GLOBAL EQUITY [THORNBURG INSIGHTS]

Mid-Year Global Equity Outlook: Diminishing U.S. Exceptionalism Leads to Non-U.S. Opportunities

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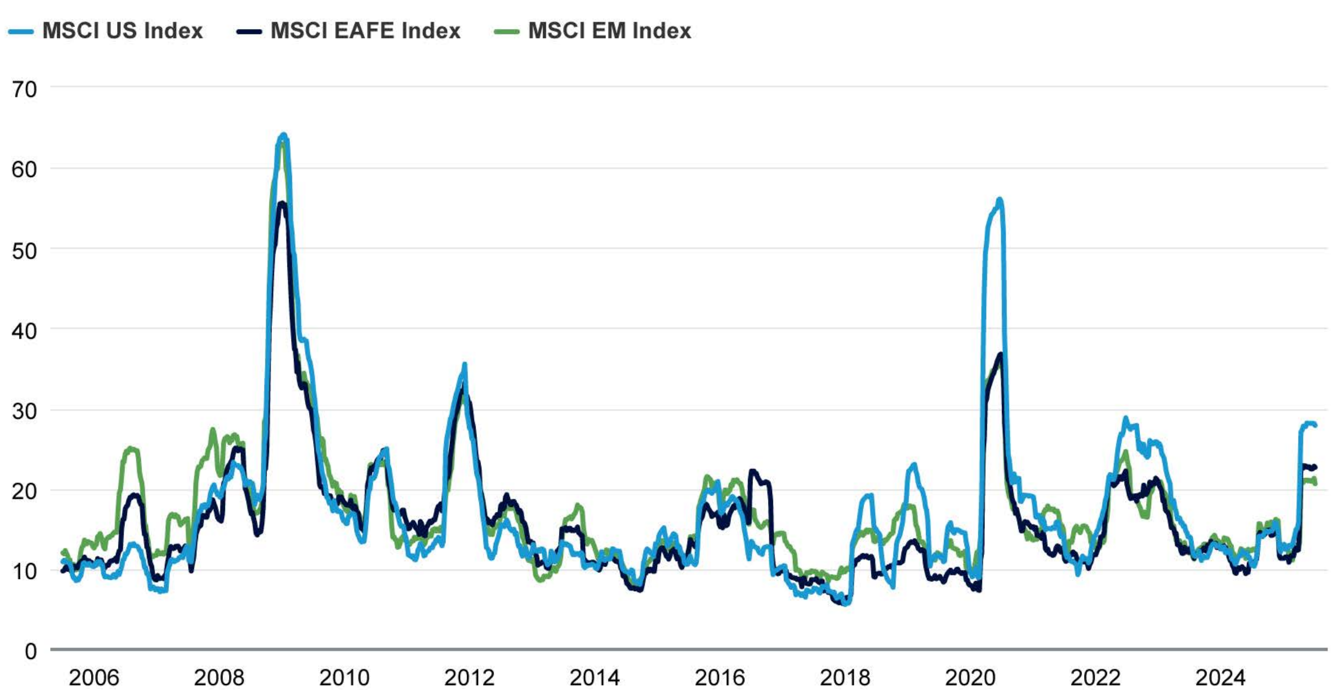
2025 has been full of surprises all over the world, which makes our thoughts at the beginning of the year, including opportunities and risks outside of the U.S. compared to the U.S., relative value opportunities across the globe, and AI's capital intensity, that much more relevant.

Liberation Day Volatility Spike

Volatility spiked in April, following the "Liberation Day" announcements from the Trump administration. Although this surge in volatility did not quite reach the levels seen when Russia invaded Ukraine, let alone the levels of COVID, the 2011-2012 U.S. debt ceiling stand-off, European debt crisis, or the financial crisis. The market action may have felt disorienting, but it was only moderately worse than many other historical scares and not as bad as prior "big ones."

Equity Indices' Rolling 90-Day Volatility



Source: Bloomberg

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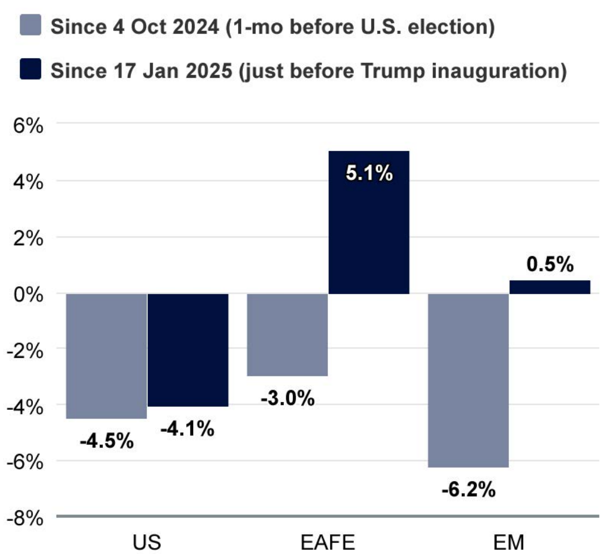
How Have Earnings Reacted?

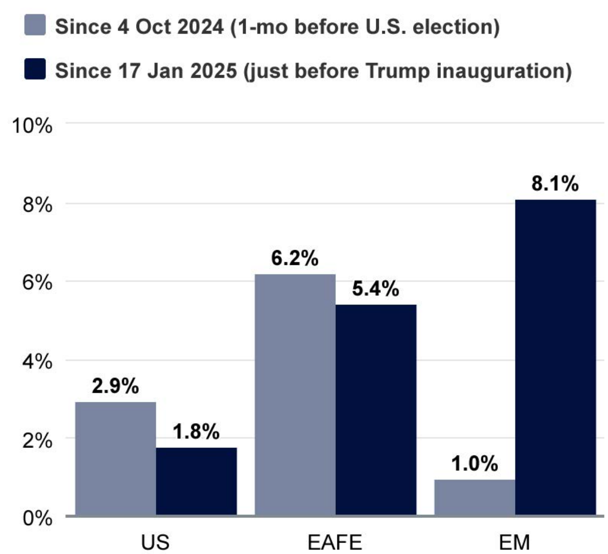
While volatility in price action was substantial, expectations for corporate fundamentals have actually been fairly steady. Through the end of June, consensus earnings estimates for major equity indices (also indicative of the health of corporate borrowers) are stable to down mid-single digits. Valuations have also barely budged, indicating investors' comfort with the growth outlook as well.

The following compares consensus expectations exiting June 2025 with expectations from two points in time: a month before last year's U.S. election, and just before Donald Trump was sworn in as President.

