RATHBONES

QUARTERLY INVESTMENT UPDATE

SEPARATING UNCERTAINTY FROM RISK AS WE PREPARE FOR WHAT'S AHEAD
Q2 2025

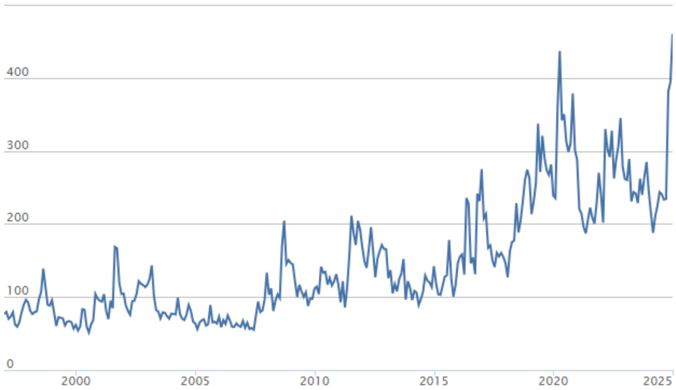
When it comes to managing wealth, there is a big difference between the concepts of "risk" and "uncertainty". Risk is deemed to be quantifiable in some way, allowing managers to construct portfolios with the right balance between assets and the right mix within those asset classes. At least then we might have some idea of the potential gains and losses to which clients are exposed.

Heightened uncertainty

Uncertainty, on the other hand, offers a much broader range of potential outcomes with the prospect of greater volatility to boot. In such circumstances it pays long-term investors to stick closer to benchmarks and we certainly do not see this as a time to be playing fast and loose, although we remain fully invested.

As you might imagine, uncertainty is difficult to measure, but there is a Global Economic Policy Uncertainty Index with data going back to 1996 (compiled by the academics Scott Baker, Nick Bloom and Steven Davis) and it currently has its highest reading since we were in the early stages of the Covid crisis (see the chart below). If there is any ray of light here, it is that spikes in the index tend to create contrarian buying opportunities in risk assets, although it is fair to say that on this occasion the sell-off has not been anything like as severe as in the past, hence our reluctance to significantly overweight equity risk.

GLOBAL ECONOMIC POLICY UNCERTAINTY INDEX



Source: Economic Policy Uncertainty, as of 26 March 2025

America's aggressive trade policy and geopolitics are the main factors creating this elevated uncertainty, but there are things we can do to prepare, as we'll explore in this quarter's update. The good news is that not everything is negative!

Trump 2.0: Trade

When it comes to apportioning blame for the current uncertainty, fingers are pointing at the US. Investors have been wrongfooted and the expected bullish "Trump Trade" has not been borne out by events. The consensus view was that Americans would be getting tax cuts and deregulation to sweeten the pill of tariffs. It was supposed to unleash animal spirits and to provide support for equities and the dollar. However, it's been just the bitter stuff so far. Furthermore, whereas tariffs were only expected to be a threat that would quickly be withdrawn once reasonable concessions were offered, for now they appear to be stickier.

Our view has been, and continues to be, that tariffs are an inappropriate tool with which to conduct economic policy. They hinder efficient global trade and become, in effect, a tax on the consumers of the countries who levy them. They can be inflationary if import cost increases are passed on to consumers, or detrimental to margins if absorbed by companies.

This is having a negative effect as more companies are citing policy uncertainty as a reason to withhold investment and to pause hiring. Consumers are equally unsettled by the threat of another bout of inflation as tariffs are passed through to them. Then there are the federal workers and consultants cowering in the shadow of Elon Musk's DOGE (Dept of Government Efficiency) chainsaw. Add in the anecdotal evidence of non-US holidaymakers showing a preference for other destinations and there is a realistic possibility of some weak economic data ahead.

The next twist could come on 2 April, when we learn the outcome of the Trump team's investigation into "reciprocal tariffs". These encompass everything from non-trade barriers to, bizarrely, sales taxes such as VAT. If reciprocal tariffs are imposed, the value of the goods in question could rise from around a relatively manageable $800bn to well into the trillions of dollars, although most recent reports suggest a more targeted approach.

WHAT IT MEANS FOR YOUR PORTFOLIO:

We are doing all we can to mitigate portfolio exposure to such risks at the company level. We can focus on "domestic" companies that trade primarily within their own borders. We can also identify multinational companies whose production facilities are largely located in the country of final consumption. And there will also be companies to consider for new investment that have sold off more than is justified by the tariff threat. The threat of tariffs is another reason to focus on companies with 'quality' characteristics - those with strong balance sheets, profit margins and returns on investment - which in general should be better positioned to cope with rapid changes in policy.

