RATHBONES

MONTHLY DIGEST

TESTING THE LIMITS
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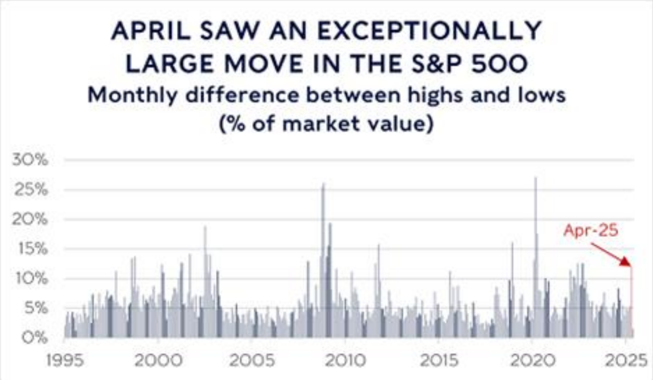
April gave investors a rollercoaster ride but the US stock market ended only modestly down and bonds regained their safe-haven status.

The first quarter of 2025 provided no shortage of incident in financial markets. And while it would be inaccurate to say that investors were totally unprepared for what was to come in April, the latest developments have been sufficiently surprising to create extreme price volatility – negative and positive.
Indeed, Deutsche Bank points out that during the month, US equities suffered their fifth-worst two-day decline since World War Two – followed quickly by their third biggest one-day rise. The net return over the month for the US's S&P 500 stock index was -0.75%, but that completely fails to capture the 12% peak-to-trough trading range.



Source: FactSet, Rathbones; data to 6 May

Other equity markets, as well as bonds and currencies, saw similar gyrations (see regional comments below). As we often point out, investors who check their portfolios monthly rather than tracking them constantly will have experienced a much smoother emotional ride.

The epicentre of the current seismic activity is located firmly in the White House, the source of April's two major market-moving announcements.

The first was the unveiling of the "reciprocal' tariffs" on the US's trading partners on what President Trump tagged "Liberation Day". The theatrical production of giant cards with various countries' tariff rates might have been laughable, were the consequences not so serious. The average tariff rate on goods imports (service imports were not included) of around 24% was much higher than expected – and much higher than the previous average rate of around 2.7%. The rates were mostly calculated on the basis of countries' net trade surplus with the US, with a base 'universal' rate of 10% for all goods imports (bar some specific exemptions). China's subsequent decision to impose its own reciprocal tariffs was met with an increased tariff of 145%.

This methodology takes no account of the economic concept of 'comparative advantage', by which the production of goods is outsourced to the country that's the most cost-effective producer (unless the production is crowded out by other even better economic opportunities). To most observers, this betrayed a degree of economic illiteracy. That, in itself, suggests that the tariffs are unsustainable in their proposed form, even allowing for some justifiable need for secure domestic supply chains in certain industries or for the President's desire to generate tax income.

In announcing these tariffs, President Trump was clearly testing the limits of both trading partners and investors. The market response suggests that he pushed too far, since investors then collectively tested the Trump administration's pain threshold for the value destruction of financial assets. This amounted to a 20% decline in US equities from their February peak and a sharp rise in bond yields, which threatened the US's already shaky fiscal position, and a fall in the dollar.

This quickly had the US leadership reaching for the pain killers. These were administered in the form of a 90-day pause on the imposition of tariffs (with the exception of China), allowing time for negotiations. There have since been encouraging announcements of potential trade talks and deals, although details remain skimpy. We note that, historically, trade agreements take much longer than 90 days to complete. For example, the USMCA deal between the US, Canada and Mexico, agreed during Trump's first presidency, took 18 months.

There's also some risk that if investor sentiment continues to recover, then Trump will be more willing to play hardball in the negotiations. Trump is clearly well-versed in the psychology of negotiating. He has anchored tariff fears at an extremely high level, allowing him to appear generous in making concessions and for everyone to feel a sense of relief that things have turned out less bad than they could have been. But let us be under no illusions – the playing field for global trade has shifted and future tariff rates are, in all probability, going to be much higher than they used to be.

Limits were also tested in the US bond market. The US government has been running a persistently large fiscal deficit. In other words, it's living beyond its means. Market participants are looking for the tipping point at which the deficit is deemed to be unsustainable. That point seems to come whenever the 10-year Treasury yield starts to move higher than 4.5% – where the rise in yields often accelerates. It's not as though the US leadership is completely blind to this risk. After all, Treasury Secretary Scott Bessent is an experienced financial market professional who had a hand in triggering the UK's 'Black Wednesday' in 1992, when the UK was forced to exit the European Exchange Rate Mechanism and the pound collapsed. He's on a mission to get the yield closer to 3%, although doing so by creating a risk of recession seems to be an odd way of going about it.

