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Quarterly economic and market update

March quarter 2025

Quarter in review

Equities faced significant turbulence in the first quarter of 2025, following strong performance since the second half of 2022. Global growth stocks, especially large-cap tech stocks, struggled, with the "Magnificent 7[1]" dropping 16% for the quarter and posting a 20% gain for the year. Australian equities declined by 2.9%, with a 18.2% drop in the Information Technology sector, while utilities and industrials gained. Emerging markets, particularly in Latin America, outperformed with a 12.8% gain over the quarter. European stocks outperformed driven by relatively lower valuations and expansionary fiscal stimulus.

As equity fears took hold, fixed income posted positive returns. Short-term yields fell as markets anticipated a faster-than-expected pace of interest rate cuts. The Reserve Bank of Australia (RBA) cut rates by 25 basis points in February, from 4.35% to 4.10%, after holding steady since November 2023. Meanwhile, mid- to long-term yields saw a slight shift higher, and Australian bonds rose over the quarter. High-yield bonds lagged as credit spreads showed some widening towards the quarter's end, reflecting investor caution and a flight to safe havens.

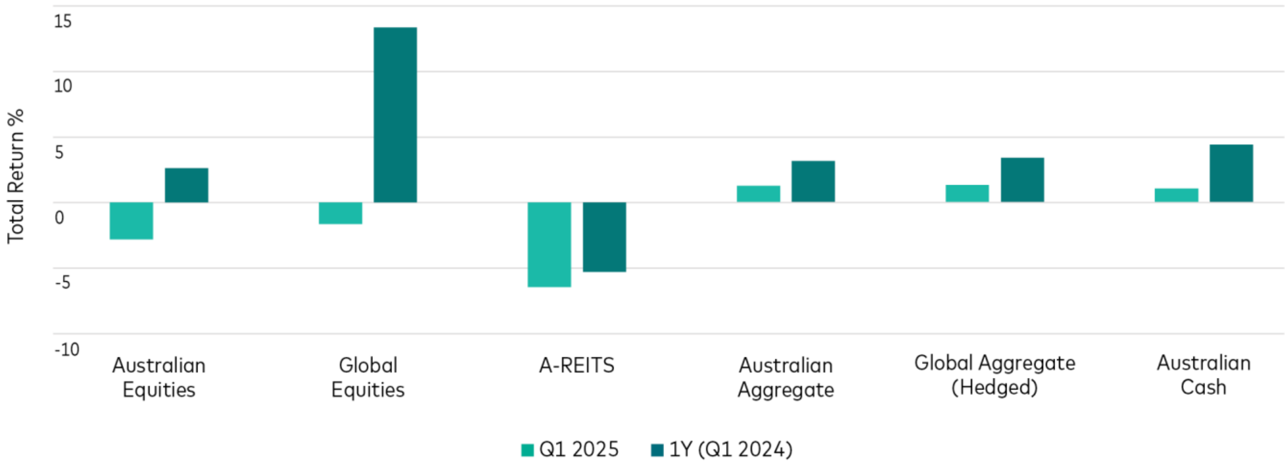
Update incorporating the first two weeks of April (market close 11 April 2025)

Ongoing uncertainty about the unfolding trade situation following the 2 April tariff announcement led to significant volatility. The first week saw widespread losses across risk assets, with the S&P 500 experiencing a two-day loss surpassing that of March 2020, and the Nasdaq entering a bear market, closing over 20% below its record highs.

The U.S. dollar also sold off, and by 11 April it had fallen 7.7% since the start of the calendar year, while investors fled to the Swiss franc, which was up 11.4%. The AUD underperformed largely due to weaker economic sentiment in China and overall weaker growth prospects in Asia, driven by the higher risk of tariff escalation in the region. Credit and overnight financing spreads spiked in major markets, with the largest movements in the United States, further highlighting market concerns. A pause in tariffs on 9 April set off a relief rally for equities and fixed income assets, but the imposition of higher tariffs on China and reciprocal tariffs brought back losses, with markets leveling off by 11 April.

