Investment review

While much of the northern hemisphere has baked under record-breaking temperatures this summer, the heat inflicted upon global stockmarkets has generally been lower with many enjoying a period of relative calm or quietly reaching all-time highs. This steady momentum follows an uncomfortable period of tariff-fuelled uncertainty earlier in the year and has been driven by a powerful mix of fundamental and psychological factors: investor confidence has been boosted by growing anticipation of US interest rate cuts, while compromises on tariffs and further progress in trade negotiations, including between the US and China, have eased some previous anxieties about the impact on the world economy and asset prices.

This more favourable backdrop, which has seen some resilience in US economic growth, quite mild inflation data and strong corporate revenue and earnings growth – especially within the technology and AI sectors – has generally set a positive tone for investor confidence. It has allowed most risk assets to post positive returns in the past quarter, restoring some respectability to this year's results after the heavy tariff-induced setbacks experienced in the spring. Even lower-risk assets such as bonds have become a more competitive source of real return now that inflation and interest rates are on a downward path.

World economy adjusting to a higher-tariff regime

Overall, forecasts suggest the pace of global economic growth is likely to remain above 3% in 2025 and in each of the next two years, with increasing evidence that the global economy is adjusting reasonably well to the new tariff regime and that the overall impact is likely to be relatively modest. Export data from emerging markets is showing resilience and there is strong evidence of continued trade re-routing by China via ASEAN ('the Association of Southeast Asian Nations') countries, which is more than counteracting the fall-off in their exports to the US.

Our expectation is for all key regions to escape recession and that the US and Asia will continue to lead the world economically: forward-looking indicators, such as Purchasing Managers' Indices ('PMIs'), are generally improving in the US and Asia while the UK and eurozone continue to face economic and business-related headwinds. In the case of the UK, we acknowledge that 'stagflation' (stagnating economic growth, rising unemployment and persistently high inflation) could become a particular challenge for the Bank of England ('BoE') and government to manage.

Inflation, interest rates and the dollar

The inflation outlook is still quite complicated, due to the potential impact of global tariffs, but it is 'encouraging' to observe looser labour markets across all advanced economies. This looks set to take the pressure off wage growth and services inflation, which in turn should see wider price pressures ease. Oil and energy market worries have subsided too after the escalation of Middle East tensions in the early summer, and a general combination of weaker oil demand growth and surplus in supply suggests that the oil price will drift lower and help contain inflation. On the back of inflation and economic growth projections, it now seems more likely that the BoE will need to respond more than other key central banks – perhaps by another 1% – in terms of policy change over the coming year or so.

In its latest move to cut interest rates by 0.25%, the first move since last December, the US Federal Reserve ('Fed') appears to have signalled a subtle shift in its focus from inflation to growth, implying that the importance of protecting employment and the economy now outweighs the risk of reigniting inflation. There is a possibility, however, that the Fed may need to loosen policy a little more slowly than markets currently expect on account of slightly stickier inflation and what appears to be a more self-sufficient economic growth trajectory in less need of stimulus.

This potential deferral of further US rate cuts and greater resilience in the US economy underpins our argument that the US dollar could regain some strength near term, particularly if the UK and core European economies (France and Germany especially) continue to be plagued, as they are being, by economic, fiscal and political fragility.

Fixed interest opportunities

We see the general backdrop of falling interest rates and inflation as not only remaining supportive for equity markets but fixed interest investments too. We are maintaining our diversified approach through allocations to both government bonds and corporate debt. In the latter area, investment grade bonds remain quite expensive versus equivalent sovereign bonds but as long as default risks remain contained, as they are, we are comfortable with the yield pick-up via our predominantly short-dated positioning in credit. This is counterbalanced with some longer-dated exposure to government bond markets which, whilst more sensitive to inflation and interest rate moves, could increasingly provide good total returns if policy is loosened further, as we expect it will need to be in places like the UK.

