

A hyperactive holiday season

3 September 2025

August's market-moving news included the imposition of high US tariffs, an intensification of Trump's war on the Federal Reserve, and continuing British and French fiscal problems. We think inflation will probably be higher in the long term. With this in mind, it's important to maintain diversified portfolios.

A month can sometimes seem much longer than that in financial markets, these days. As much seems to happen in a few weeks as happened over many months in the past – at least that's how it feels.

Maybe it's the effect of a shift in the incentives of media content creators towards generating clicks rather than more considered analysis. And while politicians have never hesitated to score points off their opposite numbers, there's an inexorable rise in the amount of vitriol poured over each other by parties with increasingly polarised views.

August proves my point: enough went on to fill an annual commentary. And this was supposed to be holiday season!

Quick take:

- Global stocks fell on tariff news and tension over the Russia-Ukraine war
- Stocks later recovered on decent quarterly earnings
- British and French government bond yields rose on continuing fiscal fears

There was, already, a whiff of panic in the air at the beginning of August following the imposition of punitive 'reciprocal' tariffs on Switzerland and Taiwan and very weak US payroll data. This triggered the sacking of the head of the Bureau of Labor Statistics (because President Donald Trump didn't like the data reflecting poorly on his leadership).

Moreover, on the very first day of the month he ordered the deployment of two nuclear submarines in response to threatening statements from former Russian president Dmitry Medvedev. And yet by month-end, the MSCI All Country World Index was 2.5% higher in dollar terms – up 3.7% from lows reached on 1 August.

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Looking at many of the price charts for the month, most of the market action took place on the first couple of trading days. There was a volatility spike, equities and other risk assets sold off, inflation expectations fell and interest rate cut expectations rose, in reaction to the above factors. And when nothing blew up (including no nuclear explosion), the 'buy the dip' crowd came rushing back to equity markets, encouraged by a decent set of quarterly earnings reports.

Canning Cook

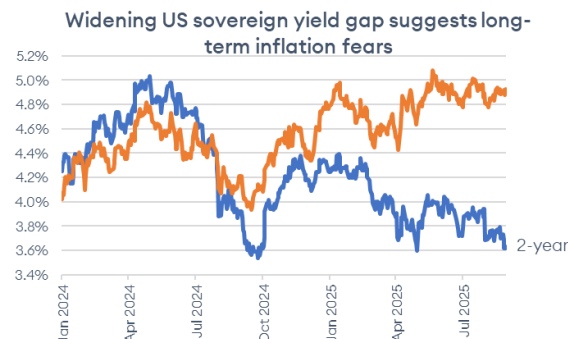
Hopes for more US interest rate cuts have also supported risk assets. That said, we're not comfortable with some of the longer-term implications of looser monetary policy, especially if it comes from White House pressure and leads to higher inflation. Unable to unseat Chair Jerome Powell, President Trump has turned his attention to another governor, Lisa Cook, whom a government acolyte has accused of making a fraudulent mortgage application. Trump has fired her 'for cause', but she is taking the fight to the courts.

A president's intervention in monetary policy matters is not exactly unprecedented, at least when it comes to getting people sympathetic to his views onto the board of governors and into the regional chairs. But the increasingly

autocratic nature of Trump's actions is unsettling.

The red line of market tolerance

Where is the red line of market tolerance, beyond which US government bond yields and other asset prices move sharply in response? We'll only know after we've passed it – but the market consequences could be unpleasant. For the moment investors, overall, view the glass as half full; they've bid up shares positively exposed to the promise of lower interest rates. The Russell 2000 small cap index, for example, jumped 7% in August.



Source: LSEG

AI anticipation

The main driver of equity returns this year, as for the previous two years, is the anticipation of the profits to come from the implementation of AI. The financial benefits have largely accrued so far to companies involved in the investment phase. That means chip manufacturers, such as Nvidia. It also means data centre

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builders: both the owners, such as the leading tech companies, and those involved in the construction and the provision of the huge amount of power the centres need.

However, investors are still beset by moments of doubt about the returns from AI-related investment. This happened in January, when China's DeepSeek Large Language Model entered the wider consciousness. The latest bout of nerves was triggered by a report from the university initiative MIT NANDA. To quote from the release:

"Despite \$30–40 billion in enterprise investment into GenAI, this report uncovers a surprising result in that 95% of organizations are getting zero return. The outcomes are so starkly divided across both buyers (enterprises, mid-market, SMBs) and builders (startups, vendors, consultancies) that we call it the GenAI Divide. Just 5% of integrated AI pilots are extracting millions in value, while the vast majority remain stuck with no measurable P&L impact."