Change in EPS Outlook CY'26 EPS (Estimate)



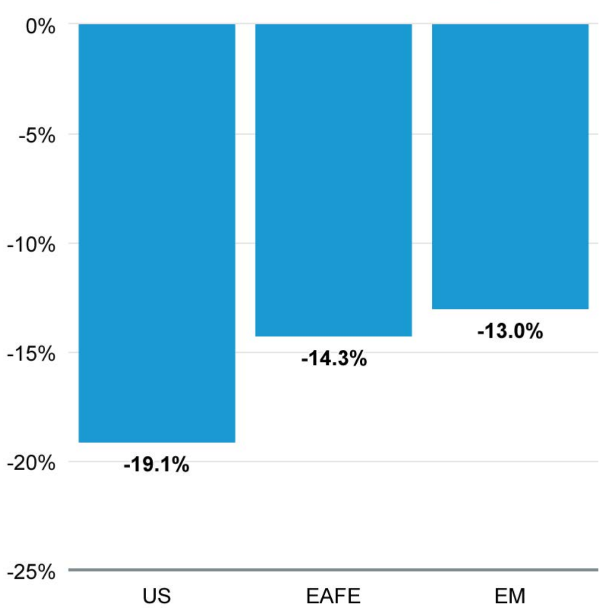
Change in Valuation: Estimated Fwd P/E Ratio



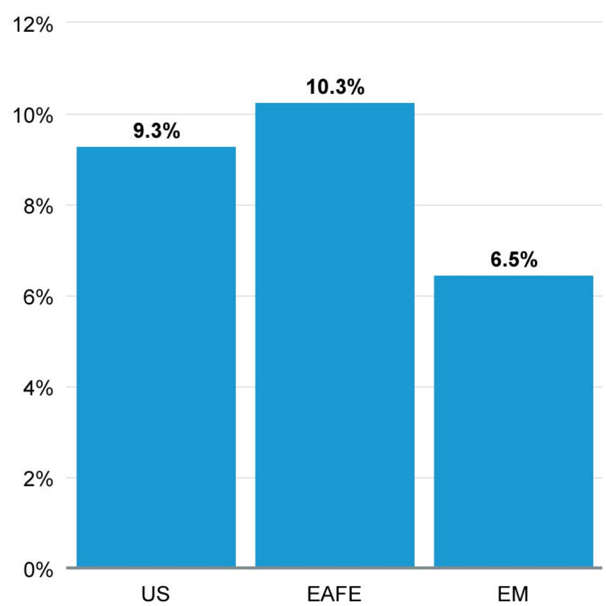
Source: Bloomberg

A notable takeaway is that, when thinking about prospective new tariff policies, investors have generally been more concerned about U.S. earnings power than a tariff squeeze on the rest of the world. Questions and concerns about the earnings outlook led U.S. equity markets to fall more after Liberation Day, and even in dollar terms, as other developed equity markets have been outpacing the U.S. both before and after tariff announcements.

USD Return from 1Q Peak to 2Q Trough



USD Return from Q3 2024 to Q2 2025



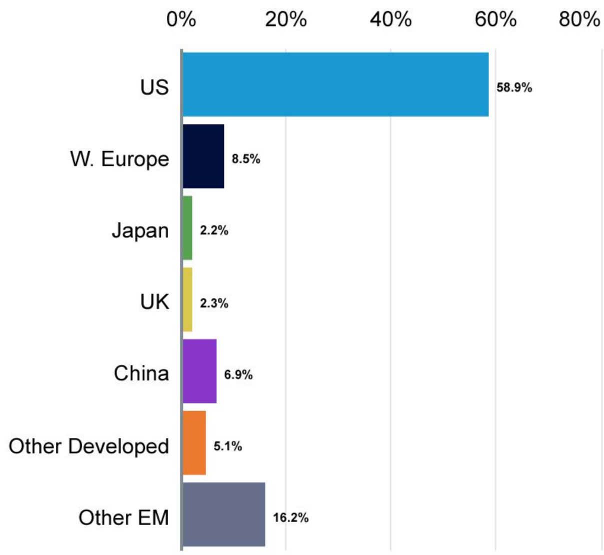
Source: Bloomberg

The Balance of U.S. vs. non-U.S. Equities

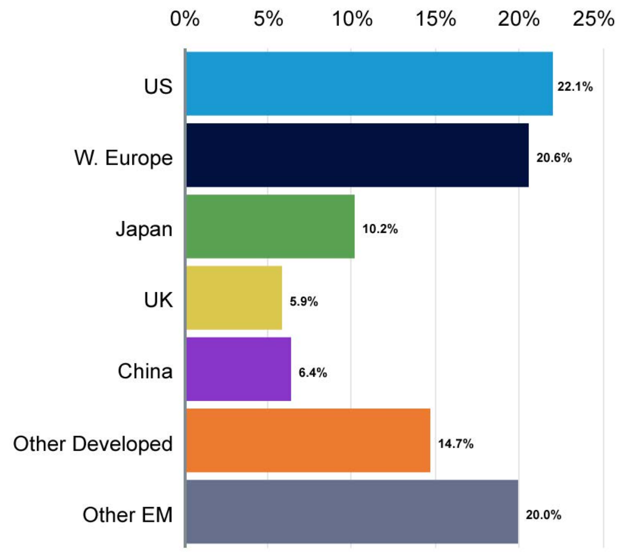
Global investors have been overallocated to the U.S. for a number of years, and foreign flows have helped support the U.S.' persistent valuation rerating over the last decade. But in a world of U.S. tariffs, investors are taking note of a different characteristic of non-U.S. companies; foreign businesses actually have limited dependence on the U.S.

We have entered a world where U.S. corporates' supply chains and U.S. consumers' spending power are being impacted more broadly and directly by U.S. tariffs compared to companies and consumers outside the U.S. This may mean that there is a higher predictability of foreign company earnings because a lower share of their business is tied to the U.S.

