RATHBONES | Incorporating Investec Wealth & Investment (UK)

05 March 2025

Market commentary

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Overview

It might seem counterintuitive to begin an investment commentary with a quotation from the founder of the Russian Communist Party, but Vladimir Lenin's words are echoing across more than a century to the present day: "There are decades where nothing happens; and there are weeks where decades happen." We began last month's commentary by suggesting that if January's market action was a harbinger of what was to come, we could expect to see "rising equities but with a broader sector and regional participation rather than leadership largely from US (technology) growth stocks [...] accompanied by all sorts of unexpected news and increasing volatility."

We would not want to make too much of one month's experience, but those words describe February quite well. The MSCI All-Countries World Index actually registered a small loss, but the ex-US version was up a little. The S&P US Technology sector sub-index was down around 1%, but the Magnificent 7 leading shares fell 9%. We shall also have to refer to events that have occurred since the month-end, as they have already had a sharp negative impact on equity markets.

The source of most our stress at the moment is the White House, from which a torrent of policy announcements and executive orders has emerged since President Donald Trump took up residency again on 20th January. These range from grand geopolitical proclamations concerning, for example, the situation in Gaza or a potential conclusion of the war between Russia and Ukraine, to a reversal of a ban on plastic straws. No issue is too important or too trivial to escape the attention of Mr Trump, who, knowingly or not, is delivering a masterclass in dissemblance that leaves political opponents and investors in a state of confusion.

The biggest diplomatic shock has been the bust-up between the US President and Vice President and the President of Ukraine, Volodymyr Zelenskyy, culminating in the latter's abrupt departure from the White House as he continued to hold firm against US demands for mineral rights in his country (with no explicit security guarantee). We remain unsure of the endgame that Trump has planned. Commentators discuss "spheres of influence", suggesting that Trump's wish is to carve up the world into three broad zones under the "control" of the United States, Russia and China. Russia's strongest card is its arsenal of nuclear weapons, but with an economy only a tenth of the size of the European Union, it does not really have much economic influence. China, as the world's second largest economy has a bigger say. One result of these events, though, is that Europe (and the UK) are highly motivated to increase their defence budgets which might provide a boost to domestic growth.

Another big shock was the imposition of 25% tariffs on exports from Canada and Mexico into the United States. These came into effect on March 4th despite the fact that there had been high hopes that yet another extension would be granted or a last-minute remedy found. If they do persist, then we can reasonably expect some downgrades to US economic growth forecasts and probable recessions in both Canada and Mexico, the lion's share of whose trade is with their neighbour. At the same time, a further 10% tariff was applied to imports from China (on top of the initial 10%), and China retaliated with its own tariffs.

None of this is conducive to positive risk sentiment. All of this is reflected in the Baker, Bloom & Davis "Economic Policy Uncertainty Index", which is currently making new highs. The last reading was published at the end of January, and one might reasonably expect the February score to be even higher. We often allude to the fact that "uncertainty" is one of investors' greatest enemies because, unlike "risk", it is hard to quantify and leaves too wide a range of potential outcomes. All other things being equal, it tends to make investors more cautious and to demand a higher risk premium for financial assets. One ray of hope is that Trump (and many of his supporters) are highly motivated by financial gains, and a falling stock market will not be viewed favourably. There is talk of a "Trump put", although nobody can be sure of its existence or its strike price. But such is his nature that we would not be entirely surprised to see him reverse gears and then declare that he has saved America from tariffs!

With so much going on elsewhere, it is almost forgotten that the US government has effectively run out of money. It has once again reached its "debt ceiling", an anachronistic constraint on the nominal amount of debt that can be issued, with a current deadline of March 14th for a resolution. There are sufficient funds in the Treasury General Account (the government's "current account" at the Federal Reserve) to keep things ticking over for now, but agreement for a new ceiling (or extended suspension of the ceiling) will have to be passed by Congress, where the Republicans' majority is thin and there is always the risk of deficit "hawks" not voting in favour. There have been shutdowns of various services in the past, but this issue has always been resolved eventually, and, despite the fractious background, we would expect it to be resolved again. Even so, it's just another unsettling aspect of US politics in the current era.

