

Why Bother with Defensive Equities During the New Trump Era?

Equity markets are facing three major sources of volatility in 2025. Uncertainty over the incoming US administration's policies, along with challenges driven by artificial intelligence (AI) and shifting macroeconomic conditions, could all prompt market turbulence.

But risk-averse investors shouldn't give up on equities. Carefully curated defensive strategies can help investors position for potential instability, while capturing return potential in companies that can overcome the hurdles ahead.

Trump 2.0: What's Different This Time?

Some investors might draw comfort from President Donald Trump's first term in office. After all, stocks performed well from 2016 through 2020, and market volatility was relatively benign.

That may be an oversimplification. As Trump's new term begins, market conditions are very different than when he first took office in 2016. At the end of 2024, the US equity market price/forward earnings ratio reached 21.1x — about 29% more expensive than in late 2016.

Meanwhile, growth stocks are much more expensive versus the broad market than they were in 2016. At the same time, defensive stocks — represented by the MSCI USA Minimum Volatility Index — are trading at relatively inexpensive valuations versus the broad market.

Macroeconomic conditions have also changed, with the US facing higher inflation than in 2016 and a fiscal deficit that has widened dramatically to 6.7%.

Current market and macro conditions warrant caution from investors and set the stage for potential bouts of market volatility, especially given the risks on the horizon.

Risk 1: Trump's Policy Agenda Spells Uncertainty

Trump's pro-business credentials mask many policy uncertainties. In his initial executive orders, Trump moved to deregulate the energy industry, and he has reiterated promises to cut corporate taxes. Then, in February, he decided to impose tariffs on China, Canada and Mexico. Measures like these seek to sharpen the competitive edge of US businesses.

But policy details will take time to formulate, and their effects on US and global companies won't be clear overnight. Tariffs, for example, aim to make imports to the US less competitive. In reality, the effect of tariffs will differ across sectors, industries and companies.

For example, goods manufacturers have more of their revenue exposed to potential tariffs than services companies, according to the analysis of MSCI World constituents. In the technology sector, semiconductors and hardware companies are much more vulnerable to tariffs than software firms.

As markets struggle to digest the impact of tariffs on individual companies, it's expected volatility to increase. This could create opportunities in companies that are mistakenly branded as victims of tariffs. Select companies that have moved to optimize supply chains in recent years could surmount tariff risk and deliver positive surprises in earnings and returns.

Other policy changes, from deregulation to tax cuts, could create opportunities for investors. It's believed that the effects of these policy changes will filter down to sectors, industries and companies in uneven ways, creating market volatility along the way.

Risk 2: The Precarious Path of AI

AI has arguably been the most powerful business theme for equity markets over the last two years. The promise of a revolutionary technology that might fuel productivity has captured the imagination of investors and propelled the so-called Magnificent Seven — the US mega-cap stocks — to record gains and market dominance.

But the road from disruptive technology to sustainable growth is fraught with risks. Yes, the Mag Seven include quality businesses that may benefit from looser regulation under Trump. But high valuations raise questions about their ability to deliver on long-term earnings growth expectations. As it's seen, passive US and global portfolios that are highly concentrated in the mega-caps look vulnerable to a change in sentiment, which could also stoke market volatility.

The good news? There are ways for investors to gain exposure to AI while maintaining a defensive mindset.

Semiconductor companies are relatively expensive based on their price/free-cash-flow yield. But software and hardware stocks trade at more reasonable valuations, and in these industries, investors can find quality businesses that are AI beneficiaries and enablers. This strategy can provide a defensive equity portfolio strategy with access to the AI story while mitigating some of the risk that comes with holding large weights in the heavyweight names.

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Risk 3: Diverging Dynamics in the Global Economy

Macroeconomic risk always influences equity markets. But this year, the dramatic US policy changes amid diverging global economic conditions could trigger acute market volatility.

Some of Trump's policies are seen as good for growth, but they also add to concerns about fiscal sustainability and are likely to be inflationary, which could lead the US Federal Reserve to slow the pace of interest-rate cuts. Given the policy uncertainties, the range of potential outcomes is wide, with AB economists projecting only a 20% probability of a recession this year.

Investors might also see more economic divergence globally. Trump's tariffs could weigh on China and Europe, regions already coping with lackluster economic growth. Chinese stimulus is a wild card. In Europe, where inflation is heading toward target, the European Central Bank should be able to continue cutting rates through the year.

To address these risks, defensive investors should aim to build macro-resistant equity portfolios. That requires using fundamental research to focus on quality businesses that aren't tethered to macroeconomic outcomes.

Equities are still vital in today's markets. Stocks have a good track record of delivering solid real returns — above the rate of inflation — over time. It's believed that stocks backed by high-quality businesses, with stable trading prices and attractive valuations — what investors call quality, stability and price—can form the backbone of an effective defensive strategy for today's fluid market and macro conditions.

Allocating to equities that help cushion portfolios during downturns can help investors with lower risk appetites stay on track in a world of politically driven instability that could rattle markets in unpredictable ways.

