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Flooding the Zone and Burning Bridges

"Promises Made, Promises Kept".

In the last quarterly update we discussed the election results at the end of 2024, and the resultant "Trump trade" (see Appendix 1) which was likely to play out and indeed already was. The focus on US policy and markets is a theme that has continued throughout the past quarter and economic developments elsewhere should be examined in this *context* – many global leaders have been forced to react in real time to unpredictability from the US.

The Trump agenda promised mass deportations, tough tariffs, America first, government downsizing (DOGE) and a raft of further tax cuts. Initially this boosted US markets and led to trepidation among trading partners. Geopolitics rumbled on, shaken up by a potential new "sheriff" in town, and change started to happen pro-actively in the Middle East and Russia/Ukraine.

The first weeks of the new US administration have been a flurry of executive orders across all of the popular talking points from the central to the peripheral, we have seen early decisive action by DOGE and a few new topics have emerged broadly that were off the radar screen of markets and pundits. These include the gestures around Greenland, the Panama Canal, Canada as the 51st state, a bold plan for Gaza and an ostracization of Ukraine.

The UK is weathering persistent inflation and barely positive economic growth, and as we write Europe is gathering itself in response to an unprecedented challenge poised by the US stance on Ukraine. The winds of change are blowing, and markets have caught them. Since the beginning of the year much of the froth has come out the formerly strong sections of US markets, while assets like bitcoin and oil have fallen, although gold remains robust.

Key Developments since the last quarterly update:

- **Inflation starts to stick, but the devil is in the detail.** As Central Banks remain data dependent there has been a lot of dwelling over data – a headline US number of 3% in January initially caused a market tantrum and worries about no further rate cuts. More analysis showed that some of the driver was food and energy and that other measures remained more subdued. Given the uptick in UK inflation and its persistence, this is likely to remain an ongoing problem going forward.
- **From Keen to Mean on Interest rates:** Given the divergent economic growth rates between the US and other developed markets, the main Central Banks have been taking different routes. While the US remains on hold both the ECB and the Bank of England are continuing to cut rates, with the ECB expected to cut again next week to 2.5%. Further cuts are also likely in the UK despite nagging signs of persistent inflation. This will accentuate the dominance of the USD v. other currencies if the rate differential persists.
- **Questioning what we thought we knew** AI and its implications for the workplace, efficiency and processing power has been central to the growth of the US large cap tech sector over the last two years, and a few large players have been emerging to carve up the pie, led by Nvidia at the helm. This was why the emergence of the Deepseek capabilities from China in late January caused such a stir in markets, revealing some of the blindspots of the group think around AI adoption. This initially caused a fall out in tech stocks and investors were blindsided and started to question future spending and investing. Quantum computing also made headlines over the quarter, although even insiders don't quite know how to process the potential impact of its time (and power) saving impact.
- **Stock markets swoon.** On again/off again tariffs and a persistent element of surprise on the geopolitical stage has sucked some of the post-election confidence out of US markets, while a revived expectation of defence spending and the centrists prevailing in elections gave Europe a boost. European and UK stock markets have outperformed their US counterparts year to date, while US markets have given back most of their post-election gains.

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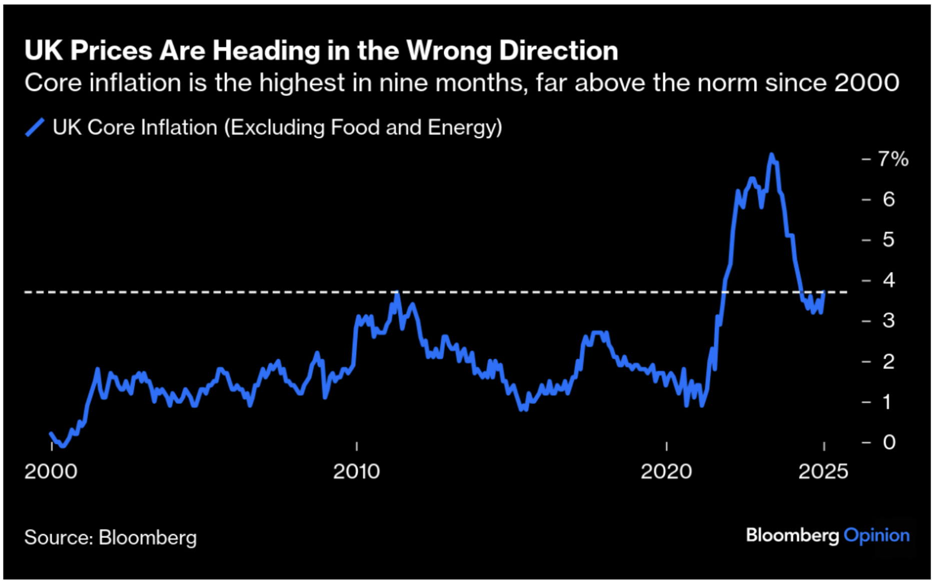
Current Macro Snapshot

