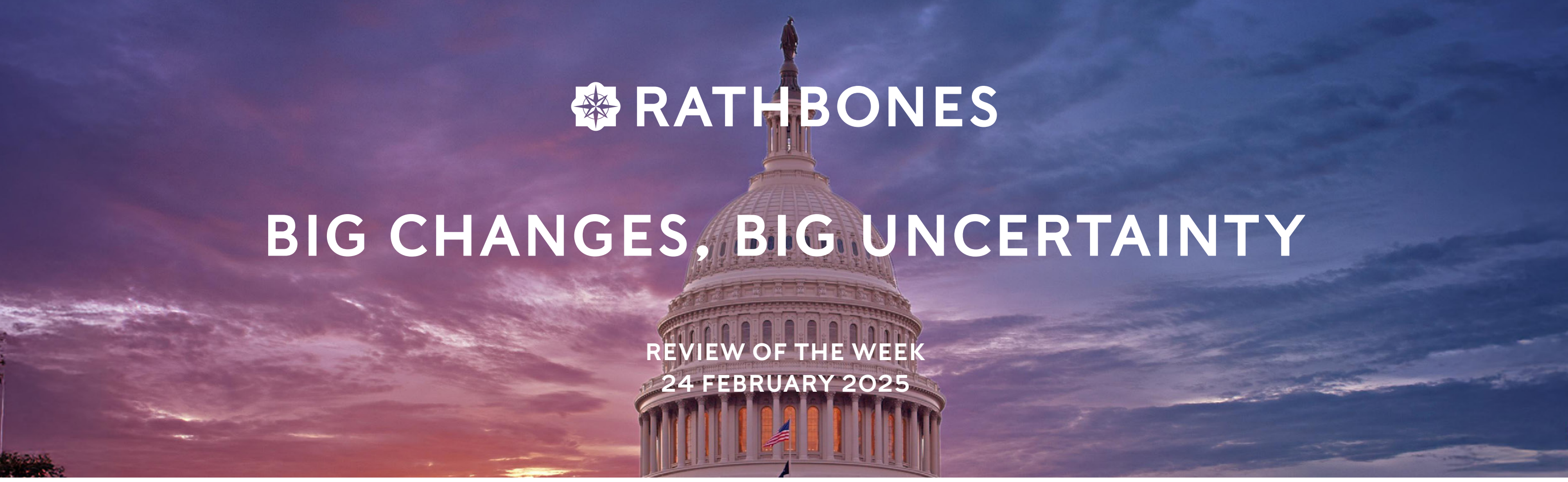


RATHBONES

BIG CHANGES, BIG UNCERTAINTY

REVIEW OF THE WEEK
24 FEBRUARY 2025

THE ANTICIPATION OF TRUMP 2.0 HAS DRIVEN STOCK MARKET EXCITEMENT AND HOUSEHOLD CONFIDENCE IN THE MONTHS SINCE HIS ELECTION. NOW HE'S IN OFFICE, IS THE REALITY STARTING TO SUBDUE THAT OPTIMISM?

US stocks fell sharply on Friday after a few poor economic releases suggested tougher business conditions, gloomier households and rising expectations of inflation. The S&P 500 index dropped 1.7%, the worst day of the year so far (including the **DeepSeek sell-off of late January**). For the week, the index posted a loss of roughly the same amount.

US economic growth is strong and far superior to that of other advanced nations, but this month concerns have crept in about the impact of tariffs which the White House is rolling out in a haphazard yet widespread fashion. How will these new costs affect businesses, particularly those that use a lot of imported raw materials to make other products? Will the increased taxes push inflation higher?

Businesses responding to the February PMI business survey said that commerce had stalled in the face of this blizzard of public policy changes. This was due to services businesses reporting deteriorating conditions. These companies blamed policy uncertainty and tariffs for increasing their costs and reducing revenue. And they were struggling to pass on the extra costs, too. If these responses are true, that would be a big deal as services – which covers everything from banking and healthcare through to cafes and air travel – now make up roughly three-quarters of US economic activity. A slowdown here would have a greater effect on the overall US economy than it might have done in the past.

