RATHBONES

QUARTERLY INVESTMENT UPDATE

AFTER MUCH SOUND AND FURY, STOCK MARKETS ARE AT RECORD HIGHS
Q3 2025

Major equity indices hit bear market territory on twists and turns in US tariff policy, before responding to news of a partial climbdown. Meanwhile, the oil price rose and fell and the dollar weakened.

With classic British understatement, you could say the second quarter of 2025 has not been without incident. But market performance over the period fails to capture the full drama. The FTSE Private Investor Balanced Index, a reasonable proxy for the majority of our industry's clients, returned around 2.5%, which could be considered slightly better than par on an annualised basis. That looked like a tall order at the end of the first week of April when it was down more than 5%.

We could see ahead of President Trump's announcement of 'reciprocal' tariffs on 2 April that it might trigger the next twist in markets, but we were shocked, along with everyone else, by the scale of tariffs and the sharp fall in equities they precipitated. Counterintuitively, bonds and the dollar, which we would normally expect to be bid up in times of equity market stress, also fell.

Towards the end of the quarter, escalation in the Middle East provided another threat to investors, but this was shaken off with remarkable alacrity. At the time of writing, the MSCI World Index (which is quoted in dollars) sits at an all-time high, although for non-dollar investors it hasn't fully recouped its losses yet.

Tariff tides

Given the constant assault of news in the Information Age, events that occurred as recently as three months ago can feel a bit like ancient history. Even so, it's important to reflect on 'Liberation Day', which turned out to be anything but. Even the US Treasury Secretary, Scott Bessent, generally considered to be the grown-up when he is in the room, appeared nonplussed when they were unveiled.

With the starting point for most economists' expectations having been an average tariff of 10%, it was no wonder that markets reacted so badly when first estimates suggested an average as high as 27%. With major indices hitting bear market territory (down 20% from the most recent peak), President Trump was forced within days to announce a 'pause', allowing time for negotiations. A pause that expires, in theory, on 8 July (and 11 August for China). This triggered an immediate and aggressive rally in equity markets, one that continued through what turned out to be a relatively positive corporate earnings report season and then extended through May and June.

And so where are we left? On current estimates, the average tariff rate could be more like 16%. Although that is a lot higher than the 2.7% that prevailed before their imposition, the fact that it is going to settle a lot lower than originally threatened is being taken as positive. Although we have yet to see clearly how the cost of tariffs is going to be distributed between exporters to the US, the wholesale and retail channel, and the end consumer, it seems to be a number that everyone can live with and, of course, it only affects goods going into the US. We'll probably never know whether this was a classic 'anchoring' tactic that can be effective in negotiations, but it seems to have worked.

One of the few trade settlements that has been reached is with the UK, although we would emphasise that this is by no means a fully fledged trade deal and the details are still being worked through. Much more important will be deals with the European Union and China, deals which somehow, given the political climate, all parties will be able to claim as a 'win'. While there remains a risk of further upset, a desire for reconciliation and 'moving on' seems to be prevailing.

Companies have become more adept at mitigating costs and rejigging supply chains, having learned from their experiences of the covid pandemic and subsequent burst of inflation, which reached its apotheosis following Russia's full-scale invasion of Ukraine. We're comfortable with remaining invested in equities, neither above nor below our long-term strategic weighting given the likelihood of more big price swings and the high level of uncertainty about their direction over the medium term. At the same time, we're maintaining our structural bias towards higher-quality companies that we believe are better equipped to weather any storms that come along and can, in our opinion, produce above-average longer-term returns.

The spOILs of war

June gave as another 'blink and you missed it' potential crisis in the form of escalating hostilities in the Middle East. First came Israel's surprise attack on Iranian military leaders and various strategic and military assets. That was followed by an even more surprising bombing raid carried out by the US on Iran's key nuclear facilities. Leaks from Washington suggest that the latter attack was deliberately carried out over a weekend so as not to upset financial markets, which could quite easily have been sent into panic. Instead, investors were faced with a *fait accompli* when markets opened on Monday, 23 June, although still waiting to see the extent of Iran's response. This turned out to be very tame, coming in the form of a telegraphed missile attack on a US military base in Qatar which was (by design) easily intercepted. A ceasefire between Israel and Iran was announced and everyone stood down.

