

Opinion **Unhedged**

Valuations and bubbles

Plus European markets shrug at the US trade deal

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Good morning. No one thinks the Federal Reserve is going to cut rates today; [CME](#) Group puts the options-implied odds of a cut at 2 per cent. This is as it should be. Inflation is still above target and the rate of disinflation is slowing down. Certain key categories of prices are actually [rising](#). Tariff inflation is just starting to [blossom](#). The labour market is ([mostly](#)) strong. Economic growth is ([mostly](#)) [solid](#). Second-quarter corporate earnings are coming in pretty well so far. Financial conditions, led by [exuberant markets](#), are growing looser. Best to wait until September. Of course, the president says rates should be much lower. If he really believes that (and there is reason to doubt it), he's wrong. If you think *we're* wrong, email us: unhedged@ft.com.

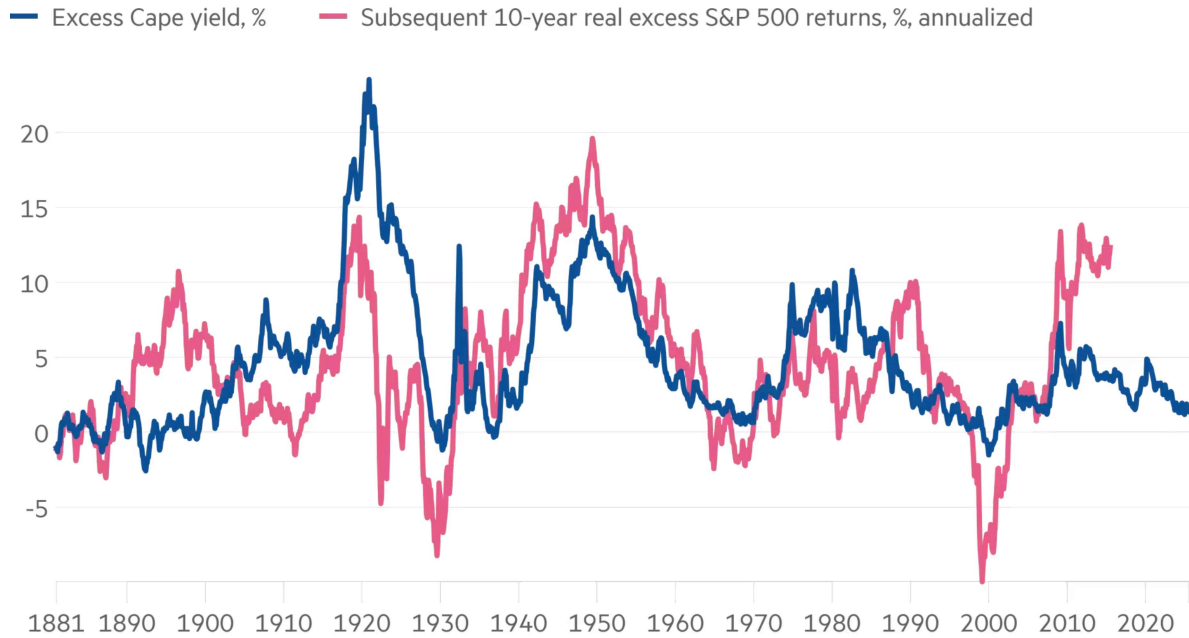
Valuation and bubbles

Yesterday I [wrote](#) that “the historical correlation between very high valuations (and other frothy phenomena) and poor long-term returns is about as solid as any relationship in finance”. It strikes me that it is worth emphasising just how much work “long-term” is doing in that sentence.

Consider the equity risk premium. Robert Shiller of Yale's version of the ERP, which he calls “excess Cape yield”, is the earnings yield on the S&P 500 (that is, earnings/price, using 10-year average earnings) minus the 10-year bond yield. It is an OK predictor of real excess returns (that is, real stock returns minus real Treasury bond returns) over the subsequent decade:

