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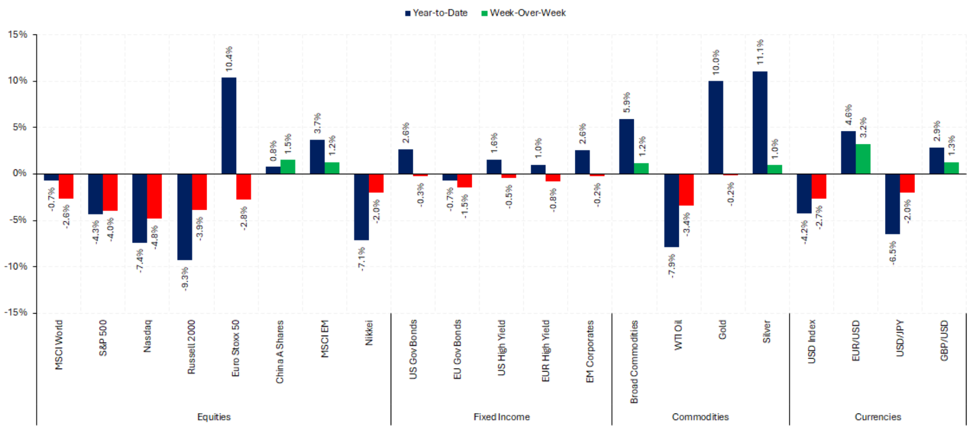
Diverging Paths: U.S. Correction vs. Eurozone's Fiscal Renaissance

Global financial markets are in the midst of turbulent changes, with U.S. equities tumbling into correction territory while Eurozone sovereign yields experience a sharp move upward. Several intertwined factors—ranging from fresh tariff policies, policy uncertainty, and shifting sentiment in the U.S. to ambitious infrastructure and defence plans in Europe—have led to heightened volatility across asset classes.

In this Insight, we examine the drivers behind these developments. In the US, the quickest decline in the S&P 500 since August of last year underscores how quickly risk sentiment can turn. Meanwhile, the Eurozone has embarked on large-scale fiscal expansion and infrastructure spending, reigniting debates on inflation and monetary policy..

Chart 1. Asset Class Returns



Source. MAM Research, Bloomberg

U.S. Equity Markets: A Correction in Context

U.S. equities have undergone their sharpest drawdown in several months. All major US equities indices are now down for 2025. The S&P 500 is down -4.9%, while the Nasdaq 100 lost -8.0%. Small and mid-caps are down -9.9% and -6.8%, respectively. The Russell 2000 is now down -17% from its November highs, dangerously approaching bear market levels (**Chart 2**).

On the surface, the proximate catalyst for this correction appears to have been a new wave of uncertainty around U.S. trade policy. The Trump administration recently moved ahead with tariffs of 25% on imports from Canada and Mexico as well as 10% on Chinese imports, though it has granted certain exemptions and delays (e.g. the auto sector is exempt from Canadian & Mexican tariffs).

Excessive policy uncertainty and erratic sequencing—typified by Trump's rapid, disruptive approach—are weighing heavily on market sentiment. The Baker, Bloom, Davis (BBD) index of economic policy uncertainty, which reflects media coverage, potential tax policy shifts, and forecast dispersion, illustrates how the administration's abrupt style is undermining confidence. Notably, the index has only risen higher at the onset of the Covid pandemic (**Chart 3**).

