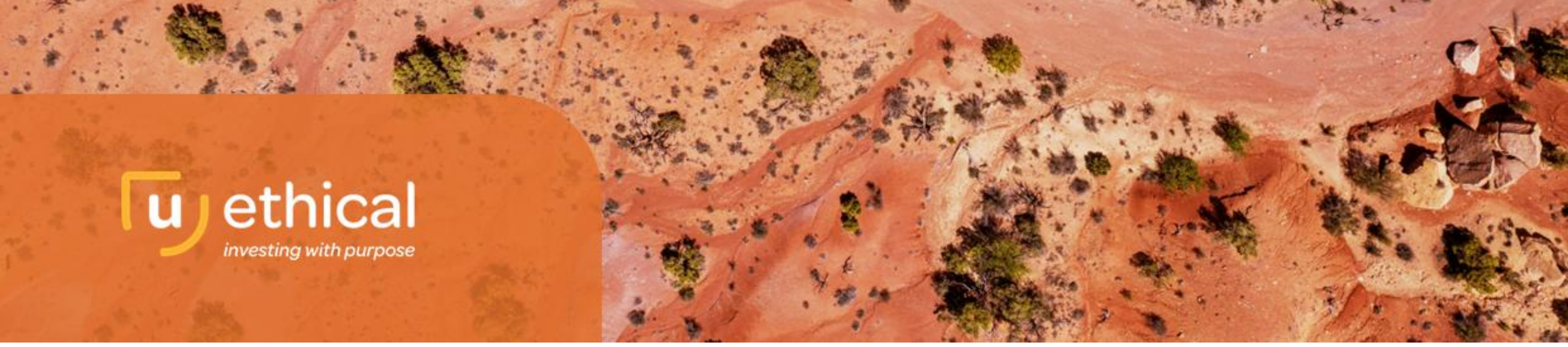


Market volatility given escalating trade tensions

"While uncertainty remains elevated, it is now becoming clear that the tariff increases will be significantly larger than expected. The same is likely to be true of the economic effects, which will include higher inflation and slower growth." **Federal Reserve Chair, Jerome Powell**

Summary

- On 2 April 2025 US President Donald Trump announced a significant increase in US tariffs to levels not seen in close to a century. This includes a minimum 10% on all countries and additional measures for another 60 countries where the US has large trade deficits such as the European Union (20%) and China (additional 34%). The estimated weighted average effective tariff is >15%.

- In response, China has announced retaliatory tariffs in line with the US and many other trading partners have signalled an intent to do so, highlighting the risk for further escalation.

- The equity market reaction has been dramatic with the S&P500 Index declining almost 11% in two sessions and the largest weekly drawdown since the pandemic. The VIX Index has also spiked to levels similar to the Global Financial Crisis.

- While there will be company specific impacts depending on the location of operations and exports to the US market, the broader concern is this will lead to lower global economic growth and higher inflation in the US.

- Australia is likely to be less directly impacted from US tariffs given a 10% tariff level, trade deficit with the US and the region only represents 5% of total exports. However, Australia will not be immune to a broader global slowdown and particularly weaker Chinese activity given they are our largest trading partner.

- U Ethical portfolios were already relatively defensively positioned with the Australian and international equity strategies having higher exposure to sectors such as healthcare and communication services, while underweight energy and materials (partly due to exclusions). Both strategies also have a beta of ~0.9.

- The U Ethical investment team retain a long-term approach to investing and focus on high quality companies with resilient business models. While this remains a dynamic situation, we expect equity markets to remain volatile in the near-term and continue to reassess positioning.

- Valuations look more attractive given the pullback, although higher earnings uncertainty means some caution is warranted. Despite this a broad market sell-off may create longer-term opportunities for investors.

Background

On 2 April, US President Donald Trump announced a significant increase in US trade tariffs for ‘Liberation Day’, including a minimum 10% on all countries and additional measures for another 60 countries where the US has large trade deficits. The European Union (20%), China (additional 34%) and other major Asian economies have all seen large increases.

