Investment Views

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BUTTERFIELD

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Markets Remain Resilient Despite Political Noise

- Bonds and equities gain in January
- Rotations within the Artificial Intelligence (AI) theme
- No escape from political noise

Financial markets have had a strong start to the year, with gains in both bonds and equities. January saw a reversal of fortunes in many regions and sectors that struggled towards the end of last year, such as European equities and Health Care stocks.

Positive sentiment towards US equities became stretched coming into the year, driven by the combination of a resilient economy and an incoming administration perceived as being positive for economic growth. AI-related stocks, and the associated data centre and energy build-out, started the year well, but the release of a new model from the Chinese company DeepSeek sent shockwaves through the sector.

DeepSeek released details of an impressive model which claimed to require a fraction of the computing power compared to other models, such as ChatGPT. This came as a surprise to the market and raised

questions about forecasts for data centre and energy requirements. It sparked a debate around "Jevons paradox", which suggests that efficiency improvements from technological advancements can lead to an increased consumption of that resource, potentially accelerating the deployment of AI technologies into businesses.

The US equity market has reached its highest concentration level since the 1960s, with the top 10 stocks now accounting for around 36% of the S&P 500 index. While a more concentrated market does not necessarily mean higher risk, it is a factor that needs to be monitored closely. If the correlation between the large stocks is low, then concentration is less of an issue. Microsoft, Meta, Alphabet and Amazon have all invested significant amounts of money in Nvidia chips to build out their AI capabilities, which increases the correlation between the stocks and requires investors to be vigilant. The DeepSeek model release has certainly led to rotations within the technology sector and others as the market considers the winners and losers. This is covered in more detail in the Equities section below.

With the return of President Trump to the White House, the market has largely focused on the more growth-friendly aspects of the incoming administration's agenda. Specifically, an extension of the 2017 tax cuts and prospect of further tax cuts, together with deregulation. Trade tariffs are the main threat to financial markets. In recent weeks, we have seen a myriad of tariff policy threats, proposals and implementation delays; noise which has been detrimental to sentiment.

Elevated political noise is going to be a feature for the foreseeable future, but the many moving parts and feedback loops make it very difficult for financial markets to assess the risks. In this environment, diversification and constructing portfolios resilient to a range of different risks remains prudent.

36%

The percentage that the top 10 stocks now account for in the S&P 500 index.

Tariffs, Inflation, and the Bond Market Balancing Act

- Corporate credit markets remain resilient
- Market inflation expectations rise despite the Fed's efforts
- US tariff rhetoric weighs on economic outlook

January underscored the fluidity of global fixed income markets. Mixed economic signals in the US, persistent inflation concerns, and evolving global growth patterns influenced yields and currency valuations. While US nominal yields remained relatively stable, market-based inflation expectations saw a noticeable increase, leading to a decline in US real interest rates. The US dollar also showed some signs of exhaustion, weakening slightly against several counterparts, reflecting shifts in regional data and investor sentiment.

In the US, the labour market remained resilient with the unemployment rate falling to 4.1%, supporting consumer spending. While inflation is not surging, there are signs of reacceleration, especially with ongoing wage growth and firmness

in parts of the service sector. US Treasury yields responded by drifting higher, particularly at the long end of the curve, as the market priced in a potentially prolonged battle against inflation. US 30-year Treasury yields peaked at 4.98% before settling lower with the weakness in US technology stocks, due to the Deepseek news, providing a boost to safe haven assets. The Federal Reserve maintained its policy rate at the end of January, with the next reduction in the base rate expected in July.

4.98%

The percentage that the US 30-year Treasury yields peaked

One of the most notable shifts in January was the rise in market-based inflation expectations. Inflation breakevens edged higher, with investors factoring in the likelihood that the Fed's efforts to curb inflation may take longer than expected, fuelled by the strength of the labour market and the elevated US fiscal deficit. This increase in inflation expectations was also reflected in the commodity markets, where industrial metals, particularly copper, rose due to optimism about global manufacturing. Precious metals gained as well, benefiting from both geopolitical uncertainties and a hedge against persistent inflation fears.

Global bond yields in other developed economies showed only incremental changes. In Europe, sovereign yields fluctuated slightly, with household activity holding up better than expected despite challenges in manufacturing. The European Central Bank is unlikely to take an aggressive stance unless inflation readings worsen and easing should continue in coming months. Similarly, the UK experienced modest gains in gilts as markets speculated that the Bank of England's tightening cycle could be nearing its end. Meanwhile, Japan's government bond yields rose slightly, spurred by signs of domestic inflation and improving consumer confidence.