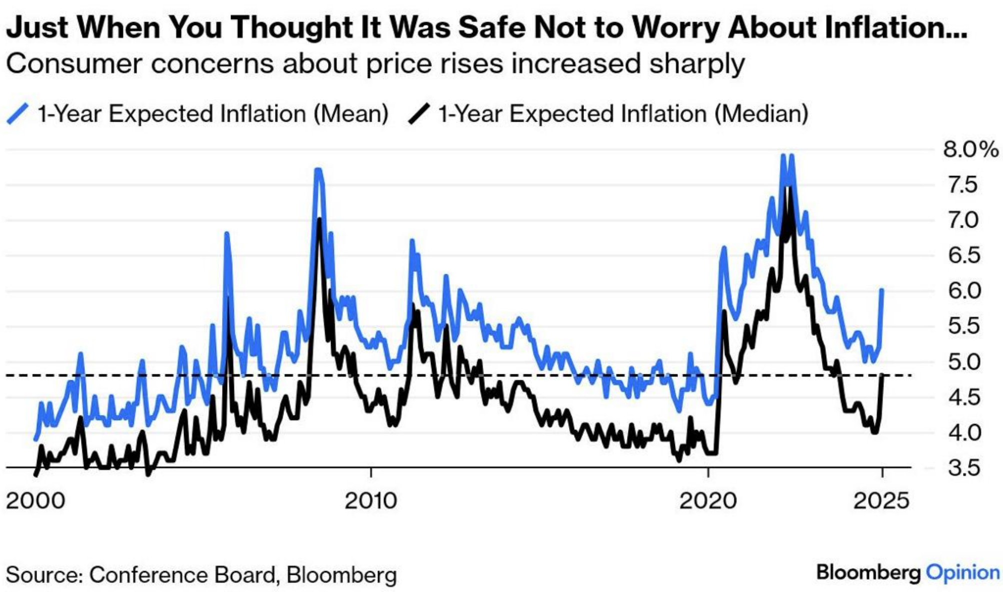
Modest growth continues, but worries about tariffs grow

The UK economy surprised with a 0.6% growth figure for 2025, which is hardly that impressive, but did exceed expectations of a negative figure. The decisive interest rate action – a 25 bps cut - by the Bank of England in February surprised some due to the nagging inflation data, but was perhaps a sign of looming problems that they were seeking to preempt. The buzz word in the UK was stagflation due to inflation being higher there than elsewhere, while growth is sluggish everywhere outside the US.

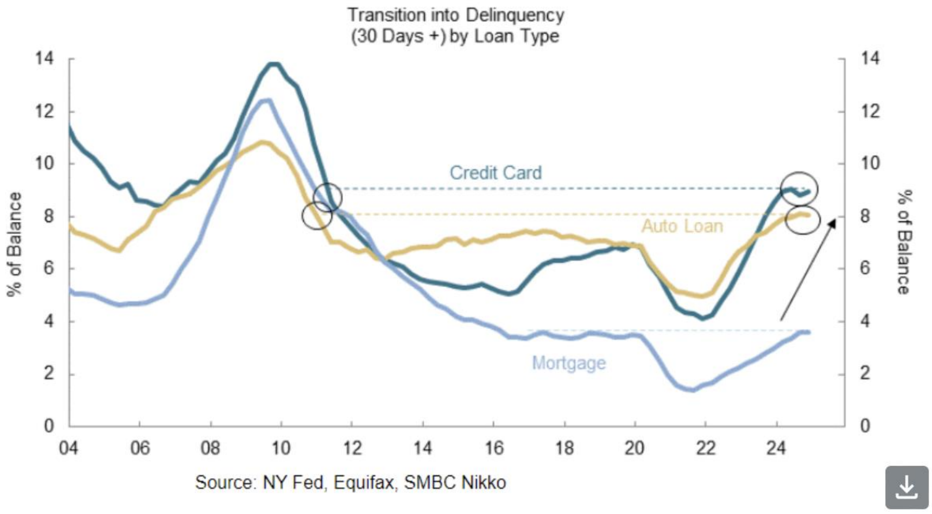
As the chart below shows there is some concern about prices heading in the wrong direction in the UK and far from a 2% target.