Reciprocal tariffs adjusted examples

Country / region	Reciprocal tariff, adjusted
Australia	10%
China	34%
European Union	20%
Japan	24%
South Korea	25%

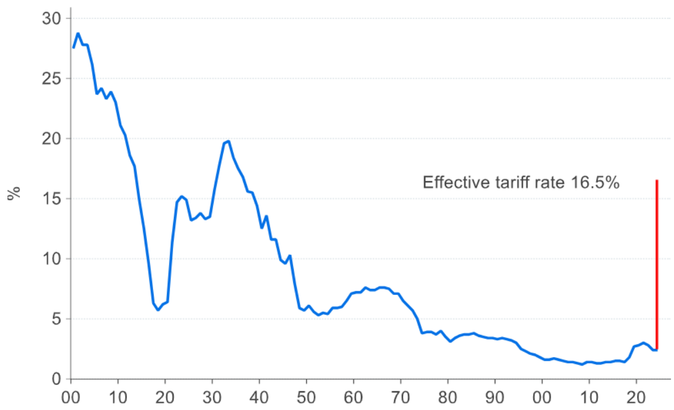
Source: whitehouse.gov

Although these have been labelled ‘reciprocal tariffs’ the (Whitehouse announcement on reciprocal tariffs), these have been calculated based on the ratio between the US trade deficit with a country/region and total exports to the US. This has then been halved to get to a ‘discounted reciprocal tariff’.

Implementation under Emergency Powers Act

The scale of tariff increases surprised the market. JP Morgan estimates weighted average tariffs by US imports of ~18%, although due to some product exclusions the effective rate is closer to 12.5%. The Tax Foundation similarly estimates the effective tariff rate at 16.5%, the highest level since 1937. At that time, tariffs were aimed at protecting US industries during the Great Depression but ultimately exacerbated the economic crisis by prompting retaliatory tariffs. Trump will use his powers under the Emergency Powers Act with the tariffs to be imposed on or before April 9.

US effective tariff rate highest since 1937



Source: Tax Foundation, Macrobond, ANZ Research

Reciprocal tariff exemptions

Currently there are some product exemptions due to either already having specific tariffs (steel, aluminium and auto parts), being under review (copper, pharmaceuticals, semiconductors, and lumber), or being strategically important to the US (energy and other certain minerals not available domestically).

Retaliation and negotiations

While we expect negotiations with trading partners may lead to lower tariffs than announced, there is also scope for an escalation. China has already announced it will impose a 34% tariff on all US imports from April 10 and further restrict rare earth exports of rare earths. Vietnam on the other hand have announced that it will cut all levies on US imports to zero.

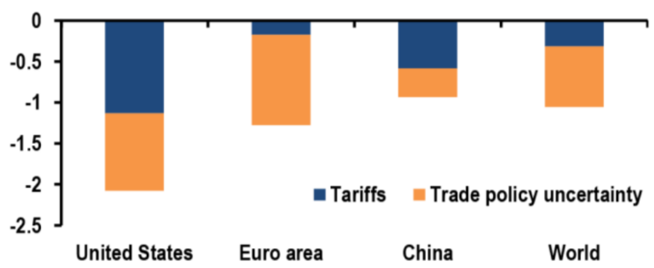
Impacts of tariffs

While there will be companies and sectors that are more directly impacted by these tariffs (particularly those with offshore operations importing into the US), the direct impact for most Australian companies appears to be more moderate. However, there are other flow on secondary risks from these developments.

Economic global slowdown

We see the major concern with the trade war escalation as a slowdown in US and global economic growth. JP Morgan have increased their probability of a global recession this year from 40% to 60%. While monetary policy easing and fiscal stimulus measures are expected to be introduced around the world this may not be enough to offset the negative impact of tariffs. International Monetary Fund (IMF) modelling estimates 20% effective US tariffs, retaliatory tariffs from key trading partners and policy uncertainty could reduce global GDP growth by 2% and US GDP growth by 1%.

Percentage point change in GDP through 2026



Source: IMF and JP Morgan

Australian economy reasonably placed, although China a concern

Australia is relatively well-placed in terms of direct impact from US tariffs given a trade deficit with the US, the region only representing 5% of exports and less exposure to manufacturing. However, the Australian economy will not be immune to a broader slowdown in global growth and pull back in asset prices. Furthermore, a key concern for Australia is the impact an escalating trade war will have on the Chinese economy, our largest trading partner. This may mean weaker demand for Australian imports and lower commodity prices.

