

The Way We See It

August 2025
Issue 44

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U.S. STAGFLATION : Will this be the new base case? Implications for markets.

A brief update report which serves to review the recent market development and to offer our outlook for the rest of the year and beyond.

Review of Developments

- Global Economies

Recent macroeconomic data indicates that the U.S. economy expanded at an annualised rate of 3.0% in the second quarter of 2025, marking a notable rebound from the -0.5% contraction recorded in Q1. This brings first-half growth to approximately 1.3% year-on-year—an encouraging turnaround, albeit at nearly half the pace observed in the second half of 2024. whilst the headline figures suggest resilience, underlying dynamics reveal a more nuanced picture.

A key contributor to the volatility in H1 2025 GDP data was the statistical treatment of imports, which distorted quarterly comparisons. Beneath the surface, domestic consumption and capital investment trends have softened, largely in response to policy uncertainty. The frequent recalibration of tariffs and the implementation of disruptive regulatory frameworks—most notably ICE and DOGE—under the Trump administration have weighed on business sentiment and consumer behaviour. The recent

passage of the “One Big Beautiful Bill” (“OBBB”), which effectively enshrines the tax cuts from Trump’s first term, adds another layer of fiscal stimulus, though its long-term growth impact remains to be seen.

Despite the Q2 rebound, a significant portion of U.S. corporate leaders and economists from leading global financial institutions continue to assign a greater-than-even probability to a recession materialising in 2025–2026. In contrast, GOJI’s base case scenario anticipates a soft landing, characterised by subdued but stable growth rather than a pronounced downturn. This outlook hinges on the assumption that monetary and fiscal authorities will respond proactively to emerging risks.

Outside the United States, economic performance across major developed markets remains tepid. Germany, after a modest expansion in Q1, has slipped back into contraction, reflecting persistent structural challenges and weak external demand. Other European economies present a mixed picture, with some showing signs of resilience whilst others struggle to gain traction. Japan, which experienced a slight contraction earlier in the year, may benefit from robust wage growth that could stimulate domestic consumption. However, its export sector continues to face headwinds, limiting the scope for a broader recovery.

In contrast, China stands out as a relative bright spot. The economy registered 5.2% year-on-year growth for the twelve months ending June 2025, positioning it as a key driver of global expansion. This performance is underpinned by targeted government interventions aimed at stabilising the property market, a resurgence in AI-led private investment, and fiscal measures designed to bolster household spending. Nevertheless, China’s export sector remains under pressure due to elevated U.S. tariffs, subdued global demand, and the ongoing reallocation of manufacturing capacity to alternative regions. These factors are likely to constrain trade growth in the near term.

Inflationary pressures are easing across Europe and other OECD economies, with both headline and core

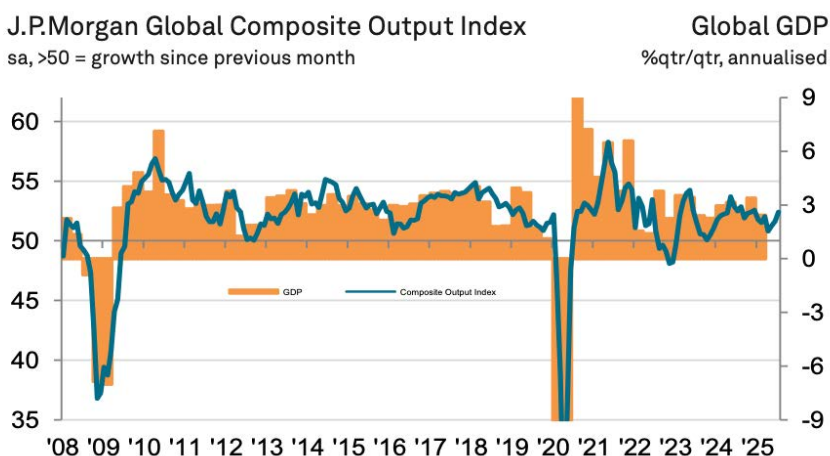
GOJI’s base case anticipates a soft-landing scenario - subdued but stable growth.

metrics trending downward. This has reinforced expectations for continued monetary easing, although most central banks appear to be nearing the end of their rate-cutting cycles. In the U.S., core inflation has moderated but remains above the Federal Reserve's 2.5% comfort threshold. Complicating the policy landscape, recent non-farm payroll data revealed notable weakness in employment, though this signal is not corroborated by other labour market indicators such as weekly jobless claims. It is plausible that public sector retrenchment under the DOGE initiative has impaired data collection, obscuring the true state of the labour market.

