

The Federal Reserve maintained its policy stance in June, with further rate cuts expected later this year

At the June meeting, the Federal Reserve kept the target range for the federal funds rate unchanged. The updated economic forecast materials continued to raise inflation forecasts and revise down growth forecasts, while the dot plot indicated two rate cuts within the year. The statement made only minor adjustments to the economic section, noting that economic uncertainty had declined but remained elevated, and removed the previous assessment that stagflation risks had increased. This was mainly due to the mutual tariff reductions between China and the United States since May, which led to a significant decline in the effective US tariff rate. The first set of economic projections released by the Fed after the “Liberation Day” continued to be revised towards stagflation. GDP forecasts for 2025 and 2026 were revised downward by 0.3 and 0.2 percentage points respectively, while the core PCE forecast for 2025 was raised from 2.8% to 3.1%, and that for 2026 was raised from 2.2% to 2.4%. Compared with March, when only the 2025 inflation forecast was revised upward, the June adjustments raised inflation forecasts for all three coming years, indicating a shift in the Fed’s stance on inflation. The Fed is no longer certain that the impact of tariffs on inflation will be temporary, and its increased concerns about inflation risks have raised the possibility of delaying rate cuts for the remainder of the year.

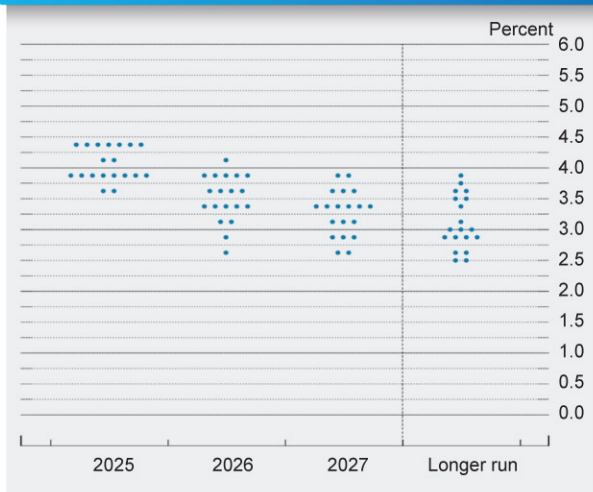
The “US exceptionalism” narrative is being put to the test

Under the combined effects of restrictive monetary policy and tariff measures, the current US economy is sending mixed signals. On the surface, economic data still shows a certain degree of resilience, but underlying structural problems are gradually accumulating. US Treasury yields continue to fluctuate at high levels amid the tug-of-war between slowing economic growth and persistent inflation expectations, reflecting market divergence over the economic outlook.

In April this year, following the implementation of the “reciprocal tariffs” policy in the US, financial markets experienced a rare simultaneous decline, with equities, bonds, and the US dollar exchange rate all coming under pressure. Although this shock initially intensified market concerns over “stagflation,” the US economy demonstrated notable resilience. While GDP in the first quarter recorded a slight decline, this was mainly due to temporary factors such as inventory fluctuations. Excluding these distortions, private consumption and corporate investment remained solid, and domestic demand continued to support the economic fundamentals. According to the Atlanta Fed’s forecasting model, US GDP growth in the second quarter is expected to return to positive territory. On the employment front, although the overall unemployment rate remained low, structural changes in job creation warrant attention. Non-farm payrolls in June exceeded expectations, but employment growth in the private sector slowed significantly, with local governments contributing the majority of new jobs. These details suggest potential hidden risks in the labor market. At the same time, the slowdown in wage growth has helped ease some inflationary pressures.

On the policy front, the Federal Reserve has maintained a relatively hawkish stance, while fiscal policy has shown an expansionary trend. The Trump administration’s fiscal consolidation efforts have been limited, with the deficit ratio remaining elevated. Coupled with the potential impact of the “Great America Act,” this may further increase debt pressure. The combination of high interest rates and fiscal expansion has formed a self-reinforcing cycle, intensifying market concerns over the long-term sustainability of US government debt. Trump has repeatedly “urged” Powell to cut rates, both to support the economy and to alleviate debt pressures.