Efforts to cut US federal spending are more sensible, although there are limits to what's achievable without cutting into 'non-discretionary spending' (spending that's much harder to cut because it's required by law, such as pensions and benefits). Republican ambitions to hand out more tax cuts will also make it hard to reduce the deficit. It feels as though this show is going to be on repeat for a while to come.

Source: FactSet; DXY Dollar Index against major currencies to 6 May

Investor appetite for US dollar-denominated assets is something else that might have been tested to the limit for now, with currency traders having recently been prescribed the financial equivalent of Ozempic, Novo Nordisk's weight loss drug. Talk of global investors' overexposure is somewhat misleading, particularly as they could not get enough when dollar assets were appreciating and many are measured against global benchmarks that are dollar-heavy.

However, various factors have led to a 10% fall in the widely quoted DXY dollar index, which tracks the value of a basket of currencies dominated by the euro. Mistrust of the Trump administration demands a risk premium. Questions about the future returns for capital spending on artificial intelligence, as well uncertainties about the effects of tariffs, have weighed on demand for leading technology shares – and there was plenty of profit to be taken, given the massive rise in tech stock prices over the years.

Europe's damascene conversion to the delights of more fiscal stimulus and, potentially, greater deregulation, provide a new alternative destination for global savings. Even so, and to paraphrase Mark Twain, we believe that reports of the death of the dollar as a global reserve currency are exaggerated.

US: three species of bear

As discussed above, US equities endured wild swings in April, although they settled barely changed over the month as a whole. Further underperformance by small-cap and value shares, as measured by the Russell 2000 and Russell 1000 Value indices respectively, indicates increased concern about levels of growth in the US economy and about where the impact of tariffs will land.

Smaller companies have less lobbying power with the government. This contrasts with say, Apple, which managed to persuade Trump to exempt smartphones from the tariffs imposed on goods from China (which is where 80% of iPhones are made, although only about half of those destined for the US). The probability of a US recession this year remains a coin-toss. The most sensitive indicator is the Polymarket betting price. This gained some credibility as a sentiment barometer in the run-up to the presidential election, although we're cautious about treating it as gospel. Even so, Polymarket's recession odds jumped from 39% to 64% in April, up from only 20% in February. A slower-moving index from Bloomberg, based on a poll of economists, currently suggests a 40% chance.

The 'recession or no recession' question will have a major bearing on equity returns. Since 1950, 10% market corrections that were not followed by a recession have led to low double-digit gains for equities on average over the next twelve months. By contrast, corrections that were followed by recessions saw markets flat.

Should equities enter a fully-fledged bear market (a peak-to-trough fall of 20%, based on closing prices), much will hang on what sort of bear market we are in. In his book 'Any Happy Returns', Peter Oppenheimer, Chief Global Equities Strategist at Goldman Sachs, categorises bear markets into three types: 'secular, 'cyclical' and 'event-driven'.

Secular bear markets include the Tech Bust (2000-3) and the Global Financial Crisis (2008-9). These are deep and long-drawn-out as excessive valuations and financial imbalances are worked off.

Cyclical bears are shorter and shallower and tend to adhere to normal economic cycles, often driven by inflation and interest rates.

Event-driven bears are the result of an exogenous shock – an unexpected event that originates outside an economy and its market, rather than being generated by them. These shocks could be anything from (geo)political to nature-based (think Covid). They tend to play out very quickly, often reversed by an appropriate policy response. For now, this feels like an event-driven (potential) bear market, with US government policy as the root cause. But we have to acknowledge that it could become cyclical if confidence continues to fall among US companies and consumers.

UK: caught in the crossfire

The UK market was caught in the crossfire of US tariffs and has recovered in tandem with US equities. It's hard to find a strong narrative to attach to UK equities at the moment. For some time they've looked relatively good value on basic measures such as price/earnings ratios and the dividend yield. But there's a persistent lack of meaningful growth catalysts.

Dollar weakness is a headwind for the multinationals heavily weighted in the FTSE 100 Index, and April saw a modicum of outperformance for mid and small-cap companies. This was supported by hopes for bigger cuts to interest rates. The UK interest rates futures contract for December now suggests that the Bank of England base rate will be 3.5% by Christmas, down from 4.5% now. That's two more quarter-point cuts than expected just a month ago.