US Corporations' Revenue Exposure by End Market



ACWI ex-US Corporations' Revenue Exposure by End Market



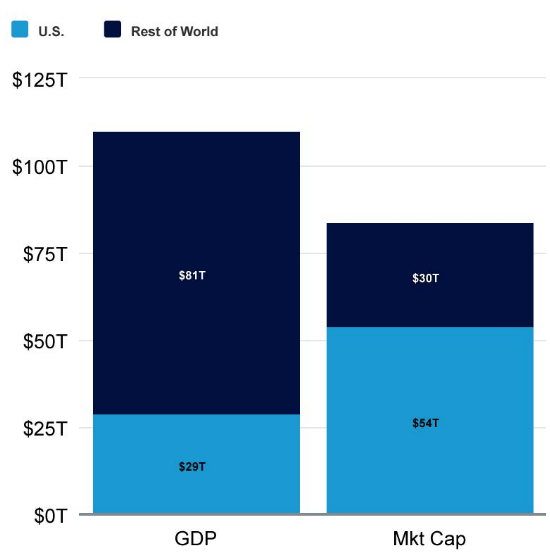
Source: Bloomberg

Investor sentiment is key to maintaining the substantial differential in valuations between the U.S. and the rest of the world. There is less certainty about "U.S. Exceptionalism" today than during the euphoric U.S. market environment late last year for the following reasons:

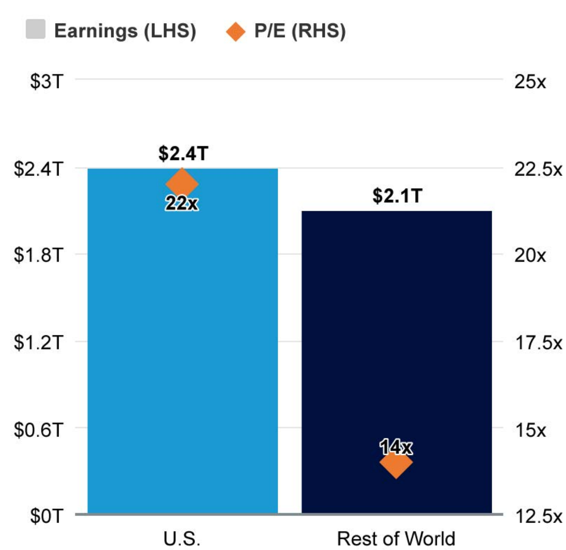
- The U.S. is about 26% of global GDP, but 64% of the global market cap.
- However, the U.S. accounts for approximately 54% of global earnings, mostly due to the higher profitability of the U.S. tech sector.
- Keep in mind that the statistics above are proportions of the total. Explained in another way, the rest of the world's GDP is three times bigger than the U.S. (3/4 vs. 1/4), but the U.S.' market cap is about twice the size of the rest of the world (2/3 vs. 1/3), as earnings are nearly the same.

Therefore, the main reason the U.S. market cap is so much bigger is simply valuation. Aggregate U.S. earnings are about 15% larger than the rest of the world. It trades at a 50%-plus valuation premium to the rest of the world, or a 25%-plus premium if equal-weighting all companies to reduce the Mag 7's impact on the U.S.

GDP & Market Cap



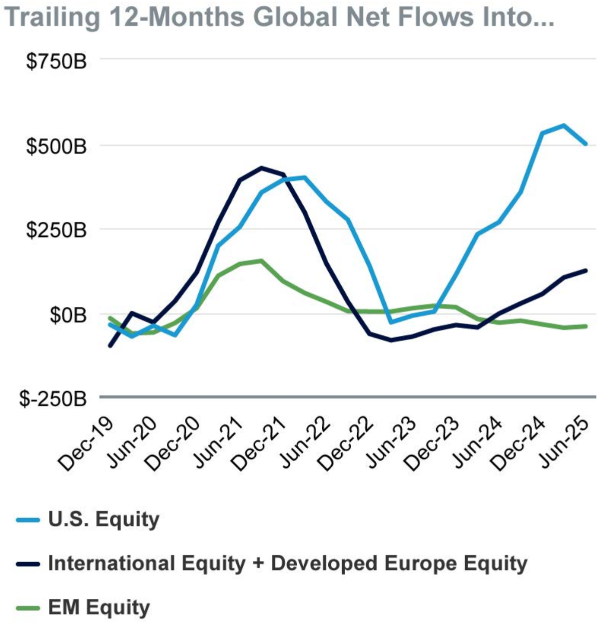
Earnings & P/E Ratio

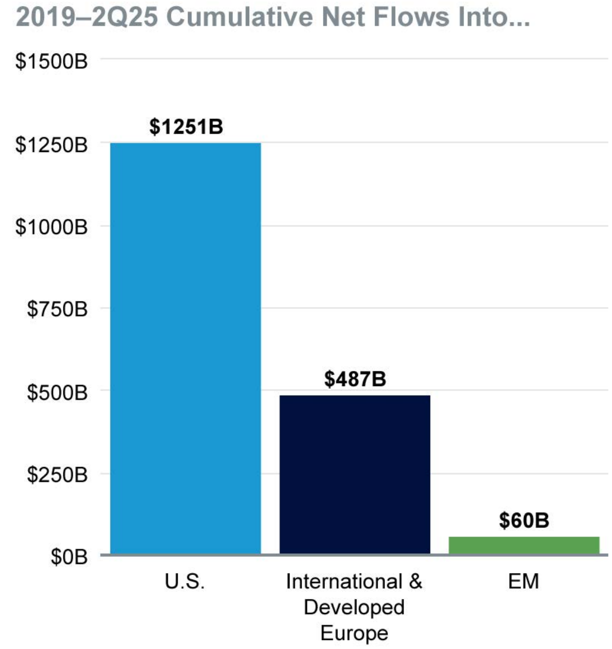


Source: Bloomberg

What we aren't declaring is that U.S. valuations are poised to collapse or that investors in U.S. equities are being senseless. But we are observing that from a relative value perspective, there are high-quality foreign companies with good outlooks that trade at lower valuations than their U.S. peers. The first half of 2025 has shown that as politics complicated the U.S. outlook, U.S.-based and non-U.S. investors have been comfortable shifting capital out of the U.S. and into global markets.

Could the mammoth inflows that have benefited U.S. valuations be reversing?