Consumers are a lot less relaxed about the prospects of inflation staying in check going forward, and concerns about price rises are increasing. This can have the effect of muting expenditure, which is beneficial for future inflation, but of course is a challenge for economic growth – it is hard to “have it all” indeed.



There is also some indication of stress emerging among the US consumer, as measured by delinquencies in auto loans, credit cards and mortgage payments. While these levels are still nowhere close to those seen in 2008, they are notably up from their lows in recent years.

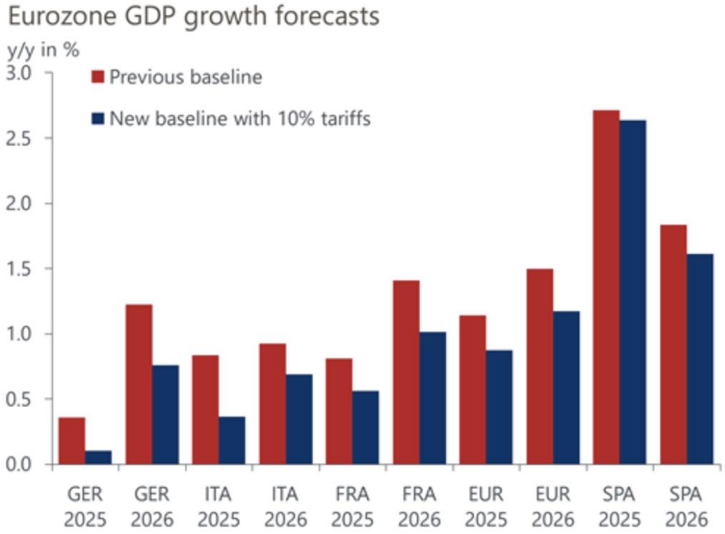


Source: SMBC Nikko

The forecasts of sizeable tariffs on Mexico, Canada and China cited in December did indeed transpire in January, but received a “stay of execution” in the case of Canada and Mexico based on commitments re. immigration reform. While once more markets remained resilient it was interesting that the overall uncertainty gauge has now been raised and markets are far from happy.

Tariffs are equally expected to have a chilling effect on most European economies. The analysis below illustrates the effect on baseline economic growth across Germany, Italy, France, Spain and the entire Eurozone, with the baseline reduced for only 10% tariffs. More recently 25% tariffs have been mooted, which would likely be even more recessionary.

