Investment review

We close the second quarter on a much more positive note than we started it. World stockmarkets having staged a powerful recovery since their nadir in the days after the US president's early April tariff announcements, now generally (and perhaps generously) referred to as 'Liberation Day'. In sterling terms, global equity market returns are still meagre for the calendar year to date. But the past quarter's strong rebound, particularly in areas that had initially been punished quite harshly, serves as a useful reminder that sitting tight through periods of sudden market stress, as we have done, is typically the better strategy in order to fully participate in those crucial recoveries that make investing a rewarding experience in the long run.

The recent significant escalation of conflict in the Middle East has reminded us of how intertwined geopolitics, energy markets and financial markets are, but it was reassuring to see the latter barely flinch when hostilities escalated, perhaps a measure of the extent to which global tensions and conflicts are already quite deeply embedded within market risk and pricing. The risk of a destabilising oil and inflationary shock – something that might have occurred had Iran blockaded the Strait of Hormuz to restrict the world's supply of key oil and gas supplies – seems to have diminished for now, but we do still need to be alert to further flare-ups that could unsettle market confidence.

Watering down the impact of tariffs

It has certainly been a noisy second quarter of the year, particularly where the White House is concerned, with US trade tariffs on the rest of the world having been the primary concern for markets and investors. Steadily, however, the volume has been turned down and it seems that the world has begun to adjust to the new economic order under Donald Trump's presidency. Market confidence has returned in recent weeks not because corporate profits or economic growth have strengthened (they have not), but because of the perception that the harshest 'Liberation Day' tariffs will be watered down significantly, ultimately doing less damage to the global economy than originally feared, not stoking inflation (so far) and giving central banks the breathing room to continue down their intended paths of gradually loosening their monetary belts. If we do revert to something close to a 10% universal tariff, with additional product-specific tariffs and a 40% mark-up for Chinese goods – i.e. roughly the base central case before 'Liberation Day' – then the consensus estimate hit to global GDP growth over the next two years is likely to be no more than around 0.5%. To us, the transition to a higher-tariff environment is unlikely to tip the global economy into recession. We are not out of the woods by any means, but as things currently stand financial market participants (and that includes us) are more confident than they were a few months ago that the global economy, whilst expected to slow a little, will not be blown too far off course.

Tariff deadlines, deals and workarounds

Of course, there are still lots of 'ifs' and 'buts' in relation to working out the true cost of trade tariffs, with many business leaders around the world understandably still trying to formulate their best tactics. We still do not know what Trump has in mind post the expiration, in early July, of his general 90-day reprieve on global reciprocal tariffs, or the pause on the higher Chinese tariffs due to expire in mid-August.

> *"...there are still lots of 'ifs' and 'buts' in relation to working out the true cost of trade tariffs..."*

There is also a possibility that the US Court of International Trade's initial ruling that Trump exceeded his executive powers in some way will be upheld in the Supreme Court. As this is written, the US president claims that a deal with China has been done already, but whether this is a mere slip of the tongue or indeed something concrete remains to be seen – it won't be the first time Trump has sent a confused message to financial markets. Currently, though, an extension to these deadlines (assuming deals have not been struck beforehand) is the working assumption, allowing time for more negotiations more negotiations to take place. Thankfully, there does now appear to be more of a reconciliatory tone surrounding tariffs than the fiery one that accompanied Trump's early April pronouncements: this adds weight to the argument that the disruption to global economic growth will be relatively contained and that we are unlikely to see a repeat of April's market chaos, even if deadlines need to be extended. Meanwhile, what we can be fairly certain of is that China in particular is already busy finding ways to circumnavigate some of the harshest tariffs: there is strong evidence of significant trade re-routing by China, with exports to the US having slumped in recent months and offset by a noticeable increase in exports to the rest of Asia. Unless the US has ceased consuming – and Asia's demand for Chinese goods has suddenly increased – the only explanation is the third-country bypassing of the harshest tariffs and perhaps some creativity on the part of China to remove the 'made in China' stamp from certain of its exported goods.

US exceptionalism bruised but still intact

A lot of recent focus has understandably been on the US economy, but it is interesting to observe that more weakness in forward-looking manufacturing and services sector surveys has actually emanated from the eurozone than the US. We are also told via global surveys that some of the world's biggest institutions have been re-positioning, albeit modestly, some stockmarket exposure away from the US in favour of Europe. However, the current data do not suggest this will be a worthwhile move in the medium term. Stockmarket valuations in Europe have already moved above their longer-term average, a combination of the first quarter's rotation away from the US and a deteriorating picture on European corporate earnings. We are holding firm in both our allocation to stocktmarkets and our regional positioning, with its bias towards the US, more inclined to trust the views of, and data shown to us by, underlying active managers, particularly those at the coal face who live and breathe US investment every hour of every day. They tell us that, even if the US economy slows a bit (which both they and we think is likely), so-called 'US exceptionalism' has not been killed off by Trump's imposition of tariffs. Yes, US corporate earnings have been revised down, but so too have those in Europe, and by a more meaningful amount. Meanwhile, US corporate profit margins continue to track higher than those in Europe.