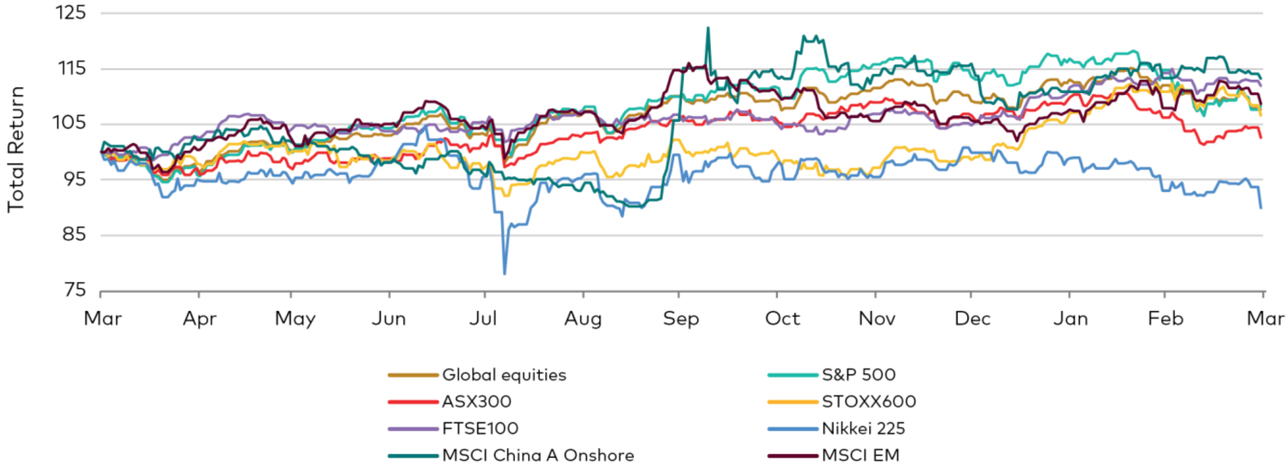
1 The Magnificent Seven stocks are a group of high-performing and influential companies in the U.S. stock market: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.

Figure 1. Fixed income outperformed over the quarter



Note: Returns are cumulative total returns denominated in AUD.
Source: Bloomberg, as of 31 March 2025.

Figure 2. Global equites declined with the U.S. and Japanese equities leading the way



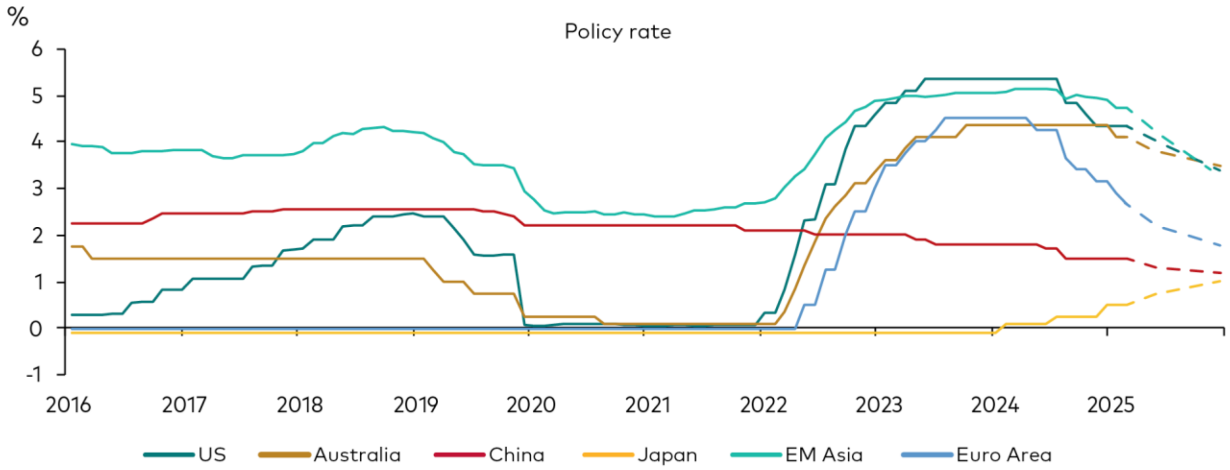
Note: Total return indexed to 31 March 2024. Returns are cumulative total returns denominated in local currency of each security's country of domicile with MSCI EM and MSCI AC World USD denominated.
Source: Bloomberg, as at 31 March 2025.

