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How to position for geopolitical shocks during Trump 2.0

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Executive summary

Geopolitical risks continue to remain heightened during Trump 2.0, necessitating the need for investment strategies that could help us navigate these risks. We continue to recommend staying long on gold, which gained about 50% amid global instability and central bank demand, and owning defensive equities. Among derivatives, we favor renting equities via long call structures, buying sovereign and corporate CDS, and using payer swap options to position for a bear steepening of the US yield curve. These strategies reflect our updated view of market dynamics and offer targeted ways to hedge against downside risks and policy-driven volatility.

Introduction

In March 2024, we published a note outlining some core ideas on how investors should position for geopolitical shocks. Our main worries at the time were a Middle East conflict-related energy price shock, or a broader repricing of risk based on global fragmentation. In this note, we review how those recommendations have performed from publication to end-July 2025 and adjust our recommendations to reflect the different geopolitical risks we believe will prevail going forward.

To recap, we had provided portfolio solutions which varied in complexity. On the one end of the spectrum, our proposed solutions included long energy/commodity volatility; long gold; and defensive equities. On the complex end of the spectrum, our solutions included renting broad equities; sovereign and corporate credit default swaps; FX hedging; and options hedging related to implied volatility.

We find long gold and defensive equities compelling enough as healthy portfolio choices in the Trump 2.0 era as well. Among derivative strategies, we maintain a preference for sovereign and corporate credit default swaps as well as renting rather than owning broad equities. Additionally, we now include payer swap options in place of FX hedging and volatility strategies.

Gold and defensive equities remain compelling

Going long gold

Our choice of going long gold to hedge against an overall reset of risk perceptions in a fragmenting world has worked: as the global order has continued to weaken, gold has notched up one of its best performances, gaining about 50% over our evaluation period.

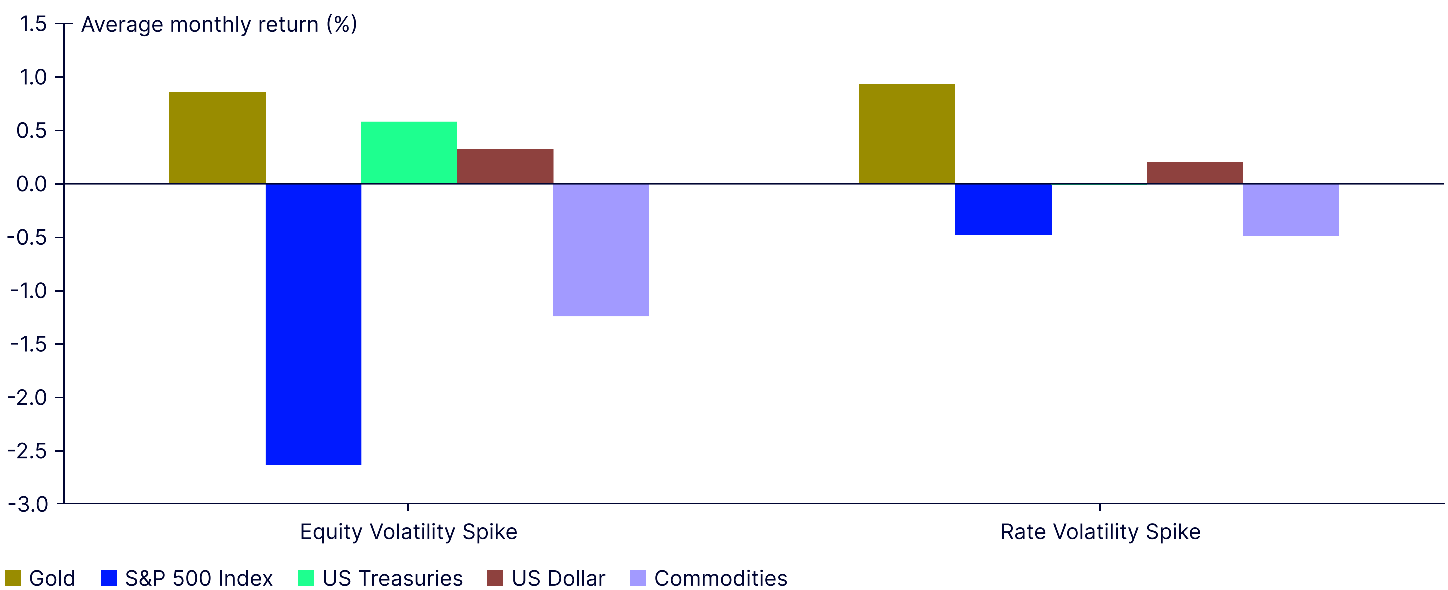
Outside of macro factors, the yellow metal also found support from ongoing central bank demand. Figure 1 illustrates how gold performed during periods of high volatility, in both the equity and bond markets.

