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The US Equity Rotation: Where Have All the Good Vibes Gone?

A turbulent landscape shaped by political shifts, economic changes, and tech-sector challenges has the US equity market navigating uncertainty in 2025.

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Key Points

- Investor sentiment in the US stock market has shifted significantly in 2025, reflecting broader economic and political uncertainties.
- Market rotation has favored value stocks and defensive sectors, with notable outperformance in Europe and China.
- Investors may want to focus on diversification, reassess fixed-income exposure, and explore sector and regional opportunities.

After riding into 2025 on a wave of election euphoria following President Donald Trump's win, the US stock market has struggled to find its footing so far this year. US yields have fallen, the US dollar has weakened, and there have been signs of a shift in market leadership. It's a good time to review what's changed and what it might mean for investors.

In my view, three things have changed since the election:

US politics – We're seeing a different Trump in his second term. The general assumption at the beginning of the year was that he would talk big but act in a more measured way. Tariffs, federal employee firings, and DOGE cost cutting all point to Trump's confidence that he has a mandate to take a more radical approach now, while more market-friendly policies such as deregulation and tax cuts may come later.

The US economy – There are early indications the economy is softening. Consumer sentiment has taken a hit on the employment and inflationary front, hinting at a less favorable growth/inflation backdrop. First-quarter forecasts for real GDP growth are being revised from positive to negative, and the US 10-year Treasury is now below 4.25%. Hard data on employment, housing, and inflation will be important to track to determine the significance of the January decline in retail sales data—the largest such slip in nearly two years.

Artificial intelligence – The mega-cap tech companies are still exceptional, but there has been more differentiation in their performance recently. Since DeepSeek disrupted the market in January, these companies have faced a growing number of questions about their $50 billion-plus annual capital expenditures (capex).[1] If competitors can perform the same functions comparably and cheaper, will that capex generate a sufficient return on investment?

One thing that hasn't changed is the Federal Reserve's (Fed) reaction function. Sticky inflation turned the narrative early in the year to a more hawkish Fed with rate cuts almost completely priced out of the market. Today, about three cuts are priced in—a response to weaker sentiment and consumer spending. If inflation declines toward the Fed's target of 2%, I expect the Fed to meet the market's expectation of more cuts. Also, US equities are still expensive relative to other regions, at 22 times 12-month forward earnings.[2]

How Has the Stock Market Responded?

Several market developments are top of mind:

Rotation of a different sort – The rotation within and beyond the US has been in full swing, with value outperforming growth and regional outperformance outside the US. However, this rotation has been somewhat unusual, given that small-cap stocks haven't benefited, while defensive sectors, such as healthcare and consumer staples, have. I suspect that allocators are justifiably building some defensive exposure into their portfolios with sectors and duration.[3]

Companies feeling the effects of tariff plans – Tariffs are a negative for US growth and inflation, and many industries rely on goods from our largest trading partners. Currency depreciation could offset higher prices for US consumers and manufacturers, but that won't work if countries retaliate with their own tariffs on US goods.

Europe's gains – Europe's recent outperformance has been driven by extreme negative sentiment, cheap valuations, hopes of an end to the Ukraine-Russia war, and some encouraging signs of the need for more fiscal spending. With the ceasefire now less certain and signs that Russia could get more concessions than Ukraine, I don't expect the European rally to last long given higher valuations driven by multiples rather than earnings.

China's comeback – China, another cheap equity market, is enjoying a resurgence as the property-market slump shows signs of stabilizing, President Xi Jinping's stance toward technology companies has become more supportive, and the potential for fiscal stimulus has increased in the face of higher US tariffs.

Investment Implications

Here are four things investors may want to consider:

- **Focusing on diversification** – The European rally may have further to go in the short term, but I think a lot has been priced in as valuations have risen over the past two months. Still, it may be a good reminder not to stray too far from a diversified portfolio with both US and international exposures. Diversification may also help tamp down volatility in a politically uncertain environment.
- **Reassessing fixed-income exposure** – The recent rally in the 10-year US Treasury is a good reminder that bonds can play a unique role in portfolios, potentially offsetting equity underperformance. Gold could be another possible fixed-income enhancer in this environment.
- **Investigating sector and regional opportunities** – With the rerating of many European sectors, including financials, industrials and healthcare, it may be time to consider US sectors that have lagged, such as IT, communication services, and consumer discretionary. In addition, Japan has structural positives that the market has underappreciated recently amid concerns about interest-rate hikes by the Bank of Japan.
- **Avoid writing off emerging markets** – If the US dollar continues to weaken, emerging-market (EM) currencies and equities may be primed for upside, especially with the rally in China providing a better backdrop for EM performance.

Talk to your financial professional about how to position your portfolio amid a changing economic landscape.

[1] Capital expenditures are funds used by a company to acquire, upgrade, and maintain physical assets such as property, plants, buildings, technology, or equipment. Capital expenditures are often used to undertake new projects or investments by a company.

[2] 12-month forward earnings refer to the projected earnings of a company over the next 12 months. This estimate is typically based on analysts' forecasts and is used by investors to gauge a company's future profitability. It's a key metric in financial analysis, often used to calculate valuation ratios like the forward price-to-earnings ratio.

[3] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

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Diversification does not ensure a profit or protect against a loss in a declining market.

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