Chart 1



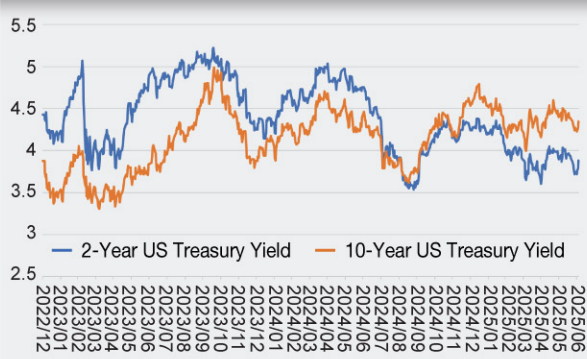
Source: Federal Reserve, as of June 18, 2025

US Treasury yields may tend lower with fluctuations

Since mid-to-late May, US Treasury yields have been trending downward, mainly driven by easing inflationary pressures, growing expectations of a policy shift towards monetary easing by the Federal Reserve, and marginal weakening in economic data. As US inflation indicators such as CPI and PCE have gradually declined, market concerns over persistent price pressures have eased, with the cooling of core services inflation further reinforcing this trend. At the same time, the Federal Reserve has sent signals suggesting a possible earlier-than-expected rate cut, which has fueled market expectations for monetary easing in the second half of the year. In addition, the weaker performance of economic indicators such as retail sales and PMI, along with a decline in corporate financing demand, reflects a weakening in economic growth momentum. Although the labor market remains resilient, slowing private sector hiring and weaker ADP data indicate potential pressures in the labor market. These factors combined have contributed to the downward trend in US Treasury yields.

Overall, against the backdrop of weakening economic growth, contained inflation, and rising expectations of monetary easing, US Treasury yields still have room to decline, though short-term fluctuations may persist due to factors such as the expansion of the fiscal deficit. As the rate-cut cycle window opens, the downward space for US Treasury yields is expected to widen, which should be supportive of US Treasury performance.

Chart 2



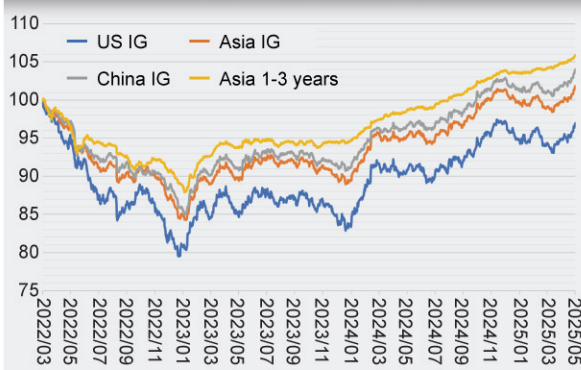
Source: Bloomberg, as of June 30, 2025

Investment-grade USD bonds remain a key allocation asset

Looking ahead, US Treasury yields are expected to remain in a high-level fluctuation pattern. Long-end yields may remain under pressure due to fiscal supply concerns and inflation expectations, while short-end yields are likely to benefit more from the opening of the rate-cut cycle window. However, potential market volatility arising from macroeconomic developments and the de-dollarization trend should not be overlooked. In the current environment, a short-to-medium duration strategy is appropriate to navigate macroeconomic uncertainties. Overall, allocating to investment-grade USD bonds allows investors to lock in historically high absolute yield levels and diversify portfolio risks. In addition to stable coupon income, such positioning may also capture capital gains from a bull steepening of the yield curve.

It is worth noting that US Treasuries experienced considerable volatility in Q4 2024 and again in April this year, prompting investors to seek alternative bond investments with stronger fundamentals, lower volatility, and attractive coupon income. Bonds issued by politically stable Asian countries—especially those from issuers focused on domestic demand, which exhibit defensive characteristics—have become increasingly popular. Against the backdrop of macroeconomic and tariff policy uncertainties, along with potential interest rate volatility, short-duration investment-grade USD corporate bonds present an optimal allocation choice, balancing yield and risk. Credit spreads have narrowed, supply-demand dynamics remain healthy, and absolute yields on short-dated investment-grade bonds—particularly in Asia—continue to be attractive. With relatively low default risks, such bonds provide investors willing to look beyond Treasuries with a highly appealing, low-volatility investment option.