Soon we should have clearer signage on the prospects for the UK gilt market, for example, once the state of the government's finances and its ongoing borrowing needs are outlined in November's Budget. We are keeping an open mind about positioning as attractive opportunities could yet open up if UK interest rates do indeed fall materially by the end of 2026.

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Equities have continued to do well

As noted, global stockmarkets have moved higher over the summer, led by continued enthusiasm for technology – particularly anything linked to AI – which has helped drive key stockmarkets like the US higher too. The merits of some global investors' Q1 2025 rotation away from the US and into European markets, partially based on valuation and an expectation that momentum in technology-related sectors would wane, has been questioned by a series of strong earnings upgrades from US businesses, principally from some of the mega-cap technology heavyweights. We are pleased to have held our ground with US exposure and whilst valuations have become elevated, these have been backed up by strong corporate earnings growth.

We believe this momentum can continue, particularly since it has been delivered without the helping hand of a lower-policy environment. Technology and tech-adjacent sectors have historically benefited most on the resumption of rate cuts: we believe it augurs well for further upside in these sectors now that the Fed has come off the fence when combined with firms' continuing commitments to invest in AI and innovation. Accordingly, we plan modest adjustments to our US positioning to slightly increase exposure to large-cap growth momentum, while maintaining our strong allocation to global AI through a dedicated fund held within our thematic allocation.

Encouragingly, smaller US companies have begun to reverse their underperformance relative to larger ones in recent weeks. Valuations are now broadly back in line with historical medians, but we continue to see opportunities in the lower echelons of the US market, which we typically access via active manager allocations.

While the narrative of 'US exceptionalism' has softened this year, we believe the long-term case for domestic US businesses remains compelling and therefore exposure to mid and small caps in our portfolio construction is still warranted. We remain committed to giving active managers the opportunity to uncover undoubted value lower down the market cap scale.

Markets and economies are not aligned

A deeper look at market structures – by geography and sector – reminds us to look beyond regional economic labels. Accessing tech and AI exposure, for example, is largely limited to the US and Asia, while the UK and European stockmarkets offer better access to sectors like financials. Active managers help us navigate these structural market nuances, but we also plan to adjust positioning to capture evolving global opportunities and close any gaps in sector, style, or market cap exposure.

Homing in on the UK, its stockmarket still offers strong overseas revenue exposure and access to underrepresented sectors in other global markets. With the outlook for the UK economy still looking very fragile, and with what looks like a challenging November Budget looming, UK newsflow is unlikely to turn positive for some time. We therefore intend to make some slight adjustments to UK equity market positioning by reducing some biases to the UK economy, typically arising from within mid- and small-cap exposures, in favour of increased commitments to more internationally-diverse earnings streams found higher up the market cap scale. This should also increase sector diversification and some defensiveness through more international earnings, whilst giving more breadth to what remains a generous dividend-paying market.

There have been headwinds (for non-US investors) from a weaker US dollar this year, but it is pleasing to see more stability over the summer and currency influences playing less of a part in investment returns. Having more international revenue exposure through our UK stockmarket commitments should be beneficial if the pound does weaken from here – as we believe it will – based on the UK's shaky economic credentials.

Asia – another important access route for technology exposure

One key area of our stockmarket allocation – Asia – has performed particularly well this year. Historically, a weaker US dollar has been positive for emerging and Asian economies and markets as investor inflows increase and the cost to companies of servicing their dollar-denominated debt falls. Importantly, Asia's stockmarkets also offer access to an alternative sleeve of 'technology' companies not domiciled in America, something that has not gone unnoticed by us and other international investors.

The region's behemoth is TSMC ('Taiwan Semiconductor Manufacturing Company'), ranked in the top ten of global firms by market capitalisation and the world's largest supplier of semiconductors – a business probably touching, somewhere, every global business and consumer.

