Goldman Sachs Exchanges

Mid-year outlook: diversify and hedge

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Allison Nathan: What will the second half of the year bring for markets, and how should investors position now? I'm Allison Nathan, and this is Goldman Sachs Exchanges. I'm joined once again by Christian Mueller-Glissman, who heads Asset Allocation Research in Goldman Sachs Research, and by Alexandra Wilson-Elizondo, co-chief investment officer of the Multi-Asset Solutions business in Goldman Sachs Asset Management.

For a change, I am in London this week. And Christian and I are both in the London office, and Alexandra is joining from our New York studio. This has become a bi-annual event and I’m looking forward to our conversation.

Christian Mueller-Glissman: Yeah, great to have you in London.

Alexandra Wilson-Elizondo: Thanks so much for having us.

Allison Nathan: So, let's get started. Christian and Alexandra, when we last spoke in January, you both emphasized that investors should really be thinking about diversifying away from the mega cap US tech companies that everyone was so focused on into different stocks, different assets, even different geographies, and that's turned out to be a pretty good strategy if you look back to the first half of the year. But there's been a lot of unexpected shifts in terms of US policy, in terms of the economy. And given those unexpected shifts, what has surprised you most about the market reaction to them? Christian, maybe you can kick us off.

Christian Mueller-Glissman: I think you're absolutely right. There's two value-adds that we can bring as asset allocators to the portfolio, either market timing or diversification. And I think diversification has worked really, really well, as you said, but market timing was very tough. And what really surprised me is the speed of some of those moves.

I think we clearly have seen surprising policy shifts. There's no doubt about that. We even have geopolitical risks that have entered the picture in the last few days and weeks. But I think really the speed of some of the moves we've seen have been absolutely mind boggling in terms of the VIX, kind of, spiking, equities correcting very sharply, and it's just the reflection of this very unprecedented type tariff shock that we saw. So that surprised a bit.

I think the direction, I think we don't disagree, I think was very clear that it's negative. But then you could also argue, wait a second, we still have the tariffs uncertainty and shock and markets are back to the all-time high. So there's a surprise in terms of both how far we and how fast we've come down but also how fast we've recovered.

Allison Nathan: Alexandra, do you agree?

Alexandra Wilson-Elizondo: Yeah, I think to your earlier point, both Christian and I were not surprised by the volatility, just given that there was such a high level of execution risk around the economic policy by the administration. But what's really surprised us has been this rare convergence of structural, geopolitical, and macro tailwinds that have driven ultimately some of the market behavior that one wouldn't expect in a drawdown.

So, the two places I would draw attention to are the safe haven status of the US dollar, in particular how it's not performed with its rate beta or the level of rate divergence across the globe. And the second was how boon market actually performed as a safe haven status. And just given the level of yields and lack of liquidity, the fact that it trades 10% of what the US treasury market does, we would say that's unsustainable but nevertheless quite noteworthy and interesting.

Allison Nathan: Yeah, I mean, in general, we have had a year where equities, dollar, and bonds sold off together, which, as you just noted, Alexandra, that's very unusual.

Christian, do you have thoughts about that convergence as well in terms of these moves?

Christian Mueller-Glissman: Yeah, I think certainly we've seen periods where equities and bonds have sold off together, like 2022. And coming into the year, we did highlight that equity-bond correlations are not back to the negative levels that we have been accustomed to pre-COVID. And we did highlight you want to think about broader safe haven diversifications.

We had obviously some early fiscal concerns. We had periods of bear steepening in the yield curve, so we knew that we are not completely at equilibrium with regards to longer-dated bond yields. But what is a new factor, as Alexandra mentioned, is of course the way the dollar is behaving. And I think it puts into focus really a major portfolio construction problem that I think we've already had on the table before Liberation Day, which is US asset dominance in portfolios.

This whole idea of diversification coming into the year was not necessarily motivated by the dollar, but the dollar puts even more pressure with regards to rethinking US asset dominance in investors' minds. So, the way I think about it is the following. If you think about the portfolio risk contribution of FX in a global multi-asset portfolio, which essentially is for European investors, for example, like, in the last few years that would have been pretty small. You would look at single-digit type contributions to portfolio risk coming from FX. And that's gone up to 20-25%, so nearly a quarter of a European investor's risk is driven by FX right now in a multi-asset portfolio.

And I think that the reasons for that are exactly what you mentioned. Two things. The dollar has obviously been more volatile and has shifted quite sharply but, in particular, in risk off. So it has become more correlated with equities, and that needs to be hedged and be thought about because you could argue a lot of investors are not being paid to take that FX risk and are not feeling comfortable with that. They are trying to harvest risk premia in the transition asset classes.