More positively, companies, in aggregate, fared well in terms of reporting their earnings for the fourth quarter and full year of 2024. This is important, as we do not wish to be reliant on rising valuations for our equity returns. Current consensus forecasts suggest reasonable earnings growth in 2025 of 9% in the US, 7% in the UK and 8% in Europe. For 2026, the respective forecasts are 12%, 11% and 12%. To be fair, it is rare for reality to meet expectations in most years – the exceptions usually being when economies are recovering from a downturn – but there is, at least, a bit of cushion in these numbers, and total returns will be bolstered by a combination of dividends and share buybacks. What should also be noted is that there is little to choose between the regions, which makes a big change from the last few years when American companies have trounced the rest of the world in terms of earnings growth. This could lead to a more even distribution of performance in regional terms and even some catching up by the laggards, signs of which we are already seeing. There are more regional details in the following sections.

Markets – US

With almost all of the companies in the S&P 500 Index having reported their earnings, the outcome was positive. It's easy to be cynical about the usual game of reducing expectations and then beating them but, for once, the reductions had not been as large as usual and so the bar was set quite high. In the end, 75% of companies have beaten expectations and by an average of 7%. This delivered overall earnings growth of 13% compared to a year earlier. That came on 5% sales growth (1% higher than expected), meaning that operating margins continued to rise. There is a school of thought that margins will eventually mean revert downwards, a risk that many commentators have been forecasting for some time, and yet they remain resilient. In our opinion, the operating nature of today's market leaders is conducive to margins being higher than in the past. They operate with fewer people per dollar of sales and employ far less capital. Of course there are risks, and we are mindful of them. For example, we shall have to see how much of the import tariff impact is taken by companies as opposed to by exporters or end consumers. And the heavy spending on AI-related infrastructure will also need to generate more revenues as the assets begin to be depreciated. But a return to a world dominated by capital and labour-intensive "smokestack" businesses appears improbable. Even so, the rate of earnings growth of the Technology sector is expected to decline in the years ahead as it runs into the law of large numbers, and it is reasonable to expect a broader contribution to overall market performance. If we were to pick out one specific company to discuss, it would have to be the semiconductor chipmaker Nvidia, for a while recently the world's largest company by market capitalisation. It's greatest sin when reporting its fourth quarter earnings was to beat expectations by "only" 5%. That compares to an average of 9% for the previous three quarters and an average of 20% over the previous year, which was its annus mirabilis. Such are the dangers of setting high expectations. Having said that, the consensus analyst forecasts for future annual earnings growth for the next four years are 54%, 26%, 14% and 18%. It would seem dangerous to bet against that given the potential demand for AI-related services.

UK

The UK reporting season is not as advanced as that in the US, but it has also been reasonably encouraging, with the FTSE 100 Index on track to grow earnings by 6.5% in 2024 relative to 2023. When one considers the drag from two big sectors, Energy and Materials (mainly Mining companies), which have been constrained by weak underlying commodity prices, the overall outcome looks even better. The outstanding performer has been the Financials sector, with Banks continuing to benefit from the higher interest rates which allow them to generate a higher margin from their deposits, as higher rates tend not to be passed on fully to depositors. And although the UK economy remains weak, there is no great sign of distress evident in banks' bad debt provisions. The strong performance of the Banks sector is an object lesson in how a once-reviled industry can regain its lustre – at least in the eyes of investors if not necessarily the public.
Tighter regulation and stronger capital positions have made them much safer than they

were in the run-up to the Global Financial Crisis and the current management teams have been wary of taking on too much risk, allowing them to generate strong cashflows which they have used to increase dividends and buy back large amounts of shares. One unusual feature of the UK market currently is that mid-cap shares (FTSE 250) trade on a lower forward price/earnings ratio than the large-caps (FTSE 100), with the P/E being 11.6x vs 12x. The mid-caps also sport a higher forward dividend yield (4.1% vs 3.7%). Historically, the mid-caps have traded at a higher valuation owing to their greater growth potential. They are currently being held back by the persistent selling of UK-listed stocks by investors who are taking a more global approach to portfolio construction as well as by the disappointing performance of the UK economy at a time when the Bank of England is being circumspect about cutting interest rates. Furthermore, smaller companies with a greater exposure to the UK economy are impacted by the increase in employer National Insurance contributions and the higher national living wage. But we continue to note that good companies are being picked off one by one by bigger competitors and by cash-rich private equity funds and we continue to see potential value.

