RATHBONES | Incorporating Investec Wealth & Investment (UK)

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Market commentary

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Overview

Stock market seers love nothing more than a shortcut and one perennial favourite is the old saw that "As goes January, so goes the year", also known as the "January Effect". It's not exactly rocket science, crudely suggesting that equity markets' trend is established early. The fact that they tend to rise in January as new money is put to work, and that they trend higher over time, means that the odds tend to be in favour of those making the bullish call and so there is limited career risk! And so, what are we to make of the outlook based upon the experience of January 2025?

If it's to be more of the same, then we might expect rising equities but with a broader sector and regional participation rather than leadership largely from US (technology) growth stocks. However, that will be accompanied by all sorts of unexpected news and increasing volatility. It feels as though the ride could be bumpier this year.

Already we have had to face a mini tantrum in government bond markets, the launch of a disruptive Chinese competitor to the western Artificial Intelligence (AI) industry leaders, and the threat and then imposition of trade tariffs by the US on several countries. All of which we will cover in this section. In the regional sections we will look specifically at local economies and the interest rate outlook. And we will also drop in on the Gold market for an occasional visit and to celebrate the fact that it closed January at an all-time peak in both dollar and sterling terms.

The first shock of the year came from government bond markets. Although it has already receded, it is still worth examining the underlying concerns voiced by investors, because they might well resurface. The bond markets' problems were two-fold. First, there were concerns in both the US and the UK that inflation was not falling fast enough to allow central banks to cut interest rates. Then, as bond yields rose, there was increasing anxiety that the higher interest rate liability on government debt might undermine solvency. The UK's position was exacerbated by the fact that a weak economy further impairs Labour's fiscal position. Yields on longer dated Gilts reached levels last seen in 1998, but that finally drew income-seeking buyers. The stress has eased for now, but the onus is on Chancellor Reeves to restore growth and confidence, possibly with a helping hand from the Bank of England.

In technical parlance, what we are witnessing is an increase in the "term premium", which is effectively the extra yield that investors demand for buying longer duration bonds relative to short-term instruments. The extra return provides some compensation for the uncertainty of committing funds for a longer period, during which bonds will be influenced by cyclical growth (or lack of it) and inflation. Most current investors and market participants have only ever experienced a term premium that has been in a falling trend, which started in the early 1980s after the high inflation and interest rate trauma of the previous decade. Two initial decades of benign disinflation, helped along by increasing globalisation, the end of the Cold War and technology-led productivity growth were followed by the deflationary effects of the unwinding of the turn-of-the-century technology boom and then the Global Financial Crisis. Term premiums troughed in negative territory thanks to the post-Covid Central Bank bond buying spree. The tide turned as inflation rose and Central Banks raised interest rates to combat it, leading to a sharp rise in yields and a severe bond bear market in 2022, from which it has failed to make a meaningful recovery. Governments are increasing defence spending again as geopolitical tensions rise, global trade is threatened by tariffs and inflation is proving harder than hoped to return to the 2% target maintained by most Central Banks, which are also now reducing their holdings of bonds. While we believe that the resetting of interest rates and yields from the zero-rate era has now largely played out, 10-year government bond yields hovering around long-term nominal GDP trend growth represent no better than fair value, and the potential for increased bond market volatility (in light of the factors mentioned above) leads us to recommend a relatively short duration in our bond holdings.

The second shock emanated from China in the form of the rapid rise in popularity of DeepSeek's R1 (DSR1) large language model (LLM). We covered the situation in some detail in the most recent Weekly Digest (Weekly Digest: Learning curves), but opinions continue to evolve. Briefly, what DSR1 appears to have achieved is to produce answers to questions that are as accurate and credible as those provided by well-known American LLMs such as Chat-GPT (created by Open AI) and Llama (Meta), but, crucially, at a fraction of the cost. In very simple terms, deprived of an endless supply of cash and high-end GPU chips, the creator, a division of a Chinese hedge fund, harnessed the creativity of software engineers to produce an LLM which manages to do its "thinking" without having to activate its whole "brain" – just the parts that it needs to provide the answer. Yes, there are questions outstanding about the true costs behind the venture and the fact that it was “trained” by using the data from existing, expensively assembled LLMs, but the principle of a relatively low-cost solution that will be good enough for the majority of users seems to have been established.

