Financial conditions remain highly resilient amid trade wars uncertainty

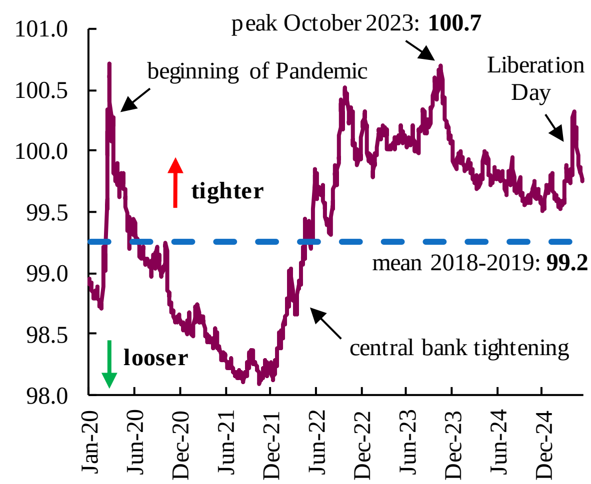
The beginning of the year launched under a general tone of optimism, underpinned by a benign economic growth outlook, policy rate cutting cycles by central banks in major advanced economies, and constructive overall investor sentiment. At that time, investors and analysts were directing most of their attention to any signs that would uncover the direction of the US economy under the incoming administration of President Trump. The new government inaugurated with a strong mandate, as well as the unambiguous willingness, to shake policy and support a pro-business agenda, suggesting an end to the "business as usual" decision making. Initially, this shift was met with optimism, as markets awaited further tax breaks and deep de-regulation. These expectations supported a rally in US equities and the USD, pointing to US global outperformance.

However, market sentiment began to reverse sharply as the new government began to unveil its policy agenda. On April 2, President Trump declared "Liberation Day," announcing sweeping tariffs – including a 10% baseline on all imports, and higher rates on selected countries – with the vague goal of asserting US economic independence. Financial markets reacted negatively to the announcements, with US Treasury yields rising on fears of de-anchored inflation expectations and tainted policy credibility, while the growth narrative debated the odds of a recession, and major stock markets reversed back to pre-election levels.

The Financial Conditions Index (FCI) provides an informative summary of the overall state of markets in advanced economies. The FCI spiked after Liberation Day, briefly reaching levels that typically mark moments of stress, and interrupting the previous trend of easing conditions. In our view, market dislocations will prove to be temporary, and financial conditions are set to improve and resume a more benign trend. We discuss the three main factors that support our outlook.

First, central banks in the two major advanced economies are on track to continue with their policy rate cutting cycles, which will contribute to bring global interest rates down. In the US, inflation is gradually returning to the 2% target of monetary policy, while the economic growth consensus has weakened to a 1.4% expansion for this year, half of the 2.8% rate in 2024. These conditions should prompt the Federal Reserve to implement two further policy rate cuts of 25 basis points (b.p.) during the year, taking the upper bound of the policy benchmark rate to 4%. In the Euro Area, subduing wage and services price pressures support the disinflation trend, while the growth outlook has continued to deteriorate. With this backdrop, the European Central Bank (ECB) is expected to implement one additional rate cut of 25 b.p. during the year, taking the benchmark deposit rate to 1.75% by end-2025. Lower policy rates by the Federal Reserve and the ECB will further reduce borrowing costs for households and business, adding support to consumption and investment.

Financial Conditions in Advanced Economies
(headline index, 100-level: long-run average)



Source: Goldman Sachs, QNB Economics

Second, after a period of high volatility, corporate credit spreads are narrowing, signalling improved market sentiment and easier credit for firms. Corporate credit spreads, defined as the difference between interest rates paid by firms and those paid by sovereigns, are a key indicator of financial conditions, reflecting the compensation demanded by investors for bearing the credit risk of companies. Investment-grade and high-yield spreads have been on a downward trend for several years, interrupted by the recent trade rifts and the uncertainty this represented for investors. Corporate spreads have come down since their peaks this year, and are likely to descend towards more supportive levels, as the more damaging trade-war outcomes become less likely.

High Yield Corporate Spreads in Euro Area and US

(bond spreads for US and CDS for Euro Area, in percentage points)

Source: Bloomberg, QNB Economics

Third, after a significant correction following Liberation Day, stock markets have staged a notable recovery backed by resilient corporate earnings and the expectations of monetary easing. Furthermore, markets expectations have readjusted on the premise that initial tariffs threats set the point of departure for negotiations. In the US, major indices have approached previous highs, reflecting increased confidence in a soft landing scenario and the prospects of policy rate cuts, as well as better-than-expected results in key sectors. In Europe, the MSCI Europe Index has been one of the best performing regional indices this year, rising by close to 20% in dollar terms, with a boost provided by Germany's historical fiscal policy shift and alleviating energy price pressures. Going forward, absent a major re-escalation of trade retaliations, or a re-ignition of hard-landing fears, the environment will continue to be supportive for stocks in the major advanced economies.

All in all, in our view, after a bout of significant market volatility, financial conditions in advanced economies will slowly resume their positive trend towards a more supportive environment on the back of policy rate easing cycles, improving corporate credit spreads, and a supportive environment for stock markets.

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