RATHBONES | Incorporating Investec Wealth & Investment (UK)

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Market commentary

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STOP PRESS

Liberation Day

There are odd occasions when an important event occurs right in the middle of the writing schedule for this commentary, and this month one of those has taken place. On April 2nd, US President Donald Trump announced his much-heralded 'reciprocal' tariffs on imports into the US. There had been a lot of speculation as to the outcome, but it still turned out to be a lot worse than expected. Furthermore, the tariffs were calculated in such a bizarre way (with reference to existing overall trade deficits as opposed to products or sectors) that it is extremely difficult for the countries affected to propose an immediate solution. Indeed, many are threatening to impose retaliatory tariffs on the US.

The initial reaction from equity markets has been universally negative. First estimates suggest that, for the US, the measures announced will increase aggregate consumer prices by 1 to 1.5%, with a similar reduction to GDP. Although that would not necessarily lead to a US recession, given the relatively high starting point for growth, it certainly increases the probability of one occurring and corporate earnings will almost certainly come under pressure. This comes just as there has been a hint of slowing growth in the US and when both consumer and corporate confidence have been declining. Neither can we ignore the potentially negative influence of falling stock markets on wealth, the past accumulation of which has been an important factor in supporting US consumption.

Our reaction to this news is that it represents a meaningful change to the investment landscape and calls for a slightly more conservative asset allocation. Even so, we still envisage what unfolds as being more of a correction than a fully-fledged bear market, and certainly see no grounds for any sort of financial crisis to develop. Despite the fact that inflation has been stickier than hoped for, central banks do have rate-cutting capacity now. And we can also point to more positive stimulus announcements in Europe and China as a counterweight to US policy.

The UK has come out of the tariff process relatively unscathed, in that we are subject to a 10% universal base rate and no higher. China, on the other hand, sees its overall tariff rate rise to around 60%, with the EU at 20%. The EU remains our largest trading partner, and so a negative effect there could impact us too.

This is likely to be a fast-moving situation. President Trump could (kindly) be described as mercurial, although other, more damning, adjectives also come to mind. Most commentators have continued to believe him to be ‘transactional’ in nature and it is possible that ‘great deals’ could be announced soon, de-escalating the risks. We would also observe that he is front-loading a lot of bad news and that there is still the potential to announce more popular tax cuts and looser regulations. Indeed, that would suit the Republicans’ timetable for campaigning ahead of the 2026 mid-term elections. One thing seems highly probable, though, and that is that higher levels of volatility will prevail for some time to come.

The following commentary was written before the tariff announcements. All market and stock performance is to the close of business on 31st March 2025. Although markets have moved materially in the interim, the review of important themes and performance in the first quarter remains valid.

Introduction – Uncertain Times

When it comes to managing wealth, there is a big difference between the concepts of ‘risk’ and ‘uncertainty’. Risk is deemed to be quantifiable in some way, allowing managers to construct portfolios with the right balance between assets and the right mix within those asset classes. At least then we might have some idea of the potential gains and losses to which clients are exposed. Uncertainty, on the other hand, offers a much broader range of potential outcomes with the prospect of greater volatility to boot. In such circumstances it pays long-term investors to stick closer to benchmarks and we certainly do not see this as a time to be playing fast and loose, although we remain fully invested.

As you might imagine, uncertainty is difficult to measure, but there is a Global Economic Policy Uncertainty Index that has been around since 1996 (compiled by the academics Scott Baker, Nick Bloom and Steven Davis) and it currently has its highest reading since we were in the early stages of the Covid crisis. If there is any ray of light here, it is that spikes in the index tend to create contrarian buying opportunities in risk assets, although it is fair to say that on this occasion the sell-off has not been anything like as severe as in the past, hence our reluctance to overweight equity risk today.

America’s aggressive trade policy and geopolitics are the main factors creating this elevated uncertainty, but the good news is that not everything is negative! There has been a sea-change in attitudes towards fiscal deficits and investment in Europe, triggered by a realisation that it will have to spend more to defend itself. Germany has come to the fore in this regard following the election victory of the Christian Democrat Party, with its leader, Friedrich Merz, the Chancellor-elect, pushing spending bills through Parliament with unnatural urgency. More details can be found in the regional comments below.