Defensive equity sectors

We also recommended defensive equity sectors, such as utilities, healthcare, and consumer staples. In a prolonged crisis, these sectors typically outperform the rest of the index. Given that there has been no crisis or economic downturn, and in fact markets have broadly rallied over the period, these sectors have underperformed relative to the rest of the market.

During the tariff led sell-off in April 2025, only consumer staples and utilities had above index returns, as fiscal policy was expected to negatively affect the healthcare

Figure 1: Average monthly gold return during equity and rate volatility spikes



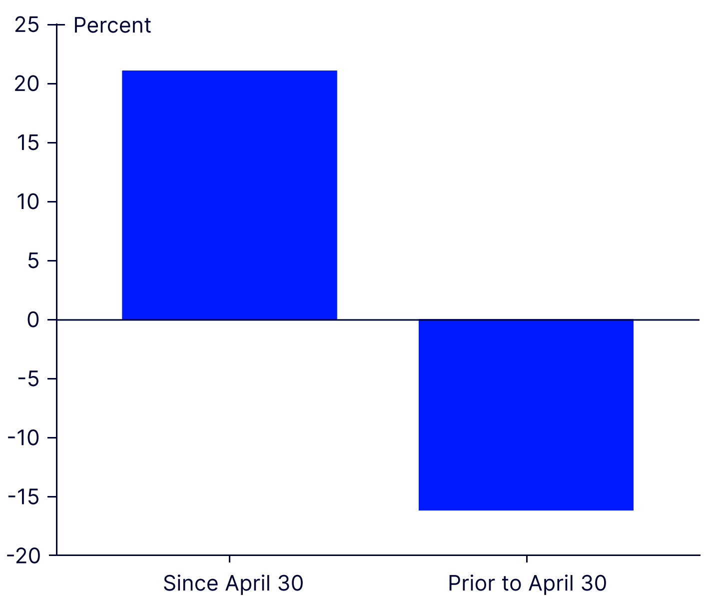
Source: Bloomberg Finance L.P., State Street Investment Management. Data from January 1, 1990 to July 31, 2025. **Past performance is not a reliable indicator of future performance.** Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. Equity volatility spike represented by one standard deviation rise in CBOE Volatility Index on monthly basis. Rate volatility spike represented by one standard deviation rise in ICE BofA MOVE Index on monthly basis. Gold = gold spot price in US Dollars. US Treasuries: Bloomberg US Treasury TR Index. US Dollar: US dollar spot index. Commodities: S&P GSCI TR Index. S&P 500:S&P 500 TR Index.

sector. Utilities and consumer staples were up 0.09% and 0.28%, respectively, while healthcare fell 4%.

For the quarter, all defensive sectors underperformed the S&P 500 as the market rallied off the pause in tariffs. Nevertheless, the initial drawdown helps illustrate the natural reaction function of defensive sectors, such as utilities and consumer staples, to a rapid downside repricing of growth assumptions. And it is worth mentioning that healthcare services—the most domestic sub-industry as well as an industry synonymous with "necessities"—produced positive returns during April (also above the S&P 500) and the quarter.

These divergent performance trends can also be found when dissecting low beta versus high beta stocks. The market recovery post April was driven by high beta stocks, reversing the trend through the first four months of the year where high beta stocks trailed low beta (Figure 2).

