

## WEEKLY DIGEST

OLD LADY SETS PUZZLE

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**A three-way split over interest rates at the Bank of England highlights the difficult job of working out the right level of interest rates. Meanwhile, US tariffs look set to hit the domestic economy – but exporters may not emerge unscathed.**

What connects the Men's High Jump in the 2020 Tokyo Olympics, the crazy golf match between Bart and Todd Flanders in *The Simpsons* and last Thursday's August interest rate decision by the Bank of England's nine-strong Monetary Policy Committee? The answer is that all these events resulted in a draw.

The mathematically minded will be wondering how a draw can emerge from a decision made by nine voters. The solution to this puzzle is that there were actually three results. Four Committee members, including the Bank's Chief Economist, Huw Pill, voted to keep its benchmark rate unchanged at 4.25%. Another voted to cut by a quarter of a percent. The ninth, Alan Taylor, opted for a dramatic half a percent cut. In contrast to the high jumpers and the protagonists of *The Simpsons*, for the Bank of England there was a quick resolution to the impasse. In an unprecedented second round of voting – the only time the Committee's had to do this in all its 28 years – Taylor trimmed his suggested cut to a quarter-point to get a new benchmark rate of 4% over the line.

It's a measure of the uncertainty over the UK economy that Committee members entertained not a mere two but three options. This reflects the twin realities of economic weakness and inflationary pressure.

#### Slacker UK labour market

The quarter-point camp noted a slacker labour market. UK payroll employment has fallen for five straight months, pushing unemployment up to 4.7%. This has contributed to slower wage growth – people are less likely to bargain hard over starting salaries or pay rises when they sense it might be harder to find an alternative job. People's average earnings rose 5% in the three months to May, down from a December peak above 6%. Easing wage growth reduces inflationary pressure, by keeping a lid on companies' costs.

The one-man half-point camp – Mr Taylor – adopted a gloomier tone, even mentioning the R word. "UK sentiment was weak, with subdued consumption and investment", reads his argument in the minutes of the Committee meeting. "This picture was one of

#### QUICK TAKE

- The Bank England narrowly voted for a quarter-point interest rate cut
- US tariffs are likely to boost domestic inflation and impose costs on businesses and consumers
- We favour shorter-dated UK and US government debt because of inflation and fiscal concerns
- Japanese exporters' profits could be hit by US tariffs, but there's much to like about Japanese stocks

downside risks in coming years, namely: inflation below forecast, and activity weak or an increased risk of recession." Taylor recommended the half monty of a half-point cut as "insurance" against these risks.

Finally, the stay-as-we-are camp cited high inflation expectations among both businesses and ordinary people, including rising inflation for food and energy. These are two types of inflation that can be particularly crucial in setting ordinary people's inflation expectations because they're so visible. It's hard to feel that inflation is coming down when the price of chocolate bars in Aisle Seven has risen so fast (sweets and chocolates are up 9.9% in the year to June, according to official figures). Higher inflation expectations tend to become self-fulfilling: they influence how hard people bargain over their wages, for example.

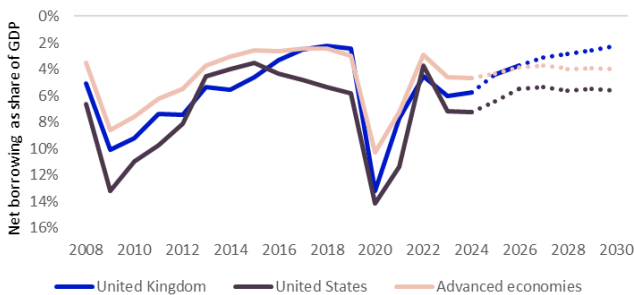
It's revealing that after the vote at the Old Lady of Threadneedle Street – an affectionate sobriquet for the Bank – financial market expectations in the surrounding City of London of the likely interest rate at the end of this year actually rose rather than fell. Markets were previously pricing in a 90% chance of another quarter-point cut this year. After the news, they were less certain, pricing in a 75% chance.

It's partly because of concerns about inflation that we favour shorter-dated UK government bonds (known as 'gilts'). Debt with longer maturity is more sensitive to changes in expected inflation. We also worry about the difficulty the government will face in cutting the fiscal deficit – the gap between the government's income and its spending. This is a further reason to favour shorter-dated over longer-dated debt, which is more sensitive to

The value of investments can go down as well as up and you could get back less than you invested. Past performance is not a reliable indicator of future performance. This information should not be taken as financial advice or a recommendation.

fiscal problems. That said, Britain's fiscal deficit is considerably less than in many other advanced economies. Moreover, looking to what might happen to the deficit in the future, Chancellor Rachel Reeves is showing every sign of fiscal conservatism – more than the US administration, for example.

### THE UK DEFICIT IS ABOUT AVERAGE. THE US'S IS HIGHER



Source: International Monetary Fund April 2025 Fiscal Monitor. Includes IMF forecasts.

### Tariffs: the domestic cost

Across the Atlantic, US President Donald Trump sees greater income from tariffs as one way of reining in the US's enormous fiscal deficit.

The government collected nearly \$30 billion in tariff revenue last month, according to the Treasury Department. That's a 242% jump compared to last July.

