RATHBONES

WEEKLY DIGEST

THE FIRST INNINGS

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Markets have reacted positively to news of US trade deals with the UK and China. But these are still bad deals compared to the previous status quo, so what could propel equity markets higher from here?

There's nowhere quite like the UK on a sunny day in late Spring. Although, in trying to channel my inner Sir John Major, I didn't see any old maids on bicycles or have a pint of warm beer over the weekend, I did spot several cricket matches being played – not on county grounds but on village greens or in parks. There is often a lot of hullabaloo if a team's score in the first innings deviates much from what might be considered the norm. No doubt it gives cricket reporters something to write about and plenty to chew on besides the cucumber sandwiches at teatime. But the truth is that until the second side bats there is no real way of knowing just how good or bad that score was. Scoring can often be affected by, for example, the condition of the pitch both sides are batting on.

Last week's announcement of the trade agreement between the US and the UK reminded me of this. We won't really know if it's any good, on a relative basis at least, until we see what everyone else manages to negotiate. Is the UK getting any favourable treatment or has the government played into the hands of the US by being so desperate to get some runs on the board?

A Win For Both Sides

No doubt there was something in the deal for both sides, at least from a signalling perspective. It was a welcome 'win' for Prime Minister Starmer following the mauling the Labour Party received at the hands of Reform in the recent local elections and it was notable that his team whisked him off to a Jaguar Land Rover facility for the conference call with the Oval Office. For President Trump it was proof that he was doing a deal, which is what he is all about.

Even so, the details were skimpy even if there were all the usual theatrics and a strong narrative which Starmer and our Ambassador to the US, Peter Mandelson, were all too happy to play along with. But it's hard to escape the fact that our trade position with the US is worse than it was before, with a 10% tariff rate now in place on the majority of goods versus an average of around 2.2% previously. Trump himself alluded to the fact that this would bring in $6bn of revenue for the US government, although it remains far from clear how the cost of that is going to be apportioned between exporters, importers and consumers.

As for the headline $10bn aircraft purchase by British Airways from Boeing, only the most naïve observer would believe that this was something cooked up in the space of a few weeks to curry favour with the Americans, but it made for a great announcement. Lost in the noise was the fact that parent company IAG is also buying $8bn worth of planes from Airbus for its other operators. Forgive me for being sceptical, but for my money there was a lot of heat generated but not much light.

China 'De-escalation'

Over the weekend we had more positive headlines about a trade deal between the US and China. The headlines spoke of "substantial progress", although once again there were no early details. Then, even as I was writing this, more news came out that both sides are going to reduce the most draconian tariffs on each other for ninety days. In the US's case, this brings tariffs on Chinese exports from 145% to 30% with the move in the other direction being from 125% to 10%.

However, the hardest part of this conversation is probably yet to come. Again, it's not difficult to produce a positive headline but the devil is going to be in the detail and in future negotiations.

As I suggested last week in the *Monthly Digest*, it looks as though Trump has produced a masterclass in anchoring everyone's expectations to such a dreadful outcome that a merely bad one is interpreted positively. In market terms, we're witnessing a classic market case of 'pricing out the left tail risk' (that's the one where assets fall in value), but that might also suggest that we need to see more actual positive news to start going after the right tail.

The Bulls Are Back

Nevertheless, the initial market reaction has been very positive. This comes after investment bank strategists have been busy downgrading their year-end targets for US equities and investor surveys have revealed a generally downbeat attitude. But it appears that the worst of the bad news has been discounted and that marginal buyers now have the upper hand.

One cohort that seems never to have lost faith in US equities and that maintains a 'buy the dip' mentality is the US retail investor. April fund inflows of around $40bn were the highest on record, an impressive feat even if some of that was directed towards bond ETFs. Companies themselves remain strong underlying buyers of equities too, with firms having announced plans to buy back a record amount of their own shares at this point in the year, already closing in on $700bn. Goldman Sachs calculates that companies will spend over $1 trillion buying back shares this year. Apple alone announced a new $100bn programme when it released its recent results. It also looks as though the positioning of shorter-term traders was reduced during the sharp sell-off that we saw in early April, meaning that likes of trend-following CTA funds, volatility control funds and hedge funds are all reasonably well placed to keep buying as the market rises.