And to your question on what has driven that, it's very much related to a combination of policies that make people rethink their allocations to the US, so there's a capital flow dynamic. There is a lot of uncertainty with regards to stagflation risk coming from the tariffs. And there's an element of the fiscal risk where I think we have the big, beautiful bill that's looking to pass through the House and

Senate. And the market is quite worried about what that actually means for stagflation risk, for the supply of bonds, etc.

Allison Nathan: Alexandra, if you think about these different factors that Christian just laid out, we are in tariff limbo, we have fiscal legislation running through Congress now that investors are generally concerned about. Ultimately, how is that impacting how you're viewing the macro backdrop at this point?

Alexandra Wilson-Elizondo: So our expectation is that the economy is going to cool without contracting. And in fact, we've seen actually somewhat of a Goldilocks scenario recently where you have GDP forecasts moving upwards and inflation data coming through much cooler than anyone had anticipated. And against that backdrop, we do expect the Fed to stay on hold and to really adopt a wait-and-see approach, which is appropriate in our minds, just given that we're operating in these 90-day increments with very fluid policy.

But it's actually been quite resilient. And one of the great debates in the market has been who's going to win between soft data and hard data? And in fact, with the marginal piece of information, you're starting to see sentiment and soft data come and hard data actually pretty much proving resilient. Yes, there's some cracks under the hood. Pretty robust still considering all of the different factors that you mentioned. A cooler economy but one that's still chugging along.

Allison Nathan: And so Christian, if you think about the forward from here, we've talked about the fact that US stocks, tremendous volatility to the downside, tremendous volatility to the upside. So, what does the opportunity set look like? If we have a cooling economy, what does that opportunity set look like at this point? Because by the way, also, valuations are still quite elevated in the aftermath of all this volatility.

Christian Mueller-Glissman: Yeah, no, I think exactly right. It's a tougher climb from here because, on the recovery from the liberation drawdown, you had sentiment and positioning being very low. Our risk appetite indicator fell to the -2 level, the very famous level which gives you a signal that you might be oversold. And you had a bit of relief on the valuation question, exactly right, coming into the year. We were, as in recent years, we were a bit worried about valuations and market concentration on the most highly valued stocks, the Magnificent Seven. We discussed that last time. And you had a bit of relief there.

You remember, like, you had the DeepSeek-related drawdown which led to a bit of valuation relief, and then obviously the Liberation Day. But all of those issues are a bit back on the table. In May, the Magnificent Seven have led the market higher. And to be fair, driven by fundamentals. I think they had good earnings, and I think they'll still keep delivering.

So in summary, to answer your question, the business cycle is getting a bit more challenging. I think we're dealing with slowing growth with possibly a bit of upward pressure of inflation. I wouldn't call it stagflation. It's more stagflationary momentum, as Alexandra said, from a relatively good level of growth relative to inflation. I think we had a bit of this inverse Goldilocks scenario. I agree on that. So you're moderating that.

And I think, so the opportunities will be linked to exposure in areas that are not exposed to that. And sadly, you could argue the Magnificent Seven are kind of one of those areas, so it's not completely irrational that a market maybe goes a bit towards those areas. They have structural growth. They have delivered good momentum on their corporate fundamentals.

And you might remember, we discussed this before, but ROE -- return on equities -- one of the most important variables we are watching for the S&P 500. And most of the ROE driven by the Magnificent Seven, especially the high levels, and every month this year the ROE has actually ticked up on the S&P 500. And that supports especially for these highly valued, highly profitable companies, the current valuations. And as long as they keep that momentum, I think that can be part of the opportunity.

But obviously everything in the AI ecosystem that is more structural growth, that is not exposed to the business cycle, I think that will definitely be one part of the opportunity in the second half. And the second part is probably to be a bit more defensive. So we've been quite focused at low volatility. Like, low volatility stocks, which is like a defensive strategy, can be a very good way to moderate risk while staying invested. And essentially also free up risk budget to maybe own some of these more convex but more volatile parts of the market like tech and the Magnificent Seven.

So to some extent, the opportunity, if you want to sum it up in one word, is again diversification in the second half. Maybe other places, maybe more opportunities, trying to reduce the cyclical beta, and trying to find opportunities that are a bit more structural and possibly a bit more carry as well. If you don't expect the recession, if you don't expect a severe slowdown, which I think the market is certainly moving towards and I think our economic view is also not expecting a recession as a baseline, we've reduced our recession probability to 30% at this point. So marginally above the unconditional probability. With all of that in mind, there is also the potential to look for selective carry strategies.

Allison Nathan: So Mag 7, defensive. Alexandra, where do you stand on that question?