This divergence in employment metrics presents a dilemma for the Federal Reserve. Should policymakers prioritise inflation containment, or pivot toward easing in response to labour market fragility? The upcoming Jackson Hole symposium in August and the September FOMC meeting will be pivotal in shaping market expectations. Investors should monitor these events closely for guidance on the Fed's policy trajectory.

Dilemma for the Fed: inflation containment, or ease to support labour market.

J.P.Morgan Global Composite PMI™



Source: J.P.Morgan, S&P Global Market Intelligence

Adding to the complexity, President Trump has unveiled a comprehensive tariff framework targeting the majority of U.S. trading partners. Announced just ahead of the August 1 deadline marking the conclusion of the 90-day reciprocal negotiation period, the new regime imposes average tariffs of

approximately 15% on OECD countries and 20% on emerging markets. These measures are expected to exert downward pressure on global growth and upward pressure on U.S. consumer prices. As tariffs function effectively as a consumption tax, retail activity is likely to decelerate further—particularly if the labour market proves to be as weak as suggested by recent payroll data.

Geopolitical risks, whilst somewhat diminished, continue to pose challenges. Sporadic disruptions persist and escalating military conflicts in regions such as Ukraine and the Gaza Strip are exacerbating humanitarian crises and undermining economic stability. These developments underscore the importance of geopolitical risk management in portfolio construction and asset allocation.

In aggregate, the global economic outlook remains subdued relative to its long-term potential. The landscape is fluid, shaped by evolving trade policies, shifting geopolitical dynamics, and the pace of bilateral and multilateral negotiations. For investors, agility and strategic foresight will be essential in navigating this environment. Diversification, active risk management, and a keen understanding of policy signals will be critical in identifying opportunities and mitigating downside risks.

- Global Markets – review of July

Global financial markets continued to reflect a complex interplay of optimism and caution in July. The strong V-shaped recovery in U.S. equities observed in Q2—largely propelled by mega-cap technology names and the so-called “Magnificent Seven”—extended into July, delivering another month of positive returns. This momentum was underpinned by investor enthusiasm surrounding artificial intelligence and its transformative potential across sectors.

However, performance across international developed markets was more subdued. Equities outside the U.S. experienced modest corrections, as valuations have become increasingly stretched and much of the positive macro and earnings news

The strong V-shaped recovery in U.S. equities extended into July.

appears to be priced in. The imposition of a 15% U.S. tariff on European goods has further clouded the outlook for European exporters, with anticipated pressure on sales volumes and corporate margins.

Market sentiment remains delicately balanced. On the constructive side, the AI-driven growth narrative continues to support upward revisions to global economic and corporate earnings forecasts. There is growing confidence that monetary policy across the U.S. and other OECD economies will remain broadly accommodative, whilst fiscal support—both domestically and internationally—is expected to persist. In response to U.S. trade actions, both Europe and China have introduced expansionary monetary and fiscal measures aimed at cushioning the economic impact, which may help stabilise broader macro conditions.

Nonetheless, concerns about the durability of the recent equity rally are mounting. A significant portion of the S&P 500's 29% rebound from its April trough to July's record high has been attributed to retail-driven momentum, short-covering by hedge funds, and algorithmic buying from trend-following CTAs. This raises questions about the sustainability of the rally, particularly in the absence of robust institutional participation. Investor caution is further reinforced by the prevailing view among market participants that the probability of a U.S. recession or stagflation scenario remains above 50% over the next six to twelve months. Additionally, expectations for near-term rate cuts by the Federal Reserve remain muted, suggesting that monetary conditions may stay restrictive in the short term.