Chart 2. US Indices Drawdowns

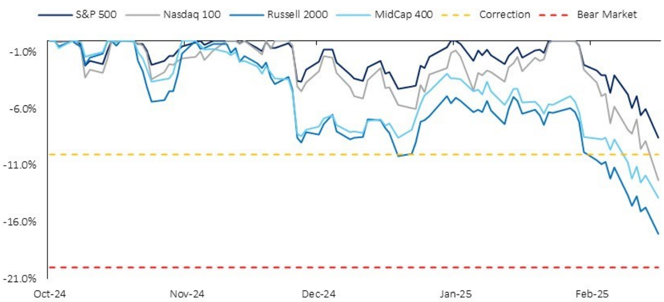
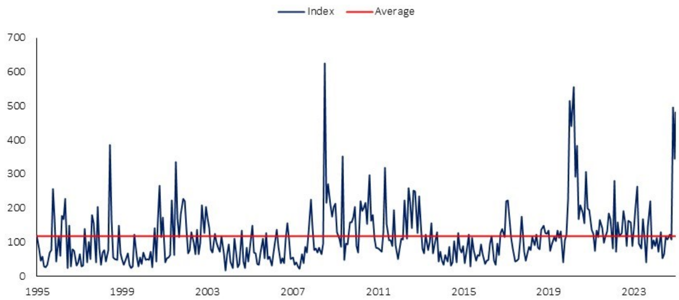


Chart 3. BDD Index of Economic Policy Uncertainty



Source. MAM Research, Bloomberg

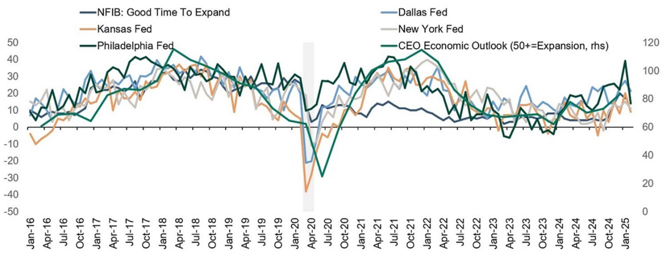
A key issue is that contrary to the approach of Trump's first administration, the early emphasis this time has been on market-adverse tariff and immigration measures, while more market-friendly initiatives like tax cuts and deregulation have been postponed. Market optimism immediately following Trump's election largely reflected an expectation of near-term pro-growth actions—particularly tax cuts and deregulation. However, since the inauguration, the administration's announcements have centred on potentially disruptive trade and immigration policies, as well as deeper reductions in government services.

Trump has clearly signalled that he views financial market performance as secondary to what he considers a more urgent mission: narrowing the U.S. budget deficit.

Poor sentiment is weighting on activity. U.S. Real Personal Consumption fell -0.5% MoM in January, the sharpest decline since January 2021, led down by durable goods and especially cars. The view that we are seeing a policy uncertainty-driven slowdown fits with what we have seen in the bond market. Since Treasury yields peaked in January, their decline is almost all down to falling real rates — which are linked to growth — rather than to declines in inflation expectations which have held steady.

Finally, uncertainty may also weigh on investment, which would decrease longer-term growth. US corporate capex plans have been rising steadily since early 2023 but abruptly ticked down in February (**Chart 4**).

Chart 4. US Corporate Capex Plans



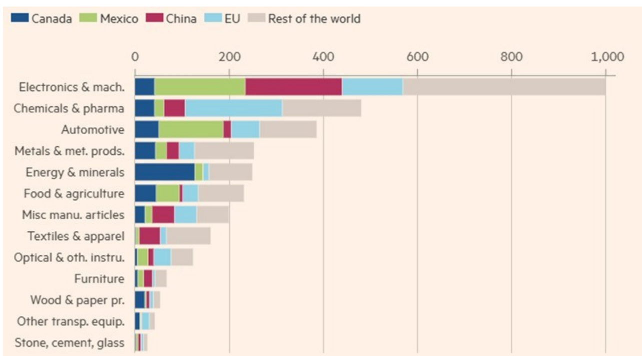
Source. Apollo Global Management

Growth vs. Tariffs Scare?

While the "it's Trump's fault" hypothesis is logical in broad outline, stocks may be responding to a growth decline first. The economy has been running above its long-term trend growth rate, and a slowdown is no surprise. With the Fed's policy rate parked at 4.5%, it is no surprise to see a more realistic 1-2% real growth.