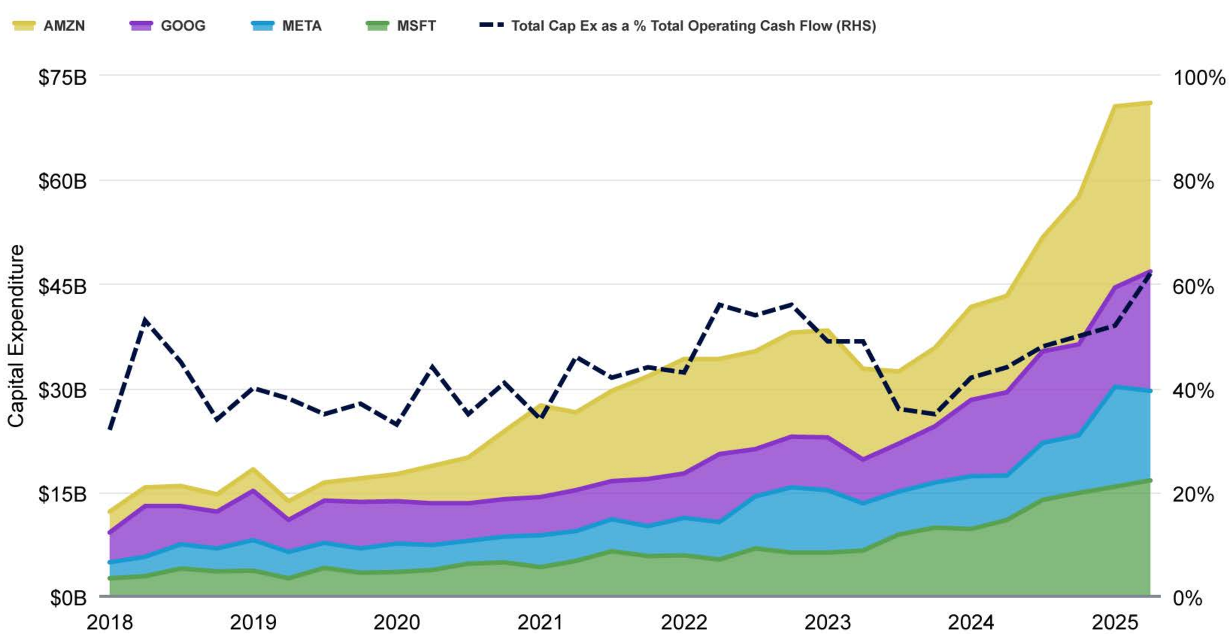
Source: Bloomberg

We're Still Talking About AI

It's still too early to tell if there was a paradigm shift in the artificial intelligence (AI) outlook in January when the Chinese company DeepSeek announced a new AI model that was clearly competitive with the top models in the U.S. However, beyond how "good" the model was, the real paradigm shift may have been focused on cost. DeepSeek created a design for building, training, and operating the model that has lower operating costs and requires lower capital expenditures (perhaps also less dependent on bleeding-edge chips.

This dynamic certainly matters for the Mag 7, and perhaps for the broader U.S. market. Big Tech's huge cash flow has supported the optics of, on average, solid U.S. corporate balance sheet health for many years. Big tech previously had low capital intensity, which supported big net cash balances and excess cash flow, creating the potential for buybacks and dividends. But since OpenAI first changed the world's perspective about how advanced generative AI has become, Big Tech has notably increased its capital expenditures on data centers and advanced GPU chips.

Quarterly Capital Expenditures Relative to Cash Flow



Source: Bloomberg

Whether DeepSeek is a long-term winner is less relevant than the way it opened the world's eyes to the fact that competitive advantage in AI may no longer be the same as was previously expected. Silicon Valley has been the clear leader of the global technology industry for decades, and it was expected to sustain this leadership with AI. But for non-US companies pursuing AI solutions or innovation, DeepSeek demonstrated that the barriers to entry are lower than previously believed.

The future "Masters of AI" are now more likely to be global, rather than only sitting in the Western United States. This may change the valuations applied to US tech leaders, or it may lead shareholders (or management teams) to question their allocation of capital and whether they should dial back on AI investments.

There is a complicated balance for identifying where value lays, and where investment opportunities offer asymmetric return potential. Among considerations for earning an appropriate real return:

- **U.S. Equities**: There is low compensation from the dividends, so confidence in both the duration of earnings growth and a low equity risk premium (supporting elevated valuations) is required.
- **International Equities**: Dividend yields are higher than in U.S. equities, but not competitive with yields in the bond market today. However, the potential earnings growth has improved, and there is an opportunity from valuation or a further strength in non-currencies**.**

Final Thoughts

All in, there's no "easy trade" today. But the U.S. environment is at a trickier point, relative to the rest of the world, than it has been in quite some time. This makes it easier for equity investors to consider reducing their U.S. allocations to diversify into other geographies. Moreover, foreigners now own close to 20% of the US equity market. It's not just whether Americans want to invest more internationally, but the relative value outside the U.S. may also attract global investors and could trim U.S. holdings to fund new investments in other markets.

OUTLOOK [THORNBURG INSIGHTS]

Mid-Year Fixed Income Outlook: Uncertainty Yields Tight Credit Spreads

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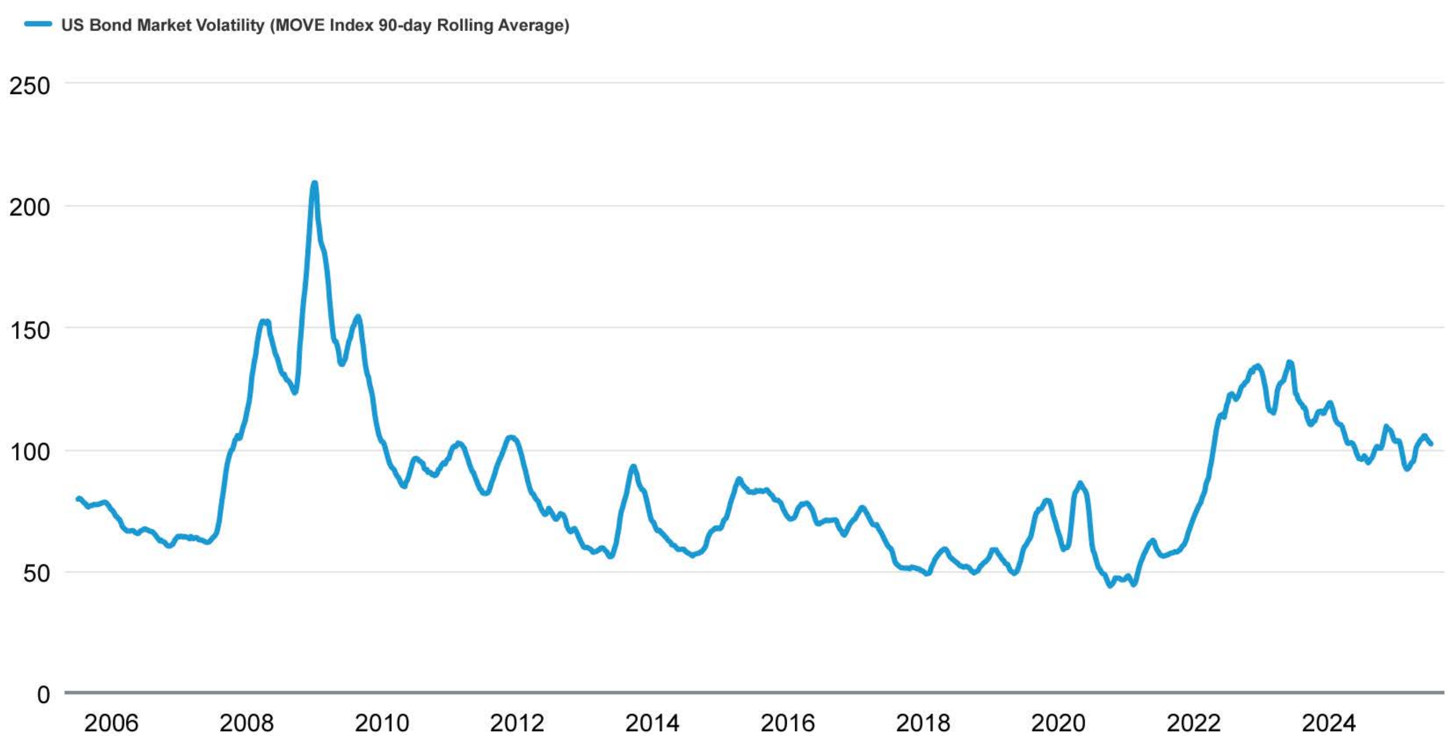
Our observations at the beginning of the year included several fixed income themes that investors have had to navigate, including the impact of politics on economics and markets, and balancing the search for yield against being fairly compensated for risk.