In terms of performance, global equities (in USD terms) rose by +1.3% in July. U.S. stocks outperformed with a +2.3% gain, whilst non-U.S. developed markets declined by -1.2%. Emerging markets posted a solid +2.0% return, led by China, where the MSCI China index surged +4.8%, reflecting renewed investor confidence amid supportive policy measures.

Fixed income markets were mixed. U.S. Treasury bonds declined by -0.4%, whilst global bonds fell by -2.0% in USD terms, largely due to the strengthening of

Sustainability of the rally in question in the absence of institutional participation.

Near-term performance of various asset classes

Asset Class	US Equities	Global Equities	Global ex US Equities
Index	MSCI USA	MSCI World	MSCI World ex USD
1 month	2.29%	1.31%	-1.19%
3 months	14.49%	12.04%	6.05%
YTD	8.77%	11.19%	18.04%
FY 2024	25.08%	19.19%	5.26%

Asset Class	US Corporate	US Treasury	US Aggregate
Index	Bloomberg US Corporate	Bloomberg US Treasury	Bloomberg US Agg
1 month	0.07%	-0.39%	-0.26%
3 months	1.92%	-0.18%	0.54%
YTD	4.24%	3.39%	3.75%
FY 2024	2.13%	0.58%	1.25%

Asset Class	Global Govt Bonds	Global Aggregate	Global Commodities
Index	Bloomberg Global TSY	Bloomberg Global Agg	CBR
1 month	-2.02%	-1.49%	0.84%
3 months	-0.91%	0.02%	3.81%
YTD	5.36%	5.67%	1.03%
FY 2024	-3.58%	-1.69%	12.47%

Asset Class	GEM Equities	Asia ex Japan Equities	China Offshore
Index	MSCI EM	MSCI AC AxJ	MSCI China
1 month	2.02%	2.63%	4.84%
3 months	12.94%	14.76%	11.77%
YTD	17.90%	17.81%	23.14%
FY 2024	8.05%	12.51%	19.67%

Source: GOJI, MSCI, Bloomberg; data as of 31/7/2025

the U.S. dollar. The dollar rebounded against its trade-weighted index, driven by the Fed's reluctance to signal a rate cut at the upcoming September meeting.

Commodities posted modest gains, with oil prices rebounding on supply-side dynamics and geopolitical tensions.

In summary, whilst July delivered positive returns in select asset classes, the broader investment landscape remains fluid. Investors should remain vigilant, as policy developments, trade dynamics, and macroeconomic indicators continue to shape market direction. Strategic positioning and risk management will be key in navigating the evolving environment.

Broad investment landscape remains fluid; investors should remain vigilant.

Market Outlook of H2 2025

GOJI's outlook for the second half of 2025 remains modestly constructive, though notably more measured than the prevailing consensus. whilst

certain tailwinds support a cautiously optimistic stance, the investment landscape is increasingly shaped by macroeconomic fragility, policy uncertainty, and valuation concerns.

GOJI's investment framework continues to be anchored in a multi-dimensional analysis of macroeconomic indicators, corporate earnings trajectories, asset valuations, investor sentiment, capital flows, and technical chart dynamics. This holistic approach informs our strategic positioning and risk-adjusted expectations across asset classes.

Outside the United States, the macroeconomic environment is expected to remain broadly supportive, contingent on the absence of further escalation in U.S. trade policy—particularly additional tariff measures. Europe and China have introduced expansionary fiscal and monetary policies aimed at stabilising growth and mitigating the adverse effects of U.S. tariffs. These efforts may help preserve economic momentum, though structural challenges persist.

Within the U.S., however, investor concerns are intensifying around a potential stagflationary scenario—characterised by decelerating growth and rising inflation. Several factors contribute to this outlook: the lingering impact of tariff conflicts, labour market disruptions linked to the DOGE initiative, tighter immigration enforcement, and emerging signs of weakness in private sector employment. whilst short-term sentiment has improved following the finalisation of Trump's tariff framework and the passage of the "One Big Beautiful Bill," which is expected to be marginally growth-supportive, inflationary pressures are becoming more entrenched.

