WEEKLY DIGEST

ESCALATING TENSION, LIMITED REACTION

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We're mindful of geopolitical tensions. That includes the latest escalation of hostilities in the Middle East and the ticking tariff timebomb. But we see reasons to avoid over-reaction. That puts us broadly in the middle, in our appetite for risk.

Please note that this commentary was written on the afternoon of Monday 23 June. Subsequently, Iran fired retaliatory missiles at a US military base in Qatar, but with sufficient warning that they were intercepted. This action will have satisfied the 'honour' of Iranians in being seen to react to the bombing of its nuclear facilities but, at the same time, sent a message that further escalation was not the intent. Investors certainly interpreted it that way, selling oil and bidding US equities higher into the close. This morning, for once, we woke up to more good news in the form of an apparent ceasefire between Iran and Israel. Experience suggests that this might be fragile, and one has to be concerned that there are factions within Iran that will not wish to lay down arms so easily. We must consider, too, the various Iran-sponsored proxies scattered around the Middle East who might yet wish to have their own say. It also remains to be seen exactly what Israel's ambitions are for any potential regime change in Iran. In the same way as we did not see fit to reduce risk as tensions escalated, neither is there a hurry to increase risk immediately. As outlined below, there are plenty of other uncertainties in the world at the moment. The original commentary remains relevant as a summary of the key risk factors in the current situation and also outlines our approach to investing at this time. Of course, we will continue to provide timely updates in response to further developments.

Every Monday, I host our internal morning meeting and one thing I do is to look back at financial market performance over the last week. This week, as I had been away on holiday, it was a two-week retrospective and so it took in the latest escalation of hostilities in the Middle East. What was most remarkable was the overall lack of investor reaction. The FTSE Private Balanced Total Return Index (which I use as a proxy for a 'typical' wealth manager's portfolio) was up 0.13% over the period. If I hadn't been keeping up with the news, I might've drawn the conclusion that everyone else had been on holiday too. I doubt that if anyone had been told what was going to happen and asked to predict the response, they would have been so unflappable.

Markets don't always get it right – I struggle to believe that they are truly efficient when it comes to pricing in all the influences – but you still have to respect what they are telling us. In this case, despite the extremely worrisome headlines (and don't forget my belief that media in general is a lot more 'shouty' today than it has ever been as all the outlets compete for our attention), Mr Market believes that the escalation in the Middle East will not have spillover effects into the wider global economy.

A dire strait

It's widely recognised that those spillover effects will depend almost entirely on the supply and price of crude oil and, specifically, what happens in the Strait of Hormuz. Around 20 million barrels of oil (including oil-related products), or about a fifth of global supply, is shipped on tankers through the Strait every day. Needless to say, if that route is closed, as has been called for by Iran's parliament, supply shortages will develop very quickly and most analysts' forecasts suggest the oil price could quickly rise above $100 per barrel (from $76 as I write and as low as $60 just a few weeks ago) and possibly as high as $150 if there is a dash for supply early on.

As an example of the risks, there are some clues in the performance of European equities over the last couple of weeks. This was the weakest region in terms of equity market performance over that period, perhaps exacerbated by some profit-taking after a strong run. Europe is more vulnerable than the US to higher energy prices, being a big net importer. Deutsche Bank calculates that a $10 per barrel increase in crude prices could add a quarter percentage point (ppt) to inflation within a quarter or 0.4 ppt if sustained for a year. In the latter case, GDP would be reduced by 0.25 ppt.
A jump in local natural gas prices would also (further) hinder European industrial companies' competitiveness against US equivalents. Europe is effectively already paying about three times as much for its gas as the US. Europe is more reliant than ever on imports of liquefied natural gas (LNG) – especially having had to wean itself off Russian supplies – whereas the US is a net exporter thanks to the shale production boom. President Biden banned the construction of new LNG export facilities, adding to the domestic surplus. Although this has since been lifted by President Trump it will take a while for the LNG to flow abroad.