> *"Having a meaningful commitment to Asian markets, as we have, not only reflects the strong pace of economic growth and demand being generated from within the Asian region: it also provides diversification in terms of access to another seam of fast-growing sectors like technology..."*

Then comes Tencent (imagine a combination of Meta (Facebook), Microsoft, PayPal and Japan's Nintendo), followed by Alibaba (broadly the Amazon of China) and Samsung Electronics (Apple's South Korean consumer electronics competitor). Through both our active and passive exposures to Asian markets we have meaningful allocations to these fast-growing, globally-important businesses as well as the next generation of growth companies that can compete both for a slice of regional market share and that of the global consumption pie that is still dominated by the US.

Having a meaningful commitment to Asian markets, as we have, not only reflects the strong pace of economic growth and demand being generated from within the Asian region: it also provides diversification in terms of access to another seam of fast-growing sectors like technology, including those involved in the advancement of AI, via the region's growing export markets.

Swerving around tariffs

As we know, the US president is determined to protect the American franchise through the imposition of high tariffs. It is testament to Asia's economic strength and capabilities that makes it a big threat to the US and therefore it is easy to see why President Trump has hit the region with some of the harshest tariffs. However, far from doing damage to the region, higher US tariffs on goods from Asia than those generally inflicted upon other key economies do not seem to have killed off momentum in Asian export markets. On the contrary, emerging markets export growth, the lion's share of which emanates from Asia, has strengthened this year and there is evidence throughout export market data that critical exporting countries in the global supply chain, such as China, are finding plenty of alternative ways to enter it through ASEAN and other emerging markets to swerve around higher tariff barriers.

There is also evidence that firms are responding to US tariffs by stepping up production in their US subsidiaries. Car manufacturers, for example, which have been particularly hard hit by Trump, have responded to the new levies by planning or actually shifting some production into their US plants. Figures from Toyota, for example, show that production from its US facilities has risen by almost 30% in the past year (and we have not yet had six months of higher tariffs) versus a fall of around 5% in output from its Japanese factories. Honda and Hyundai have made or planned similar shifts in production and in Europe the likes of Mercedes and Volvo are also making moves to mitigate tariff risks.

We acknowledge, however, that it may not be so easy for smaller non-US auto component producers to divert manufacturing to dodge some penal tariffs. Of course, it will be music to Trump's ears if shifts in manufacturing to the US create more jobs and help maintain momentum in the US economy, but we should not forget that the profits, wherever generated, ultimately still find their way into the hands of the shareholders of the parent company outside the US.

Thinking globally

It is clear that the re-drawing of the global trade map (which advanced during the Covid pandemic) has been given a further nudge forward through the unveiling of US tariffs. We do not believe that US exceptionalism has been thwarted (indeed, as noted, we think it can regain some of the momentum we witnessed in late 2024 with the help of some more positive policy levers). But it is probably a slight wake-up call to global investors (and perhaps the US president), particularly those fixated on the US stockmarket, that there are still plenty of opportunities in other parts of the world giving the US a run for its money. Firmly in our minds is the fact that stockmarkets are not necessarily reflective of economies, so even where economic activity is sluggish, like in the UK and eurozone, one can still find many businesses, both large and small, that are playing a critical part in (and benefitting from) both the goods and services supply chains that keep the cogwheels of the global economy spinning.

The global manufacturing map continues to evolve, and we must therefore be flexible in terms of how we allocate to economies and the route through which we access market opportunities.

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Wrapping up

Our planned small modifications within our US and UK stockmarket positioning are all part of moving with the times to ensure we have the right balance between today's market leadership and the next generation of growth companies, particularly filling some of the gaps that may not be plugged naturally by our choice of active managers.

The favourable winds of moderating inflation, lower interest rates, resilient economic growth and positive corporate earnings momentum are still blowing for risk assets but trimming the sails to optimise performance is still necessary. That is what our forthcoming actions will be focused on, aiming to adapt to market trends and the opportunities presented by a morphing world economy.