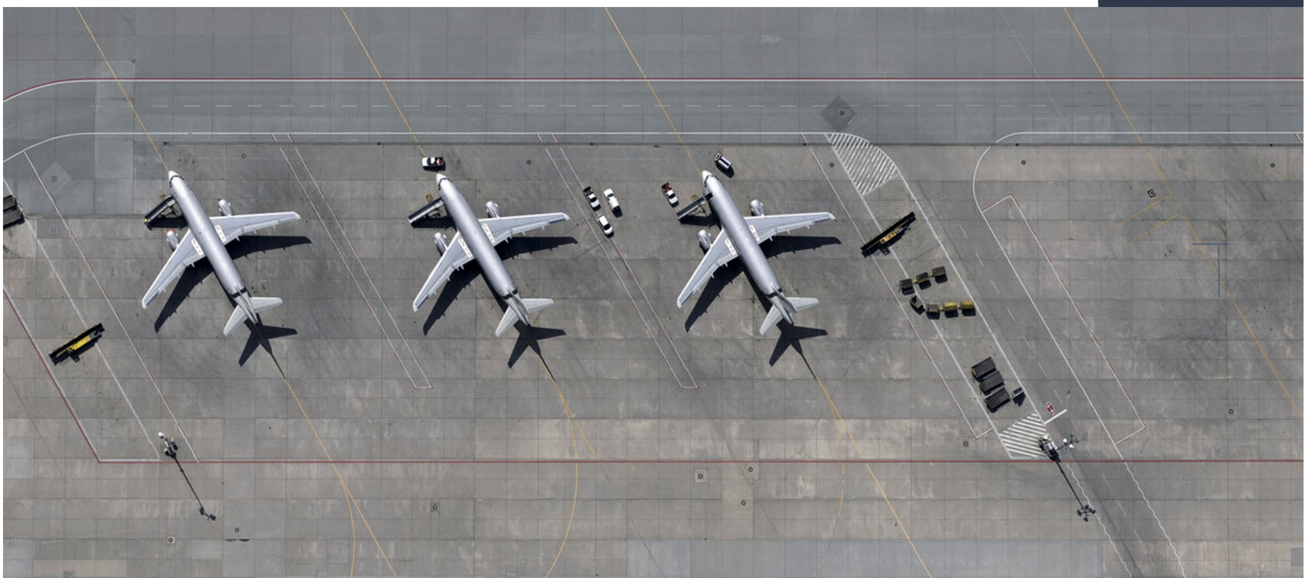
RATHBONES | Incorporating Investec Wealth & Investment (UK)

WEEKLY DIGEST | 18 March 2025

Tariffying!



John Wyn-Evans
Head of Investment Strategy

The price one pays for being a sports fan is the inevitable disappointment of one's team(s) going through a bad patch. And while one cannot realistically expect to win matches every week and trophies every year, the current travails of Wales's rugby team are, to say the least, somewhat dispiriting. At least David Moyes has injected Everton with a bit of pep, although, to be realistic, silverware remains a distant ambition. Even so, as a home supporter, one can console oneself with visiting (as of next season, in Everton's case) a couple of the finest sports stadiums in existence.

Once equity markets get into their stride, investors can quickly forget the bit of the disclaimer that reads "investments can go down as well as up". It seems that US investors, especially, are waking up to that reality after two consecutive years of well-above-average returns. And although the S&P 500 Index has only retrenched to levels first reached last July, the psychological phenomenon whereby people feel the pain of losses much more deeply than they enjoy the gains is once again in evidence. And, of course, when your portfolio is rising in value it's always on account of your investment genius, whereas when it's falling it has to be someone else's fault!

And so, where are fingers pointing now? As I suggested last week, the main source of market stress is the United States, and its government in particular. Investors have been wrongfooted by events and the bullish "Trump Trade" has not evolved as expected. They thought they were getting tax cuts and deregulation to sweeten the pill of tariffs, but it's been just the bitter stuff so far. Furthermore, whereas tariffs were only expected to be a threat that would quickly be withdrawn once reasonable concessions were offered, they appear, for now at least, to be stickier. And that's before we get onto threats to annexe Canada and invade Greenland.