As we look to the second half of the year and beyond, these themes are still relevant. We continue to maintain a comprehensive market mosaic within the foundation of an active global investing perspective.

April Volatility

Fixed income markets dislocated in April, but primarily due to capital flows rather than a credit event. This was nothing like Silicon Valley Bank's insolvency, and high interest rates haven't yet created any surprises in mortgages or corporate bonds. The MOVE Index measures U.S. bond market volatility, and when looking at its 90-day rolling average, we actually see that its volatility has been slowly trending down since it spiked with the Fed's aggressive interest rate hikes in 2022.

U.S. Bond Market Volatility



Source: Bloomberg

Will Investors Talk About the Government's Fiscal Deficits and Debt Outstanding?

While the developing AI story reflects a debate about *corporate* capital allocation, we also seem to be at the beginning of an actual debate about government capital allocation.

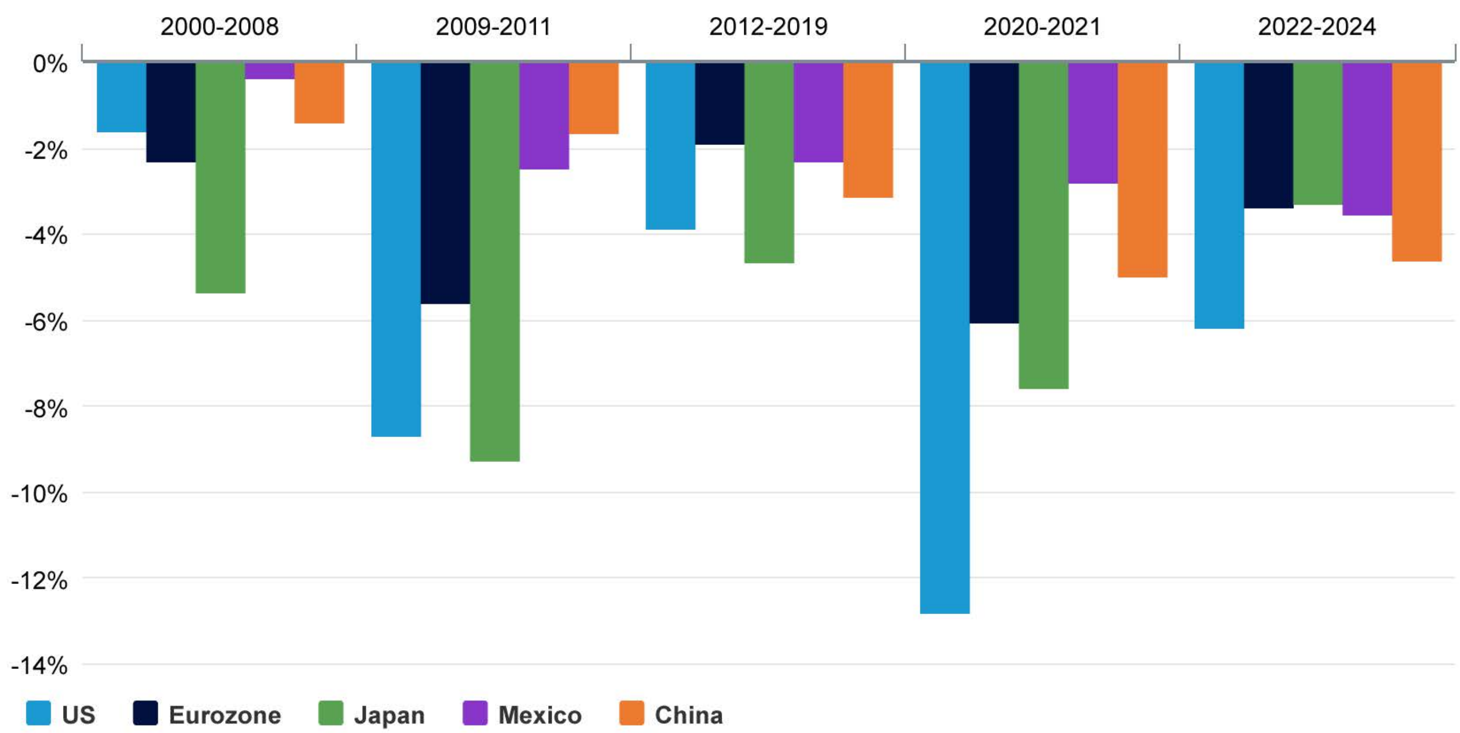
GDP = Consumption +/- Net Exports/Imports + Investment + Government Spending. It is essential to remember that although net exports increase GDP while net imports detract from GDP, the debt incurred for consumption or government spending is not incorporated into GDP calculations.

If nominal GDP grows faster than the fiscal deficit, a country's debt/GDP ratio declines (because the denominator grows faster than the numerator). If a country has high economic growth, but an even larger fiscal deficit, its debt/GDP ratio increases. But the fact that borrowing was required to generate the GDP growth is not considered in the GDP calculation itself.

The U.S. has maintained notably strong growth since the financial crisis, and while emerging from COVID, particularly in comparison to other developed countries. Many countries have been more conservative than the U.S. over the last decade when it comes to deficit spending. Particularly in Europe and some emerging markets, this fiscal caution limited GDP growth because there was far less stimulus (lower taxes or higher spending) compared to the U.S.