Key Events

Owing to the rapidity of news flow at the moment, we will leave this section much shorter than usual and focus on the regional comments, which we hope will provide a bit more local colour. The first quarter of 2025 has certainly been eventful, and retrospective comments for the first two months of the year can be found here:

Market Commentary March 2025

Market Commentary February 2025

We have also provided commentary on the recent UK Spring Statement which can be found here:

Weekly Digest: Report cards

investment_update_spring_statement_03-25.pdf

Markets – US

The first quarter has witnessed a rare period of underperformance for US equities. There have been two key factors behind this. The initial shock came from China in the form of DeepSeek's launch of its R1 Large Language Model capable of competing with established Generative Artificial Intelligence (AI) models (think of Chat GPT as an example) but at a fraction of the cost. Every share touched by the enthusiasm for all things related to AI was hit hard, and these ranged from chipmakers and software providers to those involved in building datacentres and supplying the power, as questions were asked about the ability of these companies to make decent returns from the huge amount of capital they have invested (and plan to invest) in AI. This initially triggered a broad rotation into sectors other than those dominated by the Technology giants, but even that development has been somewhat undermined by the second factor, which is the President's economic policy. This not only embraces the use of tariffs, which we believe to be potentially inflationary, but also, under the aegis of Elon Musk's DOGE, swingeing cuts to government spending and employment. While this might yet turn out to be a masterstroke if it curtails the fiscal deficit without undermining activity, the threat of job cuts and contract cancellations is real. The reaction is showing up in 'soft' economic survey data, if not yet in the 'hard' data. The Expectations Index of the Conference Board's Consumer Confidence survey hit its lowest level since 2013 in March. The University of Michigan's monthly survey of 5 to 10-year inflation expectations rose to 4.1%, the highest levels since 1992. All of this has been reflected in a decline in earnings growth expectations for 2025, from low double digits down to mid-single digits. In stock market terms, this has led to a sharp derating of the previous winners, including the so-called Magnificent 7, which, as a group, are down 15% year-to-date. The broader S&P 500 Index has fallen 4.6%, while the S&P 493 (excluding the Mag 7) actually gained 0.5% over the period. From a sector perspective, the three dominated by Technology stocks are all in the red. These are Consumer Discretionary, home to Amazon and Tesla (-13%), IT (-12%) and Communications Services (-5.5%). All other sectors were positive, led by Energy (+10%) and the defensive Consumer Staples (+5%).

UK

UK equities, in aggregate, have been a relative safe haven. Perhaps surprisingly, this has come at a time when sterling has been firm against the dollar, rising from $1.25 at the start of the year to $1.29 at the end of the quarter. For once, UK investors are not bemoaning the paucity of Technology stocks. The UK's biggest listed tech share is Sage, the accounting software firm, and its shares fell 5.5% (having risen by 70% over the previous two years). A couple of companies deemed to benefit from integrating AI into their core businesses have done well to hold onto past gains. RELX (legal services) and London Stock Exchange Group (which is more involved in index data provision than actually trading shares these days) are up 6.7% and 1.6% respectively this year, capping gains of 63% and 61% over 2023 and 2024. In terms of FTSE 100 Index points, the biggest contributors were all very different again, which we view as a healthy feature. These were Shell (a firmer oil price amidst ongoing Middle East tensions as well as a promise to deliver more of its cash to shareholders); HSBC (a beneficiary of improved sentiment towards China as well as the helping hand of higher interest rates which boost net interest margins); Rolls Royce (continues margin improvement in its core aero engine and turbine businesses, as well as being a potential future winner in the development of Small Modular [Nuclear] Reactors); Astra Zeneca (a classic safe haven in the pharmaceutical sector); and BAE Systems (benefitting from the projected boom in defence spending). It's fair to say that all of these companies have a positive narrative and are well insulated from a sluggish domestic economy. It is notable that the more UK-exposed FTSE 250 Index fell by 5%.

Europe

The German language is famous for putting words together to make new ones, and Zeitwende is a good example, deriving from 'Zeit' (time) and 'Wende' (turn). Literally, it is a turning point, but Langenscheidt's German dictionary gives it the much more expansive meaning of "a new era". Something has been brewing in Europe for a while. In a report for the European Commission (EC), former European Central Bank President Mario Draghi outlined the need for much greater investment and looser regulation. From tiptoeing in this direction, the EC has now broken into a moderate trot. And even if this turns out to be a marathon in terms of achieving its ambitions, the newly elected German Chancellor sees it as a sprint.

Trump's threat to withdraw America's security umbrella has woken Europe up to the fact that it will have to spend more to provide its own military deterrent – a lot more. The European Union has already launched a €150bn bond programme and believes that as much as €800bn can be raised for defence spending by allowing governments more fiscal leeway. Germany, with its relatively low debt-to-GDP ratio of 62%, has already pushed bills through Parliament to lift the deficit cap on defence spending and to fund a massive €500bn domestic infrastructure spending programme. This follows a cautious approach to fiscal deficits that has starved the country of investment.

All of this has triggered something of a stampede into European equities, with Germany being the main beneficiary. While the MSCI Europe ex-UK Index was +6% in the first quarter, Germany's leading DAX Index was +10.7%. Even more remarkably, the leading German defence company, Rheinmetall, saw its shares rise by 118%. But if this really is a 'Zeitwende', and there are many who remain sceptical that it is, there should be plenty of gains left to play for in Europe. A recent fund flow analysis suggested that for every one-hundred investment dollars that had left Europe since 2022, only three had so far returned.