Chart 3 : Performance of Major Bond Indices

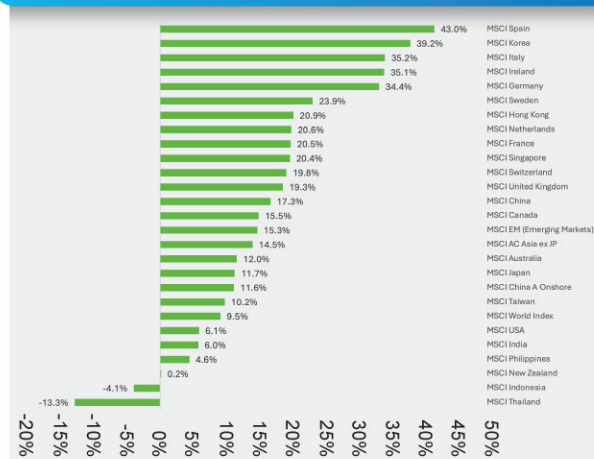


Source: Federal Reserve, as of June 18, 2025

A highly nimble and active, unconstrained multi-asset investment approach is to best capitalize on the opportunities

A look back at markets in Q2, when tariff uncertainty sparked volatility. Uncertainty over US trade tariffs dominated markets in the quarter. However, equities made gains as the initially announced tariffs were later suspended and recessions fears receded. In fixed income markets, the focus began to turn from interest rate cuts to worries over debt sustainability.

Chart 1: YTD Market Returns (as at Jun 2025)



Source : FactSet, MSCI, Schroders, in USD, data as at 30 June 2025

For international investors, European equities are well ahead in 2025

As investors have highlighted, the favourite expression of European resurgence is mid-cap stocks. But another area that could benefit from higher investment spending in Europe is the industrial sector.

Since 2020, the forward earnings of US and European industrials have followed a similar trend. However, in the last six months, earnings have inflated higher in Europe, while US earnings have not moved materially.

Chart 2 : MSCI Europe vs S&P500 YTD Total Return



Source: LSEG Datastream, Schroders

As outlined previously, Europe has posted some of the strongest USD returns in 2025 and is a region investors continue to favour, in particular the industrials sector and mid-caps. Opportunities in the US are starting to reemerge, where investors are seeking asset classes that should benefit from the longer-term implications of Trump's policies.

Investing beyond US exceptionalism

- As the S&P 500 appears increasingly expensive, the landscape is shifting:** There is potential for more efficient models emerging from various innovators, including those like DeepSeek, which raises intriguing questions about the US' enduring supremacy in sectors like artificial intelligence (AI). This signals that it may be time to broaden the focus and exposure beyond just US mega-caps from a global thematic approach to better capture growth.
- Looking towards Europe:** Europe, often overlooked, presents an attractive investment opportunity due to its appealing valuations. Current sentiment is largely negative, but that pessimism could pave the way for surprising outperformance. Ultimately, whether European markets exceed expectations or move in sync with US trends, the risk-reward profiles look compelling. By embracing these new horizons, investors are better equipped to navigate whatever the market may throw the way.

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3. Maximising diversification with alternative sources of income: To further enhance diversification with an investment portfolio, consider allocating to alternative sources of income besides traditional credit and equities. Two noteworthy options are:

Securitised credit: This sector's average performance has historically consistently outperformed other fixed-income assets in rising rate environments. It taps into various economic drivers, such as consumer behaviour and housing markets, and typically shows low correlation with traditional corporate credit, making it a powerful tool for diversification.

Insurance-linked securities (ILS): ILS offer attractive risk-adjusted returns and low correlation to conventional asset classes like equities and bonds. These securities are designed to transfer insurance risk associated with large natural disasters, opening up unique investment opportunities.

In summary, while US equities have performed admirably for valid reasons, it is essential for investors to adopt a more balanced and diversified approach to navigate uncertainty in a dynamic manner. Integrating European equities, exploring opportunities in non-mega-cap US sectors, and incorporating diverse, alternative income sources are all crucial steps toward building a diversified, resilient portfolio. By broadening the investment landscape, investors can better position themselves for potential outperformance and a resilient income stream in a dynamic market environment.

Source: Schroders

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