Trump 2.0: Geopolitics

If Trump the Trader poses a threat to commercial equilibrium, then Trump the Diplomat presents a more existential threat. Alongside the sabre that he is rattling at supposedly friendly places including Canada, Greenland and Panama, he has waded straight into the discussions between Russia and Ukraine as well as having his say in the Middle East. With almost daily pronouncements being made with respect to both theatres of conflict, we are aware that anything written here may have a very limited shelf life (indeed, that is the case in an unusually high number of current situations). Even so, we may be on a path towards some de-escalation in the Ukraine war, which would be helpful to sentiment, although not necessarily on terms that most people would deem to be acceptable (that is, they will end up favouring Russia with respect to territorial gain and Russia might not be punished for its actions so far). Yet all of this has proved to be the catalyst for a seismic shift in the European political agenda, which could have far-reaching effects for investors.

Zeitenwende: "The times they are a-changin'"

The German language is famous for putting words together to make new ones, like Zeitenwende, from "Zeit" (time) and "Wende" (turn). Literally a turning point, or in the more expansive Langenscheidt's German dictionary "a new era". Something has been brewing in Europe for a while. In a report for the European Commission (EC), former European Central Bank President Mario Draghi outlined the need for much greater investment and looser regulation. From tiptoeing in this direction, the EC has now broken into a moderate trot. And even if this turns out to be a marathon, Germany's newly elected Chancellor sees it as a sprint.

Trump's threat to withdraw America's security umbrella from Europe was a kick up the backside - a case of unexpected collateral improvement. This has woken Europe to the need to spend more to provide its own military deterrent – a lot more. The EU has already launched a €150bn bond programme and believes that as much as €800bn can be raised for defence spending by allowing governments more fiscal leeway.

Germany is the one country that can clearly afford to spend more, given a relatively low debt-to-GDP ratio of 62%, and Chancellor-elect Merz has already pushed a bill through Parliament to lift the deficit cap on defence spending. He has also championed a bill that would provide a massive €500bn for infrastructure. It is widely recognised that Germany's cautious fiscal approach has starved the country of investment, with its trains being even less punctual on average than those in the UK, if you can imagine that. (My trusty proof-reader informs me that Greater Anglia trains are extremely punctual and should be spared this calumny!)

All of this has triggered something of a stampede into European equities, with Germany being the main beneficiary. But if this really is a "Zeitenwende", and there are many who remain sceptical, there should be plenty of gains left to play for. A recent fund flow analysis suggested that for every hundred investment dollars that had left Europe since 2022, only three had so far returned.

WHAT IT MEANS FOR YOUR PORTFOLIO:
We continue to look for opportunities in companies with exposure to both defence and infrastructure spending (fortuitously, a few straddle both), and for companies that stand to benefit from a broader revival of animal spirits. You can read more about our views on this volte-face in European fiscal policy in our *Investment Insights* magazine, out soon on our website.

DeepSeek

Given the torrent of political news, it would have been easy to overlook another momentous market event – news in January that a relatively unknown Chinese entity, DeepSeek, had created a Large Language Model capable of competing with established Generative AI models (think of Chat GPT as an example), at a fraction of the cost. Every share touched by the enthusiasm for all things related to Artificial Intelligence (AI) was hit hard, and these ranged from chipmakers and software providers to those involved in building datacentres and supplying their power.

After a bounce, most have come under further pressure. All of the Magnificent Seven leading US technology shares, bar Meta Platforms, are trading below their average share price over the last 200 trading days. That represents a severe loss of momentum. In many ways this is no bad thing because it blows away much of the speculative froth that had been evident in the US market (and we will address overall market levels later). But there are questions being asked about the ability of these companies (and others) to make decent returns from the huge amount of capital they have invested in AI.

As Microsoft founder Bill Gates is alleged to have said about technological progress, "People often overestimate what will happen in the next two years and underestimate what will happen in ten". We can also cite the Jevons Paradox, which states that new technologies will only be adopted more quickly as greater efficiency makes them more affordable.

WHAT IT MEANS FOR YOUR PORTFOLIO:
We certainly have no grounds to bet against the continued penetration of AI-related services into our daily lives and view the current shakeout as a reasonable opportunity to add some exposure to our favoured companies.

Equity Market Perspective

European equities have enjoyed a strong, and unusual, outperformance versus the US so far this year. US equities suffered a brief correction in March (a fall of 10% from peak to trough). The FTSE World index also suffered a correction in sterling terms, before subsequently stabilising. By contrast the MSCI Europe ex-UK index has risen by 10%* since the start of the year, led by Germany's DAX (+15%), as investors responded favourably to relatively cheaper valuations and the promise of looser purse strings. Companies that are expected to benefit from increased defence spending have been the big winners.