Figure 2: High minus low beta stock returns



Source: Bloomberg Finance L.P. as of July 31, 2025, based on the returns of the S&P 500 Index constituents in 2025, grouped by their trailing 3-year beta of returns into quintiles. **Past performance is not a reliable indicator of future performance.**

The same pattern prevailed across sectors, controlling for intra-sector betas. Across all eleven sectors, high beta stocks outperformed low beta stocks from the end of April—a reversal from the first four-month trend where low beta stocks beat high beta.

For equity factors, the flip-flop was equally stark, and quite cleanly divided between Q1 and Q2 of 2025. For example, Minimum Volatility outperformed strongly from mid-February to the beginning of April but has since then given up most of its gains. The Growth factor has been the inverse, underperforming in Q1 before staging a strong rebound into Q2.

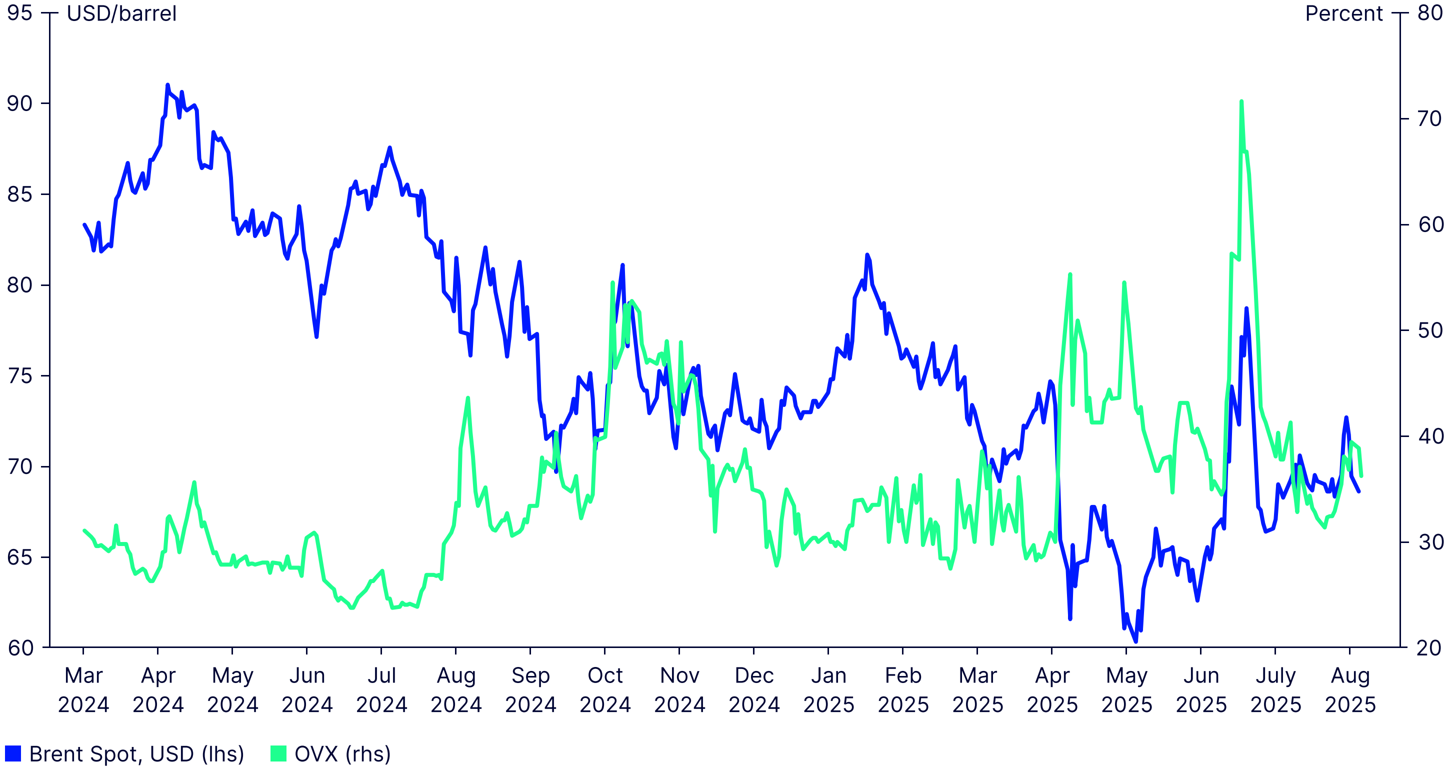
Long commodities or energy less compelling

One of our primary concerns at the time of the earlier note included a potential energy price increase related to conflict in the Middle East and a broader adjustment in risk assessment due to global fragmentation. For the energy shock, going long commodities or energy was a compelling option then, although we preferred to be long commodity volatility given risks to demand destruction in any crisis scenario. But oil price depreciated over the period and any spikes were short lived (Figure 3).