This can be evidenced by sector returns decomposition. The recent underperformance of the Mag7 big tech stocks, down -15% over the past month (vs a -6.8% drop in the S&P 500) does not look like a response to Trump policy noise. Looking at US imports (**Chart 5**), one would expect industrials and materials to suffer the most. Instead, the biggest loser was big tech, down -9.6% over the past two weeks. The relative decline looks like a natural correction after a wild bull run which led them to become overextended. On the other hand, defensives rose (Staples up +0.3%, Healthcare flat), a classic risk-off move. Reduced equity positioning, now standing at 38th percentile, indicates notable level of increased risk aversion, consistent with risk-off moves.

Chart 5. US Imports ($bn)



Source. Financial Times

More evidence that growth rather that tariffs is primarily in play: the dollar has been falling for more than a month. If there is one reliable consensus about tariffs among their fans and foes, it is that they are dollar-positive (tariffs reduce demand for imports and therefore the foreign currencies needed to buy those goods). So, what is driving the greenback down now? Again, lower growth expectations; they drive down interest rates (in particular real rates), lowering the differential with rates in Europe and elsewhere. The unwind of a very crowded trade reinforces this effect.

Simply put, the tariffs were an unpleasant surprise that followed and added to, rather than caused, a bundle of bad signals from the economy and markets.

So where is macro data at?

Against this trade-policy backdrop, U.S. economic data still reflects an economy that is growing but faces new headwinds. The ISM manufacturing PMI remains above 50, indicating expansion, but new orders have slipped. Meanwhile, the services PMI is holding up better, highlighting the enduring strength of domestic demand. The Federal Reserve's latest Beige Book noted that "overall economic activity rose slightly," but also flagged rising "price sensitivity" and "moderate" price increases. Policy risk—covering tariffs, immigration, and possible federal spending cuts—came up repeatedly in discussions with businesses.

The February jobs report showed a modest 151,000 additions—slightly below consensus—and a small rise in the unemployment rate to 4.1%. That said, job growth is still positive, and wage gains continue at around 4% year-over-year. The labour market picture is no longer "red hot," but it remains historically tight. Moreover, job openings continue to decline meanwhile permanent job losses progress higher. Hirings and quits continue to decline while layoffs remain steadfast, an evolution to monitor closely.

Elsewhere, after two years of tight policies, money supply growth has been ticking higher, in line with leading economic indicators which are seeing sequential improvements.

Nevertheless, we remain worried about certain aspects of the economy. Notably, revolving credit growth has been the weakest in three years and YoY Credit Growth decelerating further. However, the "why" matters a lot: people cannot borrow more. Consumer credit data continues to depict a negative outlook across more vulnerable income quintiles. Consumer delinquencies across multiple categories (i.e., credit cards, auto loans) continue to climb higher while consumer & corporate bankruptcies are reaching new post-Great Financial Crisis highs.

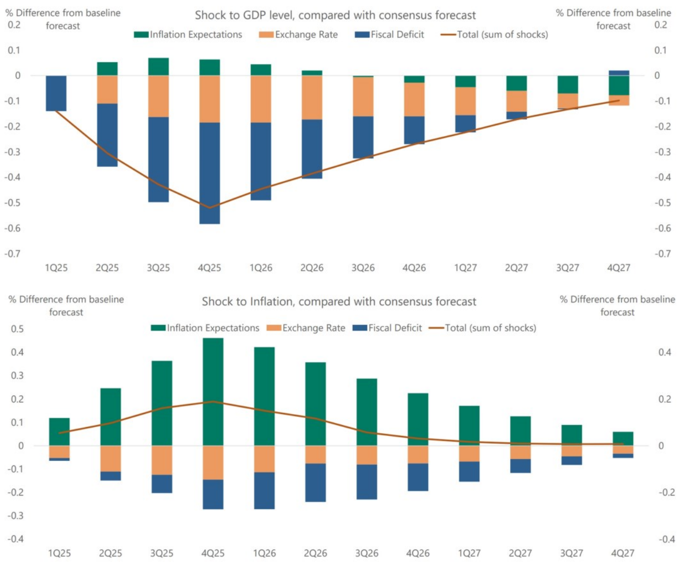
Moreover, after undergoing a pronounced inversion, the 30s2s curve has steepened considerably since last summer. Currently at 64bps, it now stands at levels last observed prior to the 2000 and 2007 equity market crashes, making this a highly significant threshold (**Chart 6**).