In currency markets, the US dollar saw a mild depreciation, particularly against the yen. The Australian dollar also gained, buoyed by positive commodity trends and hopes for stable domestic policy. In contrast, the British pound faced downward pressure due to softer economic indicators and speculation about the pace of the Bank of England's rate hikes. The Canadian dollar, on the other hand, was under pressure, partly due to concerns

over President Trump's tariff threats, which could slow growth, and range-bound energy prices. This added uncertainty to the Canadian currency, compounding its weaker performance.

January's market movements highlighted the ongoing sensitivity to the policy-growth-inflation dynamic. The US labour market has been a strong anchor for consumer demand, preventing inflation from declining sharply and leaving room for further Fed tightening if needed. Meanwhile, Europe and Japan are grappling with their own inflation and growth challenges. Markets are closely monitoring economic data for signs of weakening demand or potential shifts in central-bank rhetoric. Unless there is a significant economic downturn, inflation concerns are likely to remain a dominant influence on yields and currency flows in the months ahead.

The rise in US term premiums - the highest in 10 years - reflects concerns over the Federal Reserve's recent policy actions, particularly the fear that recent rate cuts could have been a mistake. Additionally, worries over the growing US fiscal deficit have led to investors demanding additional compensation in US bonds. This has made US treasuries increasingly attractive and has supported a neutral interest rate duration position, with a slight tactical overweight in our US dollar bond funds. As we approach the traditionally weak seasonality for risk assets and the likelihood of President Trump increasing tariffs, bond yields may peak soon, especially if efforts to reduce the US fiscal deficit gain traction.

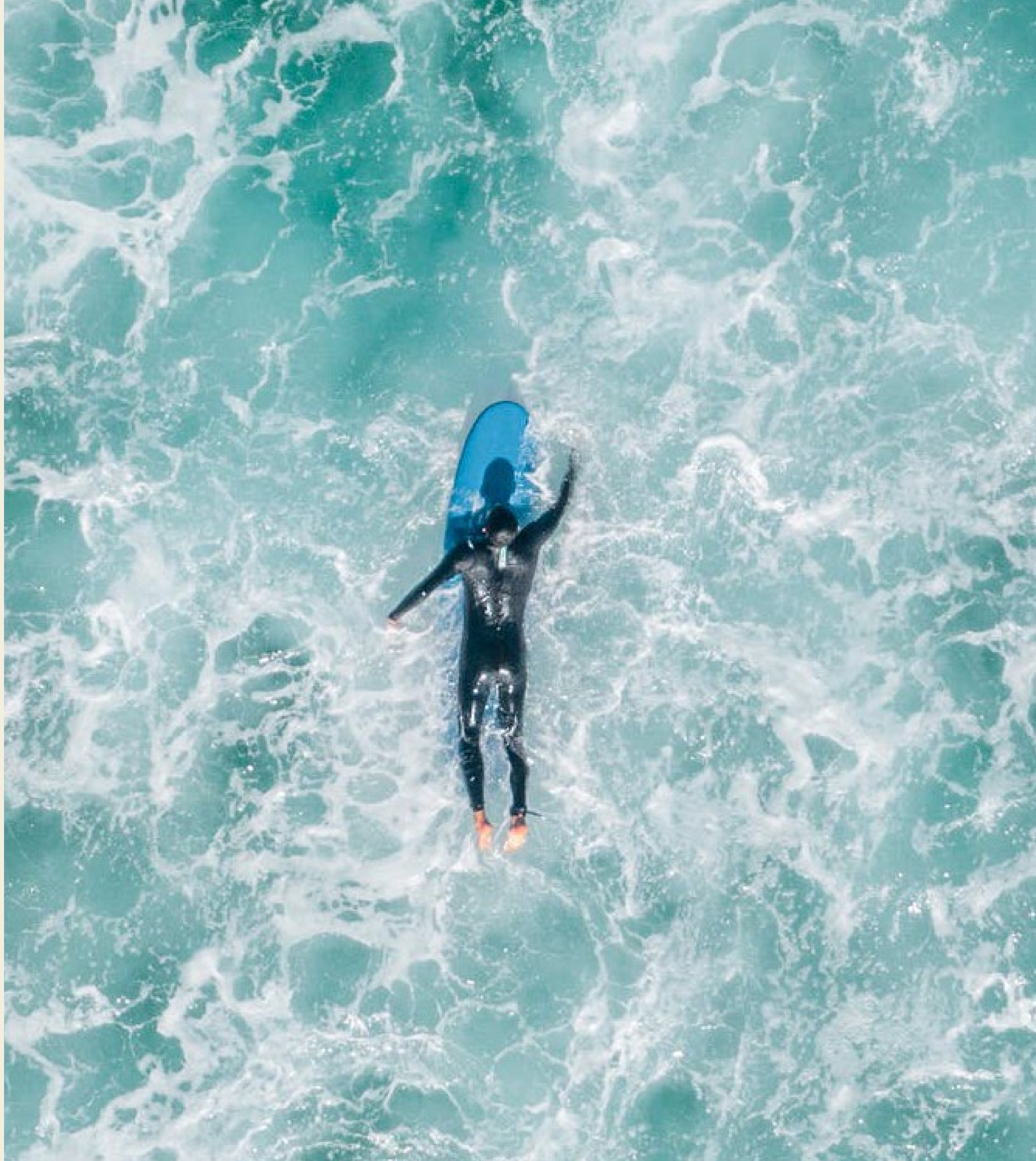
In corporate credit markets, spreads remain tight relative to US Treasuries, but with nominal US growth stable above 5% and corporate balance sheets healthy, there are few catalysts for a risk-off event. As a result, we continue to roll maturities into longer-duration exposure, given the positive yield curve. In currency markets, we remain overweight the US dollar, though our positioning has been volatile, with shifts between shorts in the Canadian dollar, Swiss franc, and British pound, reflecting the evolving global dynamics.

