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Report Card

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I must admit that I used to dread the school report season, which often had the capacity to ruin Christmas, Easter and my birthday (which lands in the summer holidays). It's not necessarily that they were all bad, more that my parents were inclined to focus on the 'C's rather than the 'A's. Furthermore, my interpretation of 'satisfactory' (good enough to get away with) did not match theirs (more effort required for better results)! I would like to think that my erstwhile teachers and my parents would be proud of my current levels of diligence, although the problem with financial market analysis is that hard work does not necessarily produce optimal outcomes. We are always balancing risk and reward and sometimes the scales can tip too far in one direction.

As we hit the end of the first quarter of 2025, it's time to review progress so far. There will be a full commentary in next week's longer monthly edition, but there is a lot going on that needs more immediate treatment, or at least to lay the ground for forthcoming events such as this week's 'Liberation Day' in the United States. That's not a new national holiday, but President Trump's name for the day when he reveals the full extent of his 'reciprocal' tariffs and frees the US from being exploited by its trade partners (so he thinks).

Spring Statement Review

First into the headmaster's study, though, is Chancellor Rachel Reeves. Last week I previewed the Spring Statement and the best thing I can say about it is that the UK equity market, bond market and the pound are still roughly where they were a week ago, and so there were no own goals scored. A more detailed review created by my colleagues is available here (A spring statement on fiscal discipline | Rathbones) and so I will just focus on what I see as the major implications.

There is no doubt that Ms Reeves was playing a poor hand, although at least part of the blame is on her as she dealt it to herself by promising to stick rigidly to the fiscal rules. There is also more than a suspicion that the combination of lower revenues and higher funding costs hemming her in were the self-inflicted wounds of the policies announced last October in the Autumn Budget. Remarkably, though, thanks to a series of spending cuts, she managed to get the Office of Budget Responsibility to sign off on fiscal headroom of £9.9bn, which is exactly what she had five months ago. Although that might seem like a victory, the problem is, as we have seen, that this headroom can shrink rapidly. It's the very small difference between two very large numbers (tax revenue and spending) and even if just one of those shifts adversely, there is a problem, with the trouble being that they rarely seem to offset each other. If growth (and tax receipts) is under budget, then things like benefits payments tend to be rising.

Another problem is that the projected balancing of the books only comes towards the end of this parliament, another four years or so away, potentially. And it relies on more productive government as well as a promise to rein in spending in the later years, a course of action that tends not to suit a government planning on being re-elected. New long-term growth forecasts also rely on a looser regulatory environment, which might be difficult to deliver, although I applaud the ambition (as long as nobody builds a house in my back yard, obviously!). I suggested after the Budget that this would not stick and that further tax increases might be on the cards. There are a lot of commentators who think that those tax increases are going to come as early as this Autumn and I'm not inclined to disagree with them. Could we see a repeat of the months between last year's election and the Budget in which consumers reined back spending and increased savings in anticipation of higher taxes? This is the concept of Ricardian Equivalence, the theory developed by the economist David Ricardo in the nineteenth century. It turns out not to work quite as neatly in practice as in theory because there are all sorts of other factors affecting spending. One of them is interest rates, and it could well be that the Bank of England has to play its part (non-politically, of course) in navigating the obstacles ahead.

Trump Undermines Confidence

Another factor affecting consumer behaviour is confidence, and that remains in short supply almost everywhere as we are assailed by numerous headlines daily proclaiming the end of the world as we know it. That could refer to climate change, democratic institutions or the rules-based world order that has prevailed since the Second World War. The actions of the US President are doing far more to upset global confidence than Russia's continuing presence in Ukraine or the ongoing conflict in the Middle East, and we are a day away from Liberation Day.

There are far too many unknown factors to allow us to make even what we think might be informed bets on the outcome. Here is a short list of the variables that we will have to examine to come to a conclusion:

- Which countries will be targeted?
- What will the tariff rates be?
- What industries might be targeted?
- What could be excluded?
- Will VAT and other non-tariff barriers be included?
- Will tariff rates be fixed or floating?
- Are the threats credible or will they be negotiated away? And how quickly?
- Who might retaliate? And how?
- Is this part of a broader coherent economic strategy? And, if so, what is it?
- How long will it all take to be a) implemented, and b) show up in the data?

Once we have worked our way through that lot, we will be better placed to judge. But whatever happens next, there is a strong groundswell of opinion that trust between the US and its trading partners (and even supposed allies) has been broken irrevocably and that there will be some redrawing of the trade map.

Marking Our Own Homework

I will be honest here and say that the results so far this year have been mixed. We were right to suggest at the start of the year that we would see increased market volatility in 2025, but the rapidity of the decline in the mega-cap US technology shares has taken us by surprise, even if we were sceptical of claims that they could continue to deliver the sort of gains made in 2023 and 2024. Like others, we did not anticipate the release of the DeepSeek R1 Large Language Model in January that upended expectations about the future returns from investment in AI-related growth. But neither had we gone 'all in' on AI. We continue to believe that this is more of a speedbump than a roadblock on the path to broader adoption, but we might need to see more concrete evidence of enhanced profitability before sentiment can improve. It would also be beneficial to markets to see a broadening out of the beneficiaries.

As for Donald Trump, it's easy to say in hindsight that he was going to unleash chaos, but I struggle to find much (mainstream) evidence of people forecasting the full extent of his tariff campaign without at least mitigating it by talking about the 'transactional' nature of the tariffs, suggesting that the bark would be worse than the bite, which, of course, it might yet be. Still, whilst all seems like gloom and doom, we must remember that we have only so far seen the 'bad stuff', such as tariffs, and not the 'good stuff', potentially to include extended and new tax cuts and deregulation. Who knows, Elon Musk might even have success in cutting excess from government.

Neither can I say that we were exceptionally bullish on Europe, which has performed well, but we did see the virtues of it being the home of good quality companies at a reasonable valuation. The sea-change in fiscal policy in Europe has been a once-in-a-generation affair, driven by a realisation that the US is not going to provide a security umbrella and that, following the recommendations of last year's Draghi Report, there is an urgent need for investment. The victory for centre-right Chancellor-elect Friedrich Merz in Germany was a key catalyst for change. There is more runway for Europe if it can hold its nerve, although the stricture of existing high fiscal deficits in most countries (ex-Germany) is a restraining factor.

All in all, we have tended not to stray far from our benchmark equity weightings this year, but the current episode of volatility might yet throw up some interesting opportunities. It must have been sorely tempting for many to cave in and allocate even more to the tech-heavy NASDAQ or the Magnificent 7 at the end of last year after they had looked like the only game in town, but, once again, a more diversified portfolio has reduced the volatility for those who prefer a more comfortable ride.

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