Alexandra Wilson-Elizondo: Yeah, I think that we would characterize the opportunity as being more selective optimism rather than broad bullishness, very similar to what Christian is speaking to. And the recovery, it's getting mature. So a lot of the different variables that one would look at in terms of positioning and technicals, etc. The stars have already aligned there.

I think in line with guidance, we're going to continue to see more divergence and dispersion across names and sectors, and so it's an opportunity very ripe for active management. And we think that you can stay invested with prudent defense, similar to what Christian highlighted there. But that it is really important to keep an eye on long-term innovation trends and places where you truly believe that the growth trajectory will materialize.

Allison Nathan: And so Christian mentioned that, given the policy uncertainty in the US, investors are reassessing their global allocations potentially away from the US. What are you observing, Alexandra, in terms of thinking about other developed markets versus the US at this point? What are you seeing?

Alexandra Wilson-Elizondo: I think against the backdrop of divergence and desynchronization and more just broader tensions in the geopolitical landscape, diversification is really important. And that's one of the things that we highlighted at the beginning of the year. And that the opportunity set is really different based on where central banks are, levels of interest rates, but equally some regionalized localized things that are happening.

And so when we're thinking about -- you know, we've talked a lot about public markets in this dialogue -- but when we're looking at some of the private spaces where there's less competition, smaller pools of capital in places outside of the US, we're seeing that as a potential alpha driver. There's different dynamics, whether it's relating to urbanization and real estate in all of these different places where you can have really good underwriting and ultimately, despite what's happening in the bigger macro picture, you can really find some opportunities to put some profits in P&L on single names and then broader sectors. We're very focused on, yes, diversification is really important regionally, but equally across both the public and the private spectrum.

Allison Nathan: And Christian, would you agree with that? What are you observing? And there's been a lot of focus on Europe and some of the positive themes that are running through the European economy at this point on the fiscal side, on the remilitarization side. Should we buy into that theme?

Christian Mueller-Glissman: Yeah, I think the way I think about it is a bit like what Alexandra said. You have to work a bit harder now, and we are seeing certain constraints coming from our cycle position, which is somewhat late cycle. And the plummet rates are low, profit margins are high, risk premia are compressed, alpha gets more important. You look at all kinds of opportunities that become a bit more specific, and I think we've looked at Europe definitely. The European fiscal infrastructure spend is a very interesting anchor. And that anchor is, in my opinion as of now, in a lot of conversations much more about lowering left-tail risk than generating right-tail risk. So people are not necessarily buying yet into this opportunity that Europe might outgrow or outperform kind of US equities or US assets.

But there is an openness to say that the downside tails are different compared to the last cycle where you went into negative rates, where we were fighting deflation. And I think that is worth something. That is worth something with regards to valuations and risk premium and might justify a bit of narrowing of risk premium. So we have these discussions that feeds into opportunities like European banks.

European banks have been very badly hit by negative rates. We have been very badly hit by the last cycle of deleveraging and relatively poor growth in Europe. But they are now actually looking better. They have been increasing profitability. There is restructuring. There is consolidation. There's possibly a bit of deregulation. And obviously there's a positive linkage to higher rates. And if you get steeper yield curves globally, like, banks are a bit like a hedge and there's liquidity.

And I think the big challenge when we speak to investors about international diversification is to some extent the size and the liquidity of the US in the benchmarks, in the global opportunity set. And European banks are one of the more liquid parts of the European equity index. We've got some companies that are above 100 billion market cap.

So I think we definitely see people being selective. Opportunities related to fiscal infrastructure, related to banks, possibly still defense in Europe. And I think we have also more focus on emerging markets, and I think the opportunities that you might get over there.

Allison Nathan: And my key takeaway so far from this conversation is diversification, still a key theme for the remainder of the year. But has anything shifted, Alexandra, about how you will think investors should be approaching long-term asset allocation, given all of this policy uncertainty right now?

Alexandra Wilson-Elizondo: I think one of the core tenets of a successful investment process is one that is not constantly changing but one that is constantly being re-underwritten and evolving with real structural changes. And we have long believed in alternative risk premia. We think it provides uncorrelated returns to a portfolio. It gives you, on the defensive side, proper tail risk hedging. But there is no silver bullet as it relates to the tail risk hedging. And we saw rates didn't provide that ballast, as we mentioned, nor did the dollar. It's more of a constellation of strategies coming together.

And so we're actively in the lab really thinking through what is that proper constellation? And we mentioned the divergence or dispersion amongst single names in this kind of backdrop. And so we think adding something like that to portfolios, these left-tail strategies do have a cost to them, but you can structure them appropriately so that you can still stay invested. In fact, you can collect more risk premia or invest more in risk assets while having some of these tail risk cabin strategies in the portfolio.

