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CIO OUTLOOK

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From Noise to Signal: Positioning Beyond the Narrative Regime

We expect markets to enter a new phase. So far in 2025, policy shocks, geopolitical risk, and high narrative volatility have been the dominant market drivers. If meaningful progress on trade deals is struck over the summer, we anticipate a transition to a regime where economic data, rather than headlines, regains primacy. Market volatility has declined since April, driven by gradually but consistently receding uncertainty. While recent data suggest the economy is in a soft patch, we believe that a rebound in late 2025 and into 2026 is possible, supported by easing macro constraints and structural tailwinds from industrial policy.

While we remain alert to risk, we are increasingly confident in a roadmap that includes an attractive opportunity set in interest rates and FX. This is a market that will reward patience and preparation over panic. All that said, there is no room for complacency. If there is something we have learned so far this year it is to be prepared for more policy surprises from the U.S. administration, especially in the coming weeks as trade negotiations move toward finalization.

Key Takeaways

- Markets are moving from a narrative-driven environment to one focused on fundamentals, with improving data and easing uncertainty supporting a shift from tactical to strategic positioning.
- Key opportunities lie in steepening yield curves, a potentially weaker USD, and agency MBS, as policy shifts and macro signals align to create asymmetric risk-reward setups.
- Despite lower volatility, risks ranging from executive pressure on the Fed to housing market fragility remain and will demand disciplined, conviction-led investment and readiness to adapt.

From Volatility to Fundamentals

The regime of a market lacking equilibriums that dominated H1 has normalized from its peak in April. Narrative-driven moves are giving way to data-driven markets, supported by less uncertainty – as discussed below – and possibly the expectation that the weakness that the economy has been going through will remain shallow and will be followed by an uptick in activity into year end.

We believe the key uncertainties that weighed on markets in H1 are on path toward resolution:

- **Tariffs:** While risk remains, especially considering the respective July 9th and August 12th trade negotiation deadlines, the U.S. administration appears to adhere to market-imposed restraint. The trade hawks within the government have lost influence over the pragmatists. The framework that the U.S. agreed to with the UK was unspecific in actual policy but set the tone for the administration's broader strategic intent. China remains a special case, but in our view, realism within the Trump team has set in regarding the leverage each side holds. We and the consensus are now looking for the effective tariff rate to settle in the mid-teens, below the post-Liberation Day peak of roughly 25% but above the 2.3% effective tariff rate in 2024. This is a net negative for the U.S. economy, but less severe than many had feared in the aftermath of "Liberation Day," especially as the administration has demonstrated a limited appetite for a true shutdown in trade between major trading partners. The good news is that continued uncertainty would be much more damaging to the economy than simply moving forward with higher border taxes, especially if those remain at or only modestly above the 10% base that even the UK accepted (despite its trade deficit with the U.S.). We are by no means complacent, however, as experience has taught us to be ready for surprises. Our point is that markets are more likely to look past the noise of tweets and threats and instead focus on the expected final outcome.
- **Fed Policy:** We expect that by September, visibility into the path of future Fed policy will be clearer, as the central bank will likely have shifted towards an easing path, provided that summer inflation data does not show a significant boost from tariffs and the hard data continues converging towards the weaker soft data heading into Q3 (e.g. weaker jobs momentum and domestic demand). The pressure for rate cuts is mounting as diverging views within the FOMC over the wait-and-see approach continues to grow.
- **Geopolitics:** While major geopolitical risk vectors are unlikely to be fully resolved, we are hopeful that some progress towards resolutions will be achieved in the second half of the year. The U.S. administration likely feels emboldened by the success of the joint Iran campaign, which has opened the possibility of a broad realignment of the region. In Europe, Ukraine may have to accept a U.S.-led uncomfortable truce that cements the status quo. This would be a tragedy for Ukraine's ambitions, but, if accompanied with sufficient safeguards, it would at least reduce the risk of further escalation by Russia in the medium term and eventually open a window to reintegrate resource-rich Russia back into the world economy. The U.S.-China tensions may also at least temporarily be reduced if a broader strategic deal can be struck that includes trade, security and co-existence of both superpowers.

This is a transitionary window, and it requires a shift in strategy from tactical trading to strategic positioning. The next section discusses some themes that we are focused on as opportunities in the coming quarter.

Trading Interest Rates in a Period of Fed Transition

The Fed is in a tricky situation. It is being attacked by President Trump, who has floated the idea of diluting its independence by possibly announcing a "shadow Fed chair." The president wants the Fed to cut rates aggressively to stimulate growth and lower the cost of debt for the government. If the Fed cuts, it could look politically motivated and thereby damage its credibility. Chair Powell has been managing the central bank with a steady hand and demeanor but faces another complication in a wider distribution of views amongst members of the FOMC, with some arguing for immediate cuts and others for a continued patient approach as tariffs are likely to boost inflation in coming months.

We believe inflationary pressures from tariffs will prove to be a one-time level shift, not a persistent trend, especially given that the labor market is softer than it was in the high inflation period in 2021-22 and domestic demand is slowing. So far, there is limited evidence that a significant portion of the tariffs are passed through to consumers (high corporate margins appear to be cushioning the impact), but the peak impact is not expected to show up before Q3, again pointing to difficult tradeoffs for the Fed.