Chart 1: We have cut our GDP growth forecast for all major European economies

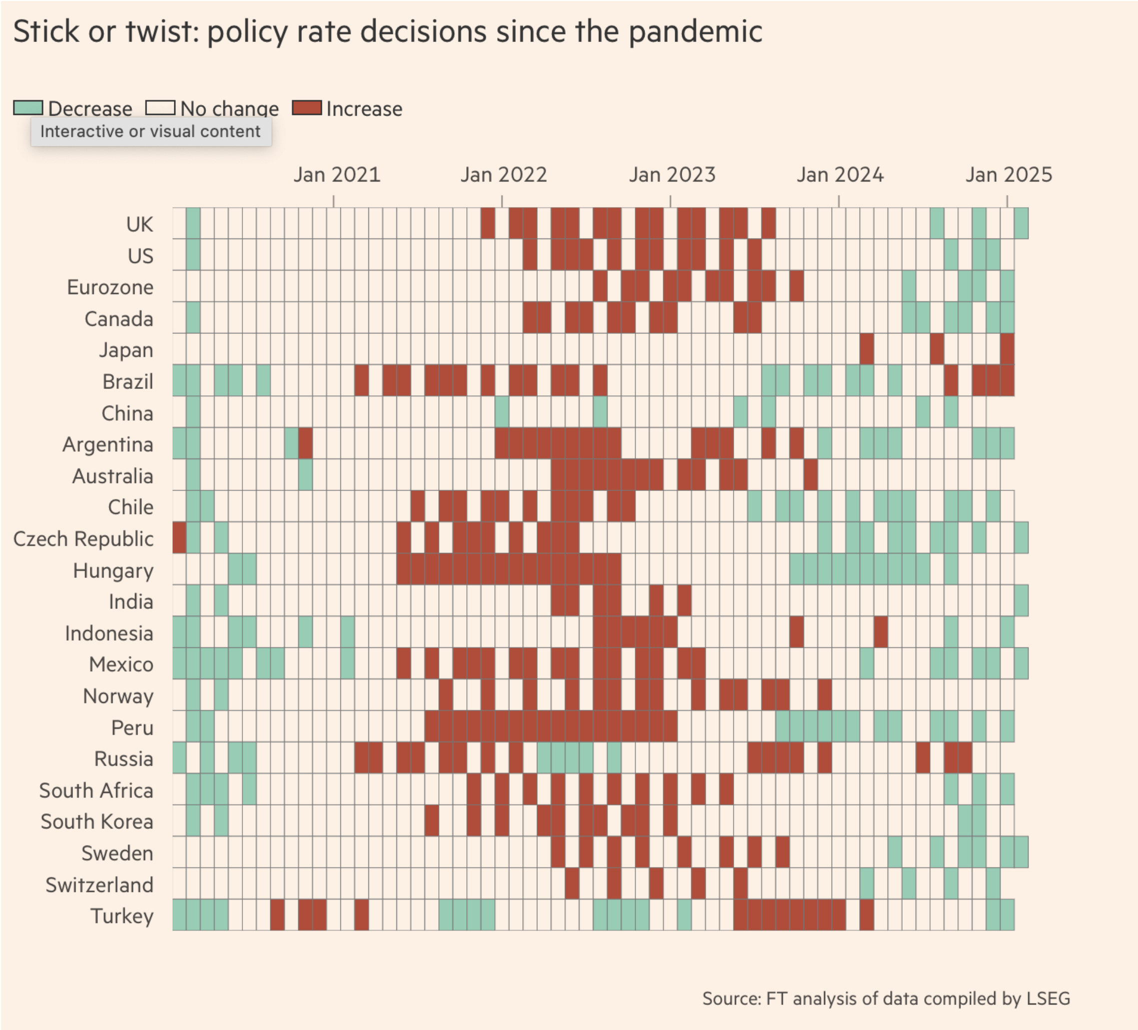


Source: *Oxford Economics/Haver Analytics*

Divergent paths for interest rates

A hallmark of recent years has been a marked increase in fixed income volatility, as bond markets second guess the direction of Central Banks that seem to be lacking clear direction themselves. Some criticism levied at Central Banks was whether data dependency was suitable when the data itself is so divergent and unpredictable?

The chart below is from the interactive section of the Financial Times, and shows the divergence in interest rate paths taken by central banks with the majority now in rate cut mode, but some cutting more aggressively than others.



Other Policy Changes

Geopolitical shifts have had an obvious effect on the demand for European defense stocks, as the likelihood of the European block stumping up more for defense grew to a certainty. This had an immediate impact on defense stocks – particularly v. those of the US.

Last quarter we discussed the rally in bitcoin and gold – in recent weeks these assets have diverged, with Bitcoin dropping by 20% and gold continuing its upwards trajectory. Gold in February traded to over $2900 per oz, driven in part perhaps by a fear for fiat currencies around budget deficits.

A new mood of austerity:

Budget deficit chatter and concern has certainly gained increased airtime recently, some of it triggered by ostensible savings that could be wrought by DOGE (Department of Government Efficiency) in the US It is worth recalling the statistic that Trump's fiscal policies were estimated to add over $7 trillion to the Federal Budget deficit. Now that we know that many of his policies are being implemented exactly as telegraphed, this number can be seen as "firm".

DOGE has proven to be a bit of a "wrecking ball" and it is also ushering in the language and mood of austerity – something Europe has long learned to converse in. We hear echoes of this austerity otherwise in the world too – notably in the UK where pension reform is underpinned by a drive for efficiency and cost savings. The performance of DOGE – and chain saws – might well give a permission slip for similar cuts and movements globally but with such anemic growth rates, there may be little margin for error.