So yes, it's diversification, but it's also acknowledging some of the changes in the backdrop and making sure that you have the right construct of things coming together for your total portfolio.

Allison Nathan: When we think about everything that's going on right now with the bond market, how does that influence how you're thinking about the role of bonds within a portfolio at this point?

Christian Mueller-Glissman: I mean, it's definitely a rethink where, in the last 20 years or 35 years if you like, bonds were a positive carry instrument that was risk reducing. And now we have to rethink that. There might be a period where bonds are actually repricing to an equilibrium of higher bond yields, which means that their kind of returns might be actually lower compared to the yields that are currently standing on the tin as such. And the equity-bond correlation is more positive.

So like there's an evolution that needs to happen in multi-asset portfolios because of that. And you look at alternative diversifiers, both across and within asset classes. So that means that you need to find alternative safety which might include assets like gold that have been negatively correlated with the dollar but also in risk of have been uncorrelated. They actually haven't gone up all the time in risk off in a big way, so that didn't give you the convexity that bonds sometimes gave you. But certainly they haven't gone down, and that helps. And they've been trending up.

And you need to look at styles and factors that have the ability to be uncorrelated to both equities, bonds, and the dollar. And I think I agree with Alexandra. Like, the tail-risk hedging styles, the tail-risk hedging factors, they obviously cost; you always need to balance the cost versus risk-reduction trade-off. And how much risk budget are you freeing up to actually earn back the carry that you might have to pay for some of those risk-reduction strategies? That's not an easy one, but if you can find positive carry type diversifiers that might not be negatively correlated, it might not give you the upside convexity in risk off but diversify, that can be very attractive.

We've seen a lot of focus on commodity carry as a good example that has actually performed reasonably well this year depending on the construction. But it has been interesting as a diversifier. So, I think it all comes back to the evolution, stepping back a bit away from the benchmarks. Not just saying you have a 60-40 portfolio and let's try to make it a bit better but think very holistically about the dimensions of risk. So you have traditional asset class dimension, you have the macro risk dimension, you have the factor risk dimension. Take a total portfolio approach and try to understand how each of those are interacting.

And it's more like a mosaic. It's not like one solution, as Alexandra said. It's multiples things. And that's the beauty about multi-asset portfolio management. But also the sad thing, it used to be very easy to do well with a 60-40 portfolio. But now, like multi-asset portfolio management needs to work harder, but it has all the tools and all the ability to actually do better than 60-40.

Allison Nathan: So Alexandra, if you think about the opportunities and risks, what is your best advice for investing clients at this point?

Alexandra Wilson-Elizondo: It would be embrace the positive and hedge the risks. We think that this summer there is a high probability that you're going to see more volatility just given liquidity dries up a bit. And so, every marginal headline that we see is going to be exacerbated in terms of price action.

But that being said, we're looking through to what the forward growth trajectory looks like, and we've seen many positive things on the horizon as it relates to 2026 and the high velocity nature of some of the tax policy changes and fiscal stimulus within Europe. And I think that investors should already start looking forward into what some of those positive catalysts will ultimately be for the next year, including the change in the Fed chair. And so along the lines with the market, it's time to continue to look forward to what the next six months will have.

Allison Nathan: Christian, advice?

Christian Mueller-Glissman: Yeah, I mean, listen, we are relatively close to home in terms of our asset allocation, so we're relatively neutral on risk going into the summer. I agree there's a few catalysts we're worried about. There's the tariff deadline. There is French elections. There's obviously the Middle East conflict.

I think the best approach is, as I mentioned, build a well-diversified portfolio that can deal with a certain amount of shocks, and stay invested. Stay close to home, somewhat neutral. And one thing I would highlight is hedging. I think in line with the significant pickup in risk appetite and valuations, you've seen a significant decline in volatility. And that means that hedges are relatively cheap again. And I think especially for investors that are sensitive to volatility because our baseline is probably not consistent with severe bear market risk into the second half, but you could definitely see a difficult summer.

Liquidity might exacerbate it, like, the deadlines, the communication around policies might exacerbate it considering where sentiment and valuations are. I think there's a really good case to think about hedging the summer risks that you might have.

Allison Nathan: So a lot to watch in the second half of this year and into 2026. Alexandra and Christian, thanks again for joining us on Exchanges.

Christian Mueller-Glissman: Thanks for having us.

Allison Nathan: This episode of Goldman Sachs Exchanges was recorded Tuesday, June 17th. I'm Allison Nathan. Thanks for listening.

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