You might be surprised to discover that we engaged in very little trading during this episode and held to our overall tactical positioning. Though history is of course no guarantee of future results, selling in response to geopolitical events has not enhanced portfolio returns on average. One reason for this is that it makes you more likely to miss out on a subsequent recovery. In this case, we reasoned that the key factor was going to be what happened to the oil price.

Sharp rises in the oil price have in the past been a catalyst for recessions, especially when the price spikes have been triggered by a curtailment of supply. Iran always holds the threat of closing the strategically important Strait of Hormuz, a channel along its border through which around 20% of global oil-related products pass on a daily basis. But it was only ever going to be the ultimate (and effectively self-defeating) 'scorched earth' option. As we write, it remains open, and we believe that there are enough vested interests involved to keep it that way, not least those of China, which aligns diplomatically with Iran and is a big net importer of oil via Hormuz. Given the already shaky nature of its economy, China cannot afford an energy shock.

The oil price was volatile during the period. From a recent low of $60 per barrel, Brent crude jumped to more than $80 at one stage as some investors and consumers hedged themselves against an even bigger increase. It has since settled at around $67 – remarkably, bang on its ten-year average. The world can easily live with this price, especially as an ever greater share of energy is generated from renewable sources, and there is certainly no underlying shortage of supply, with the Opec cartel currently producing well below its capacity. It's also interesting to consider how the evolution of the US shale industry might have changed that country's attitude to oil supply shocks. The US was a net importer of oil from 1950 until 2019 but is now a net exporter.

From an investment perspective, we see value in some of the major oil producers mainly as generators of income rather than as growth vehicles. Oil industry management appears to have learned (the hard way) the lessons from overinvesting in exploration and now displays much greater discipline in how it invests capital, with returns having improved in recent years. High dividend yields and generous share buyback programmes are the result, offering a steady potential total shareholder return.

That sinking (dollar) feeling

We briefly mentioned earlier the fact that non-dollar equity investors are facing something of a headwind. The fact that US equities accounted for 64% of the market capitalisation of the MSCI All-Country World Index at the end of May means that they have an outsized influence on global investors' returns. For the past few years, this influence has been positive, as investors have ridden the twin waves of a rising US stock market and a stronger dollar. However, the tariff shock (combined with concerns about America's fiscal stability) turned everything on its head. While the dollar has often been a safe haven in times of trouble, the fact that the triggers of the market sell-off evolved in the US meant that the dollar was suddenly vulnerable. Anecdotal evidence suggests that the dollar's fall was accentuated by some fund managers, notably in Europe, who had been relying on it to rise if US equities fell and were forced to offload some greenbacks when the opposite happened.

Looking at the numbers, the widely quoted DXY dollar index (which is heavily weighted to the euro) has now fallen by 11.5% from its most recent peak in January and by almost 15% from what appears, with hindsight, to have been the latest cyclical peak in September 2022. For UK investors, the pound has risen from a low of $1.22 earlier this year to $1.37, though this is largely a 'weak dollar' phenomenon. The wider dollar index is currently sitting very close to its 10-year average of 98.4, at 97.2, so this sharp move down in the dollar could be seen as reverting from overvalued levels back toward its mean.

Even so, questions are being asked about whether we are on the cusp of some sort of major sell-off or crisis, and the dollar's global reserve currency status is being questioned too. Most of the discussion in the media fails to make the distinction between the dollar's level and its status as a reserve currency. In terms of its level, there are four broad influences that we can look at to assess these risks. The main, but in many ways, least reliable one, is valuation, a factor that tends to be dreadful for market timing but which does in the end hold sway. Remember the wise words of Warren Buffet, the retiring leader of Berkshire Hathaway and a man generally recognised as the greatest investor (as opposed to trader) of all time: "Price is what you pay, value is what you get".

Bearing that in mind, our own long-term forecasts for asset class returns have built in a decline in the dollar over the next decade owing to it being overvalued on several measures. Some of that has just come more quickly than we expected.