In the medium-term, we expect U.S. yield curves to steepen, supported by the ample room the Fed has to lower rates and long-end term premium repricing, due to the worsening fiscal position of the U.S. and other developed countries. Two more thoughts on other catalysts that could support the steepening:

- The housing market is showing increasing signs of regional distress, particularly in major markets such as Texas, Florida, Arizona, Colorado, and Washington, D.C. Inventories are rising while affordability is declining, presenting notable downside risks. We consider this a somewhat overlooked risk for the economy, which could also push the Fed towards easing short-end rates.
- National policy goals are driving up debt and therefore pushing up the long end. Major economies, particularly the U.S. and Europe, are increasingly leveraging fiscal policy to shape economic outcomes, directing resources toward strategic sectors such as defense, semiconductor manufacturing, infrastructure modernization, artificial intelligence, and in Europe renewable energy. This pivot toward active government intervention, characterized by significant public investment, targeted incentives, and regulatory support, is reshaping growth models and creating durable shifts in sectoral performance and global competitiveness. Such "fiscalization" is not a temporary stimulus but represents a deeper structural change aimed at achieving national economic resilience and technological sovereignty. It has far-reaching implications for productivity, long-term inflation trajectories, and international investment flows. While understanding and anticipating these government-driven shifts will be essential for effective investment positioning over the coming years, it is likely to receive an immediate reaction in the long-end of the curve.

The current curve structure offers asymmetry: risk to the upside in yields is more contained, while steepening has multiple catalysts.

In addition to these opportunities in government bond markets, U.S. agency mortgage-backed securities (MBS) also offer attractive trading prospects, which we are approaching through a macro lens. The MBS market is experiencing noteworthy developments:

- Refinancing activity has slowed sharply due to elevated insurance premiums, tightened underwriting standards, and a notable deterioration in borrower credit quality, resulting in longer-duration and less negatively convex mortgage securities.
- Regulatory clarity remains crucial for the stability of the mortgage market. Domestic banks' decisions around capital allocation can influence the market too. We estimate that there is around $165bn excess capital on their balance sheet that can be deployed once they are able to do so. This would be a form of soft yield curve control which should be appealing for an administration that eyes the 10-year yield as benchmark. The MBS market provides compelling trade opportunities that could benefit if this scenario materializes.
- Technological advances and industry consolidation in mortgage servicing are reshaping operational efficiencies but have yet to meaningfully offset broader market weakness.

Notwithstanding our conviction that we are entering a period where fundamentals will dominate the narrative, one needs to remain vigilant and open-minded. Adjustments may be necessary as positioning may be overextended in trades, making their risk-reward unattractive. An unusual but important new risk factor to watch are the interferences of the executive branch into the independence of the Fed, as considerations of a "shadow Fed chair" exemplify.

Dollar for Sale but not a Bargain

The USD has weakened almost 10% since the beginning of the year and is now back to levels of Q1 2022, before it rallied hard into the tightening campaign of the Fed and then again around the U.S. Presidential election in 2024. The case for a weaker USD, particularly versus the EUR, remains intact:

- The counterbalance to the U.S.' current account deficit is a capital account surplus; its fiscal deficit requires foreign money inflows. This unbalance had been in place for many years and did not stop the USD from strengthening. However, it increases the vulnerability of the USD to a reduced willingness of foreigners to fund Americans' profligacy.
- A more confrontational tone in U.S.-ally relations is encouraging institutional investors to diversify away from U.S. assets, reflecting pressure from their constituencies.
- The unpredictability of U.S. economic policymaking erodes confidence in the quality of the USD.
- Confidence in Europe's fiscal and industrial policies is increasing and is pulling money into the region.
- The U.S. government welcomes a weaker USD as part of its attempt to rebalance trade.

It is fair to assume that the short USD theme is crowded. We have seen periods of counter-trend rallies, such as the one in May, that challenge positioning and may force investors to close positions, only to see the short trend re-establishing itself thereafter. However, the risk in the coming month is to the downside (weaker USD), at least until U.S. growth reaccelerates.

The JPY remains fundamentally undervalued, but the BoJ has struggled to normalize interest rates. The issuance skew from the long to the short end suggests a continued delay to depart from the repression of ultra-easy money, with the currency acting as a "pressure valve". The Swiss National Bank ("SNB"), on the other hand, is struggling with an overvalued franc which strangles its export industry but doesn't want to get entangled in negative interest rates with unintended consequences. The SNB had negative rates between 2015 and 2022, which led to property market distortions, pressured bank profitability, pushed depositors to move fee-charged cash balances into riskier investments, and caused domestic political discontent.

All of this reflects a deep opportunity set, but one that needs careful consideration for wide tails and trade construction.

Final Thoughts

We believe the coming quarter will mark a shift from tactical positioning to more strategic deployment of capital. While uncertainty is diminishing, emerging risks—particularly from the policy shifts, weakening housing market, and rising U.S. deficits—will continue to require vigilance. Disciplined decision-making and sound risk management will be crucial. Our mandate remains unchanged: to deliver alpha through conviction, discipline, and adaptability. As the noise fades, the signal becomes clearer, and we intend to act decisively and prudently.

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