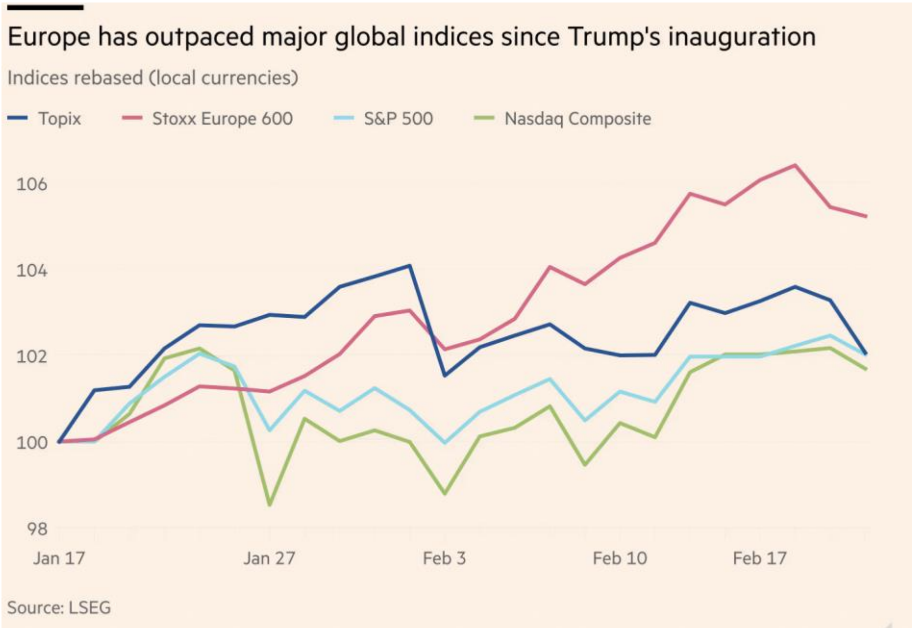
Individual Asset Class Performance.

- Equities
- Fixed income

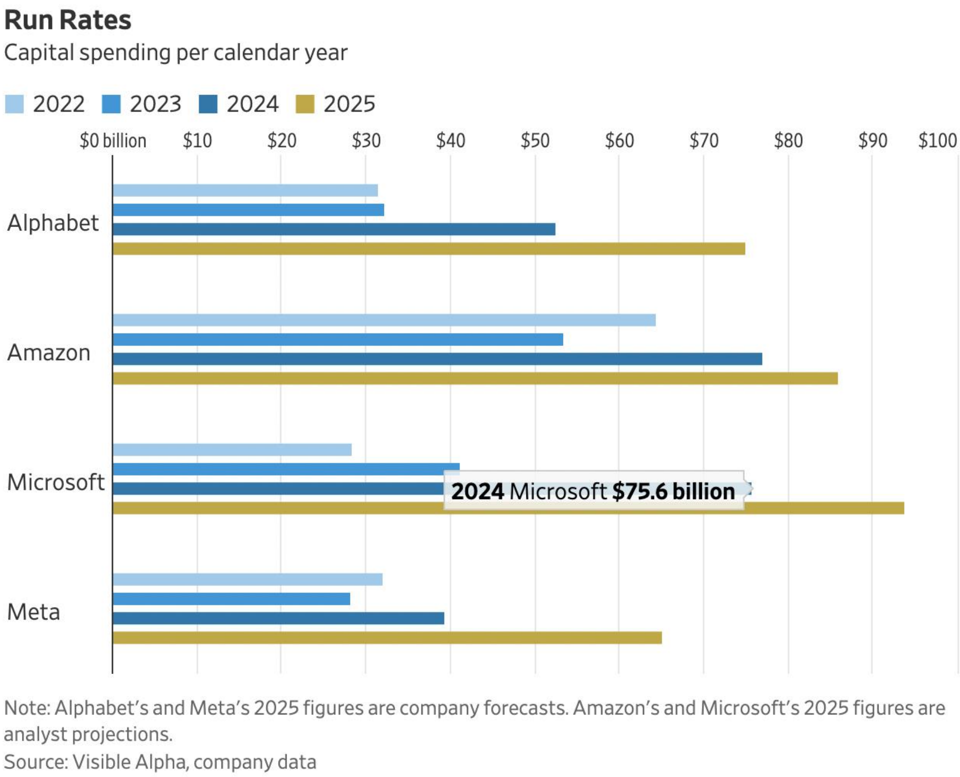
The chart below shows recent performance in main equity indices (at February 28, 2025):