As for manufacturers, they were in much better spirits. While noting that input prices were rising fast (a third of respondents blamed tariffs directly), manufacturers were increasing their own prices by the most in two years to compensate.

Meanwhile, serial entrepreneur Elon Musk's Department of Governmental Efficiency is laying off thousands of public sector workers in a mixture of voluntary and involuntary cuts. The US state isn't as big relative to the economy as in many other countries, but public services are always large parts of society. The federal government employs two million people and while 450,000 are based in Washington DC and abutting states that house big federal institutions, the rest are spread throughout the nation. People notice when friends and family members are made redundant, making for a bit of a shock and a reminder that there's always the risk it could happen to you too. It can temper your feeling that things are going alright or introduce doubt. Friday delivered a sharp fall in the University of Michigan Consumer Sentiment survey.

Given that most concerns regarding US inflation have focused on services and the cost of labour, could this new dynamic of rising goods prices but cooling services actually rebalance inflation? It's a possibility and one to watch. The US has enjoyed pretty red-hot economic performance for several years now, so this slightly cooler news is probably nothing to worry about. But it's worth keeping an eye on the nation's mood as 2025 develops.

Inflation and next years's earnings

The US Federal Reserve's (Fed) favourite inflation measure, PCE, will be released on Friday. Economists expect the January figure to drop back by 0.1% to 2.5%. The core number, which removes volatile food and energy costs, is forecast to drop back to 2.6% after three months at 2.8%. If this number falls back toward 2% over the coming months, that will give the Fed more confidence to cut its benchmark interest rate.

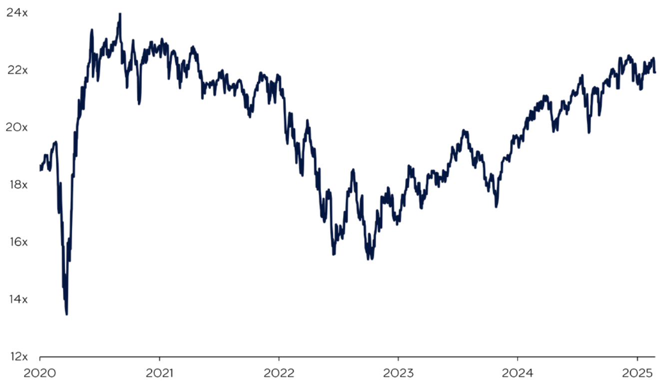
Lower interest rates mean cheaper borrowing, which makes it easier for households and businesses to increase spending on other, more fun and productive, things. It also makes lending new money and holding cash in the bank less attractive. That, in turn, encourages people to take more risk with their money to get higher returns. That's another way of saying it encourages households and businesses to invest more, which leads to more employment and commercial opportunities for everyone. In the round, that's the reason why lower rates push the value of stocks and bonds higher.

The exception to this, of course, is when rates are falling because the economy is already in or fast approaching a recession. At that point, the risks of company profits falling markedly and investments going bust because of the bad business environment override the benefits of easier borrowing. You also find investors cashing out of investments to ensure they have the spare money to pay their own bills and make it through a rough patch.

In recent months, investors' hopes of a continued fall in the US benchmark interest rate have shrivelled as **inflation has reaccelerated and tariffs threats and general policy uncertainty have grown**. Investors expect the Fed to keep its rate at the current band between 4.25% and 4.50% until July.

This could easily change as more information tumbles out of the US. But, for now, American stocks will need to rely on better profits to deliver returns to shareholders. Expecting shares to appreciate because investors put a higher value on each dollar of profit (relying solely on a higher price-earnings multiple) will be less rewarding than it has been in the past couple of years.

US STOCKS COULD STRUGGLE TO RISE ON HIGHER P/E MULTIPLES ALONE



Source: FactSet; S&P 500 index price divided by next year's earnings, 1 Jan 2020 to 24 Feb 2025

These figures refer to past performance, which isn't a reliable indicator of future returns. The value of investments and the income from them may go down as well as up and you may not get back what you originally invested.

*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.*