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Fever Dreams, and the Cloud of Uncertainty

So much for the Trump trade. And American exceptionalism.

As the US administration under President Trump 2.0 moved beyond its first 100 days, the flavour of market responses have drifted considerably. The last quarter has seen a series of "big bang" announcements with respect to global tariffs, followed by a series of roll-backs, and markets have lurched violently in response - in both directions. The reaction to "America First" has led to efforts to "make Europe great again (MEGA)" or find alternative trade work arounds (e.g. as pursued by Canada). It has affected the outcome of global elections (also Canada), seen a surprising surge in nationalism elsewhere and a redoubling of efforts to act in solidarity as a counterforce.

Inflation remains difficult to tame – it retains the propensity for negative upwards surprises – as just occurred in the UK, when it was measured at 3.5% annualized. With growth subdued, and expectations highly dependent on the end game with tariffs – governments are keen to avoid a repeat of stagflationary stasis. This is making the role of central banks a little more challenging – they are data dependent and keen to avoid another inflationary crisis. Some are more committed to rate cuts than others at this juncture.

Broadly, the "US exceptionalism" thesis is breaking down, with relatively stronger performance in non-US markets, a weaker dollar, weaker demand for US treasuries and a weakened position in foreign policy. The UK is forging its own path in a US/UK trade deal, but details were sparse, while inflation and weak growth on the home front continue to create challenging conditions. The rise of gold and other "safety assets" outside government bonds underscore the skepticism arising around government fiscal prudence as well as a nagging need for shelter in the storm.

Key Developments since the last quarterly update:

- **Liberation Day Tariffs** On April 2 the Trump administration unveiled a list of tariffs against US trading partners that went well beyond the "reciprocal" tariffs promised, based on a mathematical calculation that seemed complex and esoteric. This kickstarted a flurry of analysis, regrouping by trade partners and, at least initially, stock piling of inventories by consumers and businesses alike. The modelling of the impact of tariffs is complex and uncertain, made more so by the regular noise around tariff negotiations (the UK was one of the first to have a trade deal announced). This uncertainty continues to plague corporate earnings statements and outlooks, and is impacting the ability to plan for the future, freezing hiring, capex and expansion. As an indication of their expected severity, however, some market commentators immediately started to predict a recession with more than 50% probability once the tariffs were brought into effect. Thes moves suggested that the equity market was remaining too optimistic and not properly estimating the effects on tariffs.
- **Interest rates cut in UK and beyond** While initially in the quarter inflation levels seemed tame, central banks in Europe and the UK saw sufficient basis to cut rates – the ECB made its 7th consecutive rate cut in April (to 2.4%), while in May the Bank of England cut its rate for the fourth time in seven meetings – to 4.25%. The US Fed remained on hold, and data dependent as it watches closely for evidence of the effect of tariffs. The bond market continues to second guess central banks and sow concern regarding the market outcome and fiscal prudence continues to affect bond yields. Bonds continue to sell off in the US and rates are reaching highs not seen for decades.
- **An Equity Market "Fever Dream"** Equity markets have displayed stark volatility, particularly in the US, with multi-day downturns and rallies, sharp intraday reversals and large single stock moves. However as much of this was driven by tariff chatter, when the tariff negotiations were announced with China in early May this triggered a euphoric nine-day streak in US markets, which essentially eradicated the downturn, and rendered the time since Liberation Day (April 2) as akin to a "fever dream", given in early May it was as if the downturn had never happened. As discussed below however, there is ample evidence of the uncertainty and potentially inflationary impacts of tariffs being more widespread and limiting of future investment by companies, which could be detrimental to economic growth and equity markets in the near term. This again highlights the importance of global diversification.
- **Moody's Downgrade.** On May 16 Moody's downgraded US government debt from Ass to As1, the last rating triple A credit from the three major ratings firms, Fitch and S&P previously downgraded the US in 2023 to 2011 respectively. This set off a cascade of further downgrades from agencies dependent on US government debt, but was dismissed by some as a "catch up".

It was still a notable move, however, and stocks were moving with less conviction in the days afterwards.

- **Geopolitical flashpoints remain.** Despite a renewed burst of pressure on Russia/Ukraine to restart peace talks and further returns of hostages from Gaza, the same hostilities are bubbling in the same geopolitical flashpoints, with little progress. The news flow from areas such as the middle east occasionally affects the price of oil, and this has generally been weaker, over the period, as economic growth is uncertain.