There is potentially bad news but also good news to be drawn from this. It brings the amount of capital that will have to be spent on future investment in LLMs into question. Thus chipmakers, including market leader Nvidia, and companies involved in building, fitting out and supplying the power to data centres saw their shares hit hard. On the other side of the coin, companies who are the spenders on all this expansion of capacity stand to benefit from lower costs in future. Furthermore, investors also had a crash course in the benefits of the Jevons Paradox. This was first posited by the economist William Stanley Jevons in 1865. He proposed that more efficient steam engines would lead not to lower consumption of coal but the greater employment of steam engines and thus even greater consumption of coal. And he was right! It is a paradox that has held through the development of many new technologies and one that might well hold today in the field of AI. Lower costs will encourage wider adoption and the more that companies and individuals use LLMs, the more efficient they (both the users and the LLMs themselves) will become.

Our overarching conclusion remains that this episode does not presage an imminent “bust” to follow the “boom” that has taken place in the AI industry, more a re-ordering of investors’ preferences. Companies that can provide consumers with a user-friendly way to enhance their productivity stand to benefit, as do those with proprietary data that can be mined to enhance their offer to customers.

The final straw, as it were, in January, was added to the camel’s back by President Trump. Although he had wrongfooted traders betting on the “Trump Trade” of a stronger dollar by not explicitly mentioning trade tariffs in his inauguration speech, he more than made up for it. First, he threatened Colombia with 25% tariffs on goods exported to the US when President Petro refused to allow illegal immigrants to be repatriated on military planes. Petro swiftly backed down and the tariff threat was removed. Chalk up an immediate win for President Trump to wave in front of his supporters. Emboldened by this easy victory, Trump then threatened to impose 25% tariffs on Mexico and Canada as he blamed their porous borders for being an easy access point for illegal immigrants and the highly addictive opioid drug fentanyl into the US.

Although the imposition of tariffs was not exactly a surprise, it was the size and immediacy of execution that shocked investors, leading to a sharp sell-off in equity markets. There had been talk of them being imposed incrementally and with sufficient time to allow negotiations. In response, both Canada and Mexico initially threatened counter-tariffs, but then quickly announced increased expenditure on border patrols and upped their commitment to stamp out fentanyl production and distribution. Trump offered a one-month stay of execution to see if any progress can be made. Chalk up another victory for “Tariff Man”. Stock markets recovered.

China was also targeted with a 10% blanket tariff and responded with its own on US exports of energy and various consumer goods, as well as export controls on certain high-value materials. At this stage, we believe that much of this is posturing with limited economic impact on either side. Even so, President Trump appears to have chosen his weapon of choice – tariffs – and we expect him to continue to wield it. One can only assume that Europe is next in the firing line, but at least the UK appears to be less vulnerable. Of the major trading economies, BCA Research calculates that only Australia is in a better position than the UK, with the most vulnerable countries being Mexico, Canada, Germany and Belgium.

Markets – US

One constant factor in the global economy in recent times has been the health of the US economy. Apart from having a small wobble in the middle of the year, it powered through 2024, growing at 2.8%, only marginally lower than the 2.9% achieved in 2023. Not bad, considering that in January, a poll of economists by Bloomberg had the odds at 50/50 for a recession to begin during the year. That probability has fallen to 20% for 2025 and it rarely goes much lower given that the unconditional probability of a US recession occurring in any single year is deemed to be around 15%. Household consumption continues to be a key driver, although a government running a fiscal deficit of more than 6% of GDP provides a strong helping hand. These will be the key factors to monitor when assessing the current trajectory. With unemployment still at a lowly 4.1% and wages growing in real terms, the wind is set fair, although we are also keeping an eye on the impact of Elon Musk's Department of Government Efficiency and what that might mean for federal spending and employment. Another powerful influence on US consumption is household net worth. The average figure has risen from $106k to $160k over the last five years, handily outstripping inflation, although much of that will have accumulated to wealthier households owning financial assets. The aggregate numbers are staggering. During the first three quarters of 2024 for which data has been published, the gains in total wealth were $5.9 trillion, $2.8tn and $4.8tn, highlighting the virtuous circle formed between financial assets and the economy. Of course, that comes with the caveat that the process can go into reverse. The strong economy means that interest rate cuts are off the table for now, with no change expected until June at the earliest. But we would prefer that interest rates remain where they are owing to a resilient economy than be cut owing to weakness.

