RATHBONES

WEEKLY DIGEST

AS TIME GOES BY
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Some calm has returned to markets amid a temporary truce in the tariff wars, but the clock is ticking and there is plenty of potential for further volatility. Meanwhile, things are less rosy in bond land. Still, as John notes, there is reason to relax and enjoy the bank holiday weekend.

Way back in 1988, I was living and working in New York. Little did I realise at the time that the seeds of today's tariff wars were being sown at an auction of Hollywood memorabilia. One of the items for sale was a piano used in the classic film Casablanca. It was not the one 'played' by Dooley Wilson in Rick's Bar, but one used in the flashbacks to scenes in Paris where the main characters, Rick and Ilsa, fall in love. Even so, it came with a hefty price tag of $154,000 (equivalent to $416,000 today). The winning bidder was a Japanese collector. The unlucky loser who was outbid was none other than Donald J Trump! According to legend, it is this episode that triggered his belief that foreign entities were taking advantage of the United States and today we are dealing with the consequences. I hope that he is not harbouring any other long-standing grudges that need to be settled.

The last week has seen some calming down of the tariff situation following the de-escalation between the US and China. Perhaps that was because the President was on a whistlestop tour of the Middle East which involved announcing all sorts of investment deals, one of the biggest being the largest ever order for Boeing planes. This was announced by Qatar and amounts to $96bn. It makes for good headlines and provides more red meat for the MAGA crowd, but as with the British Airways deal announced the previous week, you still can't persuade me that Qatar became suddenly enamoured of Boeing jets and placed the order to curry favour with the US. And it's going to be years before they are all delivered (and even then, some of the order is only an option to buy).

Meanwhile, the clock is ticking on the tariff pause which allows the US to 'negotiate' with trade partners. The main pause runs out on 8 July, with China's extension running until 12 August. From a global perspective, what the US ends up agreeing with China and the European Union is going to be the most impactful. While all three parties are highly unlikely to end up cutting off trade entirely, it's hard to see either China or Europe being quite as accommodating as the UK. There's still the potential for lots of volatility over the next few weeks.

In a bad Mood(y)

From a market perspective, equities have largely made the round trip back to where they were before 'Liberation Day' when the tariffs were originally announced. However, things are not as rosy in the bond market. The latest news is that the bond ratings agency Moody's has downgraded the US by one notch from a pristine Aaa to Aa1. The fact that it's 14 years since S&P Global made a similar cut makes you wonder why it has taken so long. There was nothing surprising in the reasoning, given projections of a relentless increase in the ratio of US government debt to its GDP and the rising level of the government's interest payments as bond yields rise. Even so, US Treasuries took a bit of a hit, pushing yields (which move inversely to prices) up by a few more ticks.

This all comes at an interesting juncture as the Republicans attempt to pass their budget reconciliation package through Congress. For all the talk of DOGE cost cutting, reducing the deficit and getting bond yields to start with a "3" (at the time of writing 10-year Treasuries were yielding 4.55%), it looks suspiciously like classic 'pork barrel' politics aimed at shoring up votes in the mid-term elections next year. Over the next ten years, the proposed package offers almost $5 trillion in tax cuts. This includes extending $2.2 trillion worth from the Tax Cuts and Jobs Act in 2017 that are otherwise due to expire. Without this extension, there would be a severe tightening of fiscal conditions.

Talk about the 'never never'. One of the ways of getting that Act through the House in 2017 would have been to promise that the cuts were temporary. The old joke is that there is nothing so permanent as a temporary tax – that now seems to apply to tax cuts too! These cuts are offset by around $2tn of tax increases, but there is an element of smoke and mirrors here too. A cap of $30,000 is being proposed on the amount of state and local taxes (SALT) that can be offset against income for federal tax purposes. However, the supposed savings of $915bn are relative to what would happen if the existing cap of $10,000 expired leaving no upper limit, as it is scheduled to at the end of this year. The $677bn savings on spending related to tackling climate change are worrisome for other reasons.

The point to make here is that, for all the talk of being less profligate, the current US administration seems to have little appetite to consolidate. This is once again raising questions about whether the US is set to face its own "Truss Moment", which has become market shorthand for a sharp sell-off in bonds and the local currency as investors lose faith in the country to honour its liabilities (at least in real, inflation-adjusted terms). Such talk can sound alarmist, especially given the dollar's position as the main global reserve currency and the incredible depth and liquidity of the US Treasury market, but we have learned to have to think the unthinkable in recent years.

In reality, the fact that US Treasuries are the bedrock upon which the whole global financial system is built means that there is a huge incentive to avoid any disruptive market failure at all costs, even if that means intervention by the Federal Reserve. However, in the longer term, the most expedient solution for the US, barring some sort of unexpected productivity-led growth miracle, is to inflate its way out of the debt. This could be done by allowing nominal GDP (not adjusted for inflation, which is the standard way GDP figures are reported) to grow by more than the level of interest rates, much as it did following the Second World War. I continue to believe that this is one of the risks that investors in gold (which can act as a hedge against inflation) have detected.