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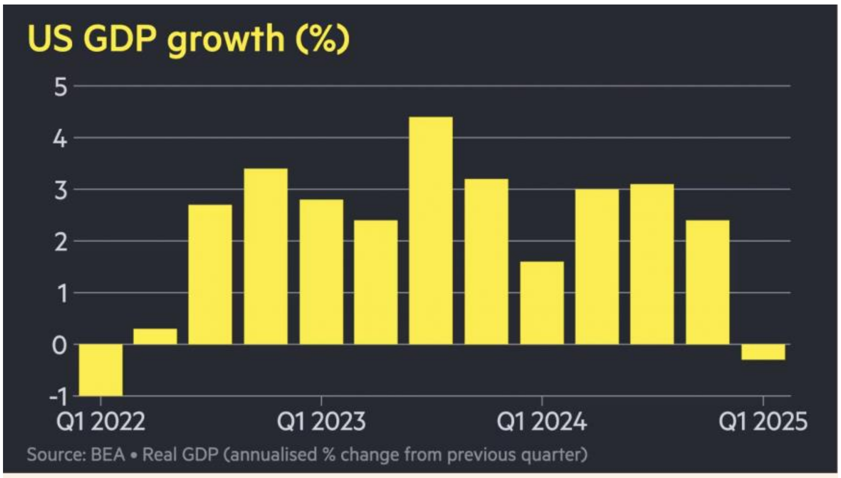
Current Macro Snapshot

Growth hinges on the direction of global trade

The first quarter GDP was marginally positive in the US (0.3%) and 0.7% the UK. US figures were clearly distorted by inventory buildups and stock piling – and there is some evidence that consumers pulled forward expenditure into the first quarter in anticipation of shortages and higher prices once tariffs came into effect. This may have been a global phenomenon too, even though the impact of tariffs was not at all clear around the world.

Overall, the direction of travel – weaker – is clear, and recession expectations have risen as tariffs loom. In the UK, there is a particular focus on stagflation due to inflation being higher there than elsewhere, and the most recent inflation number in the UK – 3.5% - adds fuel to this fire.



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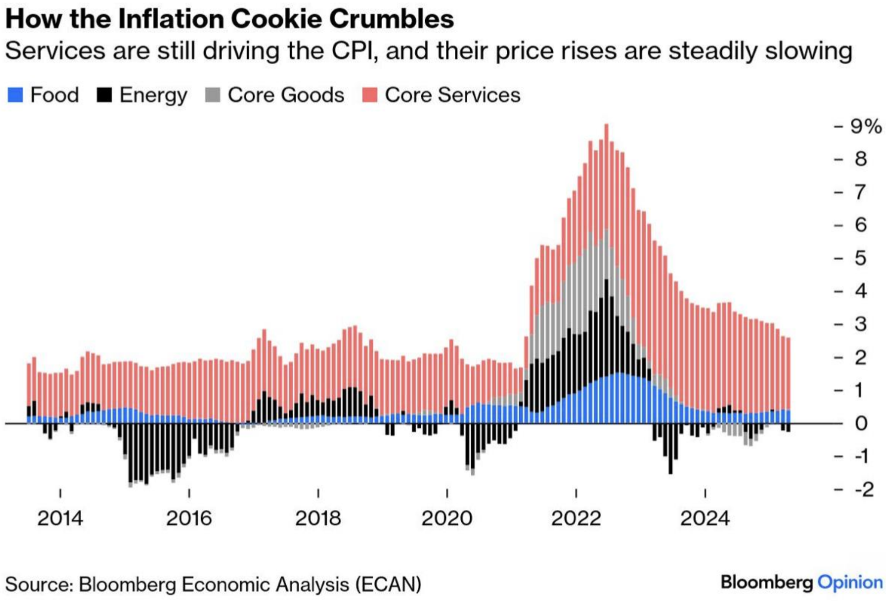
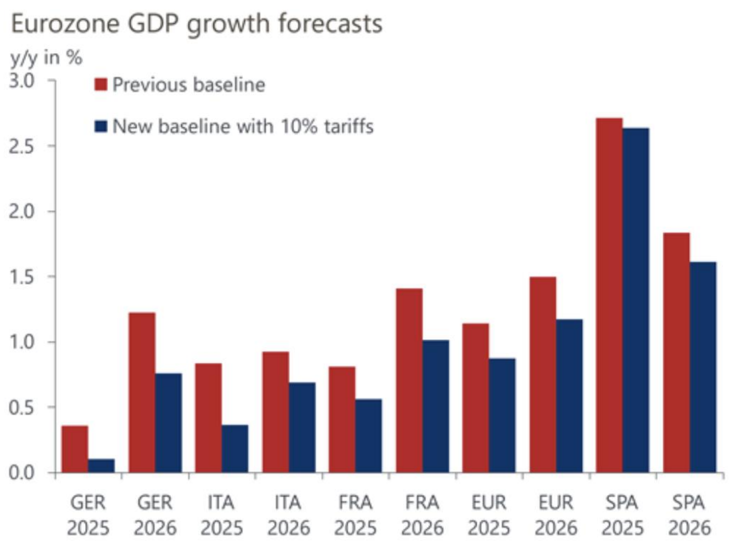
Inflation – A mixed picture