Recent goods price data confirms that higher tariffs are translating into elevated consumer prices, reinforcing the stagflation narrative. Should this trend persist, the Federal Reserve may opt for a symbolic 25 basis point rate cut later in Q4, rather than in September, and hold at 4.00% to enter 2026. This would reflect a delicate balancing act between inflation containment and growth support.

World ex U.S. macro environment is expected to remain broadly supportive.

Intensifying concerns around stagflation within the U.S.

Fed may opt for a symbolic 25bp rate cut in Q4 (rather than in September).

Global GDP growth is projected to remain below its long-term trend, weighed down by persistent trade tensions and uneven recovery trajectories in key economies. Europe's monetary easing cycle appears to be nearing its conclusion, whilst China's policy stance remains accommodative. In the U.S., further monetary easing in Q4 remains a possibility, particularly if economic data deteriorates. Such measures could help sustain liquidity conditions and bolster investor confidence.

Corporate earnings are expected to remain relatively resilient, though downside risks are emerging. Trade-related disruptions and a potential slowdown in U.S. economic activity may prompt downward revisions to earnings forecasts. The broader investment landscape—particularly in the U.S.—could face valuation headwinds if macroeconomic uncertainty persists. The implementation of tariffs and other trade policies continues to cloud visibility around corporate profitability, especially in sectors with high exposure to global supply chains.

U.S. equity valuations remain elevated, with the S&P 500's forward price-to-earnings ratio hovering between 22 and 23 times. This level implies a premium relative to historical averages, and sustaining such valuations will require continued outperformance from leading firms—especially the Magnificent Seven and other high-growth technology names. Additionally, the 10-year Treasury yield must remain below 4.50% to support equity market valuations and investor sentiment.

The U.S. bond market remains unsettled, shaped by a combination of technical factors and structural pressures. GOJI advises investors to approach U.S. fixed income selectively, favouring entry points where risk premiums offer sufficient compensation—ideally at yields approaching 5.00% per annum. In contrast, non-U.S. bond markets have already experienced significant yield compression, limiting their attractiveness unless recessionary conditions intensify. Current valuations in global fixed income offer limited upside, and duration risk should be managed carefully.

It requires continued outperformance from Mag-7 and other high growth names to sustain this elevated valuation level; 10Y Treasury yield needs to stay below 4.50%.

Recent positioning data as of early August reveals a divergence in investor behaviour. Systematic strategies have continued to accumulate equities, with positioning nearing maximum overweight levels. These strategies, driven by momentum and volatility signals, remain aggressive despite valuation concerns.

Consolidated Equity Positioning



Source: Deutsche Bank Asset Allocation

Discretionary vs Systematic Equity Positioning



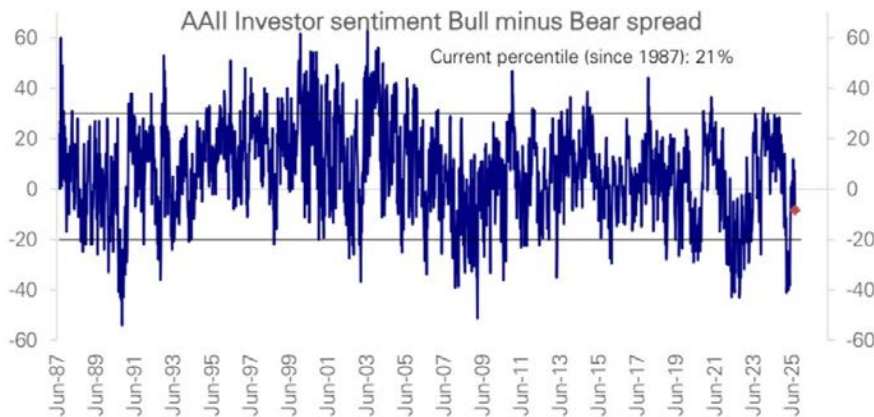
*Wtd average of Z-scores for positioning indicators, weights based on explanatory power in regression of equity performance on indicators

Source: Deutsche Bank Asset Allocation

Discretionary managers have turned cautious amidst high global equity valuations, Fed indecision in a stagflationary climate, and unclear tariff effects on corporate margins. With rising uncertainty over who bears these costs, active positioning has shifted to neutral, reflecting a defensive stance in response to mounting macroeconomic and policy concerns.