Economic and market outlook

Global uncertainty has been elevated since earlier this year, reaching historical highs after 2 April with tariff tensions escalating as the trade situation evolved. Concurrently, U.S. growth in 2025 is showing signs of softening earlier than anticipated. Three key surprises relative to the start of the year include: 1. Larger- and earlier-than-expected tariff increases, 2. More elevated and widespread policy uncertainty, and 3. Indications that the U.S. administration is willing to tolerate near-term economic pain to achieve longer-term policy objectives.

In Europe, weaker growth and a (medium-term) inflation outlook imply a more dovish stance from the European Central Bank. In China, economic growth is expected to be notably hit by higher-than-expected U.S. tariffs, driven by a notable decline in exports to the United States and limited room for export diversion to other countries, a softening of global demand, and a negative confidence shock with spillover effects on domestic demand.

Figure 3. With heightened uncertainty, expect a more cautious stance among central banks



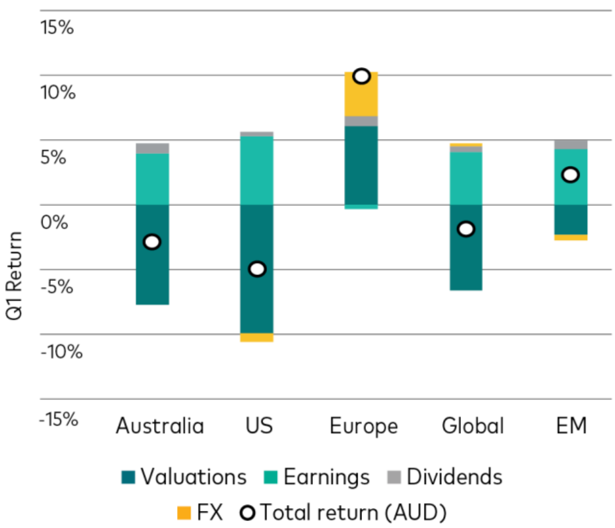
Sources: Vanguard calculations, based on data from CEIC as at 15 April, 2025.

The tariffs should have limited impact on Australia, as although exports are an important driver for Australia's economy, exports to the United States are very limited, accounting for only around 4.5% of Australia's total exports. Australia is also better placed than most economies in the face of U.S. tariff shocks as the U.S. reciprocal tariff rate on Australia is the minimum 10%, the lowest among other countries. As Australia's largest trade partner, in response to the external shock, Chinese policymakers may front-load and significantly raise policy support to bolster public demand as external headwinds stiffen. Consequently, it will drive more infrastructure investment and increase the commodity demand from Australia, potentially offsetting the negative direct impact.

Markets have increasingly grappled with the implications of tariffs for the global economy and company earnings, but policy and market uncertainty remain high. Possible negotiations between the United States and its trade partners are expected to interplay with central banks reacting to the macroeconomic dynamics, as well as broader market and consumer sentiment.

Over the past 12 months, divergence in economic pace across regions continues to pose questions for the markets. In Q1, European stocks performed better than others due to valuation expansion and currency changes, while the U.S. and Australian markets saw a drawdown dominated by valuation contraction (**Figure 4**).

Figure 4. Valuations broadly weighed on equity returns in Q1 2025



Note: Index returns decomposed into change in valuations, EPS, dividends, and currency for quarter ended 31 March 2025.
Sources: Vanguard calculations, Refinitiv, as at 31 March 2025.

Looking ahead, Vanguard remains constructive on equities as a long-term driver of portfolio growth but continues to see pressures on equity markets persisting. The U.S. stock market's strong performance over the past decade, driven by high valuations, is unlikely to continue at the same pace. The valuations and forward growth expectations in the United States are above fair value estimates, and although U.S. corporate earnings are still expected to outpace their ex-U.S. counterparts, there's less room for further growth in profit margins. This is compounded by nearer-term uncertainty over the impacts of tariffs on earnings. Australian and other international markets might benefit from lower valuations and higher dividend yields, but are not immune to the dynamics of global trade. During periods of volatility, investors should be reminded of the importance of diversifying investments across different regions and currencies.