Equity Index	Last 12 months	Year to date (February 28, 2025)
FTSE 100	14.67%	7.79%
S&P 500	15.91%	1.24%
Nasdaq	15.81%	-2.4%
Stoxx 600	11.98%	9.77%
Hang Seng	38.29%	14.36%
Shanghai Comp	9.71%	-0.92%
Nikkei 225	-6.87%	-6.9%

The divergence in US v. European performance year to date is nicely shown in this chart but it is also clear from the table above that this divergence is continuing. Year to date Europe, the UK and Hong Kong are at the forefront of performance with Japan suffering a lacklustre year.

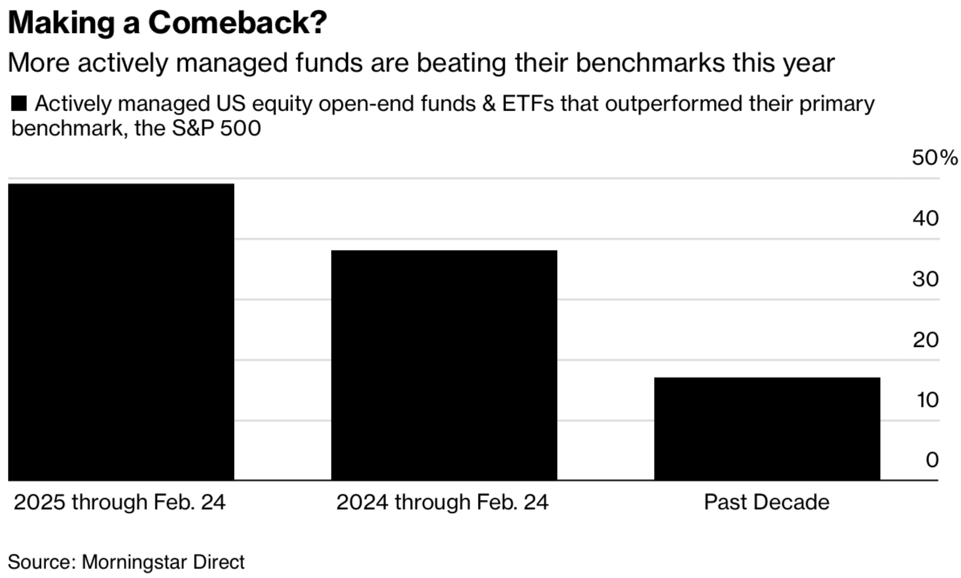


Despite a volatile year in terms of performance there is still an extraordinary amount of focus on the large tech stocks and as the chart below shows, armed with significant cash piles they are poised to make massive investments in AI that dwarf previous trends of capital spending.

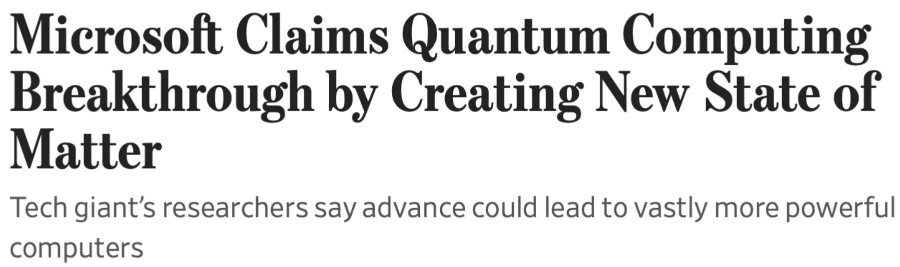


This ability to spend to protect moats and margins sets the large cap stocks apart from mid and small cap companies and these sectors remain overlooked and somewhat unappreciated as the year goes on.

As some rotation is evident between large cap and mid/small cap sectors as well as from the tech sector into more defensive ones, active asset management has enjoyed a bit of a comeback this year – although it still has some ground to recover as the majority of active managers remain behind their benchmarks year to date.