Europe is also light on energy in its equity indices, with the MSCI Europe ex-UK exposure being little more than 2% against more than 10% in the MSCI UK Index. That makes the UK a slightly better hedge against rising oil prices. Even so, we continue to have a positive view on European equities for the longer term, having detected a favourable shift in the desire to boost government spending (notably in Germany) and a growing realisation amongst European leaders that they need to remove some regulatory barriers and encourage greater investment and innovation.

Returning to the Strait of Hormuz, the good news is that anyone who cares about this body of water is acutely aware of the risk and there is an expectation that the US, alongside other Gulf states, would intervene quickly to remove any blockage. How easy that would be if mines were launched into the strait is hard to judge. There are also reports that the US has requested that China use its influence as the main buyer of Iranian crude oil to persuade Iran not to block the passage of tankers. Indeed, such a blockage would be detrimental to Iran's own finances given that 90% of its own oil is loaded at Kharg

Island to the west (although it is only functioning with limited capacity, if at all, owing to Israeli missile strikes) and has to pass through the Strait too.

Another thing we have to ponder is the nature and scope of any potential Iranian retaliation. Locally, there is the threat of strikes on the oil facilities of neighbouring producers, possibly through proxies, as well as on US military bases in the region. Almost more worrying is the concept that Iran will attack other targets anywhere in the world at a time of its choosing in the indeterminate future. Thus, hopes have to be pinned on a diplomatic solution and one that offers Iran a credible 'off ramp' which would, one expects, involve a pledge not to maintain its aspiration to become a nuclear state.

Although movements of US military equipment and personnel in the region had suggested some possibility of readiness to launch an attack, another key surprise factor is that Trump had previously vowed not to get involved in such situations. His Monday morning social media posts went a step further in openly suggesting the possibility of regime change (although from within rather than necessarily sponsored by the US). Unsurprisingly, his actions have triggered an extremely unfavourable response from US Democrats, but there is also discontent within the isolationist camp of the Republican party. And with the ghosts of Iraq and the non-existent 'weapons of mass destruction' still haunting Washington, the fact that the intelligence about the nuclear facilities was not 100% verified and that Congressional approval was not sought raises the prospect of a domestic political backlash too. Not to mention the potential cost just as Congress is trying to pass the One Big Beautiful Bill Act in the face of resistance from fiscal conservatives.

The tariff timebomb Is still ticking

As if that's not enough to be getting on with, there is still a trade war going on in the background and the pause on 'reciprocal' tariffs that was instituted by President Trump in the face of financial market turmoil is close to running out. The key date is 8 July for all countries except China (11 August). Apart from the 'deal' with the UK, which was long on theatre and remains short on fine details, there seems to have been little progress elsewhere and I don't have much confidence that two of the major trading partners, Europe and China, will acquiesce easily to Trump's (somewhat unclear) demands. Will Trump 'chicken out' again and extend the pause? Can he realistically deal with the Middle East and tariffs at the same time? We should probably prepare for a bit more uncertainty.

Central banks' dilemma

The final factor to consider is monetary policy. Higher oil prices and the threat of higher inflation complicate matters for central banks as they weigh that threat against weaker growth prospects. It's one of those quirks of economics that although higher energy prices are deflationary from the perspective of diverting household income from non-energy-related spending, they can quickly be transmitted to headline inflation indices and potentially, as a result, to long-term inflation expectations. Central bank chiefs live in constant fear of inflation expectations becoming unanchored and tend to be hawkish, sometimes too hawkish. This was the case with the European Central Bank (ECB) in 2008 when it raised interest rates because of higher oil prices even as the Global Financial Crisis was beginning to unfold.

Even so, there is little evidence of inflation expectations slipping anchor for now. Market-based indicators for future inflation in the UK, US and Europe have been behaving well following the big post-covid reset and are certainly not hitting new highs. And when looking for any parallels with 2022 and Russia's invasion of Ukraine, we should also compare the background for monetary policy. Central banks were already in tightening mode before the invasion owing to covid-related supply chain issues and the demand boost from stimulus packages (notably in the US). This time, they are very much in loosening mode (even if the US Federal Reserve and the Bank of England paused last week).