Emerging Markets

Following a long period of being the 'poor relation' in Emerging Markets, China is having a moment in the sun. The MSCI China Index has risen 15% this year. Having stalled after the rally following the big stimulus announcement last September, it gained a second wind after the DeepSeek news, being the beneficiary to offset the losses inflicted upon US tech shares. Somewhat contrary to the US's intentions, it is possible that by attempting to isolate China from high specification technology components it has only galvanised an increased level of innovation. Meanwhile, the government's efforts to rekindle animal spirits amongst consumers are taking longer to bear fruit. Even so, there are tentative signs that the worst is behind them in terms of, for example, falling real estate prices, even if there is a general reluctance to reflate that market aggressively. There have also been tentative signs of improvement in the latest round of purchasing manager surveys, with all readings above the 50 mark that demarcates expansion from contraction. Overall, though, EM indices have struggled so far under the threat of trade wars, with the MSCI EM ex-China Index down 1.7%. Of the other major EM benchmark indices, India was -0.25%, Taiwan -10% and South Korea +4%.

Gold

One asset that continues to make new highs is not exactly new or innovative, but one with a six-thousand-year track record of maintaining its purchasing power, and that is gold. We noted a couple of years ago that the gold price's traditional relationship with bond prices, inflation expectations and the dollar had broken down and it has become evident that much of this is down to central bank buying of gold as a reserve asset alternative to the dollar, with the biggest buyer being China. The US's move to freeze Russia's dollar-based paper assets (such as Treasury bonds) following that country's invasion of Ukraine awoke in many other countries the desire to diversify their reserves, and physical gold held in your own vaults is about as safe an asset as you can buy. Ascribing any sort of 'fair value' to gold is well-nigh impossible since it produces no income, but one cannot argue with the performance. We continue to advocate for gold as a valuable diversifying asset.

Fixed Income

January's bond market sell-off, triggered by fears of fiscal profligacy and sticky inflation, seems like ancient history already given all the other things going on in financial markets. The Bloomberg Global Aggregate Bond Index is +2.9% so far this year. The main driver of gains has been the US bond market, where the 10-year Treasury yield has fallen from 4.56% to 4.20% (via a peak of 4.79%) as a result of concerns about a slowing economy. The UK 10-year Gilt yield has risen from 4.56% to 4.67%, with two very distinct peaks. The first (4.89%) came during the global yield spike in January; the second (4.78%) in response to the Spring Statement. European yields have also risen following Germany's expansionary fiscal shift. The 10-year Bund yield has increased from 2.36% to 2.73% with an interim peak of 2.89%. Our strategic view remains that inflation and interest rates will remain structurally higher in the post-pandemic world, with geopolitics, domestic politics, demographics and climate change all contributing to that view. Thus, we are still not minded to chase yields lower, especially as we believe that the current weakness in economic indicators is a 'soft patch' rather than the beginning of a more serious slowdown.

All UK Conventional Gilts have delivered a total return of +0.6% over the last three months and -2.8% over the last year. Index-Linked Gilts returned -1.6% and -9.6% over the same respective periods. Emerging Market bonds produced a total return of +3.1% in sterling over the three months to end March (+8.2% over 12m). Global High Yield bonds delivered +0.4% (+3.9% over 12m) in sterling.

Conclusion and Outlook

In December, we identified the potential risks ahead, citing concerns about Trump's policy direction in particular. We also suggested that 2025 would be a year of greater volatility in stock markets, but that the bumpy ride would still get us to a reasonably pleasant destination in the end. We are still on the ride and the temptation to get off or turn back is great. We continue to point to the fact that equities trend higher over the long-term owing to their participation in the nominal growth of economies.

It's unusual for the US stock market to fall more than 20% in the absence of a recession, although there have been two occasions during the last forty years when that has happened. The first was the Black Monday crash in October 1987 which (although triggered by overvaluation and legitimate economic concerns) was exacerbated by automated sell orders driven by portfolio insurance products (after which "circuit breakers" were introduced to prevent a recurrence). It's barely visible on a long-term chart. The second (once the economic data was revised) was in 2022. Again, there was speculative froth to be blown off, but this was also a period which featured a unique repricing of money, during which the Federal Funds (interest) rate rose from zero to 5.5% and the 10-year US Treasury yield jumped from 0.5% to 5%. We do not envisage such circumstances being repeated today. However, we will remain sharply focused on the US economy in the weeks ahead.

To wrap up on a brighter note, what could go right? A selection of positive signposts could be: Donald Trump backs off his more disruptive policies in response to stock market weakness; Elon Musk's DOGE team succeeds in cutting a lot of fat from the government without damaging any muscle, paving the way for tax cuts and easing pressure on the bond market; Europe's stimulus is front-loaded; energy prices fall as more supply is encouraged in the US; and real signs of AI-related productivity enhancements emerge.

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