But when considering how tariffs might reduce the deficit, we also have to take into account the likely hit from tariffs to the US economy, and therefore to the tax revenue that dictates the deficit's size.

We also believe that the cost of tariffs will largely be borne not by exporters reducing their profit margins, but by US businesses and consumers. That will reduce corporate profits and put pressure on household budgets. We expect this to begin showing up in US inflation figures for September or October. It's not just the cost that's hard for businesses – it's also the uncertainty over what their costs will be.

Just as for gilts, we favour shorter rather than longer-dated US government debt because of the outlook for inflation and the fiscal deficit.

The latest nasty tariff surprise was last Wednesday's news of an additional 25% on US imports from India, bringing the rate to 50%. This was prompted by Trump's pique at the country's large

purchases of Russian oil at a time when Trump is angry over what he regards as Russian President Vladimir Putin's foot-dragging over negotiations to end the war in Ukraine.

That said, we do still see plenty of opportunities in US stocks – we have more investments in the US market than any other. Supporting this sense of ongoing attraction, the US quarterly corporate earnings season continued last week to produce plenty of nice surprises, where companies beat analysts' expectations.

### Driving away profits

Exporters to the US will bear some of the pain of tariffs, though, as well as US businesses and consumers. Bearing this out, last week Toyota, Japan's biggest carmaker, downgraded its full-year profit forecast by 15% after predicting a ¥1.4tn (\$9.5bn) hit this year from US tariffs. The latest rate on auto exports to the US is, at least, down from a previously threatened 27.5% to 15%. Despite this, we do see compelling opportunities in Japanese stocks.

Japan is an export-oriented economy and tariffs are a headwind. But its stock market has other drivers and has done relatively well since Liberation Day on 2 April, when Trump announced sweeping tariff plans. The country's pedigree of technological excellence sees no sign of disappearing and companies are becoming more shareholder-friendly.

Moreover, the return of inflation over recent years is both painful and helpful. Anyone sitting down with a bowl of rice to watch TV will have paid a lot more for it than when they settled down to watch the Tokyo Olympics over dinner. The price of this staple food has doubled in Japan over the past year, due to pestilence, heatwaves, speculation and policies that make it difficult to smooth out the effects of domestic imbalances of rice supply and demand.

Rocketing staples prices could cost the reform-minded government in upcoming elections, something we're monitoring closely. But counterintuitively, general inflation is good on balance for the domestic economy. It encourages consumers and businesses to spend now, rather than putting off purchases till tomorrow in the hope that the price of that cutting-edge new rice cooker, which produces just that soupçon of extra fluffiness, will fall. This is a welcome change from the deflationary trap Japan was in during the 1990s and 2000s.

*For recent economic highlights, see below on page 3.*

The value of investments and the income generated by them can go down as well as up.

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### ECONOMIC HIGHLIGHTS

**US** – The US economy has clearly slowed after the imposition of much higher tariffs, but fears that it might contract haven't been borne out. Data released on 30 July showed a 3.0% surge in headline gross domestic product (GDP) in the second quarter of 2025, rebounding from a 0.5% contraction in Q1. However, this bounce in GDP was largely driven by tariff-related distortions, with net trade flipping from a big drag in Q1 as importers tried to buy before tariffs came in, to a big boost in Q2 as stockpiles were drawn down (imports are subtracted from the data to produce GDP, since it covers *domestic* product). Within the GDP figures, a better measure of the underlying strength of the economy was real final sales to private domestic purchasers (the value of consumer spending and private investment after adjusting for inflation). This measure continued to expand, but growth slowed to 1.2% annualised – the slowest pace since 2022.

July's Institute of Supply Management survey – a much-watched gauge of business confidence – signalled stagnation, with the reading for services barely expanding (the number slipped from 50.8 to 50.1) and manufacturing falling further (from 49.0 to 48.0). Any number below 50 suggests a contraction in activity. Labour market momentum is also fading. July's 73,000 increase in payrolls employment, published on 1 August, was poor, but the real surprise came from the sharp downward revisions for May and June—slashed by a combined 258,000. This brought each month's net increase to under 20,000.

**UK** - Survey data suggest the UK economy was barely gaining ground at the start of the third quarter. S&P's Purchasing Managers' Index (PMI) manufacturing reading showed the sector stuck in contraction: it nudged up to 48.0 in July, still below the 50.0 threshold. The services reading showed continued expansion but the pace of this slowed, with a dip from 52.8 to 51.8. The retail sector saw little relief in July, as numbers from the British Retail Consortium and Sensormatic revealed continued weakness in footfall: the number of people entering shops. Total footfall dipped 0.4% year-on-year, a slight improvement from June's 1.8% decline, but still a sign of that consumers are feeling subdued.

**Europe** – Germany's industrial sector weakened in June, with production tumbling 1.9% month-on-month. May's figures were also revised sharply downward, dragging German industrial output to its lowest point since May 2020 and casting doubt on the sector's resilience to US tariffs. Stronger industrial output in France, Italy, and Spain softened the blow from the German decline, but the gains are unlikely to fully offset the German data. This suggests that numbers for the Eurozone as a whole are likely to show a fall. Elsewhere, European consumer spending showed signs of strength, with June retail sales jumping 3.1% year-on-year, beating expectations. There were also upward revisions to previous months.

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