Parmenion
Investment Management

Q4 Macro Outlook

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Summary

Growth slows and inflation is sticky
Rising trade barriers and global fragmentation may slow growth and keep inflation elevated, raising *stagflation* concerns. Central banks are now more focused on supporting growth than fighting inflation.

Uncertainty persists around tariffs
Though tariffs have scaled back, uncertainty remains. As firms run down inventories and adjust supply chains, higher costs likely pass to consumers, keeping inflation persistent and discouraging investment.

US labour market shows cracks
The US labour market is softening. If company profits fall, layoffs and unemployment could rise, hurting consumer spending and increasing the risk of a recession.

Federal Reserve makes a policy shift
The Fed has resumed easing to support growth. But political pressure from the White House could undermine its independence, pushing up long-term interest rates and weakening the dollar.

Global growth drivers are changing
The EU (especially Germany) and China are rolling out fiscal stimulus focused on domestic growth. Europe prioritises defence and infrastructure spending, while China invests in higher-value manufacturing and consumer-focused policies to boost productivity.

Implications for investment
Global growth is broadening, encouraging more international diversification. The US still leads in AI investment, but its rapid pace raises questions about returns. Other regions may benefit as adoption spreads. China remains a key diversifier, given its control of resources and capacity for stimulus.

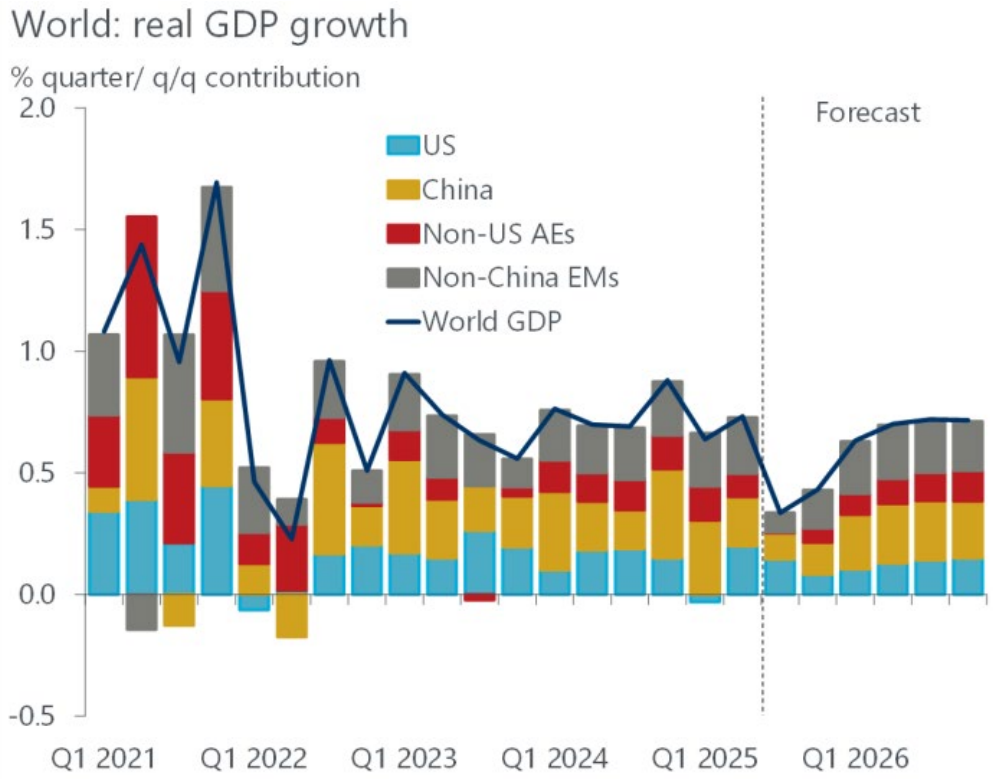
Our strategy
In this uncertain environment, we remain constructive, guarding downside risks. A sub-trend growth outlook calls for prudence, discipline, regional and asset-class diversification, and alternatives.

What's the outlook?

Despite worries about tariffs, government fiscal policy, geopolitics and Fed independence, markets have climbed to new highs.

Underpinned by solid earnings, loose financial conditions and excitement around AI, investors have embraced a 'risk on' approach. Whether this will continue hinges on a number of factors – in particular, continued resilience in the US labour market and central banks' ability to engineer the soft landing that consensus expects. This is far from straightforward, especially when political interference is rife.

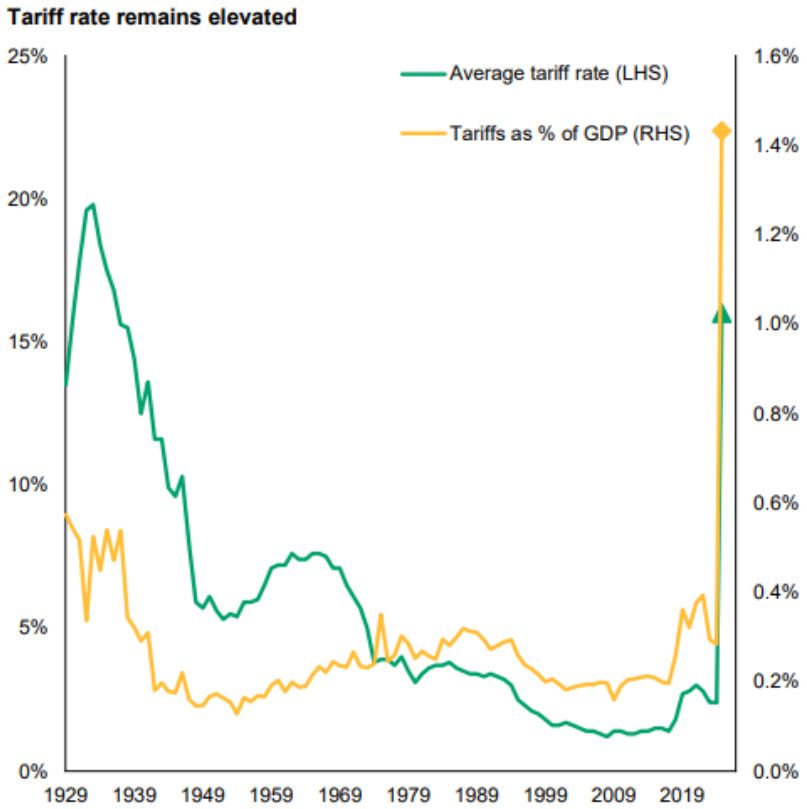
Global growth is forecast to slow alongside the pace of expansion in the US. A convergence in growth rates across geographies is likely, as stimulative fiscal policies in Germany and China plus easier monetary policies in some emerging market countries offer investors a broader range of investment opportunities.