Corporate earnings

Consensus earnings estimates have come down ~2% in the US year-to-date, but expectations are currently for 9-12% earnings growth per annum over the next couple of years. We expect these forecasts will need to be revised downwards substantially. In Australia, earnings growth is currently forecast to be 7-8% per annum. While earnings revisions may not be as large, we would also expect these to come back in coming weeks.

Companies held in the U Ethical Australian Equities strategy that may be either positively or negatively impacted by the new tariffs include:

- **Reliance Worldwide** faces headwinds in its business that would require price increases of up to 5% to fully offset the incremental tariffs.
- **Fortescue** is not directly exposed to tariffs but may be negatively impacted if a negative shock to Chinese exports occurs and drives down raw material demand.
- **Goodman Group** may benefit in the longer term if US industrial property demand rises from near-shoring and increases in US manufacturing and industrial activity.
- **Lynas Rare Earths** is one of the few rare earth producers outside China, so it should be relatively well placed for exemptions. Recently announced retaliatory export controls on rare earths out of China are supportive of rare earths more broadly.

Inflationary in US

We expect the increased tariffs will be inflationary for the US and potentially other trading partners. UBS forecasts core inflation in the US to reach 4.6% at the end of 2025 if the proposed tariffs remain in place during the year. This may put the Federal Reserve in a challenging position to balance monetary policy in a stagflation environment. For Australia, there may be some flow on effect to supply chains, but there is also the scope for goods deflation as Asian economies look to shift export markets.

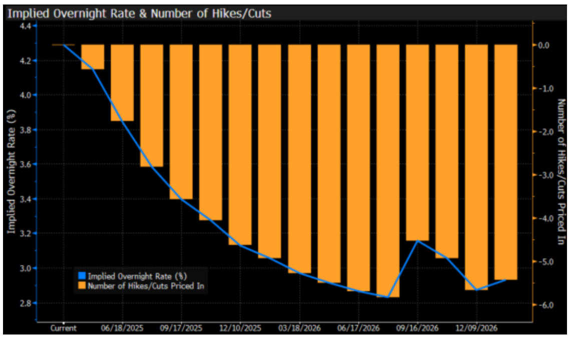
Potential for USD weakness

Historically the US dollar (USD) has been seen as a safe haven currency and lowering the trade deficit should all things being equal lead to a stronger USD. However, over the longer-term lower US economic growth and Federal Reserve easing may contribute to a weaker USD vs other currencies. Although this will also be dependent on inflation remaining under control.

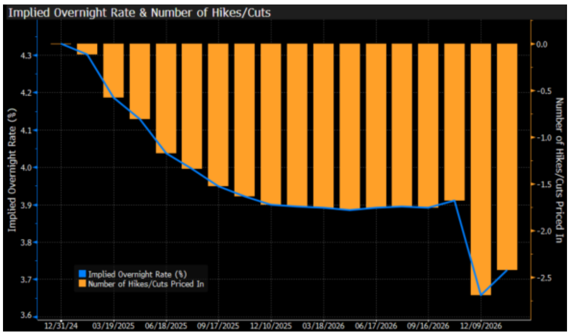
Central banks expected to ease monetary policy

Expectations have changed for the Federal Reserve to more aggressively ease monetary policy with more than 5 interest rate cuts now forecast over the next 12 months compared to less than 2 at the end of the year. Similarly, expectations for the Reserve Bank of Australia (RBA) have also shifted lower with an RBA meeting in May live. Given the current level of interest rates most central banks have significant scope for easing should this be necessary in a tougher economic environment.

Current Fed expectations



End of 2024



Source: Bloomberg as at 07/04/25 and 31/12/24

Scope for fiscal stimulus

Given increased tariffs are expected to impact global economic growth, countries may look to introduce additional fiscal stimulus measures to provide support. From an Australian perspective, China will be a particular focus given the potential flow on effect to commodity prices.

Heightened uncertainty impacting sentiment

We have already seen consumer and business confidence figures come off in the US and an escalation in trade tariffs will further impact these measures and potentially delay investment decisions. The US labour market had been robust with unemployment only ticking up slightly to 4.2% in March, although we expect this to rise substantially if the economy slows.