Consider the following perspective on why the U.S. had exceptionally strong GDP growth compared to other parts of the world, before considering differences in consumer borrowing trends. The U.S. government borrowed 1-3% more of GDP than other countries, which allowed its economy to grow several points faster.

Average Fiscal Deficit

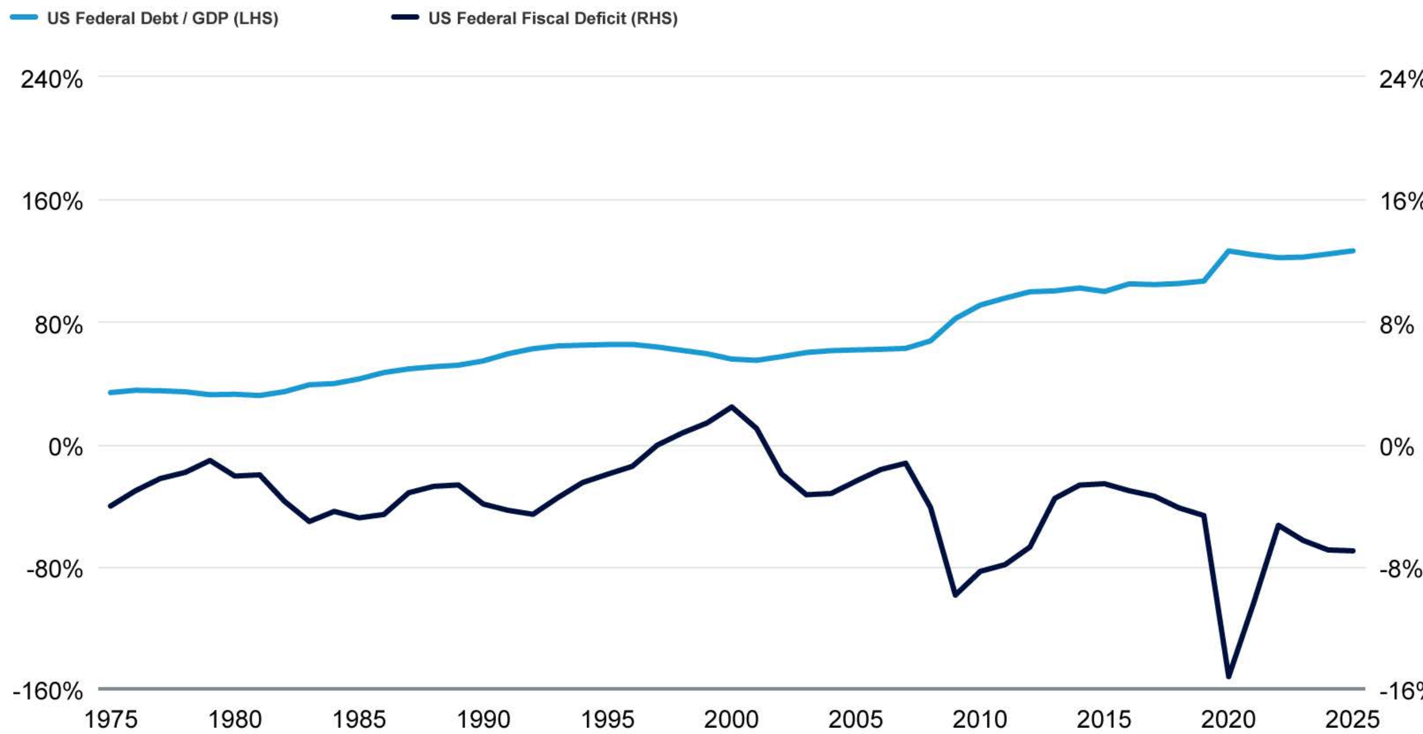


Source: Bloomberg

For the past 25 years, regardless of who controlled Washington, DC, the U.S. government generally reduced federal revenue (taxes) while still increasing spending. The just-passed "One Big Beautiful Bill Act" (OBBBA) also reduces taxes, but reduces spending as well. Supporters believe the tax reductions (and other regulatory changes) will enhance growth, while detractors argue the economic benefits do not outweigh the fiscal costs.

The U.S. has been unable to grow its way out of fiscal challenges for the last 15-plus years, but it will take a year or more to begin to see the fiscal and economic impact of the OBBBA, and even longer to have enough information to pass final judgment. For example, we know that deficits widened during the first Trump administration, but the COVID pandemic complicated a full assessment of its benefits and costs. Unfortunately, no single policy is a panacea, and it is highly unlikely that there will be a bill that solves it all.

Cause and Effect: The US Fiscal Deficit and Debt



Source: Bloomberg

However, it's a positive development that deficit complexities are no longer hiding in the shadows and that people will continue talking openly about the unsustainability of the current U.S. fiscal situation. Essentially, the U.S. has two main levers to improve the situation: reduce federal spending or raise taxes. Tax increases are now off the table, but for the first time in many years, federal spending could be restrictive for years to come.

Restrictive U.S. policies contrast with the transition taking place in other major economies. Outside the U.S., countries with more fiscal dry powder (such as Germany at 63% debt/GDP, the overall Eurozone at 87% debt/GDP, or Canada and Mexico at about 100% and below 60%, respectively) are now incorporating more stimulative policies to accelerate the transformation of their economies in relation to the realignment in global trade, defense, energy security, and modernizing infrastructure.

A "Normalization" in the Global Cost of Capital

Because the U.S. has been a key reserve currency for almost 80 years, since the end of World War II, the dollar and interest rates have been allowed to defy the laws of economics. Other countries with "twin deficits" (fiscal deficits and trade deficits) have seen their currency fall and/or global investors demand higher interest rates ("bond vigilantes"). But U.S. consumers and corporates have benefited from what's been termed the dollar's *exorbitant privilege*.