Holding steady

Taking all of these factors into account, we still find it difficult to take a strong view in terms of straying far from a neutral position on overall risk appetite in client portfolios. We continue to look to balance risks through exposure to gold, allocating to actively managed funds that can provide some offsetting balance to our equity exposure and by limiting the interest-rate sensitivity of our bond holdings to account for inflation risk. Our underlying bias to higher quality companies in our equity allocation also provides a safety net. We are only a couple of weeks away from the next earnings report season and that will give us another opportunity to inspect the health of the corporate sector. With equities having recovered, and investor sentiment with them, the bar is set a bit higher than it was in April. But there are few signs that profit margins and earnings are under pressure. Indeed, forecasts for growth in US earnings over the next twelve months have just made a new high.

You can read more about how we're monitoring and preparing for key geopolitical risks through a robust and repeatable framework – including a direct military confrontation between Israel and Iran which leads to a serious disruption in global energy supply – in our recently updated report ***Peace of Mind in a Dangerous World***.

(See page 3 below for the **ECONOMIC HIGHLIGHTS** section)

ECONOMIC HIGHLIGHTS

UK – UK economic data has softened recently, opening an easier path for the Bank of England to cut the base rate in future, which it held off from doing last week. April GDP (-0.3% month-on-month vs -0.1% expected) and May retail sales (-2.8% m/m vs -0.7% expected) reflected a shift to weaker activity after some decent positive surprises earlier in the year. It's not clear if this is the result of employer National Insurance liability increases in April, so we'll need to see if the weakness persists. On the plus side, service price inflation dropped from 5.4% to 4.7% in April (vs and expected 4.8%). This trend was confirmed by the reading for services output prices in the latest S&P Global purchasing manager survey, which hit its lowest number since February 2021. The futures market reflects an 80% probability of a 0.25% base rate cut to 4% in August. It then prices in a fall to 3.75% by year-end.

US – The Federal Reserve's Federal Open Market Committee (FOMC), its rate-setting body, left rates unchanged as expected, although there was a slightly more hawkish tone to the 'dot plot', which shows individual governors' voting intentions. FOMC members' views are becoming more polarised, with some, notably Christopher Waller, demanding more immediate rate reductions. The next cut is still not fully priced in until October's meeting. President Trump insists that the Fed is behind the curve when it comes to cutting rates, and there is certainly some evidence of a weaker economy, with employment growth stuck at around 150,000 per month and often subject to downward revisions. The housing market also remains weak, with buyers refusing to pay up and sellers refusing to take an offer. A sticky rate for new mortgages of close to 7% doesn't help when the average rate on existing mortgages is closer to 4%. Nobody wants to move and refinance at a higher rate unless they need to. The effect of the tariffs that have been imposed so far, how they will impact consumers and how they might have distorted supply chains, inject yet more uncertainty into US data in the short term.

Europe – With the ECB now having cut its deposit rate from 4% to 2%, investors continue to await signs of stronger growth that have not yet emerged. Industrial production fell 2.4% m/m in April after rising 2.4% in March, although that might have been affected by US imports being pulled forward ahead of tariffs. Headline (1.9%) and core inflation (2.3%) are in the right zone – not too high or low – to prevent sleepless nights at the ECB. Hopes for the future could be seen in rises for the Eurozone's Sentix Investor Sentiment Index and the ZEW index of German business confidence. Even so, the latest Hamburg Commercial Bank Composite PMI reading, which covers the Eurozone, came in flat at 50.2, suggesting limited underlying momentum for now. Readings above 50 indicate expansion, with readings below 50 suggesting contraction.

China – Still few signs of new life. May retail sales growth increased from 5.1% to 6.4% (forecast 4.9%) and industrial production growth was much the same at 6.3%, but urban fixed asset growth fell from 4% to 3.7%. Property investment overall was -10.7% year-on-year, illustrating the persistent overhang of the country's real estate bubble. This week's National Party Congress Standing Committee meeting offers another opportunity to inject more stimulus but hopes are low. China might well sit on its hands until the outcome of the trade/tariff negotiations becomes clear.

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