Source: Oxford Economics/Haver Analytics as at September 2025

Tariffs are bad for growth, productivity and efficiency

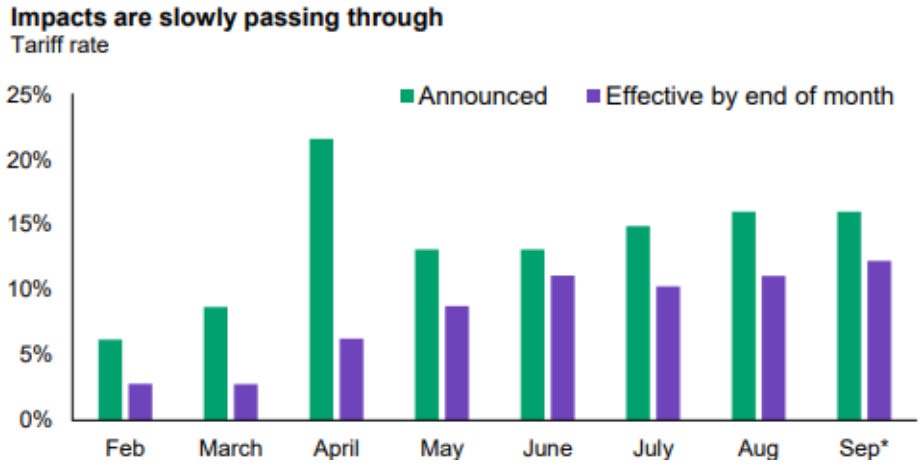
Uncertainty around tariffs persist, despite negotiations broadly softening the initial proposed headline rates. An average effective tariff rate of about 16% is now expected, and that's a meaningful tax on US consumers. Not good for growth, productivity or efficiency.



Source: BEA and J.P. Morgan Asset Management as at September 2025

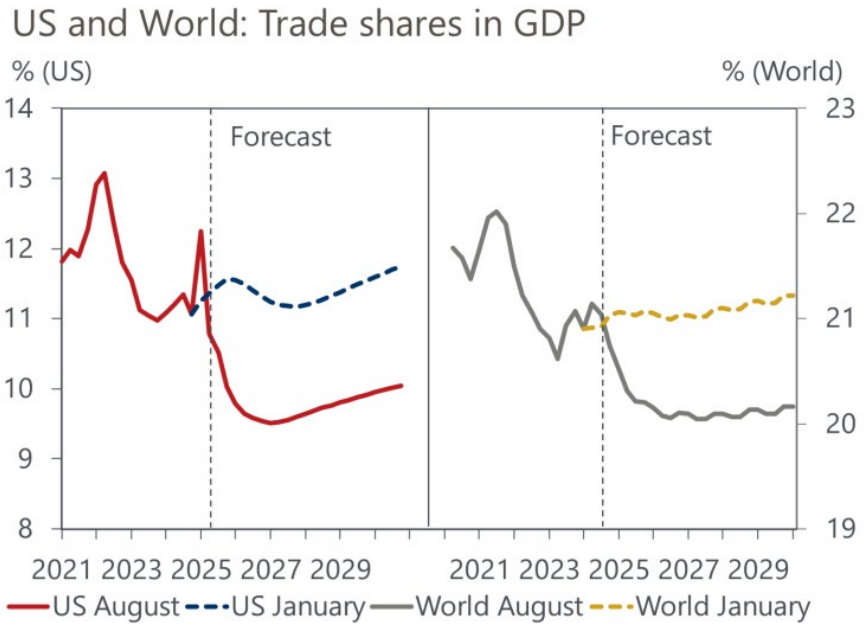
The impact of tariffs has not yet been fully felt as inventories that were accumulated before their introduction are being wound down. This is expected to change in the final quarter of 2025 and into 2026.

Companies will want to pass on higher costs to customers to protect their margins. However, with the consumer already under increasing strain from the rising cost of living and a cooling labour market, that might not be as simple as it sounds and corporates with rising costs and slowing sales face a potential double blow.



Source: BEA and J.P. Morgan Asset Management as at September 2025

The broader implication of the Trump administration's tariffs and growing nationalism is a reduction in global trade. Ironically, the US will take the hardest hit in the near term, though forecast to gently recover over time.