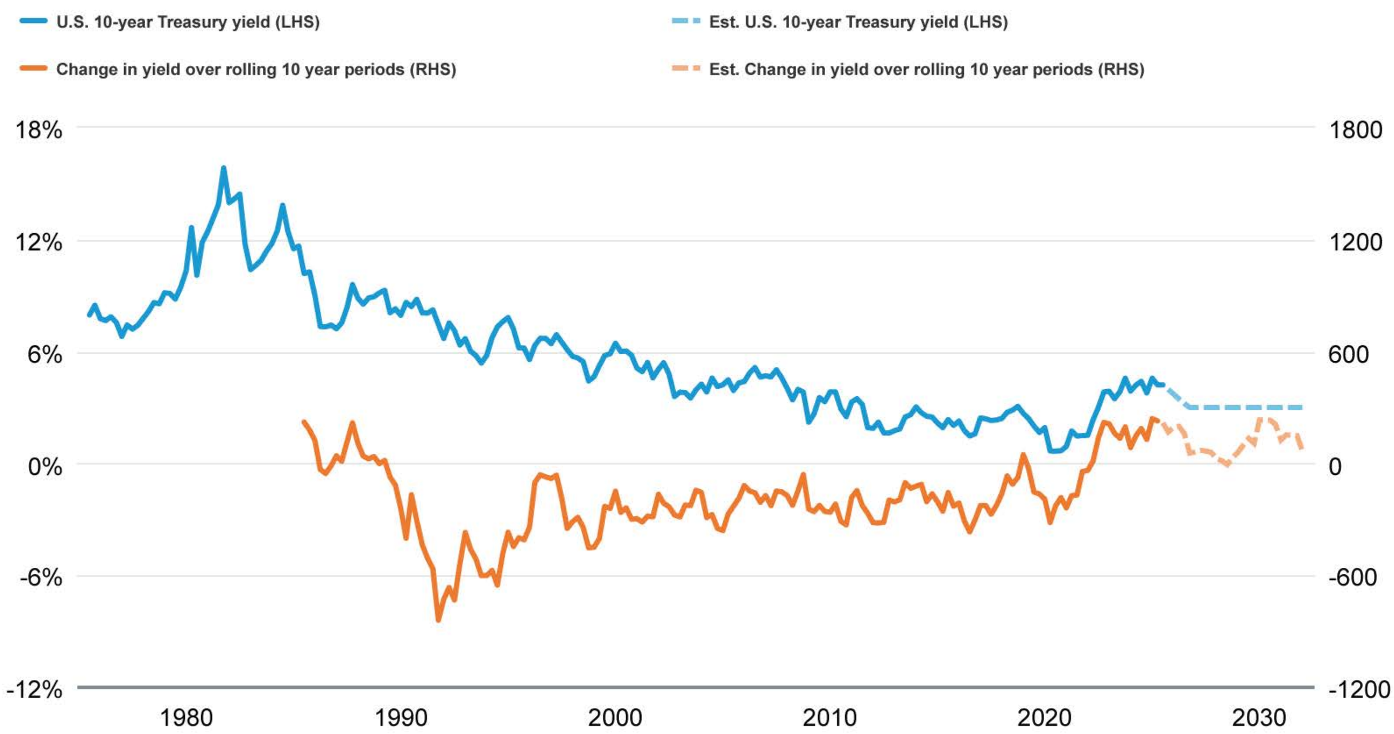
Two trends are now reversing: First, the Federal Reserve has intervened in various ways since the financial crisis to suppress interest rates, but it now seems to have a lower willingness to do so. Second, as the U.S. seeks to realign trade relationships, other countries are rethinking their relationship with the dollar as a reserve currency. Without reasonably coordinated global central bank policies that protect the dollar and/or drive flows into US Treasuries, the U.S. government may be moving into an environment where it must also pay rates that reflect the actual risks of the U.S. fiscal situation.

A higher yield environment for US Treasuries, often termed the "risk-free" benchmark, makes it important for investors to consider relative value across global asset classes. Higher interest expense for corporates can reduce net profits or dividend payouts, or higher interest expense can strain corporates' and consumers' ability to repay what they borrow.

For nearly 40 years, the yield fell on US 10-year Treasuries. For borrowers looking to refinance, the risk-free benchmark was almost always lower than it was when they'd issued the original debt. For this period, refinancing could be counted on to free up cash flow. But now, it appears we're in a world where borrowers will consistently be borrowing new money with a higher underlying risk-free rate than their prior debt, reducing the cash flow available after paying the interest.

The following chart illustrates the change in this long-term trend. The orange line is the US 10-Year Treasury Yield since 1975, which has fallen from 8% in 1975 to the mid-4% range today. Looking forward, we make a ballpark assumption (dotted line) that inflation will remain at a comfortable level for the Federal Reserve, leading to rate cuts which allow the 10-Year Yield to fall to 3% by late 2026. The green line shows the rolling change in yield over 10-year periods, and for decades, the green line was in negative territory (falling rates compared to the prior decade). But now, the dotted green line reflects that, even if the 10-Year Treasury Yield falls to 3% in future years, borrowers will still be paying higher rates than they were 10 years earlier.