DeepSeek and Trade Tariffs

- European equities bounce back
- DeepSeek challenges US exceptionalism
- No slowdown in Artificial Intelligence (AI) capital investment

January was an action-packed month with a deluge of news and market moving headlines. US news flow dominated global equity markets with Trump's inauguration and a flurry of executive orders setting the stage for what is likely going to be an eventful and volatile year. This was followed by the market's reaction to DeepSeek's latest release which challenges the notion of US exceptionalism. A week later, trade tariffs were announced on Mexico, Canada, and China. Despite all the volatility the MSCI World index had a positive month returning 3.5%.

The best performing sectors were Communication Services (up 8.8%), with Meta (up 17.7%) and Alphabet (up 7.8%). The Financials sector was up 6.6%, with most of the banks reporting strong earnings, and the Healthcare sector was up 6.4%, which appears to be turning a page after disappointing two years in a row. The worst performing sector was Information Technology (down 1.5%), which



was vulnerable to the high valuations, and dragged down by the DeepSeek announcement and Microsoft missing on Cloud revenue.

The best performing region was Europe ex UK at 7.4%, which staged a comeback after lagging materially in the fourth quarter and posting no returns in 2024 compared to 25% for the US market. Europe outperformed the US market which returned 3%. The worst performing regions were Japan (down 1.6%) and emerging markets (down 1.8%).