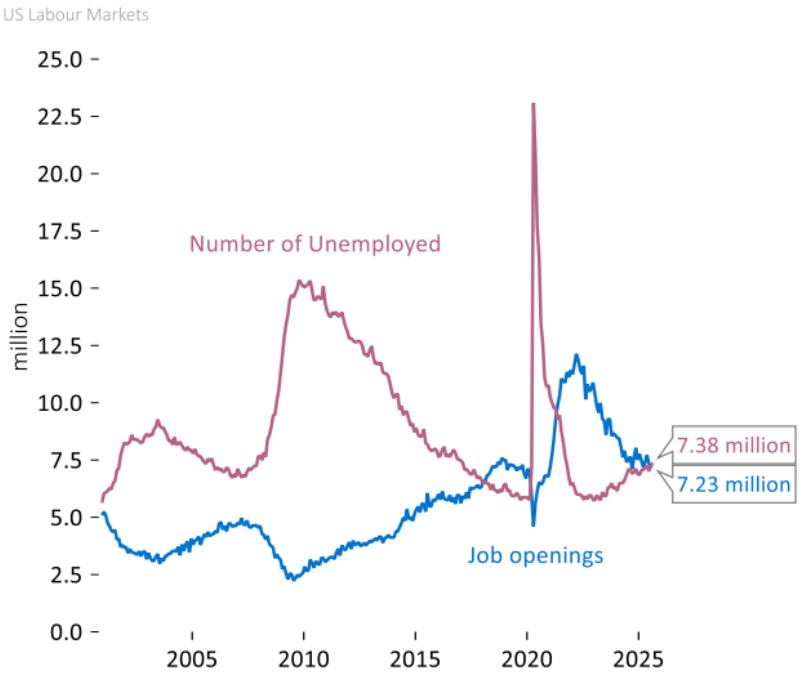


Source: Oxford Economics/Haver Analytics as at September 2025

A temporary uplift in short term inflation in the US is expected, but being a supply side shock could mean it persists. Supplies previously targeted for the US market will now be diverted globally, acting as a disinflationary force especially in Europe and Asia.

US labour market holds the key

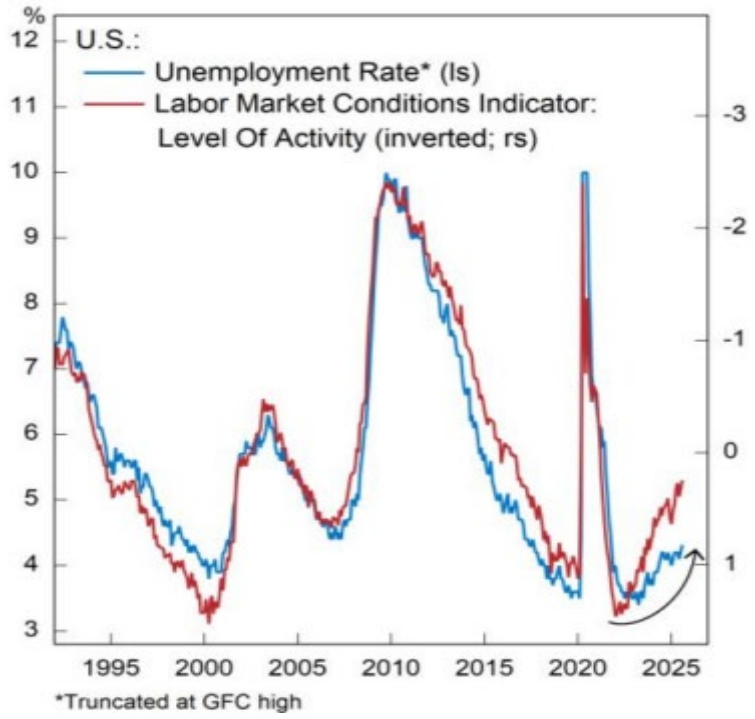
The consumer is key to the strength and resilience of the US economy, making up around 68% of GDP. Job security has been strong since the pandemic, as new openings exceeded the number of unemployed. However, that ratio has recently turned negative. Layoffs are modest, but there are increasing signs of cooling in the labour market with wage growth easing, average hours worked softening and temporary hiring drifting lower.



Source: Macrobond and Sarasin as at October 2025

This points to a weaker consumer and, with labour market data lagging, highlights why the Fed is watching closely.

The tight correlation shown below between the Kansas City Fed Labor Market Conditions Indicators and unemployment rate shows the likely direction of travel. In the run up to next year's mid-term elections, politicians from both parties will be increasingly vocal about employment stability and opportunity for their electorate.