Using energy equity as a proxy would not have been the right approach, as the sector overall has close to 0.6 beta to oil spot prices, although the Oil & Gas Equipment & Services sub-sector does have a beta of over 0.8.

In contrast, oil volatility was higher for most of the past 16 months, and at times considerably higher, given events in the Middle East. Investors would have had to be nimble to extract value using short-dated or longer-dated directional options, so the use of variance swaps might have been more effective.

Figure 3: Brent Oil Spot versus OVX March 2024–August 2025



Note: The Cboe Crude Oil ETF Volatility Index (OVX) is an estimate of the expected 30-day volatility of crude oil as priced by the United States Oil Fund. Source: Macrobond, as of August 05, 2025.

Three derivative strategies stand out

Building on our previous outlook, we continue to see value in two derivative strategies—renting instead of owning broad equities and buying sovereign and corporate credit default swaps—and now add payer swap options to our recommendations in lieu of FX hedging and volatility strategies.

Renting versus owning broad equities

First, we had proposed ‘renting’ instead of owning equities outright. This implies holding a long call structure (i.e., more calls versus puts), which in practice reduces the equity beta, a positive during market downturns at the cost of underperforming the index during rallies. The effectiveness of this approach would have been highly dependent on the timing, tenor, and strikes of any options purchased or sold.

Options pricing appears to us to currently hold asymmetric risks. Although equity implied volatility has reset at a higher floor, implied volatility still screens cheap across several metrics given macro and geopolitical uncertainty is abundant, and equities trade rich not only on a cross-assets basis but also relative to their own history. These factors create an environment where it may not take much for implied volatility to move higher.

Furthermore, in recent quarters, companies that have exceeded earnings estimates have not, on average, outperformed the S&P 500, whereas companies that have missed earnings estimates have underperformed the broader index on average by 2%–3%. This asymmetry creates interesting opportunities at the single stock level.

For example, just for illustration purposes, NVIDIA Corp’s short-dated implied volatility is trading near a 2-year low with the stock at all-time highs. This dynamic is not unique to NVIDIA as several other single stocks share similar characteristics. Moreover, looking at leverage data at prime brokers suggests that hedge funds are positioned for positive outcomes, which could lead to a reinforced selling cycle if negative events materialized, reinforcing our view on the asymmetry of risks.