The UK is caught up in this too. In the aftermath Since the Truss Budget in 2022 in 2022, the UK has had to pay more for its debt relative to other countries than it did previously. During the early summer of 2022, the 10-year gilt yield was around 0.8 percentage points (ppt) higher than that offered by German bunds. Today, the spread is more than 2 ppt. Even though France continues to suffer its own political travails, its 10-year debt yields 1.4ppt less than ours versus 0.2ppt in mid-2022. At the same time, the UK was paying around 1ppt less than the US on 10-year paper. Today it is paying 0.15ppt more.

Once the market's trust is lost, it's very difficult to rebuild it. That's one reason why Rachel Reeves, the Chancellor of the Exchequer, is having to be conservative with her plans and keeps referring to her fiscal rules. Although some of the UK economic data has been a bit better than expected recently, there is little evidence that this is helping the country's finances. There is a risk that the build-up to the next Autumn Statement could feature more threats of tax increases.

It's still the same old story…

The version of As Time Goes By used in Casablanca does not include the main introductory verse of the original song (and neither do many other versions if a brief Spotify search is anything to go by - although Tony Bennett did give it the full treatment). However, should you not be familiar with the lyrics, written in 1931 by Herman Hupfeld, they do seem to apply remarkably well to life today, nearly a century later.

"This day and age we're living in
Gives cause for apprehension
With speed and new invention
And things like fourth dimension
With Mr. Einstein's theory."
And so, with a Bank Holiday coming up, we should take Mr Hupfeld's advice that follows:

"So we must get down to earth at times
Relax relieve the tension"

As for investing in Hollywood memorabilia, Trump missed out on some decent gains because that piano was last recorded as being sold for $602,000 in 2012. Even so, he should have gone for the most expensive lot on the night, a pair of Dorothy's ruby slippers from The Wizard of Oz. These turned out to be a snip at $165,000 when they were sold again last year for $28 million!

ECONOMIC HIGHLIGHTS

UK – UK GDP turned out better than expected in the first quarter of 2025, expanding by 0.7% over the last quarter of 2024. Annual GDP has been growing in the range of 1.1% to 1.5% for the past eight months, averaging 1.3% in Q1. There was a 5.9% quarter-on-quarter increase in business investment and a decent recovery in exports and it is possible that these were boosted by orders from the US in anticipation of tariff increases. Household spending grew by just 0.2% and government spending fell by 0.5% despite plans for it to be higher. With wages still rising faster than inflation, it appears that the UK's growth could turn out better than forecast this year, although we still have to see the impact of higher employer National Insurance contributions in April. The more those contributions are passed on to consumers in the form of higher prices, the more that will tie the Bank of England's hands. The market has priced out a full quarter-point base rate cut over the last few weeks, taking projections for the year-end level up to 3.75% from 3.50% previously, versus the current 4.25%.

US – The University of Michigan's index of consumer sentiment decreased by 1.4ppt to 50.8 in the May preliminary report, below expectations and its second lowest level in the history of the index. The survey's measure of current economic conditions declined by 2.2ppt to 56.5, which would also mark the second lowest level if this estimate holds in the final print. Consumer expectations declined 0.8ppt to 46.5, the lowest level since May 1980. The survey period ended on May 13, just two days after the US/China de-escalation announcement and it was noted that "Many survey measures showed some signs of improvement following the temporary reduction of China tariffs, but these initial upticks were too small to alter the overall picture." Median inflation expectations over the next year increased by 0.8ppt to 7.3% in May, well above market expectations and the highest level since the early 1980s. Inflation expectations over the next 5-10 years increased 0.2pp to 4.6%, also above levels suggested by market pricing. The University of Michigan noted that the rise in longer-term inflation expectations reflected "a particularly large monthly jump among Republicans." That's interesting. Dissension in the MAGA ranks might well have helped to persuade the President to back down on the tariff front, at least for now.

Europe – Finally, some better data from Europe. The ZEW Survey of businesses saw the expectations component rise from -18.5 to +11.6 in April. Even so, that's still lower than the 40 recorded in March when it became clear that the European Union, led by Germany, was going to loosen fiscal policy. GDP rose by 0.3% quarter-on-quarter in Q1 and 1.2% on an annual basis. There was also quite a decent pick-up in industrial production in March but, once again, that could be a function of pre-tariff demand being increased. Data in a number of areas could well be distorted by this factor for several months to come.

China – More lacklustre data from China in the form of April retail sales growing by 5.1%, down from 5.9% in March and well below the expected 5.8%. It remains difficult for the government to persuade consumers to save less and spend more. Annual industrial production growth of 6.1% was ahead of the expected 5.7% but lower than the 7.7% recorded in March. Again, these numbers are likely to be affected by tariff-related announcements for much of the summer and possibly beyond. The latest suspension of the highest tariff rate has been met with a new wave of demand as US buyers seek to ensure stock for the key shopping periods of "Back to School", Black Friday and Christmas. The government has recently loosened monetary policy a bit more, but there is still no 'big bazooka'.

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