Source: Alpine Macro as at August 2025

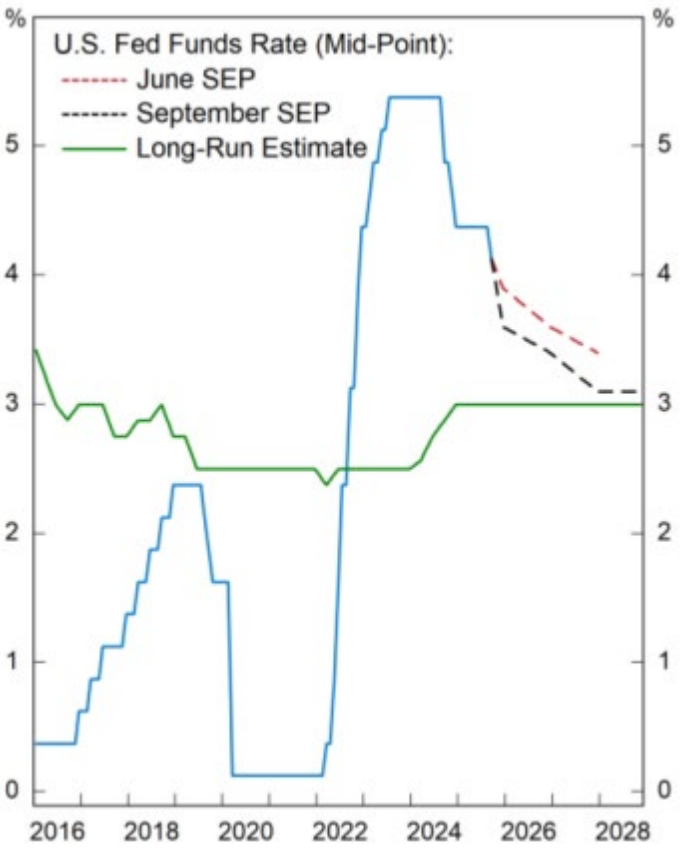
Don't forget the Sahm Rule

The Sahm Rule has been an accurate predictor of recession when the three-month moving average rate of unemployment rises by more than 0.5% from the lowest point in the previous twelve months. The markets currently see the probability of recession as low. If this proves wrong, growth assets can be expected to weaken, and defensive assets relatively outperform.

Monetary easing and supportive financial conditions

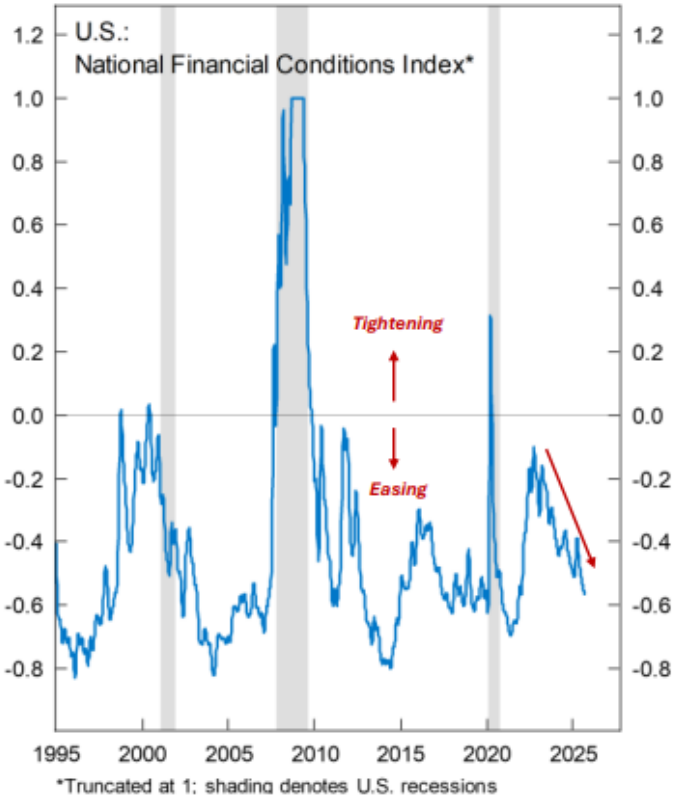
Unsurprisingly, the Fed is increasingly minded to lower interest rates, electing to cut by 0.25% in September for the first time in nine months. How much more they will cut and how quickly is unclear. The market is assuming rates to be close to 3% by the end of 2026, but with inflation still notably above the 2% target and at risk of moving in the wrong direction with tariff and currency impacts, there is a risk of disappointment.

With Q3 GDP proving strong at 3.8%, equity and bond markets performing well year-to-date and financial conditions already loose, there are legitimate reasons why the Fed should move gradually and cautiously to reduce risk of policy error



Source: Alpine Macro as at September 2025

Unless the labour market cracks, which we don't think is likely, we expect a modest rate cutting cycle to unfold, which will be supportive to equity investors.



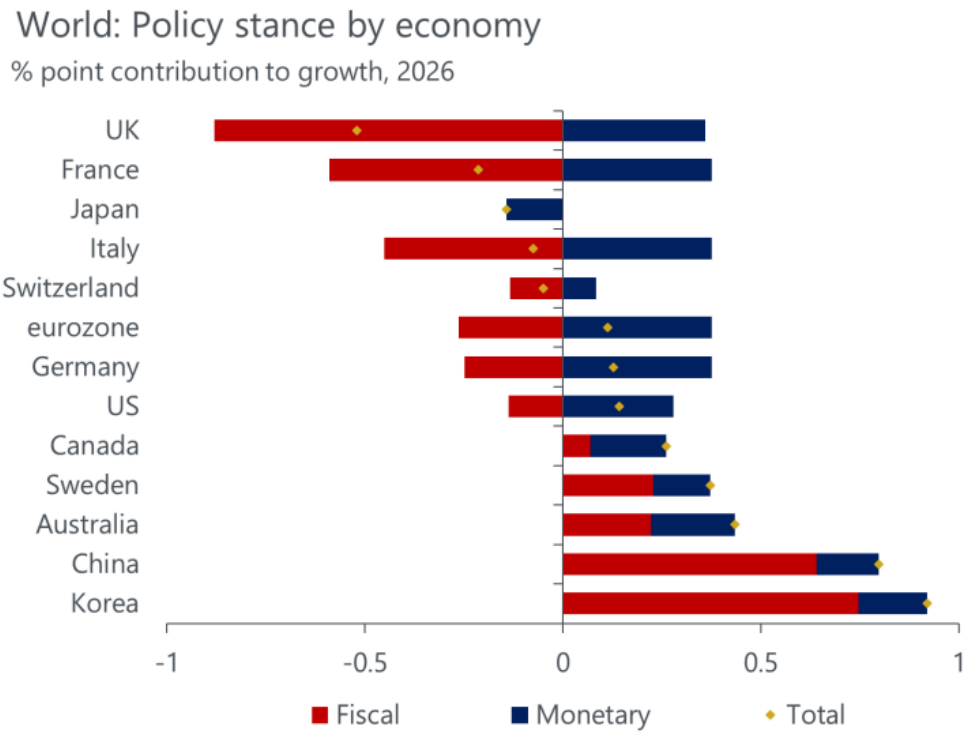
Source: Alpine Macro as at September 2025

Fiscal policy has scope for upside surprise in EU and China

The extension of current personal tax rates in the US as a result of the One Big Beautiful Bill (OBBB) helps avoid a disposable income shock for the average American household. The bill also includes tax deductible accelerated depreciation, which could incentivise capital expenditure and investment programmes, supporting GDP growth. The policy is aimed at domestically focussed activities so could help those small and mid-caps whose revenues tend to be more domestic.