Chart 6. US 30-2 Yield Curve

Source. MAM Research, Bloomberg

Finally, according to Apollo's research, the tariffs and DOGE should lead to a 0.2% increase in inflation, and a 0.5% drop in GDP (**Chart 7**). In other words, DOGE and tariffs combined are a mild temporary shock to the economy that will put modest upward pressure on inflation and modest downward pressure on GDP. Consistent with a stagflation scenario.

Chart 7. Tariffs & DOGE shocks to GDP & Inflation



Source. Apollo Global Management

DOGE & Tariffs Effects

The recently enacted Department of Government Efficiency (DOGE) austerity program centres on substantially reducing discretionary government spending, particularly in areas such as infrastructure, social programs, and federal employment. In the first year, these cutbacks are expected to trim headline GDP growth by roughly 0.3–0.5 percentage points, primarily due to diminished aggregate demand. Over the 12–24 month horizon, however, the direct drag on the economy could ease. Fiscal consolidation may modestly reduce borrowing costs, marginally supporting private sector confidence. As a result, the second-year impact on GDP growth could decline to around 0.1–0.2 percentage points. Overall, the net effect of DOGE austerity is a 0.4% reduction in GDP growth in the first year, followed by a 0.15% slowdown in year two.

Current protectionist measures—namely tariffs and other trade restrictions—are anticipated to weigh on the economy by increasing input costs, dampening business investment, and disrupting global supply chains. Within the first 12 months, these policies are likely to reduce GDP growth by 0.2–0.4 percentage points. Higher consumer prices, retaliatory trade actions against U.S. exports, and waning investor sentiment are chief contributors to this initial slowdown. Looking toward the second year, a continued reliance on tariffs and trade barriers maintains pressure on both producers and exporters, sustaining an estimated 0.1–0.3 percentage point drag on GDP. Some industries, such as metals manufacturing, may see a temporary boost, but broader competitiveness and productivity remain under stress. On balance, the trade-related impact translates to a 0.3% GDP reduction in the first year, with a slightly improved yet still notable 0.2% drag in year two.

Taken together, the DOGE austerity program and ongoing restrictive trade policies produce a combined impact that lowers GDP growth by approximately 0.7% in the first year and 0.35% in the second. While some of the initial negative effects may diminish over time—particularly if private entities step in to fill gaps left by reduced government outlays—the overall two-year forecast points to a subdued growth environment.

Investment Implication - Neutral

While equity markets have begun to correct meaningfully, our comprehensive assessment of the business cycle suggests that, although growth is moderating, the economy continues to expand. Nonetheless, signs of strain—particularly within consumer credit—are becoming more pronounced. The probability of a prolonged economic weakness has increased.

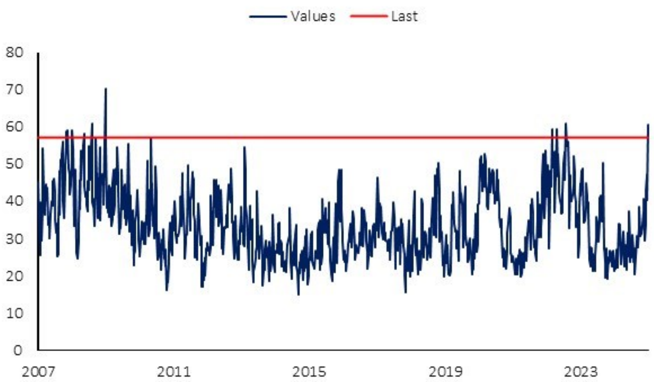
Historically, stock prices tend to outperform when earnings forecasts are too low and underperform when consensus projections exceed realistic outcomes. Despite recent downward revisions, analysts still expect EPS growth of +12% in 2025 and +9.4% in 2026—both above the long-term average of +7.9%. With expectations set this high, we anticipate a more subdued performance for equities.