But a deeper reading of the MIT report suggests it's more a problem with implementation than with the technology itself. This is especially so where a company has attempted to build its own AI capability or bought an off-the-shelf tool that can't understand its business. That could well mean that AI-based

applications will deliver better returns once people learn to use them better.

However, with US technology valuations elevated (although not in a bubble, in our opinion), share price performance will increasingly depend upon positive returns on the new capital expenditure being generated. For now, investment analysts forecast that existing high returns on capital can be maintained. If that's the case, we could also expect to see productivity benefits flowing through the economy as non-tech companies successfully use the technology.

Large and persistent deficits

Another persistent theme today is the size and persistence of many countries' fiscal deficits. Markets attention shifts from one country to another, but the net effect is that long-term borrowing costs keep rising as investors sniff out future policy risk. Two countries currently in the spotlight are France and the UK.

In France, Prime Minister François Bayrou's attempts to reduce the budget deficit ran into the brick wall of a parliamentary minority. In response, he called a confidence vote for 8 September. He's unlikely to survive, although a new premier will probably be appointed to continue along the same lines. A snap parliamentary election is also possible, but there's only an outside chance of an early presidential election. The upshot has been

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a widening of French government bond yield spreads over German Bunds, with the 10-year spread at 78 basis points (0.78%).

This is approaching the most recent high of 88bps last December. But it's still far short of the close to 200bps seen during the Eurozone crisis in 2011. A warning shot, but no crisis – for now.

In the UK, the 30-year gilt yield is at 5.6%, up from 5.13% at the beginning of the year and its highest since 1998. At that time, our debt-to-GDP ratio was a puny 32% vs around 100% today. We're fast approaching another pivotal Autumn Budget, where Chancellor Rachel Reeves must find a palatable combination of lower spending and increased taxation to stabilise finances. The UK seems to be running a real-time experiment on the shape of the Laffer Curve to determine exactly how much tax can be imposed without destroying incentives to work. This curve shows how much tax revenue is actually raised in the real world for any given rate of taxation.

Even so, we don't entertain alarmist stories that the government will need a bailout from the International Monetary Fund as it did in 1976. Much is different today. For example, inflation peaked at over 25% in the mid-1970s, thanks to oil shocks and policy mistakes in an era when the Chancellor controlled interest rates, not the Bank of England. Inflationary

pressures could push yields higher, depressing bond prices. But gilt yields are already quite high, offering a decent cushion. Moreover, sterling is doing fine, suggesting no panic move out of sterling-based assets.

The key point, though, is that French and British fiscal problems look intractable.

France hasn't generated a budget surplus since the 1970s and government spending comes to more than half its GDP. That was sustainable when debt-to-GDP ratios were lower, yields on French and German bonds were similar and the European Central Bank's (ECB's) benchmark rate was close to zero. Despite the attempt by President Emmanuel Macron's government to confront reality, opposition parties see more political capital not merely in maintaining the *status quo* of fiscal incontinence, but in giving away even more.

In the UK, Labour's attempts to curtail welfare spending were shot down by its own MPs. And the populist Reform Party, could, judging by some polls, win more votes than Labour and the Conservatives combined. Reform's fiscal plan looks unsustainable.

Two grisly phrases

One of our main tasks as custodians of clients' hard-earned wealth is to separate signal from noise. It's easy to be scared into liquidating assets after falls in

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markets, which are, sadly, inevitable. With so much going on in the world at the moment, we're taking care to navigate around the obstacles and concentrate on long-term outcomes.

It's possible that we're entering a period of 'fiscal dominance', a grisly phrase we should all become familiar with. This is when monetary policy falls subservient to fiscal policy, with interest rates forced to inappropriately low levels to reduce debt service costs – something Trump has explicitly called for. The US president is leading the way in trying to make this happen, but most other countries could also eventually be forced down the same route.

If higher inflation is the result, as we believe is probable, safer, cash-like investments will lose value in real terms. This is the concept of 'financial repression', another unpleasant phrase that we should also recognise.

It will be important to have the right mix of assets in portfolios to deal with this. Corporate revenues and earnings can grow with higher consumer prices, so equities are well placed to maintain and increase real wealth in the long run, for all their short-term volatility. Carefully selected commodities and actively managed strategies, such as hedge funds and trend-following funds, can provide diversification.