The greatest source of expected fiscal policy support for 2026 should be in China and Korea. The next Chinese Communist Party five-year plan, due to be announced in March 2026, is likely to target expanding consumption. Given the average household savings rate of just under 32% there is plenty of capacity to spend. They just need to improve confidence and stability, which could be achieved by rolling out a broader and more comprehensive social welfare programme.

There have already been selective regional tests of this, including relaxation of the hukou household registration system with encouraging results, so it is anticipated that there will be a controlled wider rollout.

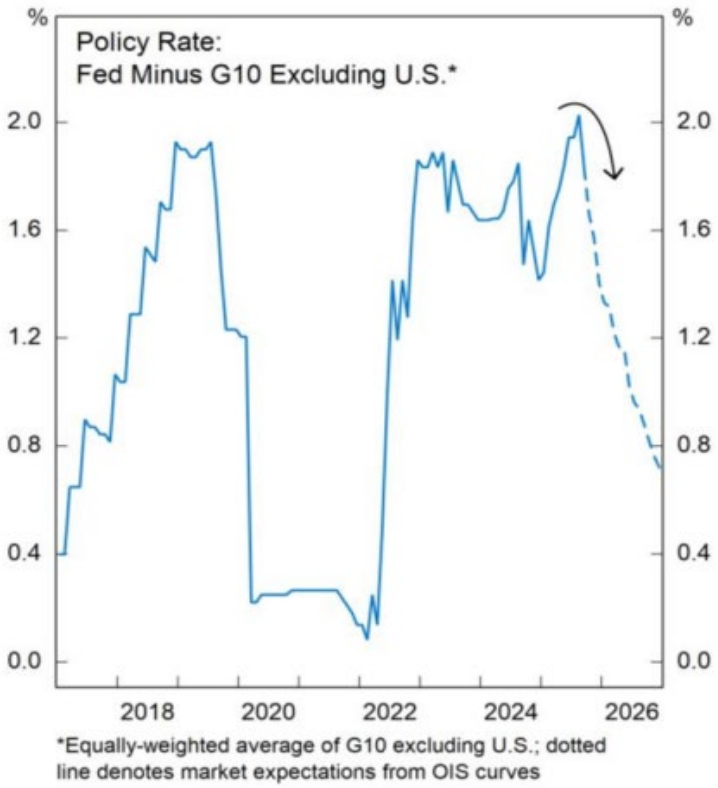


Source: Oxford Economics as at September 2025

The release of the debt brake in Germany also offers scope for upside surprise. The planned €500bn infrastructure programme from 2025-2029 is forecast to kick into gear in 2026. Its success will come down to implementation, but indications are that plans are progressing. There's increasing political determination to deliver to keep the electorate onside, especially with the coalition under threat from the growing popularity of the Alternative for Germany party (AfD).

Dollar safe haven status doesn't mean it can't weaken

The dollar's status as the world's reserve currency remains, but with the US debt:GPD ratio forecast to expand to 134% by 2034, investors are increasingly seeking diversification. With GDP growth and interest rate differentials also anticipated to narrow, the 9% depreciation seen in the dollar year-to-date seems set to persist.



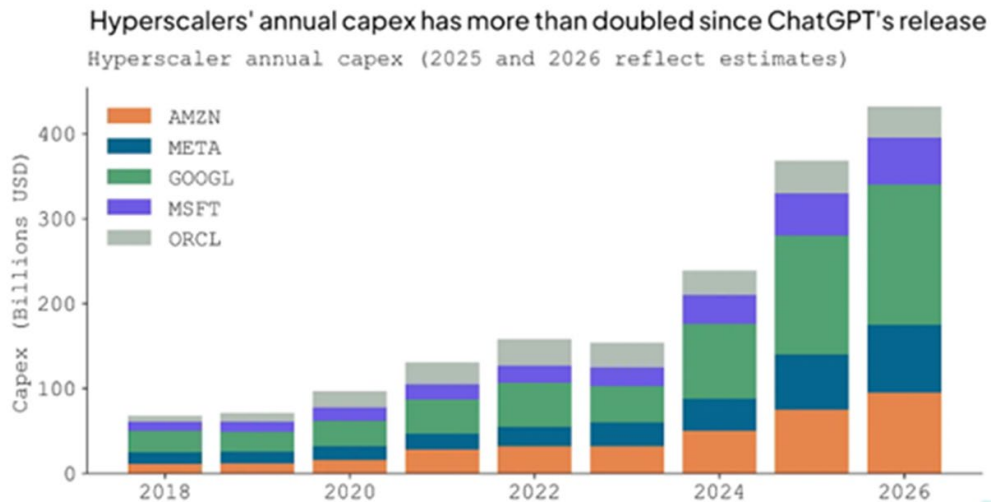
Source: Alpine Macro, Bloomberg Finance L.P. as at September 2025

Interestingly we have also started to see a breakdown in the dollar's flight to safety during risk off events. This is unusual and reinforces the view that investors are 'over-indexed' to US assets and seeking alternatives including gold, stablecoins and even Bitcoin (though that appears to have a high correlation to equities).