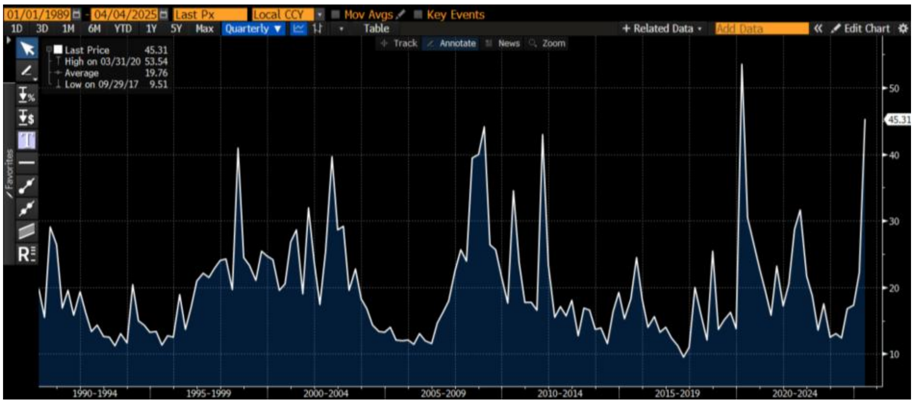
Market volatility

There have only been a handful of times the US share market has experienced a weekly drawdown of more than 9%. This includes the pandemic, global financial crisis, dotcom bubble, black Monday, the great depression and now Liberation Day.

S&P500 Index has dropped almost 11% in 2 sessions

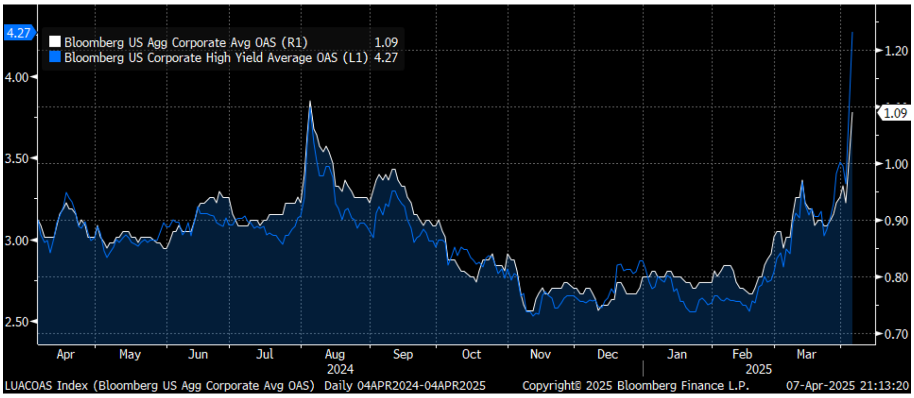
Source: Bloomberg as at 04/04/25

VIX Index at highest level since start of pandemic



Source: Bloomberg as at 04/04/25

Credit spreads have widened as risks rise

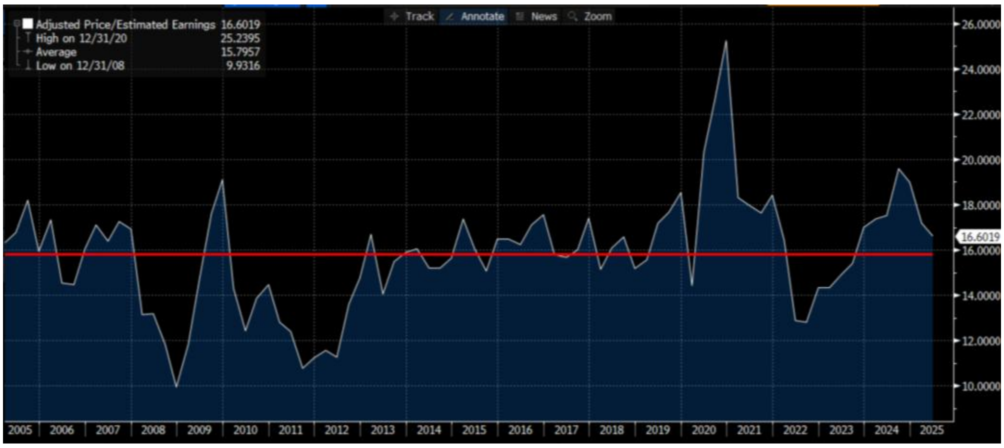


Source: Bloomberg as at 04/04/25

Valuations improved, although earnings uncertainty elevated

On face value equity market valuations have improved given the significant pullback we have seen over the last week; the forward price-to-earnings (P/E) ratio of the ASX 300 Index at 16.6 times is only slightly above the 20-year average. However, we expect earnings forecasts will need to be revised downwards if there are not significant shift from the current trade settings, which warrants some caution.