Indicative Refinancing Impact from Changing “Risk Free” Rates

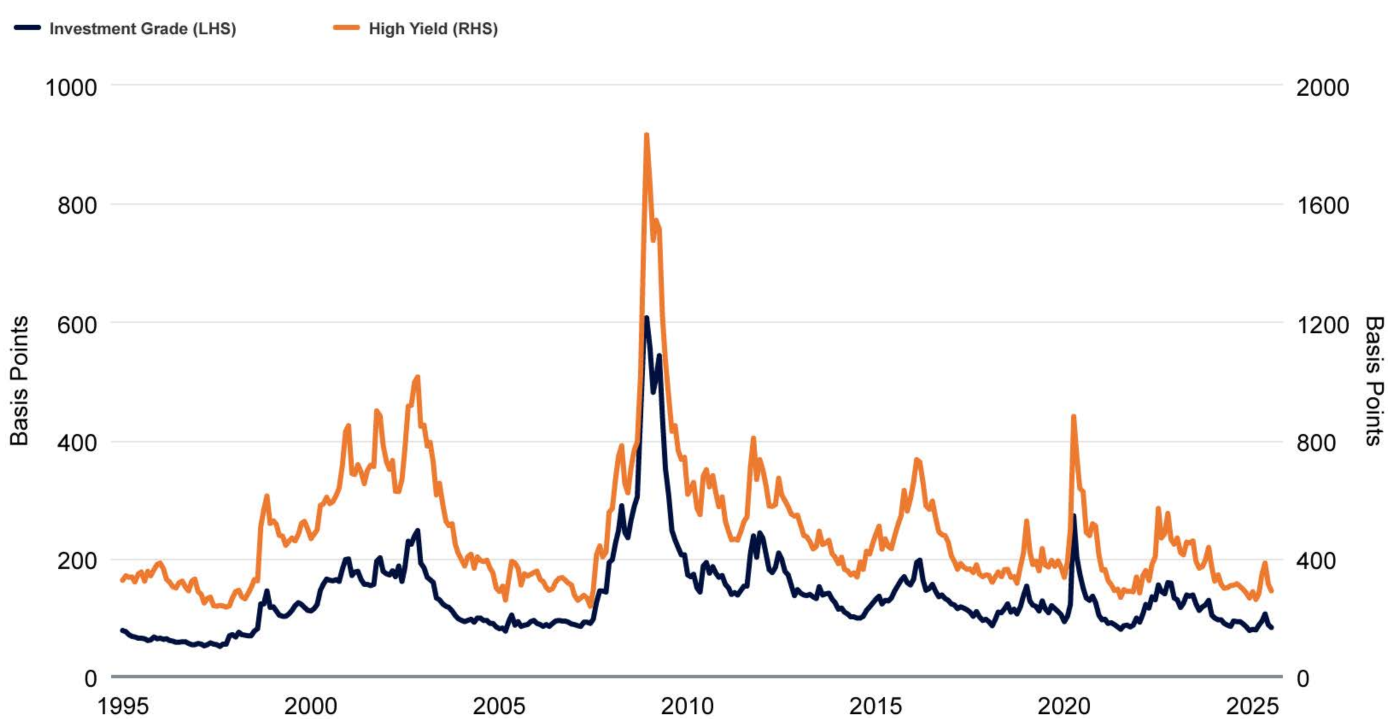


Source: Bloomberg

Tracking Credit Spreads

Beyond rising sovereign yields, we’ll need to wait to see if credit spreads remain tight relative to history or widen to reflect a less predictable environment. After briefly widening in April, both investment grade and high yield spreads have come back in and are near “all-time tight” levels.

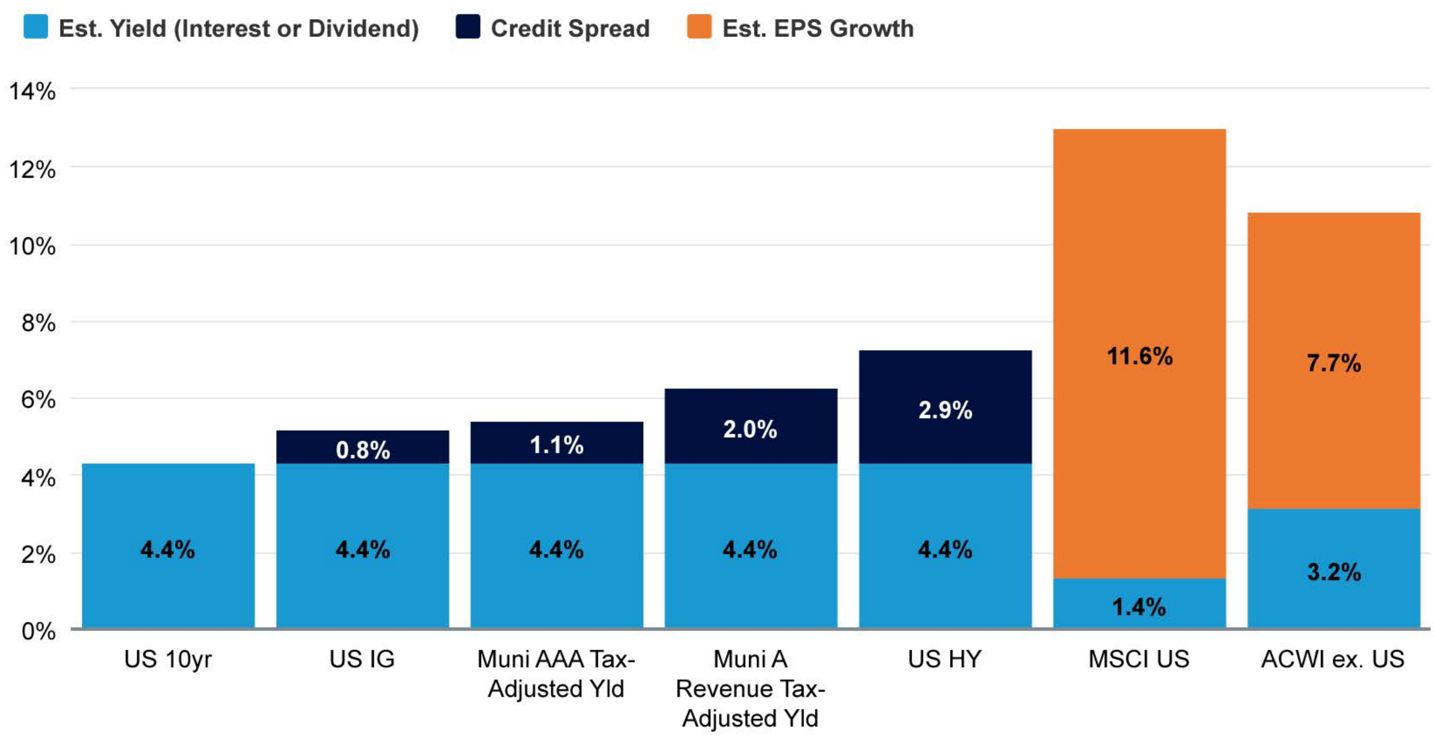
US Corporate Option-Adjusted Credit Spreads



Source: Bloomberg

Risk premia may indicate investor complacency with corporate risks, or perhaps there is an undercurrent of debate about whether governments or corporates are safer credits.

Consensus Estimates for Total Return



Source: Bloomberg

There is a complicated balance for identifying where value lays, and where investment opportunities offer asymmetric return potential. Among considerations for earning an appropriate real return:

- **US Treasuries**: Evidence of fiscal discipline would do much to bolster support and sentiment for Treasuries. Inflation remains higher than desirable, but it's also true that real yields are more attractive than they have been since the mid-2000s. It remains important to track the inflationary impact from tariffs, a weakening dollar, and immigration's impact on labor supply and wages.
- **US Corporate Bonds**: Credit spreads are notably tighter than average. Many highlight that "all-in yields" are attractive (since Treasuries' real yields have improved), but it remains to be seen how spreads might react to lower "risk-free" rates or renewed macro volatility.
- **US Municipal Bonds**: Heavy issuance and seasonality have created opportunities in the tax-exempt space, particularly for those in higher tax brackets. While the OBBBA provides near-term visibility into tax rates, we suspect that over time, individual tax rates are more likely to increase than decrease, given the fiscal picture. Occasional uncertainty about a reversal in the bonds' tax-exempt status could also create buying opportunities.

Final Thoughts

For fixed income investors, the compensation for leaning into risk is not clear, particularly with the variety of uncertain outcomes ahead. Conservative positioning, given the best real yields in two decades, is a reasonable way to maintain dry powder should we see another dislocation like April.

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