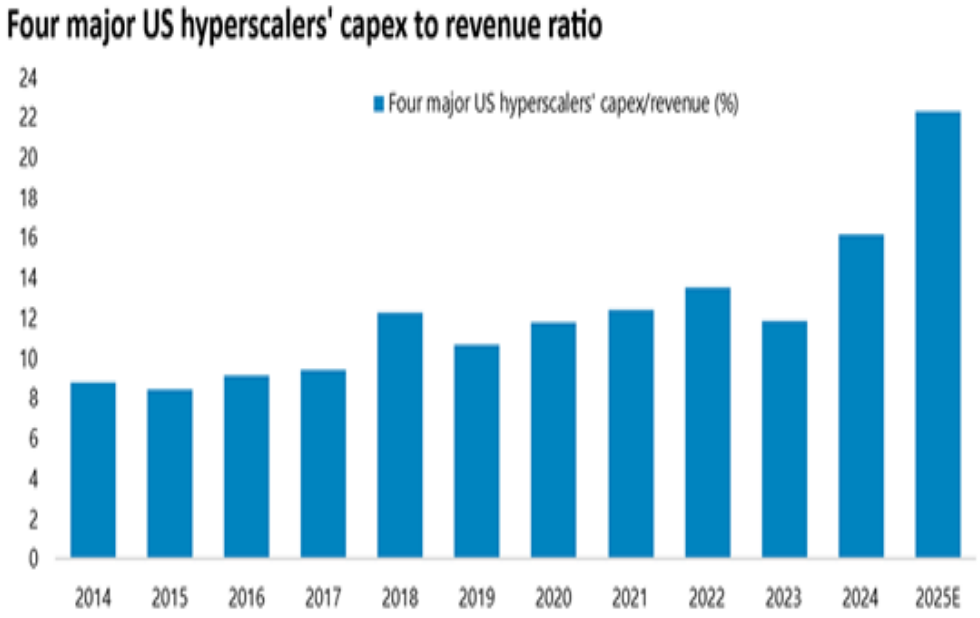
AI momentum powers on

US hyperscalers accelerated the speed and magnitude of their capital expenditure on AI through 2025, in anticipation of the potential productivity gains it would bring.

Predominantly funded through internal cashflow, investors have been willing to look ahead to future expected returns. However, if revenue growth doesn't keep pace with expanding capex plans, investor sentiment could well shift, leading to downward pressure on valuations.



Source: Citi Research as at September 2025



Source: Alpine Macro, Bloomberg Finance L.P. and Grizzle.com as at September 2025

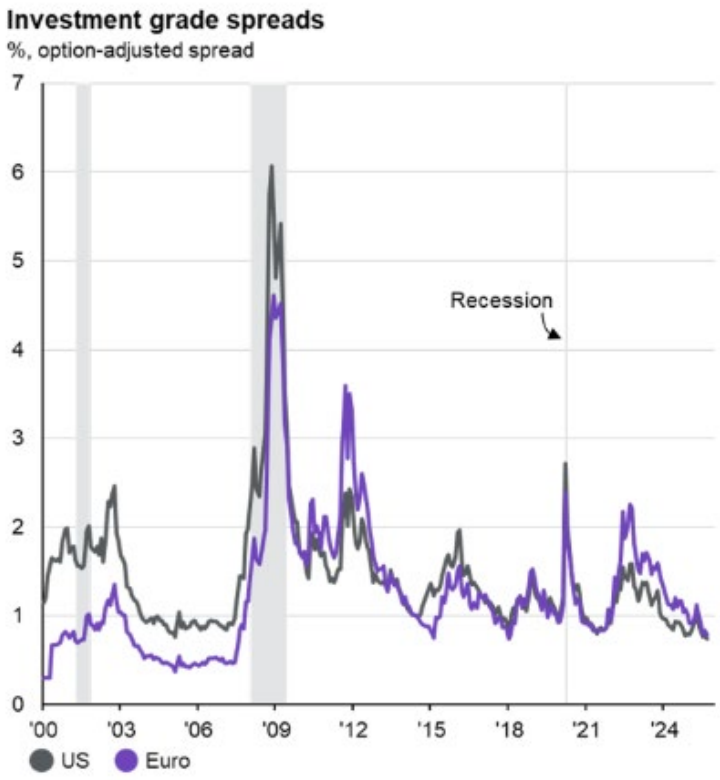
For now, the Q3 reporting season is expected to be solid for AI. However, as capex climbs, their previous 'capital lite' models are shifting. This suggests hyperscalers may see lower returns on their expenditure, and their profits cycle could become more sensitive to changes in the economy.

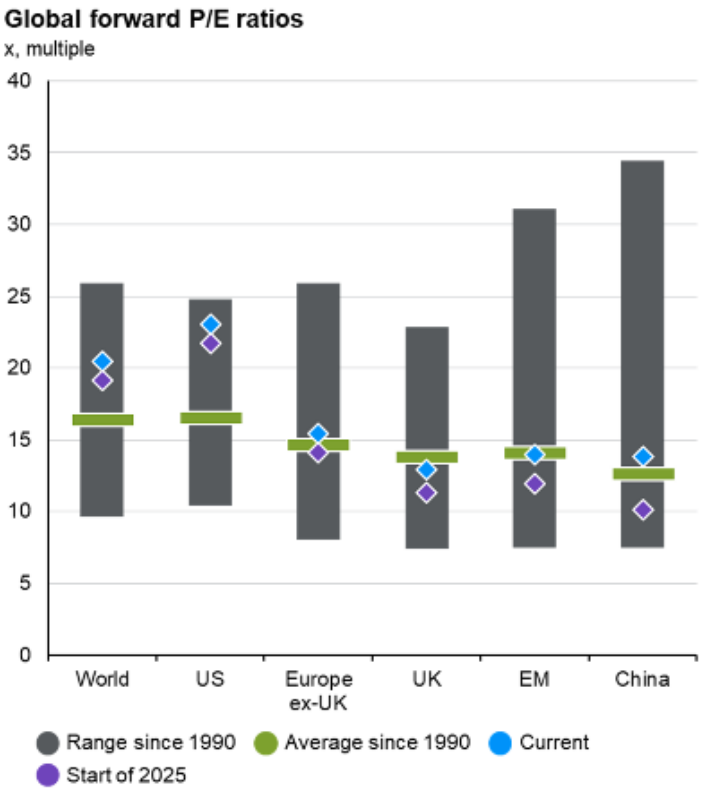
Investors are watching closely as current valuations leave little margin for error.