Interest rate differentials are another strong influence on currency pairs, and the Federal Reserve's (Fed's) reluctance to cut interest rates more quickly had also been attracting deposits to the dollar. More recently, signs of weaker employment trends, a moribund housing market and a run of lower-than-expected inflation have boosted expectations for rate cuts. Comments from more Fed governors have encouraged this view, although not (yet) from the chair, Jerome Powell – much to the displeasure of the President! Thus, another support is being gently removed.

Investment flows are another important driver, possibly the most important in the very short term. These can be in the form of capital projects by companies or portfolio flows from investors. The former were boosted by incentives to invest in certain sectors offered by the Biden administration; the latter by the trend among non-US investors to allocate more to US equities in search of higher returns, especially from the sort of global technology platform companies that have led US markets higher but are in short supply elsewhere. Questions about the returns to be made from the huge spending on artificial intelligence and the emergence of growth opportunities elsewhere, notably the promise of greater defence and infrastructure spending in Europe, have encouraged some reallocation of capital out of the US.

The final, and probably most contentious, factor is default risk. Not so much that the US will not pay off its debts, but that it will somehow chip something off the returns currently promised to holders of its debt (especially foreign ones). Potential withholding taxes were included in a section of the tax and spending bill now making its way through Congress (called the One Big Beautiful Bill Act, or OBBBA for short, proving that truth *is* stranger than fiction), although this has been withdrawn from the latest version. Alternatively, the government could find a way to depress interest rates and bond yields while letting inflation run hot and thus reduce the real value of its liabilities (which would mean investors' fixed income returns not keeping up with inflation). If non-US investors think that they are going to get fewer of their dollars back in future, it's pragmatic to sell some bonds now.

Taking all of this into account, we can see some downward pressure on the dollar persisting but nothing to persuade us that a crisis is imminent. As we'll be highlighting in an article in our next edition of Investment Insights, out later this week on our Insights page, the dollar's status as the preeminent reserve currency is based on its role as the dominant funding currency for international trade and financing. Neither the euro nor the Chinese renminbi is in a position to assume the mantle of global reserve currency. And it's not as if many of the eurozone countries and China itself don't have their own fiscal problems to deal with. It is not our policy to hedge equity market-related currency risk unless we perceive an explicit intention to devalue the currency or a specific event risk. And although this can create short-term headwinds to sterling-based investors (at least in nominal sterling returns), it does tend to even out over time. Thinking more positively, a trip to America looks a lot better value now!

The second half

We are sticking to the view we had at the beginning of the year of satisfactory overall portfolio returns for 2025 (not blowout) but achieved with more volatility than last year. Persistently high fiscal deficits (which unnerve bond investors) and a febrile geopolitical background would seem to guarantee that volatility. We also note again that current market structures and behaviours tend to exacerbate short-termism, leading to short and sharp market falls and subsequent rebounds. Balanced against that is the fact that inflation is gradually easing, allowing central banks to loosen monetary policy. Companies, in aggregate, are still growing their profits. In fact, estimates for growth in earnings over the next 12 months just hit an all-time high for the S&P 500.

At the conclusion of the last quarterly update we asked "What could go right?". It seems sensible to ask the same question again – especially since the majority of financial commentators seem to spend more time worrying about what could go wrong. Doom sells! Some sort of certainty over tariff levels would be a good start. One well-connected Washington policy analyst we met with recently suggested a one-year blanket 10% tariff on all goods to allow all parties to get used to them and, crucially, to see what works and what doesn't. Sustainable peace in the Middle East and Ukraine would be a bonus, but perhaps sits too close to 'wishful thinking' on the spectrum of optimism. The passage of the OBBBA in the US promises more government stimulus in the form of tax cuts, which could support economic activity (despite longer-term fiscal deficit fears). And we continue to note the US political cycle, with November 2026's mid-term Congressional elections beginning to be factored into the government's thinking. Expect to see more friendly policies being rolled out the closer we get.

ADDITIONAL INFORMATION

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For specialist ethical, sustainable and impact investment services
Greenbank
0117 930 3000
enquiries@greenbankinvestments.com
greenbankinvestments.com

For offshore investment management services
Rathbones Investment Management International
01534 740 500
rathboneimi.com

@RathbonesPlc

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