As good as you can hope for

Equity risk premium (Shiller version) vs long-term returns

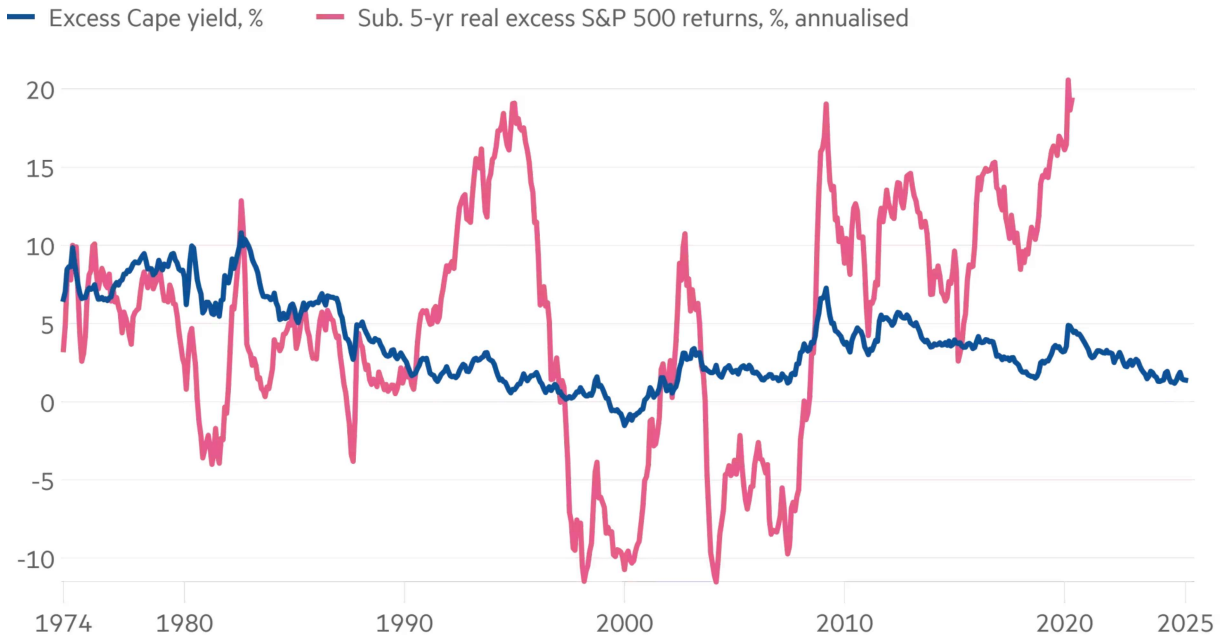


Source: Robert Shiller

The trick is not to let that chart make you think that valuations have anything whatsoever to do with shorter return periods. Stock price movements are too volatile, and their relationship to fundamentals too loose, for that to work. Below is the excess cape yield and five-year returns. I've zoomed in on just the past 50 years, rather than the 140 in the chart above:

Not much help

Equity risk premium (Shiller version) vs medium-term returns



Robert Shiller, Unhedged calculations

From 1994 to 1996, it is obvious that low valuations (ERP under 2 per cent) sent a terrible signal for subsequent five-year returns (mostly in the teens!). You will also notice, in the first chart, that the ERP also sent a false signal for 10-year returns a few years earlier. But the bad signal was “less wrong” and had a shorter duration for 10-year returns because, starting in 1991, 10-year returns began to include the dotcom crash. Five-year forward returns roared all the way until 1996.

In other words, the predictability of long-term returns using valuation is a function of the fact that financial asset prices do not separate from fundamentals — real cash flows — forever. Their relationship reverts to the mean. The period over which returns are predictable is the period that is highly likely to contain a moment of mean reversion (or, much more likely, a swing from one end of the valuation spectrum to the other). And there is no reason that, as the structure of the markets change, the length of this period might become longer or shorter. Ten is a nice round number, but it’s not magic.

For many readers this will be an obvious point. But it is worth emphasising that when we say “the market is expensive/cheap” we are saying something that has no meaning — none! — over the following few years. But Wall Street people (including, at moments of weakness, this newsletter) talk about valuation as if it is relevant to understanding short- and medium-term market action. It isn’t. We must all stop doing this.