UK

The contrast on this side of the Atlantic is depressing. UK GDP grew by 1% over the year to November, but even that is a flattering number. The growth rate has dropped off markedly since the summer, and it seems not entirely coincidental that the demise started in the wake of Labour's election victory. Warnings of a punitive Budget undermined confidence initially and the reality was, if anything, worse. Whilst individuals might have been let off the hook in terms of some of the tax increases that had been threatened, it was companies who bore the brunt of the Chancellor's fiscal grab in the form of higher employer National Insurance contributions. They will also have to bear the cost of a higher National Living Wage from April. The effect has been to reduce employment and investment intentions. Ms Reeves has been promoting Labour's growth agenda and promising a bonfire of red tape, but there seems to be little of immediate promise. A third runway at Heathrow sounds like a grand plan, but journalist wags are already suggesting that it could be Prime Minister Farage who one day cuts the ribbon to open it! One opinion poll has Reform UK as the party that would attract the greatest number of electoral votes today. The Bank of England is expected to provide some assistance to the economy, with the futures market pricing in a total of four quarter-point base rate cuts during 2025, which would take it to 3.75%. That would come as a relief to homeowners refinancing mortgages.

Europe

New all-time highs for European equity indices are at odds with the economic situation, reflecting the global nature of index constituents and some bargain hunting. GDP grew by 0.9% across the eurozone during 2024, with the "core" countries of Germany (-0.2%) and France (+0.7%) underperforming. Both are in political turmoil and Germany faces federal elections on February 23rd. Although the (increasingly) right-of-centre CDU Party is expected to gain the most seats in the Bundestag, there is no prospect of it achieving a majority. If the (more extreme) right wing AfD Party comes in second, as polls suggest, the prospects of forming a functioning coalition look dim. More positively, Spain grew 3.5% last year and Portugal by 2.7%. Both are benefitting from EU fund disbursements but have good momentum of their own, having worked through the excesses that triggered the eurozone crisis back in 2012. Ireland grew by a remarkable 6.3%, largely owing to its status as a tax-advantaged HQ for global companies. The European Central Bank is in full cutting mode. It has already reduced its deposit rate from 4% to 2.75% since last summer and the market is pricing in a drop to 1.75% by year end. But companies, households and investors would rather have had the growth.

Gold

Emerging Markets are in "wait and see" mode at the moment, with the impact of Trump tariffs, the direction of US interest rates and the dollar, and the potential for further stimulus measures in China all key factors. Thus, we turn our attention to Gold, an asset that has attracted a lot of demand from EM countries. Having, remarkably, outperformed the S&P 500 Index (+25%) during 2024 by rising 26.1%, it has carried its form into the New Year, gaining a further 7.6% in January and making a series of new all-time highs. Demand from many EM countries picked up sharply once the US slapped financial sanctions on Russia following its invasion of Ukraine. It's not that they expect similar treatment necessarily, but more a prudent diversification of reserves. This seems doubly sensible when one considers the cavalier approach to foreign policy of the US President. Although it has not been called upon yet in such a capacity, Gold could also provide insurance against a widespread monetisation of government debts, which, in the eyes of many, are intractably elevated in the absence of some sort of productivity-driven growth surge. Should the central bank printing presses be turned on again, Gold is deemed to be the sort of real asset that would benefit.

Fixed Income

Global government bonds show little sign of emerging from their torpor. The Bloomberg Aggregate Global Bond Index returned -4.7% in 2021, -16% in 2022, +5.7% in 2023 and +3% in 2024 (the last of which equates to a small loss in capital-only terms). As explained earlier, investors are seeking a higher term premium to accommodate the risks associated with inflation and fiscal deficits. Even so, we have seen some evidence of better performance during periods of potential disinflationary growth concerns and would consider increasing weightings and/or duration in the event that economic conditions worsened markedly (without inflation surging). That is not our current central view.

All UK Gilts have delivered a total return of +0.2% over the last three months and -0.4% over the last year. Index-Linked Gilts returned -3% and -3.4% over the same respective periods. Emerging Market bonds produced a total return of +4.8% in sterling over the three months to end January (+16% over 12m). Global High Yield bonds delivered +2.2% (+9.2% over 12m) in sterling.

Conclusion and Outlook

Although equity markets have posted gains at the start of 2025, there have been enough warning shots to prevent us from being complacent about the outlook for the rest of the year. So much will depend on policy, especially what emanates from the Oval Office. With such an unreliable actor in the position of greatest power, and one who seems determined to bypass the guardrails of Congress and even the Constitution, it is very hard to make big tactical asset allocation bets currently. Thinking wishfully, perhaps, “Good Trump” could unleash a wave of deregulated growth and then settle back to enjoy the plaudits and financial rewards. “Bad Trump”, on the other hand, is a force for negative disruption and global uncertainty and one is hesitant to imagine just how bad things could get. In the meantime, the best course of action remains to invest in sound companies with exposure to positive secular trends and to play the long game. Four years will go by remarkably quickly. It’s now exactly five years since the World Health Organisation declared Covid-19 to be a Global Health Emergency (31/1/20).

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