RATHBONES

ALL FINE BAR THE TARIFFS

REVIEW OF THE WEEK
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DESPITE A WHIRLWIND WEEK OF TIT-FOR-TAT ON TRADE, BORROWING COSTS HAVE FALLEN BACK. WILL THIS BOON FOR INVESTORS, HOUSEHOLDS AND GOVERNMENTS OUTLAST THE NEXT INFLATION PRINT?

Despite a disorienting blizzard of news, tariffs and presidential decrees, one of the larger concerns of the past few months – sky-high borrowing costs – continued to tiptoe lower. While still high by the standards of past years, the US 10-year government bond yield slipped below 4.5% for the first time since mid-December.

Whether that descent from January's short-lived jump to 4.8% will continue is yet to be seen. Late Friday, the yield popped slightly higher on the much-watched nonfarm payrolls report. The US added 143,000 jobs in January. While this was lower than the 175,000 forecast, everything else in the release was symptomatic of a strong jobs market. Wage growth was 4.1%, unemployment fell back to 4.0% from 4.1% and the past two months' job growth was substantially higher than first thought.

With the US economy still bounding along and inflation lingering, the jobs report adds more weight to the general expectation of a more gradual fall in the US overnight interest rate. While the latest US GDP numbers showed a deceleration from 3.1% to 2.3% in the fourth quarter, that belied very strong household spending. Whether that's equally spread between the rich and the poor, is another matter and one that's hard to determine without a long delay.

The assumption that the US Federal Reserve (Fed) will be more hesitant to cut overnight rates from here seems well baked in, but expectations of rate cuts are actually growing. Looking at markets to lock in interest rates at set dates in the future, investors believe the Fed's benchmark interest rate will be around 4.15% by the end of the year, roughly 0.1% lower than a month ago. If that's correct, it would mean just shy of two more quarter-percentage-point cuts. If rates can continue dropping and longer-term bond yields follow, that would be helpful for bonds and should help buoy stock prices because future profits are worth more if the rate of return on cash in the bank falls. At least supposing that those earnings remain resilient.

But that brings us back to the blizzard of tariffs and diktats from the White House. Last week, **Trump announced tariffs on Mexico, Canada and China**, only to delay them for a month for its North American partners at the last minute. On Sunday, while flying to attend the Super Bowl, he told reporters he'd be announcing a 25% import tariff on aluminium and steel. Alongside this, he trailed a policy of 'reciprocal tariffs' on nations that levy tariffs on US products, which would be outlined this week. Meanwhile, in response to the tariffs levied on it, China imposed import taxes of between 10% and 15% on American farm machinery and energy materials. This retaliation affects just $14 billion of US goods, and is more of a signal than a powerful act.

Trump's second presidency will likely feature tariff threats as a tool to secure political and geopolitical concessions as well to encourage a reordering of global trade in the US's favour. Europe and possibly the UK are next in Trump's list of priorities, with concessions to be sought likely to include the EU reducing its antitrust scrutiny of US big tech companies. These tariff threats are unpredictable: it seems more than a few will melt away once they have secured concessions.

Still, we may end up seeing many different tariffs imposed for substantial periods of time, so we need to be prepared for how these could affect industries and the stocks that we hold. Supply chains are complex and it's hard precisely to gauge how tariffs might impact a particular company without clear guidance from its managers. Tariffs will directly affect some companies, especially retailers of imported goods, yet many more will be impacted in more diffuse ways as trade and consumption patterns change.

Overall, tariffs are relatively positive for services (especially banks and insurers) versus goods (like cars and retailers) and for domestic US-earning companies. However, they're relatively negative for companies exposed to the consumer, which may find it harder to pass on the increased costs of imports. Similarly, companies whose products are more cyclical or one-off may suffer if consumer spending dips. Not all companies are created equal, however, for high-end products manufactured overseas and sold with high profit margins in the US, the tariff impact could be akin to a rounding error. For lower-quality items sold for a slim profit, tariffs could be very difficult indeed.

Don't forget inflation

Before there were tariffs, the number one concern for markets was US inflation. If it remains in check, the central bank has more flexibility to steadily reduce rates. Headline CPI inflation for January will be released this week. It's expected to stay flat at 2.9%. The core rate (which strips out volatile food and energy prices) is forecast to slip back from 3.2% to 3.1%. An unexpectedly high inflation print may cause a flicker of concern in bond markets. Meanwhile, Fed Chair Jay Powell testifies to Congress this week, so investors will be scouring his remarks for any hint of the central bank's preferred path for rates.

Last week the Bank of England (BoE) cut rates by 25 basis points (bps) to 4.5% as expected. It also slashed this year's GDP growth forecast from 1.5% to 0.75%, saying the Budget changes would be more hurtful than first believed. Two members of its rate-setting committee were so concerned that they voted for a 50bps cut. And one of those was previously known as a leading hawk on the committee.

Meanwhile, the central bank forecast that regulated prices and global energy costs will cause inflation to reaccelerate sharply to 3.7% later this year, before falling back once more. Stagnant economic growth, above target inflation and high unemployment. Some may call that stagflation. That hasn't been a good environment for investment in the past.

Fourth-quarter UK economic growth will be revealed this week. Having slumped to 0% in the previous quarter, a 0.1% drop is expected for the final three months of the year. If so, that would effectively mean Britain is definitely on the cusp of recession (shrinking GDP for two consecutive quarters) with higher Employer National Insurance Contributions and minimum wage increases looming.

*If you have any questions or comments, or if there's anything you would like to see covered here, please get in touch by emailing **review@rathbones.com**. We'd love to hear from you.*

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