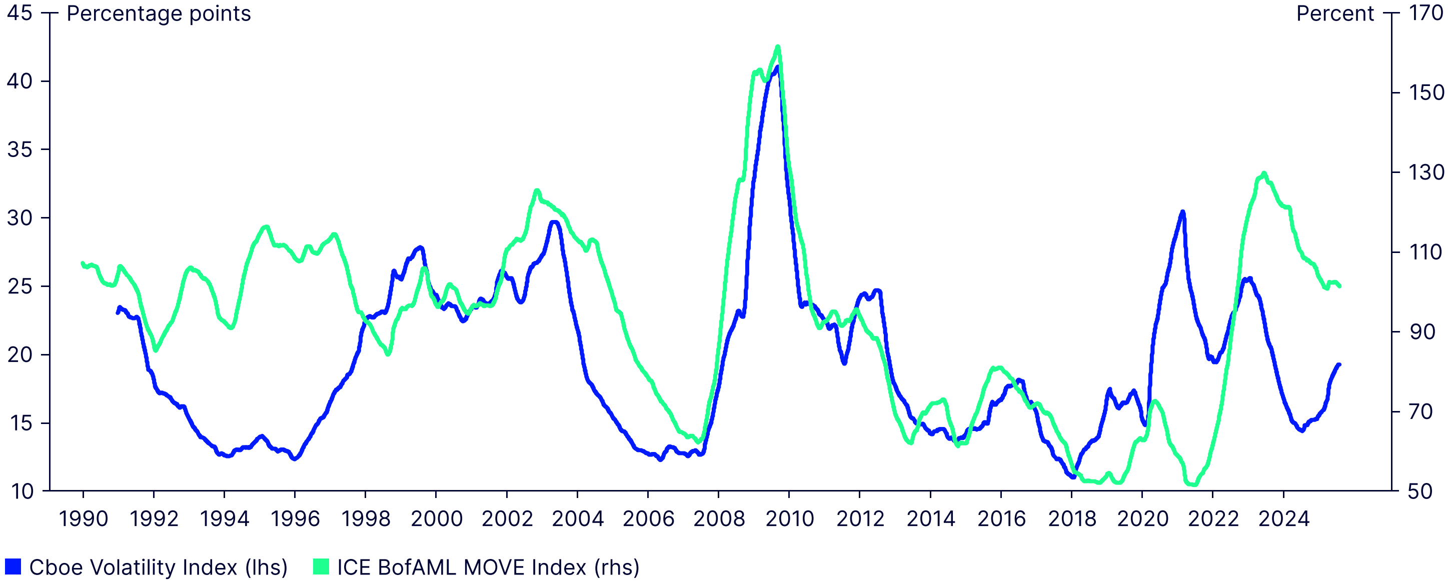
Utilizing payer swap options

Volatility was too low in the previous spring, and most volatility metrics have risen and stabilized at a higher range. We had already mentioned the oil volatility index above, but equity volatility in the form of the CBOE Volatility Index (VIX) experienced a similar shift upwards, with the 1-year moving average rising from below 15 in March 2024 closer to 20 since.

Today, we see a similar constellation in bond market volatility where the Merrill Lynch Option Volatility Estimate (the MOVE Index, which tracks volatility in Treasuries) levels are susceptible to disruption. Implied bond volatility, which was historically elevated during the Fed’s hiking cycle, has now reverted to its long-term average despite lingering concerns over the United States’ (US) fiscal situation, doubts about future Fed independence, and uncertainty over the inflation impact of US trade policy.

We believe the US nominal yield curve can continue to bear steepen from its current levels and utilizing payer swap options is the best implementation of that view given the attractiveness of long-end swaption implied volatility.

Figure 4: Move versus Vix Index (1991–2025)



Note: 1-year moving average. Source: Macrobond, as of August 05, 2025.

Buying sovereign and corporate CDS

While the sovereign credit default swap (CDS) market is relatively shallow, it has been a good instrument to reflect the shift in tail risk perceptions. Using the initial few months of forceful US trade policy as our period of analysis, sovereign CDS spreads rose for the US, its north American trade partners, China, Japan, and several emerging market economies. In contrast, it remained relatively flat for Germany, which announced a major fiscal expansion at the same time.

The same material spread widening also took place in weaker parts of the corporate credit market, such as high yield. CDS spreads here too reflected the new risk environment. Considering concerns around US fiscal sustainability and uncertainty around residual trade policy uncertainty, we believe this could continue to be a suitable instrument to hedge for bearish outcomes.

FX hedging and volatility strategies no longer viable

We no longer consider FX hedging a suitable vehicle for geopolitical risk protection. Given structural shifts in the safe-haven function of the US dollar, we think only the classic, smaller currencies such as the Swiss franc and the yen would now rally on negative news.

Similarly, implied volatility on short-dated 25 delta Swiss franc and yen puts is above 5-year averages, thereby making option related hedges relatively expensive.

Investment takeaways

Most of our 2024 recommendations performed satisfactorily. The big exception was the US dollar reversal on the back of sentiment related to policy shocks. Markets have also adjusted to the new reality and have baked in a higher uncertainty premium, although the full extent of vulnerability in the US bond market, we believe, is still to be tested. Therefore, in today's world, we would narrow our focus on the following strategies to help mitigate unknown geopolitical risks in the near term:

1. Staying long gold
2. Owning defensive equities
3. Renting versus owning broad equities
4. Positioning for a bear steepening in the US dollar yield curve via payer swap options
5. Buying sovereign and corporate CDS

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