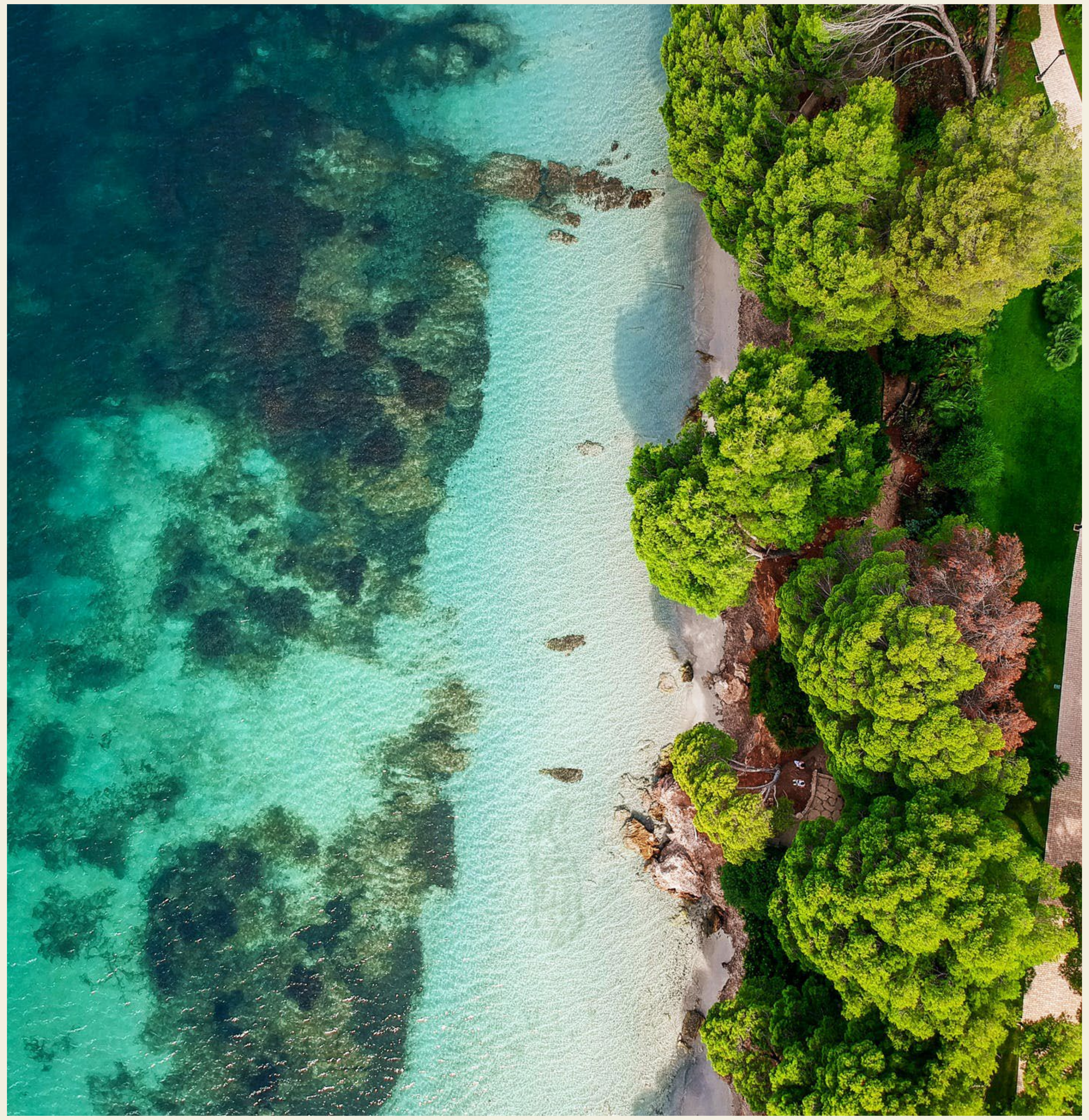
DeepSeek, a Chinese AI company, released a new open-source AI model that took the markets by storm. The model was released on Monday 20th, but it took a week for the investor community to fully realise the implications. Those who tested it likened it to OpenAI. The developers claimed to have built it in two months and for $5m. The reactions ranged from "this is a Sputnik moment" to "DeepSeek did not build OpenAI for $5m". US AI leaders responded with "we welcome healthy competition" and semiconductor company executives responded with "this will speed up adoption and increase demand for semiconductor chips".

The market's reaction on the following Monday was targeted. The S&P 500 Semiconductor and Semiconductor Equipment index fell 16%, while a JPM AI Datacenter & Electrification Basket fell 14%. Despite this, 70% of the S&P 500 stocks were up and the S&P 500 only dropped 1.5%. Within Utilities and Industrials, companies such as Vistra Corporation and Quanta Services, which are AI buildout stocks, were punished. In Technology, Semiconductors tumbled with Nvidia and Broadcom both down 17%, but AI enablers such as Apple, Meta and software companies such as Adobe actually rallied.

The real question post the DeepSeek announcement is have we reached peak AI buildout? Our bottom-up research providers do not think so. Interestingly, prior to the DeepSeek announcement, The Stargate Project was announced, a new company which intends to invest $500bn over the next four years building new AI infrastructure for OpenAI in the US. A few days later Meta announced it will increase capital expenditure (capex) for 2025 to $60-65bn vs consensus at $51bn. Post the DeepSeek announcement, the Hyperscalers have either reconfirmed or increased capex guidance. The French government then declared its intention to invest $113bn in AI over the coming years. Chinese technology companies have made significant progress over the last few years, and perhaps this a wake-up call for the US technology companies. Who will win the race is hard to predict, but what is clear is that this is just the beginning.

16%

The percentage that the S&P 500 Semiconductor and Semiconductor Equipment index fell



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Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy

	UNDERWEIGHT -	+ OVERWEIGHT
Asset Allocation	EQUITIES (MODEST UNDERWEIGHT)	CASH (MODEST OVERWEIGHT)
Fixed Income		EMERGING MARKET DEBT INFLATION PROTECTION
Equities Regional		JAPAN EMERGING MARKETS EX CHINA
Equities Sector	CONSUMER DISCRETIONARY	UTILITIES HEALTHCARE

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