Where are the opportunities for investors?

Valuations across equities and bonds are no longer cheap, but with a supportive liquidity backdrop and muted but positive growth outlook, solid real returns are expected over the next 12 months.

Globally diversified asset allocation along with a deliberate avoidance of style concentration is pragmatic and prudent. Selectivity, discipline and care are essential and chasing momentum is best avoided.

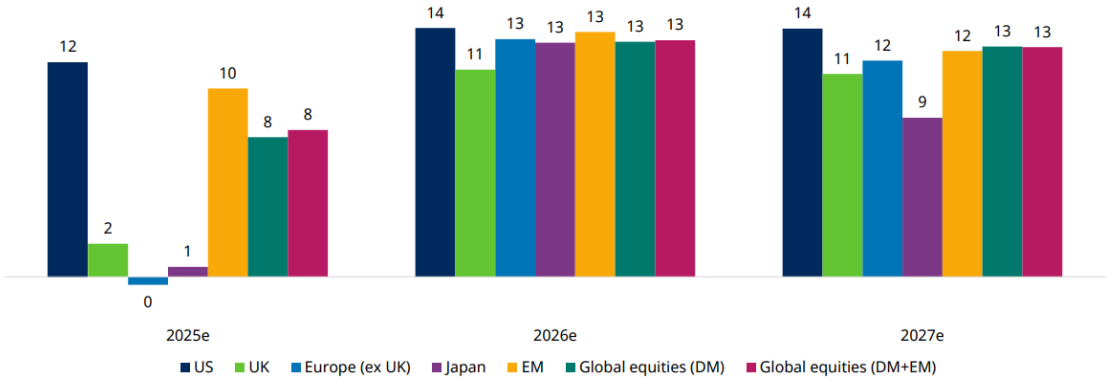




Source: J.P. Morgan Asset Management as at September 2025

Looking at fundamentals, consensus earnings expectations into 2026 are encouraging with low teens widely forecast. While the US leads with 14% EPS growth, that leadership has meaningfully narrowed, representing greater breadth of opportunity for investors - something we've not seen for a few years.

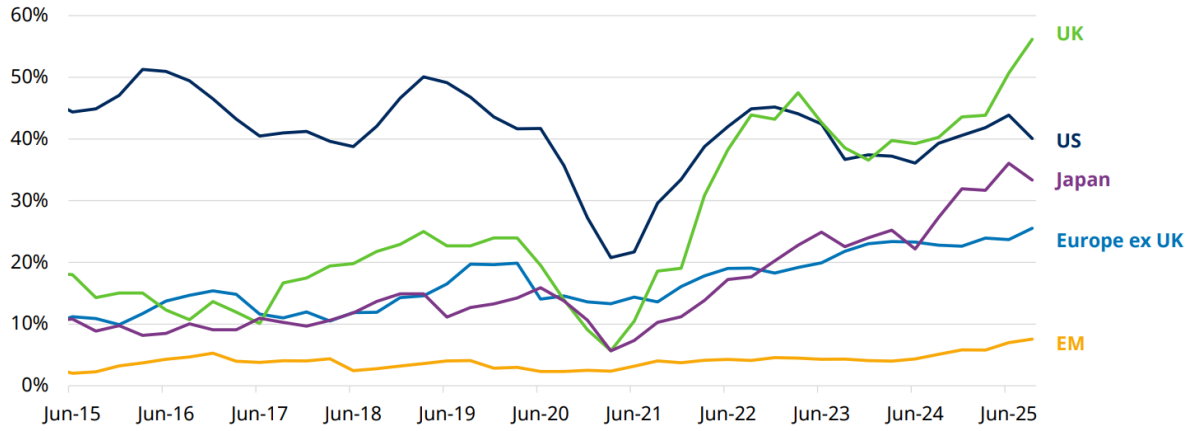
Corporate earnings: consensus YoY EPS growth forecasts, %



Source: LSEG Datastream and Schroders as at August 2025

With corporates increasingly focussed on driving total shareholder returns through share buy backs, dividends and asset value realisation, there is reason to believe in the durability of opportunity in the EU, Japan, UK and EM.