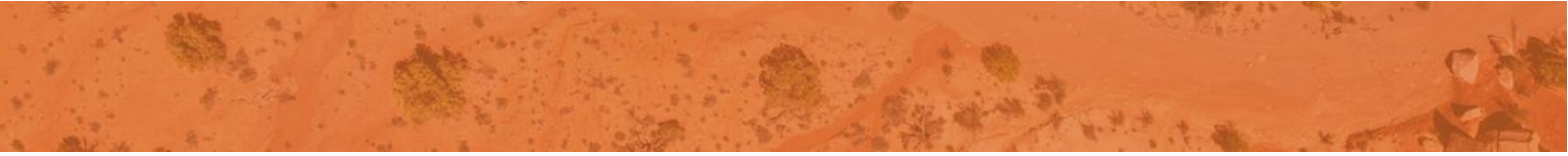
ASX 300 Index forward P/E ratio close to longer-term levels



Source: Bloomberg as at 07/04/25

However, the sell-off over recent days has been broad-based and this will present some investment opportunities for companies that are less directly impacted.

Equity markets may continue to come under pressure if there no resolution to tariff negotiations. While we could see equity markets bounce back if there is significant headway or large fiscal stimulus measures announced (particularly from China for Australian markets), the timing and scale of this remains uncertain.



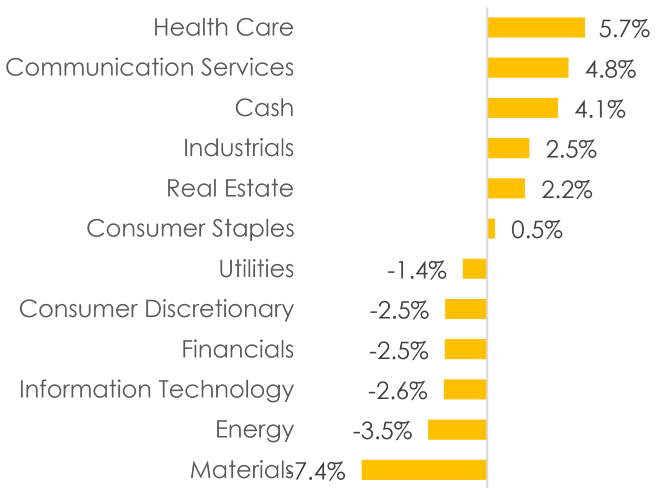
U Ethical positioning

U Ethical continue to hold diversified portfolios and have been slightly defensively positioned in terms of asset allocation, sector allocation, credit quality and cash exposure. The investment process also ensures a focus on higher quality companies that have resilient earnings. Below we provide more details on the positioning and changes we have been making to portfolios. We continue to assess select opportunities given the pullback in equity markets and the broad sell-off we have witnessed.

Australian equities

In the Australian equities strategy, we have been overweight the health care and communication services sectors given resilient earnings and structural growth opportunities. We have been underweight the energy, materials and information technology sectors (partly due to ethical exclusions) and have increased the cash holdings to over 4%. More recently we have been selectively reducing exposure to financials (particularly those exposures with more earnings volatility) and adding to the consumer staples sector.

