theory embedded in UIP and relative PPP.

For our developed market equity assumptions, we use relative PPP over a five- to 10-year horizon. For strategic asset allocation assumptions, which anchor the long-term estimates in CAMERA, we assume UIP.

In practice, that means you can earn carry over the medium term if real interest rates differ across countries, but in the long run there are no expected returns from currencies.

We think that is a sensible starting point, but we are also aware alternative choices could be plausible. In this case it is useful to think in terms of scenarios.

Currency scenarios

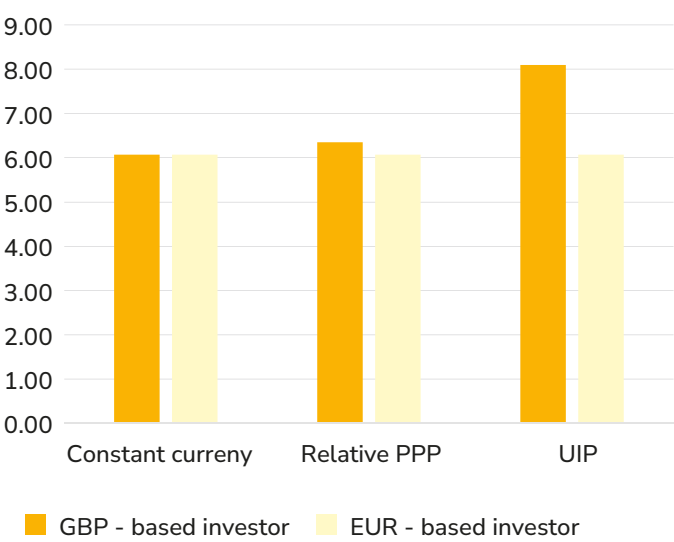
The charts below show UK and Europe (ex-UK) expected return assumptions in euros and GBP for different currency assumptions. This shows the expected return deviates by up to 2% (reflecting the interest rate differential) depending upon your return assumption.

What does it mean?

We present CAMERA estimates with the assumptions we think are most sensible. Indeed, relative PPP sits between two of the reasonable alternatives. But where there are uncertain choices, it is good to know how sensitive our assumptions are to those choices.

For example, euro-based investors should be aware that if they are assuming constant currency in their assumptions, they could be biasing international equity return assumptions upward.

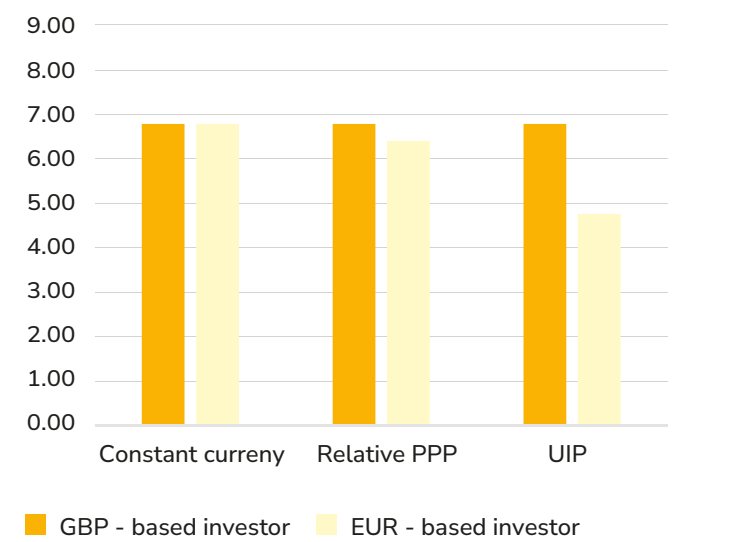
European equity nominal return assumptions over the next 5 years



Source: L&G CAMERA calculations as at 26 March 2025.

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UK equity nominal return assumptions over the next 5 years



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