This is having a negative effect on companies, more of whom are citing policy uncertainty as a reason to withhold investment and to pause hiring. Consumers are equally unsettled thanks to the threat of another bout of inflation as tariffs are passed through to them. Then there are federal workers cowering under the shadow of Elon Musk's DOGE (Dept of Government Efficiency) chainsaw and the consultants to the government who are at risk of having contracts cancelled. Add in the anecdotal evidence of non-US holidaymakers showing a preference for other destinations (or staying at home) and there is a realistic possibility of some weak economic data prints ahead.

US equity markets, being an efficient discounting medium, have already taken a lot of this on board, with the S&P 500 having fallen 7.6% from its February all-time high by close of business on Monday 17th March. At its worst last week, it had fallen by 10.1%. And if you are feeling a little shell-shocked by the speed of the reversal, that's understandable, because the initial decline from the peak into correction territory (-10%) took only twenty days, making it the fifth fastest correction since 1950 (the fastest being at the beginning of the Covid crisis in 2020, and that really was the most idiosyncratic of events). You might recall from past commentaries that I have written about the structure of (especially US) markets today and how they are vulnerable to such sentiment reversals and this was a typical example.

Such a speedy move might normally be associated with a surprise geopolitical or monetary policy event, but the catalyst this time was mainly US politics. Even so, one could also argue that at least some of the decline was the result of the unwinding of crowded and/or speculative positions. That can be seen in the relative underperformance of past winners, not least the constituents of the unofficial "Magnificent 7" group of technology titans. As a group, they are -19% from their peak in December. Over the same period the other 493 stocks in the index have, in aggregate, fallen by just 1.5%, while the equal-weighted version of the S&P 500 is down 2.5%. The market cap-weighted S&P 500 Index (which is the one you always hear about) is -6%.

What happens next in the US is, to a great degree, dependent upon the economy, with the main question being: "Will there be a recession?" As far as I can see, the only economists/strategists forecasting a recession now are the ones who were doing so for most of last year, and so one has to treat their forecasts with a bit of caution. Our own work suggests a probability of around 25%, but there is no doubt that forecasts for GDP growth in 2025 are falling. Many of them started with a two at the beginning of the year and now start with a one. Earnings growth expectations for the S&P 500 Index have dropped from low double-digits into single figures and year-end targets for the index are also being reduced (although, on average, still offer decent upside from here).

One reason to remain cautious in the short term is that President Trump and his closest advisors remain "on message" in their pronouncements that households and investors might have to endure some short-term pain in the pursuit of long-term gains. Both Trump and his Treasury Secretary, Scott Bessent, have stated that they are not fazed by the stock market's correction, which is a big shift in attitude from Trump's first presidency. I remain convinced that they will start to worry at some point, especially as a negative wealth effect could feed back into weaker household consumption, but there is currently no knowing where their pain threshold lies.

More encouragingly, the indefatigable market historians at Deutsche Bank have looked back at the sixty market corrections that they can identify since 1928. Ten of them only lasted for one day, with a further seven for no more than ten days. Twenty-six of them took place around recessions, meaning that thirty-four of them did not. Only seventeen went on to become fully-fledged bear markets (-20% or more).

It's rare for a stock market to fall more than 20% in the absence of a recession, but there are two occasions during my career when that has happened. The first was the infamous 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 really cannot envisage such circumstances being repeated today. Indeed, although it is currently in "pause" mode, the Fed's next move is expected to be a rate cut. And, whisper it quietly, should Trump and Musk succeed in cutting the fat from government without damaging the muscle, that might even prove supportive for the bond market.

Should you still be unconvinced that we should remain at least neutrally weighted in equities in balanced portfolios, then our asset allocation team has crunched some more numbers. We looked at what would have happened over the last sixty years if one had cashed in US equity portfolios after a 10% correction and then taken refuge in cash (Treasury bills) for six months before re-entering the market. The work shows that by staying in the market for the whole time one would have turned an initial $1,000 into $75,000, whereas the "chicken" strategy would have yielded only $47,000.

There are indicators that suggest that a recession is not imminent. Credit spreads (the extra yield that corporate bond holders demand above the risk-free rate of government bonds) have risen but are hardly in stress territory. Commodity prices are not collapsing – the Bloomberg Commodity Index is up 7% year-to-date (although I acknowledge that some of that will be a function of the weaker dollar, as most commodities are priced in dollars).