Australian equities relative sector allocation

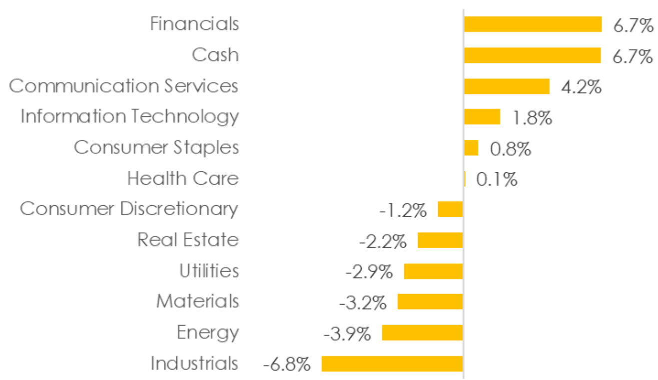


Source: U Ethical as at 04/04/25

International equities

In the international equities strategy, we have been overweight the financials and communication services sectors with more defensive earnings. We have been underweight the industrials, energy and materials sectors (partly due to ethical exclusions). More recently we have been selectively reducing exposure to information technology and financials, while adding to the consumer staples sector. On a geographic basis, we are underweight the US and overweight Europe where we have seen better opportunities and more attractive valuations.

International equities relative sector allocation

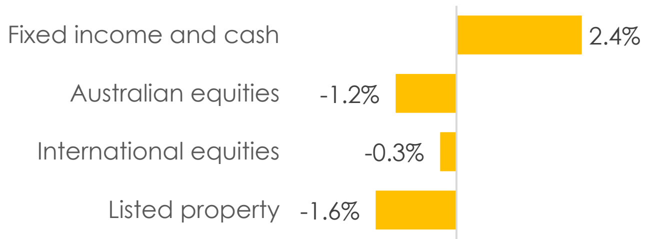


Source: U Ethical as at 04/04/25

Growth portfolio

The Growth Portfolio has been slightly underweight listed property, Australian and international equities, while being overweight fixed income and cash. The portfolio should also benefit from more defensive positioning in the underlying equity strategies. We plan to continue to build the defensive exposure in the short-term given the current uncertainty.

Growth Portfolio current positioning vs SAA



Source: U Ethical as at 04/04/25

Fixed income and cash

U Ethical's fixed income portfolios are typically geared towards strong income generation versus capital upside. The benefit to this is the relative certainty of receiving income versus generating capital gains, especially in times of market stress.

The relatively low duration of all strategies has kept volatility contained compared to more longer-dated 'Composite' type funds which experience large gyrations in times of big yield movements as we have seen over the past week.

The Enhanced Income Trust (EIT) and Diversified Income Trust (DIT) primarily operate in Investment-Grade markets which are safer, less volatile that sub-Investment Grade issues. Both Trusts are also biased to higher-quality, more resilient companies as 'core' holdings, a prime example being Australian banks.

Broadly speaking, credit markets in both the US and Australia have seen spreads widen considerably off their lows. U.S Investment Grade debt is now trading at +115bps over treasuries, up from +78 in November 2024. Australian Investment Grade debt is now trading at +96.93bps vs 79 in February 2025.

Whilst somewhat concerning, when analysing these levels relative to history, US and Australian Investment Grade debt remain 'tight' to their trimmed averages (excluding extreme outliers), with U.S debt trading at 0.95x its 10-yr average and Australia trading at 0.94x. Currently, these moves fit within a 'mean revision' categorisation rather than an explicit signal of stress. Where the concern does lie however, is the speed at which reversion has occurred, indicating pressure in markets and a reluctance of investors to hold risk assets.

Naturally, the only 'hiding' place has been government bonds, with domestic yields rallying on average -25bps across each tenor over the past month, albeit with US yields showing less outperformance given an average -10bp rally across the curve over the same period.

In the lead up to Liberation Day, the Fixed Income team strategically built-up cash reserves within the fund as a means of dampening volatility, ensuring adequate liquidity and maintaining 'dry powder' should attractive opportunities eventuate. EIT's lowest cash allocation came in January when the Trust had a 1% weight, by the end of March the Trust held a 10% weight and has maintained that level since.

The team envisages further volatility ahead with relatively thin trading conditions in credit markets and thus, is erring on the side of caution considering the idiosyncratic nature of Trump's policies and subsequent announcements. We envisage some loosening in monetary policy however, this will depend heavily on domestic data and data coming out of China with respect to economic growth and strength to weather a global trade war.

Conclusion

The U Ethical investment team retain a long-term approach to investing and focus on high quality companies with resilient business models. While this remains a dynamic situation, we expect equity markets to remain volatile in the near-term and continue to reassess positioning. Valuations look more attractive given the pullback, although higher earnings uncertainty means some caution is warranted. Despite this a broad market sell-off may create longer-term opportunities for investors.

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