Inflation remains in focus as the trigger for central bank action as well as consumer health – as the chart below shows US inflation has been quite mixed in its decline and the latest number showed a decline in core services inflation. Lower oil/fuel prices are also promising, although to date have not translated into meaningfully lower pump prices. UK inflation had been looking promising, until the recent number (3.5%) caused some concern.



It is worth a reminder of the chart we showed last quarter showing the effect that tariffs are expected to have on 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. The latest pronouncement by the Trump administration around drug pricing, whereby drug companies would be required to offer most favoured nation pricing to the US, could seriously undermine the margins of drug companies, many of which are located outside the US.

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



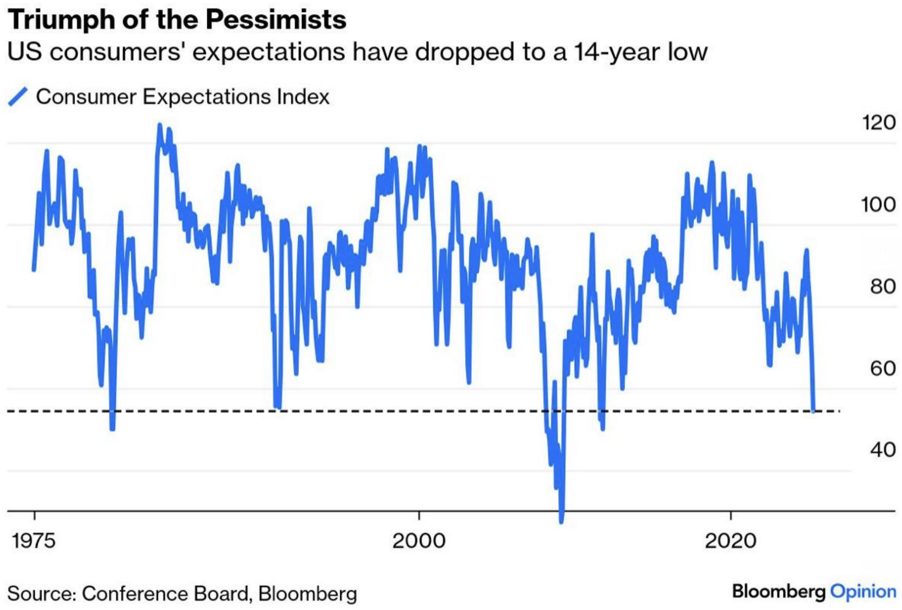
Source: *Oxford Economics/Haver Analytics*

Inflation driving interest rates

As can be seen in this chart, the unexpected rise in inflation in the UK has undermined confidence in the economic recovery here, and this has led to bond yields spiking close to where they were during the Trussonomics episode.

US government bonds are also showing reasonable volatility with rates spiking and a recent poor Treasury auction proving weak demand. This has led to yields rising and a weaker dollar, both of which illustrate the easing demand for US assets.

And as the chart below shows, this is not just a foreign investors issue – even US consumers are feeling somewhat jaded and pessimistic:



Individual Asset Class Performance.