For recent economic highlights, see below.

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US - The second-quarter corporate reporting season is largely complete. In the long run, while market multiples rise and fall, it's the earnings per share that define investment returns. Downgrades to expectations following the Liberation Day shocks had set a low bar for companies to beat – and overall, earnings came in above forecasts. However, companies that didn't meet expectations were punished more harshly than usual in this environment.

US companies enjoyed a strong tailwind from a weaker dollar when transferring income from overseas. This helped create a 4.8% year-on-year rise in S&P 500 real-term revenues (ex-energy, which can be very volatile). Earnings per share grew by 11%, well above the 4% consensus forecast.

As often the case recently, mega-cap technology companies led the way: the Magnificent Seven stocks posted almost 30% earnings growth (and technology as a whole 15%). There were also strong earnings gains for financials (14%) and industrials (8%).

Analysts expect a slowdown in the second half of the year, with both quarters seeing around 7% year-on-year growth as the delayed effects of tariffs are felt.

Aggregated analyst forecasts remain rosy for 2026, at 13%, although strategists, who look at markets in their entirety rather

than individual stocks, are slightly less ebullient, at 11%.

UK - The FTSE 100 reached more new all-time highs in August, although it ran into some resistance when banks were undermined by fears of increased taxation in the Budget. They make an easy target, having posted strong earnings growth and failed to restore their reputation with the public almost two decades on from the Global Financial Crisis.

Overall, FTSE 100 H125 earnings fell 2% year-on-year, but still beat pessimistic consensus estimates by 5%. Earnings rose 5% if the struggling energy sector is stripped out. A barrel of Brent crude oil averaged \$83 in H124 but only \$70 in H125. Dollar earners have also felt the headwind of an average £/\$ rate of \$1.30, vs \$1.265 a year earlier. While 65% of companies left guidance unchanged, there were substantially more guidance upgrades (27%) than downgrades (8%).

Europe - Europe's reporting season was the most disappointing, with earnings coming in just 1.5% above expectations and posting overall year-on-year growth of 5%. Financials was a strong performer. A strong euro provided a headwind to multinationals, with the average €/£ rate €1.13 in the second quarter of 2025 vs €1.07 in 2024. This will remain a drag through the rest of this year (assuming, as we do, no dollar revival). However, various

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factors could point to a better future. These include lower interest rates and German fiscal expansion. Moreover, governments might prove willing to cut red tape, responding to the influential report on improving EU competitiveness from ex-ECB head and Italian premier Mario Draghi. Analysts forecast 11% earnings growth by 2026.

Emerging Markets - Chinese equities were the standout performers in August, with the domestically focused CSI 300 rising 10.5%. Technology shares performed well. Data show this was fuelled by local investors borrowing record amounts of cash, with outstanding margin trades in onshore equities climbing to 2.28trn yuan, surpassing the 2015 record. Households enjoy little return from cash deposits or bonds because interest rates are pushed down to fight persistent deflation. And the real estate market remains subdued as it works off past excesses.

India moved in the opposite direction as the US imposed a total 50% reciprocal tariff. Its Nifty 50 index of leading shares fell 1%, although losses to sterling-based investors were 4% owing to a weaker rupee. We continue to find the Emerging Market label highly frustrating because of the often highly varied performance of different countries and regions.

Fixed Income - The Bloomberg Global Aggregate Bond Index is up 7.2% so far

this year, flattered by dollar weakness. The sterling-hedged version has returned 3.2%. While central banks' interest rates are falling, longer-maturity bond yields, set by markets, have failed to follow them down as investors ask for a higher term premium (the extra yield demanded for longer-term bonds) to account for future risks. These include fears of higher inflation, currency devaluation and an inability to honour liabilities.

We continue to recommend shorter-dated fixed income to shield portfolios from the higher volatility of longer-dated bonds. We're also doubtful that bond portfolios can offer the same risk diversification achieved during the first two decades of this century, owing to the potential for higher and more volatile inflation. This could hit both bond and stock prices at the same time by pushing up interest rates in financial markets, even though higher consumer prices can help some companies by increasing earnings.

All UK Conventional Gilts has delivered a total return of +0.2% over the last three months and 1.9% over the past year. Index-Linked Gilts returned -0.4% and -10.2% over the same periods. Emerging Market bonds produced a total return of 3.8% in sterling over the three months to end-August (+13.1% over 12m). Global High Yield bonds delivered +3.6% (+7.6% over 12m) in sterling terms.

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