There are also potentially positive developments elsewhere in the world, which is rewarding a globally diversified equity portfolio. There has been a generational shift in Germany's attitude to fiscal deficits, and this week we expect bills to pass through the German Parliament ratifying a lifting of the cap on defence spending and a €500bn infrastructure spending plan. Meanwhile the European Commission has also put forward plans to raise €150bn to support defence spending.

And in China, there are tentative signs that the worst might be over. President

Xi recently met with leading Chinese businessmen, which could be a sign that his suppression of entrepreneurial spirits might be lifting. Piecemeal stimulus measures seem finally to be gaining traction, as evidenced in the latest monthly activity data covering retail sales, industrial production and fixed asset investment. We are by no means predicting a boom in China, but reduced drag would be a step in the right direction.

A final thing to mention is the effect of currency movements. The pound has risen from as low as $1.22 in January to $1.30, meaning that dollar-denominated assets would have fallen in sterling terms even if they had gone nowhere in the local currency. It is our policy not to hedge currency exposure in risk assets unless there is a very specific reason such as an event risk or an explicit policy aimed at devaluing a currency (think of Japan for several years post 2012 when it adopted “Abenomics”). Although there is a lot of chatter about a potential “Mar-a-Lago Accord” (echoing the Plaza Accord of 1985) designed to reduce the value of the dollar to make US manufacturing more competitive, the details are sketchy, to say the least, and it’s not clear that there is global appetite for such an accord (although Trump might use his tariff stick to beat one out of everyone!).

Economic Commentary

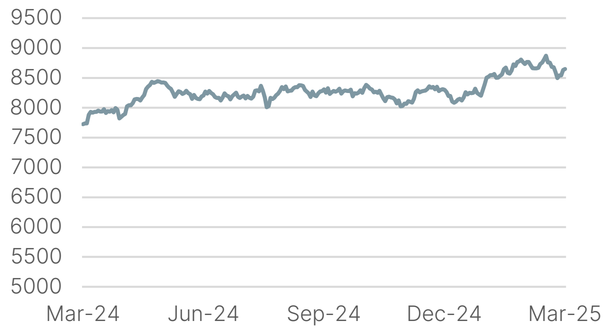
FTSE 100 weekly winners

Melrose Industries PLC	8.0%
Fresnillo PLC	8.0%
BAE Systems plc	5.8%
National Grid plc	3.9%
BP p.l.c.	3.8%
SSE plc	3.6%
United Utilities Group PLC	3.5%

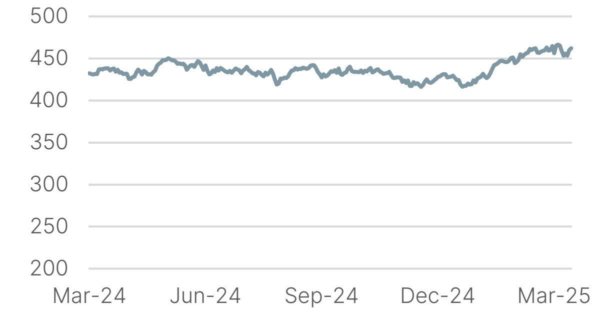
FTSE 100 weekly losers

Entain PLC	-11.9%
International Consolidated Airlines Group SA	-11.1%
Tesco PLC	-10.8%
J Sainsbury plc	-7.7%
Pershing Square Holdings, Ltd. Public Class USD Accum.Shs	-6.9%
JD Sports Fashion Plc	-6.7%
Intertek Group plc	-6.3%

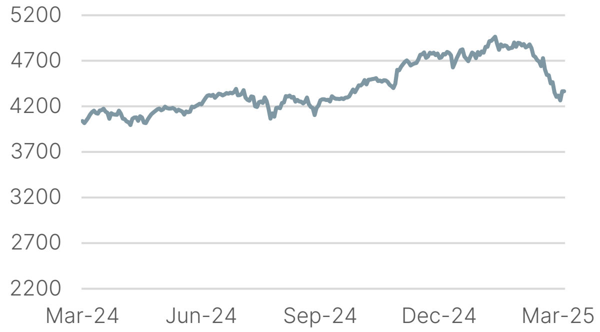
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

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