- Equities
- Fixed income

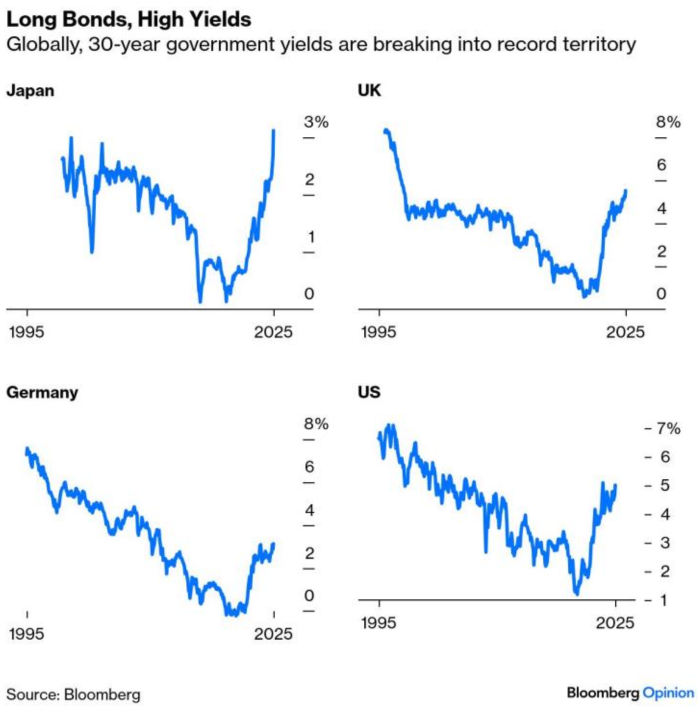
The chart below shows recent performance in main equity indices (at May 21, 2025):

Equity Index	Last 12 months	Year to date (May 21, 2025)
FTSE 100	4.73%	6.86%
S&P 500	10.13%	-0.63%
Nasdaq	12.33%	-2.27%
Stoxx 600	5.24%	8.32%
Hang Seng	24.78%	17.37%
Shanghai Comp	8.46%	0.85%
Nikkei 225	-5.4%	-7.29%

The divergence in US v. RoW performance year to date is nicely shown in this chart but it is also clear from the table above that this divergence is continuing. The sharp nature of the equity market "round trip" is masked by the figures, but a little more obvious in these kind of stock charts.

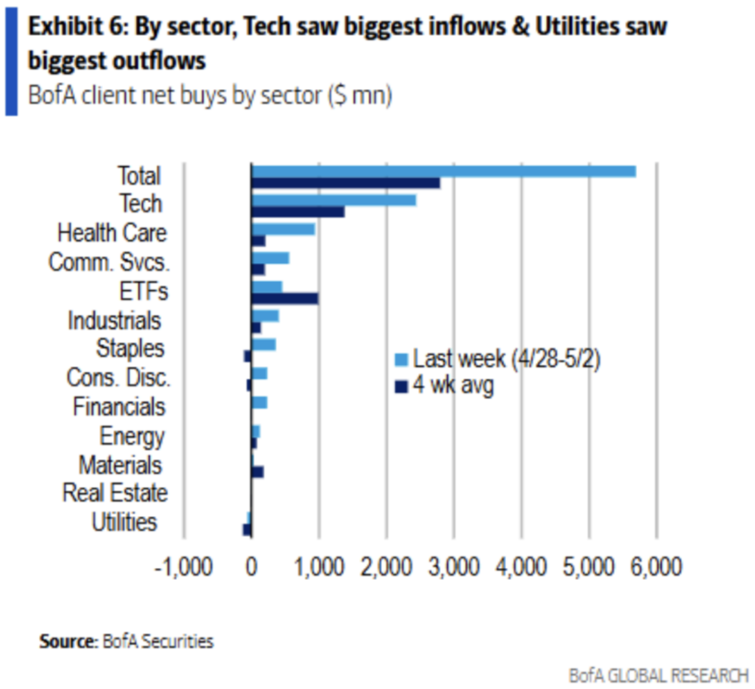
Fixed Income

Bond funds continue to experience sharp volatility as rates climb, and the recently popular diversifier – private credit – continues to hold firm. This is even a developing story at the time of writing as US bond markets wrestle with the impact of a proposed tax bill that goes nowhere to addressing the burgeoning fiscal deficit while in the UK the higher-than-expected inflation print is also denting confidence.