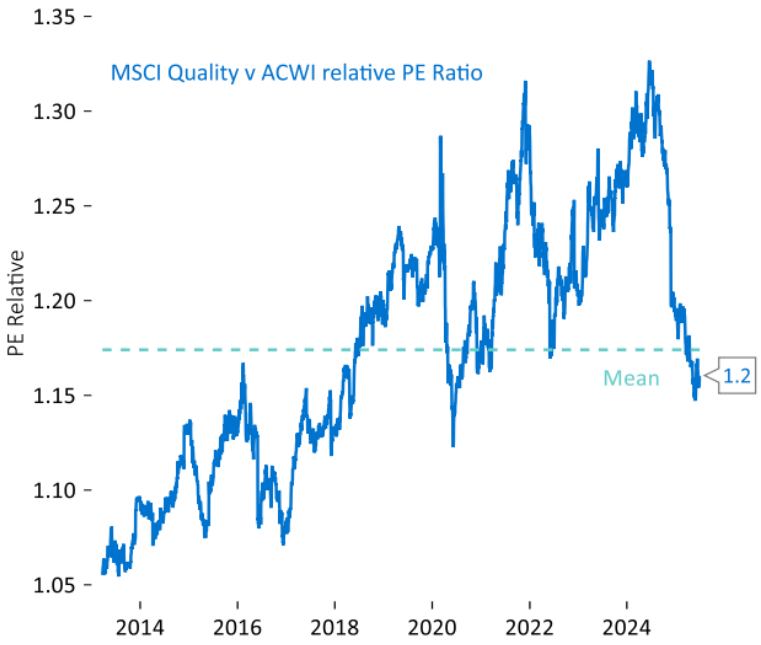
Proportion of large companies who bought back at least 1% of their shares over the previous 12 months



Source: LSEG Datastream, MSCI and Schroders as at September 2025

Quality is now cheap

Having come through a period of relative underperformance, quality is now trading at a discount. At a time when global uncertainty remains high, investors will increasingly want exposure to - and pay a premium for - the assurance of strong cashflow, balance sheets, market share and margins. The quality bias within our portfolios has been a headwind in recent times, but we believe in the benefits it brings over the long term in driving attractive risk adjusted returns.

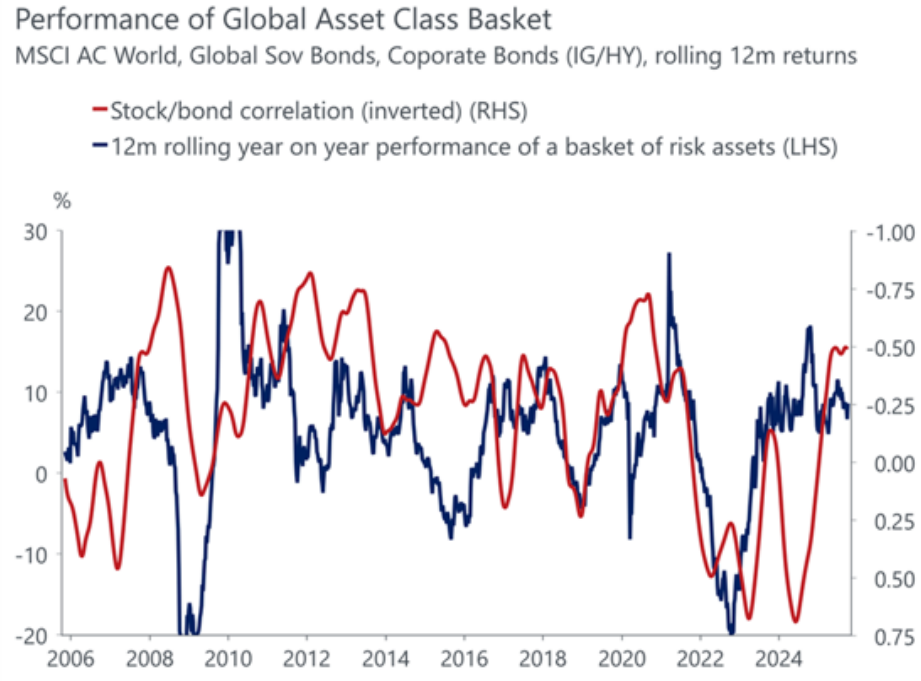


Source: Macrobond and Sarasin as at October 2025

Diversified alternatives - low correlation and low beta

Defensive and growth asset class correlations have swung around in recent years. We believe that if there is a growth shock global government bonds will act as a useful source of refuge and protection. If inflation proves sticky, or worse stagflation becomes established, broader portfolio construction and insurance is required.

This is where our allocation to Diversified Alternatives comes into its own. With exposure to infrastructure, commodities, absolute return, uncorrelated assets and trend following, it is designed to add real return enhancing defensive attributes. With the mountain of debt continuing to climb globally, Diversified Alternatives sits alongside our fixed income exposure giving the portfolios greater ballast and resilience.



Source: Oxford Economics as at September 2025

SMID caps – unloved but showing signs of life

Small and mid-caps have had a torrid time recently. High interest rates, intensifying competition and dominance of mega caps means investors have not needed to move down the market cap spectrum.

However, now earnings growth is forecast to sequentially improve, buoyed by the prospect of lower interest rates, tariffs that support domestic producers, deregulation and favourable tax changes, the discounted valuations that small and mid-caps are trading on look increasingly attractive.

Flows have started to pick up into SMID caps and we expect this to persist alongside monetary easing by central banks.

Source: Alpine Macro as at September 2025

Final thoughts

With increasing populism leading toa growth in nationalism, global fragmentation is on the rise. This is a restraint on economic growth and an impediment to efficiency and productivity, and likely to lead to increased volatility as government policies chop and change. A dynamic approach to asset allocation is warranted in this environment, as well as diversified fund selection to manage risk and ensure a balance of underlying style exposure, something we incorporate within all our portfolios.

Markets have done well, valuations are full, and expectations elevated, so care is required. However, long term opportunities are available, and we remain committed to delivering attractive risk adjusted returns for investors to help them progress towards their financial goals.

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- Past performance is not an indicator of future performance and investment returns can go down as well as up.
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Get in touch

If you'd like to chat to us about markets or our current positioning, please get in touch.

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