Systematic strategies are still adding to equities; Discretionary managers have turned cautious.

Investor bull minus bear spread



Data as of 6/8/2025

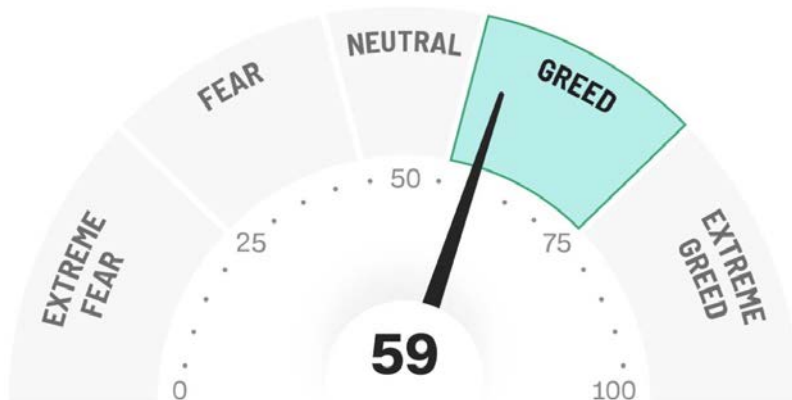
Source: Barron's, Haver Analytics, Deutsche Bank Asset Allocation

Investor sentiment surged to euphoric levels in July, buoyed by the rollback of certain tariffs and strong earnings from NVDA and other Magnificent Seven constituents. However, sentiment has since moderated. As of early August, short-term sentiment indicators have cooled and now sit closer to neutral.

Latest (early August) sentiment has cooled from the euphoric level in July.

Fear & Greed Index

- What emotion is driving the market now?



Source: CNN Business

Last update August 1 at 8:00:00 PM ET

The CNN Fear & Greed Index currently resides in the Neutral-to-Greed zone, a marked shift from the Extreme Fear readings observed in March and April during the height of tariff uncertainty. July's rally pushed sentiment into Extreme Greed territory, but the subsequent moderation reflects a more balanced investor outlook.

Short-term Technical Analysis

U.S. equity indices like the Dow Jones, Nasdaq, and S&P 500 continue to show strong long-term momentum, trading well above their 50- and 200-day moving averages. This bullish trend, sparked by Golden Cross formations in late 2023, has led the S&P 500 and Nasdaq to multiple record highs, fuelled by robust corporate buybacks and steady inflows from retail and systematic strategies. Systematic investors, guided by momentum and volatility signals, have maintained aggressive buying into August, nearing peak overweight levels and driving recent market strength. In contrast, discretionary managers have turned cautious, citing high valuations, macroeconomic uncertainty, and unclear effects of U.S. tariffs on earnings. Their neutral positioning reflects a more defensive approach amid growing concerns about sustainability.

S&P 500 Stock Price Index



Source: MarketWatch.com

The Federal Reserve's reluctance to pivot policy amidst stagflationary risks further complicates the investment landscape. As discretionary investors weigh valuation risks against policy inertia, the divergence in positioning underscores the importance of disciplined risk management and tactical flexibility in navigating short-term market dynamics. Overall, technical conditions remain favourable, but sentiment is increasingly mixed.

Technical conditions remain favourable, but sentiment is increasingly mixed.

The Way We See It

- Global Markets and Investment Thematics

At GOJI, our investment framework is built on a dual approach—balancing short-term tactical agility with long-term strategic discipline. We distinguish between tactical positioning (3–6 months) and strategic allocation (1–2 years), allowing us to navigate evolving market dynamics with precision.

Long-Term Risk-Neutral Strategy Rationale

Despite ongoing uncertainty surrounding U.S. trade policy under Trump's second term, we believe that both fundamental and quantitative investors have largely priced in tariff-related risks. Markets appear to be operating under a best-case scenario assumption, favouring pro-growth, pro-equity, and pro-digital asset policies. In this context, our long-term stance remains risk-neutral. We recommend a modest underweight in high-beta growth assets, given elevated valuations and volatility. Instead, we favour an overweight allocation to cash and high-quality, stable assets to preserve capital and maintain flexibility amid policy unpredictability.