Innovation and opportunity in the US

We believe that an allocation to the US stockmarket, whether via active funds or a mainstream index, still gives important access not just to the successes within the domestic economy but also, via truly international businesses, to the revenue streams from other markets and economies not served by their local stocks. Maintaining a meaningful allocation to the US is also relevant where it comes to gaining exposure to some of the fastest-growing companies, including those that are at the forefront of innovation, something that the US seems rather good at. To gain any sensible exposure to global technology, for example, unquestionably one needs to turn to the US stockmarket.

Many investors will be aware that the mainstream S&P 500 market index is heavily skewed to this sector due to the dominance of companies such as Microsoft, Nvidia and Apple (these three stocks account for just under 20% of the index), but even a size-adjusted passive exposure to the US stockmarket will still give investors around 15% exposure to this sector. A similar size-adjusted allocation to pan-European stockmarkets means less than a 5% exposure to technology and an over-sized allocation to comparatively moribund industrial and financial sectors, unlikely in our opinion to be the drivers of long-term excess returns for investors.

Consequently, if one wants to participate in this innovation and to have exposure to these growth opportunities, the US market is where one needs to have meaningful positioning. So, we are comfortable maintaining our diversified exposure to this vast market. We are also very happy with our separate, more targeted, investment in the fast-evolving theme of artificial intelligence – although we access this theme via a global fund, it is worth noting that the manager's market-agnostic approach, investing in what they believe are both today's and the future's brightest AI beneficiaries, still results in a two-thirds allocation to shares listed in America.

Differences in monetary policy

There is now some clearer separation in policy between key central banks. The European Central Bank ('ECB') has cut again and is likely to go further, below 2%, to combat very weak growth and an inflation number which is now undershooting the ECB's target. It is important not to be fooled by the recovery in the eurozone economy during the first quarter of 2025. We think this is a false dawn as the strength can largely be put down to tariff front-running. In all likelihood, the eurozone economy will revert to its sluggish ways, caught in a low productivity trap, which will require another cut to interest rates before the year is out.

We understand the current reluctance of the Bank of England ('BoE') to cut interest rates again after their most recent meeting, a reflection of its caution during a period of heightened economic uncertainty being compounded by potential impacts from events in the Middle East. This caution may prove to be unjustified – we feel the Bank's Monetary Policy Committee will need to do more soon to stimulate what is still a flagging economy. Market expectations are for two further rate cuts of 0.25% by the year end, which would take the UK Base Rate to 3.75%.

In our view, this leaves the US out on a limb in terms of monetary policy change. Having last cut interest rates in mid-December, the US Federal Reserve ('Fed') seems in no hurry to loosen policy further. It has cited that, for the time being, it is well positioned to wait to learn more about the likely course of the economy before changing its stance, and is attentive to the risks to both sides of its dual mandate which seeks full employment and stable prices.

The Fed has acknowledged that increases in tariffs this year are likely to push prices up and weigh on economic activity; it will also no doubt be very alert to the recent escalation of Middle East tensions and potential impact this could have on energy price inflation. So, the Fed's caution does make a lot of sense. However, there is still a danger that it ends up being too cautious, wanting to put clear water between its own views and those of the President to demonstrate its independence and strict adherence to its mandate. As a result, the policy error stakes remain quite high. Markets are currently predicting a 40% chance of two 0.25% cuts in US interest rates by the end of this year, but as the clock ticks down the case for kicking the rate cut can down the road could grow, particularly if more persistency in tariff-related inflation begins to show up in the data.

Currency considerations

The US dollar's weakness this year has been an unhelpful headwind for sterling investors and a tailwind for others, but to us the downward move now seems to be a little overdone. The US Dollar Index, a measure of the value of the US dollar versus a basket of foreign currencies, stands at a three-year low, despite the fact that increasing interest rate differentials and a relatively more hawkish Fed would, under normal circumstances, usually see strength in the currency. A key catalyst for dollar weakness has undoubtedly been concerns over US trade policy, driven by Trump's chaotic tariff announcements. Rumours that he is preparing to announce his favoured replacement for the central bank's next Chair ahead of time has also been weighing on the currency of late – an early nomination could drive a further wedge between the US president (who wants interest rates to be cut) and the central bank (which, as noted, is keen to hold fire), particularly if the Chair-in-waiting also begins to chip away in the background to undermine the incumbent's policy and weakens its credibility. These can be added to a long list of new factors financial markets (in this case currency-related) are having to contend with, and adjust to, since Trump took office.

Some commentators have taken the current negativity surrounding the US dollar a stage further by suggesting that we are seeing the beginning of the demise of the greenback's special status as the world's reserve currency.