China's equities, having stalled after a first round of economic stimulus was announced last September, have had a second wind thanks to a combination of factors (the MSCI China was up 15% in the year to date). The DeepSeek news rekindled enthusiasm about its technology sector and that was quickly followed by a meeting between President Xi and a group of leading entrepreneurs, including the recently reclusive Jack Ma. This suggests that Xi might be willing to allow private enterprises a bit more freedom to profit from their innovations. The government has also announced incremental stimulus plans to encourage consumption. Even so, we will need more evidence of improvement to buy into the bull case given the long shadow of China's still-deflating real estate bubble.

As for US equities, much will depend upon whether the US will fall into a recession. Our current central case is that it won't, in which case further downside should be limited, and as such we keeping a neutral stance on both US equities and overall equity exposure. To hear more about why we believe it makes sense to stay invested, click here to watch *Politics Versus Profits*, the latest video update from our Co-Chief Investment Officer Ed Smith.

Bonds and interest rates

Government bonds have also been volatile this year, although they have recovered well from an initial sell-off in January. While the higher yields on offer (as yields move inversely to prices) now provide a more attractive alternative to riskier assets in times of stress, the fact remains that most Western governments are highly indebted. From time to time, investors betray their concerns that governments will be overwhelmed by their liabilities, both short-term (current expenditure including rising interest payments on the debt) and long-term (future pension and healthcare funding requirements as populations age). Matters were not helped by evidence that progress toward central banks' 2% inflation target has stalled. Service sector inflation in the UK remains uncomfortably high thanks to punchy wage growth and in the US the threat of tariffs leading to price rises is also a factor – not to mention idiosyncratic problems such as soaring egg prices owing to an outbreak of bird flu in chickens. Indeed, the closely watched (although possibly over-emphasised) University of Michigan Sentiment Survey's last reading of 5 to 10-year inflation expectations hit 3.9%, a level not seen since 1993.

Central banks certainly have the capacity to cut interest rates again should economic activity slow more rapidly, but they remain very wary of allowing inflation to gain traction again, which is what happened in the 1970s. Thus, expectations for further rate cuts this year are limited to around half a percent in the UK, US and Europe. Although interest rate cuts are often seen as beneficial for financial markets, we always counsel that people should be careful what they wish for, especially if rate cuts are a response to weaker growth and lower corporate profits.

We believe that the post-pandemic world is one in which underlying inflation will be higher and more volatile than previously, and that would have negative implications for government bonds. There are many reasons for this, including the more "populist" slant of politics, geopolitical uncertainty, the stalling and possible reversal of global trade, and the impact of climate change. Thus, we will generally aim to hold much shorter duration fixed income securities in portfolios than in the past. They can still provide a solid base, but with less risk of volatility or, heaven forbid, default.

Gold

One asset that continues to make new highs is not exactly new or innovative, but one with a six-thousand-year track record of maintaining its purchasing power, and that is gold. We noted a couple of years ago that the gold price's traditional relationship with bond prices, inflation expectations and the dollar had broken down and it has become evident that much of this is down to central bank buying of gold as a reserve asset alternative to the dollar. You can read more about our views on gold in this recent *Review of the Week*.

It's a bumpy ride, but stay aboard

In December, we identified the potential risks ahead, citing concerns about Trump's policy direction in particular. We also suggested that 2025 would be a year of greater volatility in stock markets, but that the bumpy ride could still get us to a reasonably pleasant destination. We are still on the ride and the temptation to get off or turn back is great. We continue to point to the fact that equities trend higher over the long term owing to their participation in the nominal growth of economies.

It's unusual for the US stock market to fall more than 20% in the absence of a recession, although there have been two occasions during the last forty years when that has happened. The first was the Black Monday crash in October 1987 which (although triggered by overvaluation and legitimate economic concerns) was exacerbated by automated sell orders driven by portfolio insurance products (after which "circuit breakers" were introduced to prevent a recurrence). It's barely visible on a long-term chart. The second (once the economic data was revised) was in 2022. Again, there was speculative froth to be blown off, but this was also a period which featured a unique repricing of money, during which the Federal Funds (interest) rate rose from zero to 5.5% and the 10-year US Treasury yield jumped from 0.5% to 5%. We do not envisage such circumstances being repeated today. However, we will remain sharply focused on the US economy in the weeks ahead.

To wrap up on a brighter note, what could go right? A selection of positive signposts could be: Donald Trump backs off from his more disruptive policies in response to stock market weakness; Elon Musk's DOGE team succeeds in cutting a lot of fat from the government without damaging any muscle, paving the way for tax cuts and easing pressure on bonds; Europe's stimulus is front-loaded; energy prices fall as more supply is encouraged in the US; and real signs of AI-related productivity enhancements emerge.

ADDITIONAL INFORMATION

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