Tactical positioning still moderately positive in Q3

In the near term, we maintain a moderately positive outlook for the September quarter. Although U.S. equity valuations remain stretched, continued buying interest from Systematic strategies, retail investors driven by FOMO, and selective discretionary flows could sustain the rally. Upward revisions in corporate earnings and a softening in tariff intensity further support this view. However, seasonal headwinds—particularly during August and September, which are historically thinly traded due to Western Hemisphere holidays—may introduce volatility.

Importantly, this tactical positioning is not predicated on a material improvement in U.S. economic fundamentals. As such, we advise this strategy only for investors with the ability to trade nimbly and manage short-term risk exposure. Our approach remains grounded in disciplined risk management and a clear-eyed view of macroeconomic and geopolitical realities.

GOJI's view:

- **TAA modestly positive in Q3;**
- **SAA risk-neutral (u/w high-beta growth; o/w cash and high-quality stable assets).**

Postscripts

Stagflation: What can we learn from the past?

The simple honest answer is: actually, not much.

U.S. stagflationary episodes were primarily triggered by energy price shocks in the 1970s–90s and housing market disruptions in 2007–08.

The following table outlines historical performance trends across equities, bond yields, and the U.S. dollar during these periods, offering insight into asset behaviour under stagflationary pressures.

Period	S&P 500 Performance (Nominal)	10-Year Treasury Yield Trend	U.S. Dollar Trend	Economic Context & Notes
1970s	+17% for the decade; real return $\approx$ -50%	Rose from ~6% to >10% by 1980	Depreciated sharply after gold standard ended	Oil shocks, high inflation (>10%), weak growth, rising unemployment
1980–82	Volatile; bear market in 1981–82	Peaked at ~15% in 1981, then declined	Stabilized and began strengthening post-Volcker	Fed raised rates to 21% to crush inflation; recession followed
1990–91	-6% in 1990, +26% in 1991	Fell from ~8.5% to ~7%	Mild depreciation, then recovery	Gulf War, oil spike, inflation ~6%, mild recession
2007–09	-37% in 2008, recovery began in 2009	Yields dropped sharply as Fed cut rates	Initially weak, then surged in late 2008	Financial crisis, inflation fears early on, then deflationary shock

Key takeaways:

- **1970s:** A textbook stagflation era—stocks and bonds both suffered in real terms, and the dollar lost purchasing power.
- **Early 1980s:** Volcker's aggressive rate hikes crushed inflation but triggered a recession; bond yields peaked, stocks bottomed.
- **Early 1990s:** A brief stagflation-like episode with oil-driven inflation and recession; less severe asset impact.
- **2007–09:** Not classic stagflation, but inflation fears preceded a deflationary collapse; dollar surged as a safe haven.

Historically, stagflationary periods—most notably in the 1970s and early 1980s—were triggered by sharp oil price shocks, which drove inflation and bond yields higher, ultimately leading to deep recessions. Corporate earnings deteriorated, and both equities and fixed income assets experienced significant price declines. In contrast, the 2007–08 episode stemmed from a housing market bubble and subsequent financial sector collapse, exacerbated by rate hikes and systemic failures.

Looking ahead, the anticipated stagflationary phase in 2025–26 is shaped by elevated tariffs on imported goods and restrictive domestic policies, including tighter immigration enforcement. These measures are expected to raise consumer prices over the next 6–12 months. While some view this as a transitory adjustment, others warn of lasting wage inflation driven by shifting expectations.

Unlike prior oil-driven stagflation, the current cycle is likely to be milder. Nevertheless, even moderate stagflation presents a policy challenge for the Federal Reserve, which must navigate the trade-off between persistent inflation and weakening growth. In this environment, investors should prepare for intermittent volatility across bond and equity markets. Tactical flexibility and a focus on quality assets will be essential as markets adjust to evolving macroeconomic conditions and policy responses.

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