The Story of Flows

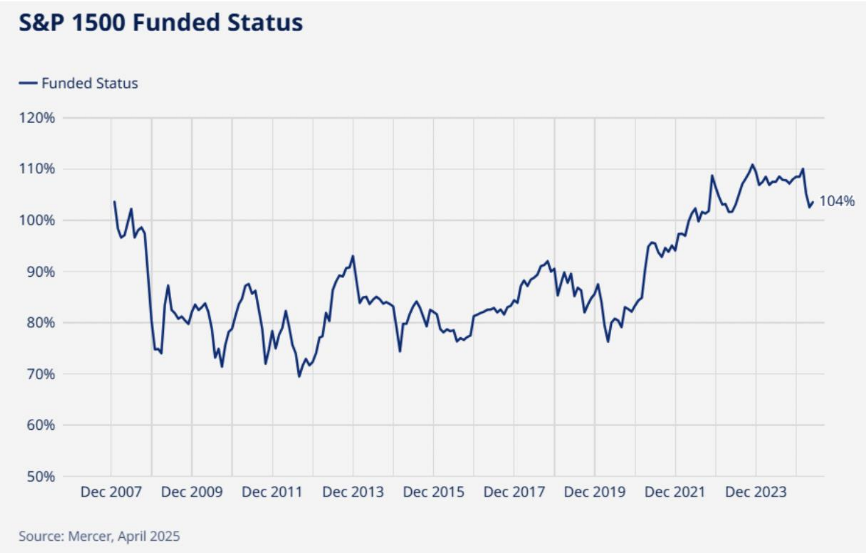
One of the remarkable aspects of the recent market volatility has been the ongoing resilience of the US stock market, and in particular the demand for equities that retail investors have shown, even as institutional investors pull back or reallocate overseas. As the chart below shows, there continues to be a strong interest in the tech sector and a shying away from so-called defensive sectors such as utilities – although some of this may be due to the persistent high bond yields (sometimes utilities and infrastructure are seen as bond substitutes).



ESG funds have continued to see outflows, and as the chart below shows, demand for these funds is increasingly dominated by European investors – the chart relates to investment in ESG labelled funds:

Source: Morningstar

The other interesting factor affecting pensions is the silver lining of the rise in bond yields. Given the contribution of these bond yields to the calculation of funding levels, the rise in bond yields has led to a lower present value of liabilities which has generally boosted funding levels. The scale of this change of fortune, from the prevalence of unfunded plans at the time of lower interest rates, can be seen on the chart below.



Outlook

Last quarter we noted the flurry of action from the US administration that was having collateral effects around the world. The volume and pace of developments were making it difficult for markets to digest the impact. For the summer period, for investment portfolios we will be watching in particular:

- **Geopolitics.** Last week we spoke about Ukraine and who was likely to blink first in the stand-off. To date, this stand-off continues, although peace talks periodically come in to the picture. The attention had shifted to the Middle East as we write, and to date there are no real signs of progress in any of the geopolitical flashpoints, but no additional ones have developed.
- **Tariffs as an Own Goal?** We discussed the climate of austerity that might be dawning if a recession seemed likely – but to date there has been little embrace of this approach, and instead fiscal prudence seems not to be in focus. Tariffs could well be the instrument that inflicts significant hardship on consumers – through inflation, supply chain uncertainty and a slow down that this pervasive uncertainty creates. While negotiations unfurl, amid these frequent 90 days stay on the tariffs, markets are far more likely to react to this, than to the actions of the central banks
- **Will the bond market take the summer to relax?** Clearly the bond market is agitated and second guessing the actions of governments and central banks. The rise in Bitcoin and Gold – which may be considered more defensive against bonds – is telling in this respect. It is

interesting that Gold is a more traditional defensive asset whereas Bitcoin is emerging as a more risky asset class yet both are rising in tandem. This evinces the level of concern around sovereign markets, and we will be watching this level of concern very carefully over the summer to see if the higher rates put pressure on consumers and corporates alike.

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A reminder that you can tune in to similar macro overviews weekly on the Markets Happy Hour youtube channel – where there are new episodes every Thursday evening.

May 22, 2025