While the emergence of Deepseek shocked the system at the end of January, AI and Quantum Computing remained at the forefront of tech news flow, although there were some indications of pauses on expenditure and data centre space commitments, which suggested that spending might not be a completely straight-line trajectory. Quantum computing has the potential to transform processing speeds and capabilities – but it is not clear what the transform



Microsoft Claims Quantum Computing Breakthrough by Creating New State of Matter

Tech giant's researchers say advance could lead to vastly more powerful computers

Fixed Income

With increased volatility in bonds, fixed income doesn't look like much of a safe haven these days, and investment grade spreads continue to be relatively tight, suggesting that better value can be found elsewhere. While in absolute terms bonds still have decent returns, as inflation stays persistent this will be quickly eroded.

Backtracking on engagement

The weeks since Donald Trump's re-election have seen an onslaught of measures and backtracking by market participants around engagement and responsible investment goals. The headlines below reveal the threats to activism, the recalibration of standards and policies as well as market conditions leading to a backtrack on energy transition goals.

While disappointing, these clear reversals do present opportunities to challenge incumbent asset managers to detect their genuine commitment to their goals. Some investors may well choose to take a leaf from the book of the People's Pension which has switched from pooled funds to separate accounts in order to better achieve better alignment with its particular objectives, switching 28 bn GBP to Amundi and Invesco from State Street.

BP blames 'misplaced' faith in green transition for its renewed focus on fossil fuels

CEO Murray Auchincloss says 'fundamental reset' will mean cut of more than £4bn to low-carbon investment plan

BlackRock and Vanguard halt meetings with companies after SEC cracks down on ESG

Regulator's rules are part of broader effort to rein in power of largest fund managers

SUSTAINABLE BUSINESS

Europe Waters Down Flagship Climate Accounting Policy

The European Commission diluted the regulatory measures after receiving backlash from companies and member countries that say the new rules hurt competitiveness and raised costs for businesses

By Yusuf Khan

Feb. 26, 2025 11:24 am ET | WSJ PRO

Outlook

Last quarter we said we were watching the **"the divergence between saying and doing"** – in that President Trump and his team have been saying a lot but once inauguration day passes we would see what he actually "does". Obviously that was an understatement and the "doing" has to date exceeded much of the rhetoric and markets have struggled to keep up with the flow.

For investment portfolios we will be watching in particular:

- **Who will blink first in the Ukraine aid standoff?** As we write, the Oval Office has seen some "tough guy" rhetoric from both sides, and most European nations as well as Canada have rallied around the Ukrainian President. This fluid situation could reshape alliances and change the outcome of the conflict but it also solidifies the cleavage in transatlantic cooperation. The repercussions for trust and security will likely be far-reaching, but to date we don't know how markets will react.
- **Will a new mood of austerity create a chill or will new spending be essential?** From pension fund pooling to DOGE cuts, economies of scale and cost savings are topics of the day and this could be the killjoy for consumer spending that is already significantly less buoyant than previously. While some consider DOGE a short-lived distraction others are more concerned about its long term impact on government and its workers. On the other hand some spending (e.g. on defense in Europe) is seen as inevitable, which could boost economic growth. It will be critical to see if economic growth can stay in the black.
- **Where renewable energy and other stocks aligned with responsible investing go from here?** Clearly we are experiencing the swing of a pendulum with respect to green stocks, responsible investing, net zero goals and engagement. Now that the rate cut cycle has kicked off there is plenty of capacity to ease – although central banks are likely to be highly alert to the potential for overheating their economies as none could stomach the spectre of inflation in high single digits any time soon. We will be interested in this as a lever to propel growth but also to examine how effective monetary policy can be these days – a controversial topic.

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We live in interesting times.

March 2, 2025

Appendix I

The Trump Trade.

Winners	**Losers**
Traditional energy	Renewable Energy/Solar
Gold	USD?
Bitcoin/Crypto Currency	Chip stocks?
Industrials	EV manufacturers
Deregulation	DEI
Inflation	Environmental Regulation
Tax cuts?	Big tech?
	Nato, Europe, Ukraine, Asian exporters
	Economic Growth
	US Fed independence
	China – now in contraction territory