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Cast the Net Wide to Capitalise on Diversified Consumer Trends

During 2024, global equities rallied, driven by resilient economic growth, enthusiasm around Artificial Intelligence (AI) stocks and easing monetary policy. The stimulus measures unveiled in China in September and the outcome of the US election also buoyed equities. That said, volatility persisted throughout the course of the year as moderating but sticky inflation reduced expectations of the size of rate cuts, while specific events such as the unwind of the yen carry trade also prompted market drawdowns. The US market outperformed against this backdrop, while cyclicals broadly outperformed their defensive counterparts. Communication services and information technology were the best performers, buoyed by enthusiasm around the AI theme. The overall backdrop for consumption was weak during much of 2024 due to persistently high interest rates and an elevated cost of living, especially as lower income consumers became much more cautious about their spending.

In 2025, investors are seeing normalisation of inflation relieving pressures on consumers. Wealthy US consumers have been less affected by higher interest rates, given the long-term nature of the mortgage market. Their spending is likely to remain resilient supported by the positive wealth effect from stock and house prices. New US government policies centred around deregulation and lower taxation are likely to be favourable towards wealth creation and the outlook for high end consumption should improve. However, how efficiency improvements under the new administration will impact mid- and low-income consumers is less straightforward. There is a risk that efficiency improvements could lead to an increase in unemployment which could further pressure low end consumption before investors see the overall productivity improvements benefiting the whole economy.

European economies are less dynamic than the US and some face structural issues linked to industries such as autos. Additionally, regulation makes it harder to build businesses and create wealth. The outlook for consumption in Europe is subdued, but exporters and tourism should benefit from a strong US dollar and spending by wealthy Americans. Elsewhere, recent stimulus measures in China could support asset prices, increasing stock market enthusiasm, and potentially boosting consumption through a positive wealth effect after a challenging period. Meanwhile, many emerging market economies, like India and Indonesia, continue to see the emergence of middle classes with a strong desire for consumption.

Diversified themes

A well-diversified portfolio is needed to navigate this uncertain environment. Investors should cast their nets wide and focus not only on companies in the consumer discretionary and staples sectors, but also on those operating across the healthcare and financials sectors that have strong consumer facing brands, and those in the technology and materials sectors that are key brand enablers and facilitate more efficient consumption.

Below are some structural themes that are underpinned by current economic backdrop and more importantly by consumer preferences:

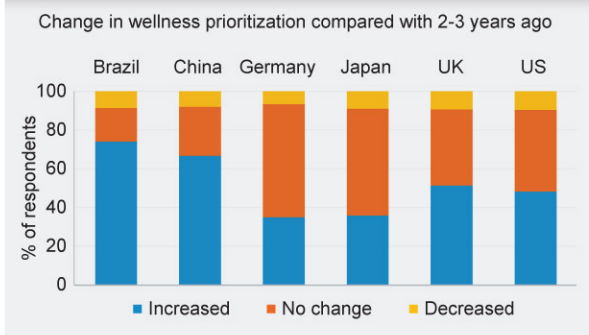
- The desire by consumers to spend on experiences and services is well established and likely to continue. So, investors should consider investing in sectors like travel and leisure, as well as entertainment and digital media, for example hotel brands and prominent entertainment service companies.
- Consumers have a strong desire to spend on their health and wellbeing. This benefits manufacturers of sporting goods, but also companies which offer treatment of obesity and companies selling aesthetic and cosmetic products. Specific examples include sporting goods companies, outdoor clothing brands, consumer-facing healthcare companies, obesity players and eyewear makers.
- The dynamic US economy should create a favorable environment for wealthy Americans to indulge in consumption of premium goods, often manufactured in Europe. Luxury brands is well positioned to benefit from this spending.
- Technology and the use of AI are creating new opportunities for consumption and making existing business models stronger, benefiting companies that are well positioned to lead innovation such as specific technology giants, semiconductor foundry, software business as well as consumer technology company.
- Declining mortgage rates should allow demand for housing to recover, and here house builders and home improvement companies should do well. The current environment also benefits financial services and wealth management brands that help consumers manage their finances and wealth. Specific examples include home improvement businesses, home builders and some US banks.
- Finally, India and China offer structurally attractive long-term opportunities for consumption by emerging middle classes, benefiting hotels business and e-commerce businesses etc. Take India as an example, local banks and financial companies should benefit from growing demand for financial services among the country's emerging middle class.

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Investors should take the opportunity to capitalise on these trends and in particular the ongoing consumer shift to online platforms and the acceleration of premiumisation across industries. For example, the COVID-19 crisis has resulted in a shift in consumers' daily activities to online platforms (e-commerce, digital entertainment, and education), increased awareness about health and fitness, enhanced focus on sustainability and the acceleration of the premiumisation trend. In view of this, investors have invested in the textiles, apparel and luxury goods sub-sector, with a preference towards global brands with greater pricing power.

Chart 1: Wellness has risen as a priority since the pandemic



Source: McKinsey Survey, The future of the \$1.5 trillion wellness market | McKinsey, April 2021.

Conclusion

All in all, when capturing opportunities in the global consumer market, investors should not be limited to the consumer discretionary and consumer staples sectors but should invest beyond this to uncover the best investment opportunities.

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