Coupled with elevated valuations—the S&P 500 currently trades around two standard deviations above its historical price-to-book norm—these factors keep us changing our neutral position in equities.

In positioning our portfolios, we recently reduced overall beta by divesting from U.S. small caps in favour of larger-cap MSCI World holdings. We also trimmed our "momentum" factor allocation in late February. At a 31% equity allocation, our portfolios are equipped for near-term volatility. Looking ahead, we recognise that markets do not fall in straight lines. While we wish to keep our equity exposure unchanged, we intend to capitalize on current market dips (**Chart 8**) by selectively increasing beta exposure, while fading rallies that appear overextended. Meanwhile, our Alternatives allocation—less correlated with equities—continues to provide a stabilizing effect during periods of heightened market turbulence.

On the fixed income front, we maintain a preference for sovereign bonds over corporate credit. Somewhat surprisingly, corporate credit spreads have not widened in line with equity volatility, likely reflecting persistent demand for fixed income investments. This discrepancy merits close monitoring: should the economic outlook deteriorate further, spreads could reprice rapidly, underscoring the importance of a vigilant and adaptable strategy.

Chart 8. AAII US Investor Sentiment Bearish Readings



Source. Apollo Global Management

Eurozone Rates

Infrastructure Ambitions Spur a Yield Spike

On Tuesday evening, Germany's chancellor-in-waiting, Friedrich Merz, announced that his Christian Democratic Union (CDU), together with their prospective coalition partner, the Social Democratic Party (SPD), intends to introduce a motion in the Bundestag to establish a groundbreaking €500 billion public investment fund. The proposal would also exempt a substantial portion of defence expenditures from Germany's constitutional "debt brake." This represents a significant departure from the CDU's historically conservative stance on government borrowing and, if effectively executed, may revive Germany's sluggish economic growth.

Two Key Components of the Proposal

€500 Billion Off-Budget Fund

The first element is the creation of an off-balance-sheet fund—amounting to roughly 10% of Germany's annual GDP—to bolster public investment, especially in infrastructure, over the next decade. Merz has further signalled intentions to amend the debt brake, permitting state-level deficits up to 0.35% of GDP to expand infrastructure spending at the regional level. This underscores Germany's chronic underinvestment in public services. In the most optimistic scenario, enhanced infrastructure could restore domestic demand—still recovering post-pandemic—and enhance the competitiveness of German manufacturers.

Defence Spending Exemptions

The second portion of the package seeks to exclude defence spending above 1% of GDP from the debt brake, effectively allowing unlimited borrowing to modernize Germany's armed forces and support military assistance to Ukraine. This measure would supplement the existing €100 billion special defence fund introduced by Chancellor Scholz following the invasion of Ukraine, of which approximately 80% has already been allocated. By tying defence spending to a potential 3% of GDP target, Germany could see additional outlays in the tens of billions of euros.

The Debt Brake: Main Obstacle to Fiscal Expansion

Central to Merz's plan is overcoming Germany's debt brake—a constitutional amendment enacted by Angela Merkel in 2009 that restricts the federal budget deficit to 0.35% of GDP. This stringent limit stands in stark contrast to most major European economies, where deficits typically range from 2% to 3% of GDP. Many analysts view the debt brake as a principal reason for Germany's limited spending on defence and infrastructure over the past decade. Growing numbers of German policymakers have advocated scrapping or revising the measure to grant the country the fiscal capacity required to address various European crises.