(Armstrong)

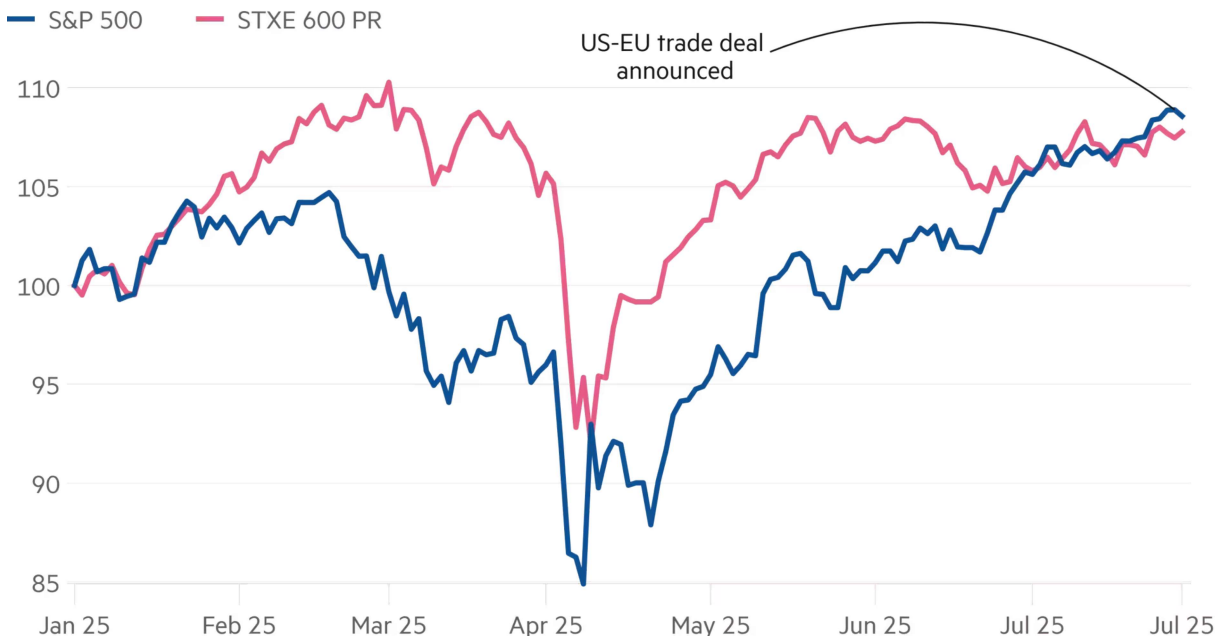
The Europe deal

The US and the EU finally agreed on a [trade deal](#) on Sunday. The near-unanimous verdict: a humiliating defeat for Europe. Too weak to defend itself, it had no choice but to accept a 15 per cent US tariff for its goods while meekly allowing US goods unchanged terms of trade (the Unhedged Podcast has the [blow-by-blow](#)).

Political humiliation, perhaps. But European markets were not too bothered. The Stoxx Europe 600 futures traded higher on Sunday night and closed just 0.2 per cent lower on Monday. Zooming out to the year so far, the move hardly registers:

Markets shrug

Indices rebased in \$ terms



Source: LSEG via markets.ft.com

The euro fell 0.8 per cent against the dollar, a meaningful move, but not a big one compared with the strengthening we have seen this year:

More than a blip, just

Euro/US dollar



Source: LSEG via markets.ft.com

Perhaps the market sniffed out Europe's weak negotiating position, and tariffs were priced in before the deal was announced. More likely, though, in Europe [as in the US](#), the tariffs are not that big a deal for economic facts that markets care about.

While the details are wildly unclear, it appears that important product categories — aircraft and aircraft parts, some agricultural products and chemicals — will be exempt from the 15 per cent rate. Steel and pharmaceutical tariffs seem to be undecided. European cars are exempt from the 25 per cent “strategic” auto tariffs, so 15 per cent is a relative relief.

The US-EU deal was on no worse terms than the US-Japan deal — which was received more favourably — Thierry Wizman at Macquarie Group told Unhedged. The dollar's advance since Sunday is more a reflection of how the market views the US than an indictment of Europe, he argues:

This wasn't really anything that implicated European growth or European risk taking. It was really just a lot of investors and traders seeing the US in a different light, given that we've seen quite a few trade deals, and in all of them, the US has managed to not face retaliation by its trade counterparties.

A weaker euro is also in Europe's interest, as it offsets some of the loss of competitiveness as a result of the tariffs.

There are always caveats. The European aerospace and defence sector, which has outperformed since "liberation day", could be at risk if the EU spends more on weapons from the US, John Higgins at Capital Economics points out. Similarly, European energy producers might lose some market share to US competitors. But Europe's promise to buy more American weapons and fossil fuels are vague and probably unenforceable. Bullish arguments for European markets, whether based on fiscal loosening or something else, should survive the trade deal mostly unchanged.

(Kim)

One good read

[Botswana vs De Beers](#)

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