Casual observers of currency markets might think that the pound has been strong, since it has risen from $1.29 to $1.33 since March. However, over the same period it has fallen from €1.195 to €1.175. This provides evidence of the flight from dollar assets, but with the euro as the preferred destination.

Europe: potential for change

We've referred to developments in Europe as a 'Zeitenwende' or 'new era', and investors appear to be embracing the potential for change. Some of this has been forced upon the continent by Trump's threat to remove the US's security umbrella. This has boosted planned defence spending. But there is more to this, as European institutions appear finally to have acknowledged that over-regulation has held back investment and innovation. It might be premature to herald a bonfire of red tape, but the direction of travel is unmistakable. Capital will be required to stimulate growth – and this has attracted funds towards the euro. It has risen from €1.035 at the turn of the year, when currency traders were screaming "parity" (when one euro buys precisely one dollar) to €1.08 at the end of the first quarter, to €1.13 now.

We note that in 2007 the supermodel Gisele Bündchen demanded to be paid in euros rather than dollars because she was so concerned about the weakness of the dollar. That turned out to be close to the euro's top! We will remain alert for such contrarian signals, but none are apparent yet.

Emerging markets: squeezing out a gain

The MSCI Emerging Markets index squeezed out a gain in dollar terms of 1% in April, a decent performance since every country in the index is subject to Trump's tariff increases to some degree. Latin American markets outperformed as they're not as firmly in Trump's sights as their Asian peers. For example, Mexico, which had already been under pressure, saw its stock market rise 13%, with Brazil gaining 5%. In Asia, mainland Chinese equities fell 5%, as did those in Vietnam, which has benefitted as production has shifted from China. India appears further ahead in the priority list for striking a trade deal; this helped its markets rise 5%.

There's bound to be a good deal of noise surrounding potential trade deals with the US: much talk but a limited amount of detail and few actual deals. But we find it hard to believe that the US can realistically operate as it has done without at least some trade with countries for which tariffs have become prohibitive. We note that a delegation of US retail giants headed by the CEOs of Walmart, Target and Home Depot attended a meeting in the White House late in April to highlight the risk of empty shelves at Christmas. This seems to have been another factor in softening Trump's stance.

We also point out that a weaker dollar, all other things being equal, tends to be positive for emerging market assets, including stocks and bonds – both corporate and sovereign – as it reduces debt repayment and servicing costs, releasing cash for other uses. Even so, significant outperformance for emerging market equities still requires greater faith in an enduring economic recovery in China.

Fixed income: shaky, then safe

After a shaky start to the year, global bonds have recovered and, in the end, offered a safe haven compared with riskier assets. The Bloomberg Global Aggregate Bond Index is up 5.7% this year, although flattered by the weakness of the dollar. The sterling-hedged version has returned 2.2%.

However, there was a period during April when government bonds were falling in tandem with equities (so called 'positive correlation'). This played havoc with risk diversification in multi-asset portfolios. There was also evidence that highly leveraged funds (funds financed by a lot of debt), exploiting the very small difference in price between bond futures and the underlying securities, were forced sellers, driving up yields. That storm has passed, but it has revealed the cracks in the façade. Investors continue to fret about accumulated fiscal deficits; any sense that these will run out of control can trigger a sell-off.

We don't expect any major countries to default on their debts, but some sort of 'yield curve control' to keep yields acceptably low could be a remedy. This involves targeting a yield for long-term bonds and buying as many bonds as necessary to hit that target. Japan's use of this tool suggests that it will probably lead to weaker currencies.

The All UK Conventional Gilts index has delivered a total return of +1.4% over the last three months and +3.5% over the last year. Index-linked Gilts returned -2.7% and -5.1% over the same periods. Emerging market bonds produced a total return of -0.1% in sterling over the three months to April (and +10.2% over the past year). Global high yield bonds delivered -0.7% over three months (compared with +8.4% over 12 months) in sterling terms.

Conclusion: don't panic

There are even more moving parts than usual in financial markets today, so this still does not feel like a time to be taking big risks with client portfolios by moving portfolios far from benchmarks. When a single presidential social media post can move leading equity indices by 10% in a matter of hours, it's very easy to be whipsawed by trying to second guess the next 'tweet'. We continue to advise investors that the structure of financial markets today lends itself to occasional bouts of extreme volatility and it is important not to be panicked into making decisions that could hit longer-term returns.

No doubt there will more volatility ahead, but we remain committed to investing largely in companies that have the power to continue to compound returns over a longer cycle, independently of the White House's current incumbent. Tactically, we can also look to take advantage of market overreactions.

ADDITONAL INFORMATION

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