Europe

Europe is the breakout story of 2025 so far. Expectations were low coming into this year thanks to dysfunctional politics and a lacklustre economy, and an expected year-on-year decline of 2% in 2024 fourth quarter earnings set a low bar. The reality of +2% was a nice positive surprise. The political tone has also improved, with Europe suddenly appearing to be more united against a common enemy, which, rather surprisingly, turns out to be the United States! France has manged to get a budget through Parliament (even if the hoped-for spending cuts were not part of the deal) and Germany is set to have a new government led by the business-friendly Friedrich Merz of the centre-right Christian Democrat Party. His first imperative is to expand the fiscal deficit to allow for greater Defence spending and he also aspires to increase spending on infrastructure. The "dirty secret" of Germany's pot-holed motorways, silted waterways and tardy trains (which are, apparently, less punctual than the UK's) is now out in the open. There is a realisation that following years of self-imposed austerity, there is a requirement for more spending aimed at boosting productivity. The European Central Bank is leading the charge in terms of cutting interest rates, and so global investors are suddenly correcting their underweight positions after years of neglect.

Emerging Markets

The release of DeepSeek's R1 Large Language Model, which we commented on last month, has galvanised investor interest in Chinese technology companies, with the Hang Seng Tech Index +24% this year and +31% from its mid-January low point. With so many investors deeming Chinese assets to be "uninvestible" owing to geopolitical concerns and tariff risks, many were caught short. But there is insufficient evidence to support being much more positive on China. The deflating of its real estate bubble is still not complete, and the government continues to find it difficult to revive consumer confidence. The next attempt might come at March's National Party Congress, the event at which forecasts are made and policy outlined. Even so, the projected GDP growth rate of 5% will be taken with the usual pinch of salt unless accompanied by credible, concrete measures to boost demand, and that would need a heavy does of fiscal stimulus, something which we believe the government remains wary of providing owing to past boom and bust cycles.

Fixed Income

Global government bonds have generated several weeks of positive returns following the sell-off which occurred at the beginning of the year. The Bloomberg Global Aggregate Bond Index is +2% so far this year. The sell-off was triggered by a variety of concerns: inflation being too "sticky"; a reduction in the expected extent of interest rate cuts to be made this year (especially in the US); worries about fiscal deficits and the need to fund them. But all of those have been set aside for now and investors are back to seeking safe havens against the threat of weaker economic growth. The UK 10-year Gilt yield hit a high of 4.89% in January and ended February at 4.48%. The respective figures for the 10-year US Treasury bond are 4.79% and 4.20%. We remain of the opinion 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 not minded to chase yields lower at this point, 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 Gilts have delivered a total return of -0.7% over the last three months and -0.6% over the last year. Index-Linked Gilts returned -3.7% and -6.3% over the same respective periods. Emerging Market bonds produced a total return of +5.6% in sterling over the three months to end February (+12.2% over 12m). Global High Yield bonds delivered +1.8% (+6.1% over 12m) in sterling.

Conclusion and Outlook

Last month we speculated as follows: ‘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.” We have definitely seen ‘Bad Trump’ in the last few weeks. Much as we would prefer to focus on companies and individuals going about their normal business, our attention is continually diverted towards political and geopolitical events as we negotiate an increasingly unfamiliar landscape. Even the veteran BBC World Affairs Editor, John Simpson, appears to be challenged by the situation, recently commenting that “there are years when the world goes through some fundamental, convulsive change”, with 2025 on track to be one of them. He describes this as “a time when the basic assumptions about the way our world works are fed into the shredder”. It is at times like these that we rely most on our investment process, with a focus on quality and the longer investment horizon.

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