> *"A key catalyst for dollar weakness has undoubtedly been concerns over US trade policy, driven by Trump's chaotic tariff announcements."*

We are sceptical on this view given the scale of the dollar's dominance and the consequent challenges that would be faced in usurping it – it still accounts for around 90% of foreign exchange transactions, around 80% of global oil trade and the majority of foreign exchange reserves, trade invoicing, international payments and loans is all conducted in US dollars.

One other consideration is where other currencies stand in relation to the dollar. Given the relative economic weakness of the eurozone and UK versus the US, and the increasing monetary policy gap between the Fed and the ECB/BoE, we see little reason for the US dollar to continue to come under too much further pressure. Currencies have a history of over-extending themselves, on both the downside and upside, before a reality check, and we believe the dollar does deserve more attention than it is currently receiving. We should also add that at the height of the most recent Iran-Israel hostilities, the dollar once again showed (albeit briefly) some strength, reminding the world that it has not lost its safe haven appeal in times of crisis.

Inflation and bond markets

Bond markets now feel a slightly less-safe space than earlier in the year. The prospect of further interest rate cuts, in time, should still be a supportive influence on this asset class, but the escalation of Middle East tensions has added an extra layer of uncertainty to an already complex inflationary backdrop created by the chaotic application of trade tariffs.

So far, there is little (if any) evidence that higher tariffs are manifesting in higher consumer price inflation – indeed, US consumer prices have actually fallen from 3% to 2.4% since the start of the year. Yet it would be foolish to ignore the caution being exercised by the likes of the Fed which, as already noted, is clearly still troubled by the possibility of higher tariff-related inflation and is citing this as one of the key factors behind its rate-cutting hesitancy.

Having reduced fixed interest exposures at the end of the first quarter, we have been content to sit out the past few months with some elevated cash positions. But as interest rates begin to retreat and with cash returns now becoming less appealing, we wish to put the excess liquidity to better work. The threat of tariff-induced inflation, potentially compounded by heightened energy-price inflation on further flare-ups in the Middle East does, however, make us nervous of recommitting the money raised a few months ago back to fixed interest markets. The cash raised largely came from corporate debt markets, but even here the yield differential compared to equivalent government bonds has narrowed significantly, meaning that investors are not being adequately rewarded for the additional risk of investing in corporate debt.

We do still have exposure to corporate fixed interest markets, but this is positioned at the shorter end of the maturity spectrum where less default risk and volatility is typically seen.

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Alternatives to fixed interest

So, with bond markets feeling a less safe place than they did due to inflation and monetary policy uncertainties, we will be redeploying cash into the alternative investments segment of portfolios, where the mandate allows, expanding the existing allocation to market-neutral investment funds via a more global approach. We expect our preferred investment fund to tap into a broader opportunity-set and increased dispersion of returns currently available within international markets, whilst simultaneously neutralising market risk to create an investment with low daily volatility. We believe it is well positioned to deliver excess returns over cash in the coming year. For more cautious mandates we are also reintroducing a low-risk 'absolute return' bond fund which should similarly be capable of eliminating the majority of market risk and is also expected to deliver slow and steady returns slightly above those from cash deposits.

Readers may recall that we made a successful tactical shift into more market-neutral alternative investment funds after Russia's invasion of Ukraine in 2022: inflationary pressures built, which posed a threat to fixed interest investments. We subsequently increased the allocation to fixed interest markets and reduced 'alternatives' when the coast became clearer. Our current planned move is a similar tactical exercise to 2022, aiming to direct capital not earmarked for conventional stockmarket risk into an area which should offer a more reliable and stable return profile, is less exposed to inflation uncertainty, and has the opportunity to beat cash as interest returns begin to dwindle.

Business as usual in equity markets

Within stockmarkets generally we are taking a longer-term view and do not feel the need to either lighten the load or change our regional positioning on account of recent tariff noise and geopolitical events. Our base case still sees the global economy growing in excess of 3% over the next couple of years, with inflation generally floating in a manageable range and close to central bank targets, allowing interest rates to retreat further. We may have to wait until later this year, or possibly into next, for the Fed to announce further cuts, but the broad expectation is for all key regions to escape recession, with Asia and the US still continuing to lead the world economically. As noted, 'US exceptionalism' may have been weakened by all the goings on this year, but as things currently stand we do not expect it to go into reverse. Corporate earnings estimates are being pared back generally since 'Liberation Day', but the longer-term momentum in profits growth and economic activity is still expected to be found within the US and Asia, hence that is where skews in our asset allocation remain.

We are also happy to maintain our commitments, typically accessible more via active managers, to attractively valued medium- and smaller-sized global businesses.

Fundamentally, with the trade tariff noise seemingly beginning to settle down to a more manageable level, and Middle East hostilities calming too, we feel the general backdrop still warrants a good allocation to risk assets. That is not to say that there will not be further bouts of market volatility in the months ahead, but provided nerves are held, as we have already shown this year, then investors' longer-term goals should remain on track. But there is also a need to be tactical to take account of shorter-term risks and opportunities, ensuring investible wealth, even in lower-risk corners of portfolio construction, continues to work as hard as possible.

Important information