Market Reaction

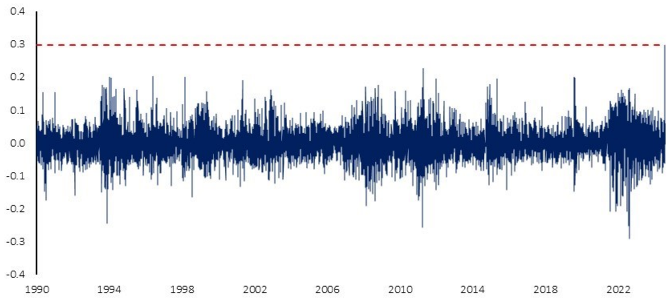
News of the proposed spending has triggered the largest sell-off in German sovereign bonds since the fall of the Berlin Wall, driving yields sharply higher. The 10-year Bund yield jumped by 31 basis points to 2.79%—its most pronounced single-day increase the 1990s (**Chart 9 & 10**)—as markets priced in the prospect of higher government borrowing. The move in German bonds also dragged yields in other Eurozone countries sharply higher.

Chart 9. German 10Y Yield (Daily)

Source. MAM Research, Bloomberg

Sceptics warn that such fiscal expansion risks turning Germany into a closer parallel to countries like Italy, France, or the UK, all of which grapple with elevated debt burdens. However, recent economic evidence suggests that increased government borrowing could offer a more effective remedy to Germany's cyclical challenges than another round of austerity—particularly given Germany's relatively manageable debt levels by international standards.

Chart 10. German 10Y Yield 1-day Δ



Source. MAM Research, Bloomberg

Investment Implication - OW Duration

In an environment where U.S. policy uncertainty is undermining investor confidence, German securities may stand to benefit if Merz can reassure global markets of Germany's solid economic fundamentals. Should these policy measures foster renewed growth and modernization, German government bonds could emerge as a sought-after safe haven, offering an alternative to the political volatility currently roiling U.S. markets.

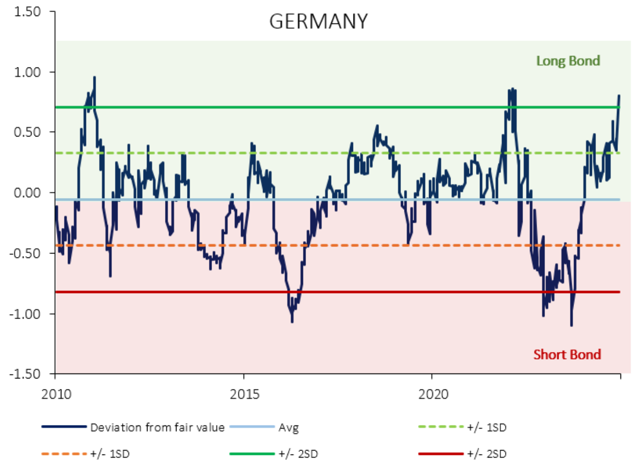
Nevertheless, we view the move as over-exaggerated. Although the fiscal package may boost the German, and to a larger extent, Eurozone economy, it remains far from done.

While structural growth prospects have brightened following Germany's pivot on fiscal policy, the benefits of higher deficits will only be felt with a lag. Short-term risks such as trade tensions and subdued Chinese policy are still weighing on European growth. Inflation and the labour market have both eased. Immediate risks to growth thus remain to the downside.

Our proprietary Sovereign Valuation model, which estimates a fair value for the 10-year German Bund by regressing (1) the short rate, (2) the inflation rate, (3) FX levels, and (4) overall financial conditions, currently indicates a fair value of 2.05%. This is about 80 basis points above the prevailing market yield—equivalent to a two-standard-deviation difference. Such a deviation has only occurred twice since the global financial crisis: once in 2011, at the height of the Eurozone debt crisis, and again in 2Q22, when inflation spiked to 9.0% (**Chart 11**). In 2011, this extreme divergence was followed by a 180bps decline in yields over four months. In 2022, although rates eventually climbed further in 2023, the initial peak deviation was followed by a 100bps pullback within two months.

Given these precedents, we intend to fade the recent surge in Bund yields. The move allowed us to adopt a slightly overweight duration stance in our fixed income allocation, increasing duration to 8.0. Should long-term German rates breach their cyclical peak of 3.20% on the 20-year maturity, we plan to raise duration further to 9.0—reflecting a more bullish position on sovereign debt.

Chart 11. German 10Y Sovereign Valuation Deviation



Source. MAM Research, Bloomberg

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