The Economy and Earnings

Investors will continue to scan for positive news in the economic data. We seem to be in a sort of twilight zone at the moment, where 'soft' survey data is weak but 'hard' data remains fairly resilient. Betting site Polymarket's pricing of a US recession in 2025 -dropped from 50% to 40% on Monday after the China tariff news. Recession risk is still close enough to a coin toss to make it very difficult to make strong tactical asset allocation decisions in either direction. We have already seen some distortions to the first quarter US GDP numbers owing to the strength of imports to get ahead of tariffs, and various distortions are likely to continue for weeks, if not months. Citigroup's Economic Surprise index for the US is currently effectively flat, meaning that the data is coming in pretty much in line with consensus expectations.

At the end of the day, though, equities can't make long-term progress without companies growing their earnings, and we've now seen enough of the first quarter reporting season to get a decent handle on that. Of course, those earnings were in the bag before 'Liberation Day' and so might not reflect what is to come. Even so, the good news is that they were fine, suggesting reasonable momentum into the tariff storm, even if the pace of global earnings growth slowed from 9.2% year-on-year in the fourth quarter of 2024 to 7.1% in first quarter of this year.

Once again, aggregate growth was dragged down by the energy sector, meaning that profit growth excluding energy companies was more like 10%, in the double digits for the sixth consecutive quarter. The tech sector was still the biggest contributor in both the US and emerging markets, while financials led the way in Europe and Japan. Earnings growth for the largest, or mega-cap, US companies categorised as growth or tech shares was a punchy 27%, although slightly below the fourth-quarter rate of 30%. Concerns about profit margins were misplaced, as they rose everywhere apart from Japan. US margins might come under greater scrutiny in Q2 as we see who is going to take the pain of tariffs. Who will it be - consumers or corporates? There has been some speculation that bigger companies might be prepared to take some margin pain as long as they think tariffs are temporary, preferring not to risk alienating customers. Smaller companies may not have this luxury.

Looking ahead, full year earnings estimates have been reined back, amounting to 4.2 percentage point (ppt) cuts in Europe, 2.9 in Japan and 1.9 in the US. Emerging markets fared the best with just a 0.8 ppt downgrade. At least some of the cut to European earnings forecasts was the result of euro strength (making them less competitive on price and eroding the value of overseas sales). That leaves consensus estimates for calendar 2025 earnings growth, in descending order, at 10.4% for emerging markets, 7.1% for the US, 6.1% for Japan and 2.3% for Europe.

Now What?

Both the US S&P 500 and MSCI World ex-US equity indices are back above where they were before the initial "Liberation Day" tariff announcements, with the latter challenging the all-time high it made in June 2021. Our initial response to Liberation Day was to be a bit more cautious, but not outright defensive. With the benefit of hindsight, we should have been piling into risk assets. We reversed our call following the tariff 'pause' announcement. The level where we felt the S&P 500 would be both oversold and offering compelling value, and therefore provide a strong buying opportunity, never came.

More positively, we emphasised the message that panicking out of the market at the height of the bad news was likely to harm long-term wealth generation. It's formidably difficult to time such exits from and entries into markets, and clients' risk profiles should account for their ability to tolerate short-term market volatility, which is a feature of the investment landscape. One can imagine having sold at the bottom, being reluctant to buy the recovery (because nobody likes to pay more) and then being forced to buy again after a strong run for fear of missing out on further gains.

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

ECONOMIC HIGHLIGHTS

UK – The main event in the UK last week was the Bank of England's decision to cut the base rate by another 0.25% to 4.25% at its latest policy meeting. However, the background details were somewhat surprising, with four of the nine Monetary Policy Committee members not going along with the majority. Two members, Catherine Mann and the influential Chief Economist Huw Pill, did not want to cut rates at all. They will have deemed inflation to be too sticky and have been concerned about inflation expectations being anchored at higher levels, a factor which can lead to higher wage demands which can, in turn, perpetuate higher inflation. We also know that, in the short term, higher prices for utilities and mobile phone contracts will put upward pressure on inflation measures. At the other end of the spectrum Swati Dhingra and Alan Taylor voted for a larger 0.5% cut, seeing greater risks to economic activity which will have been exacerbated by recent US tariff announcements. It's quite rare for there to be such a wide range of opinions. The accompanying statement reflected something of a compromise. It stuck to the familiar script that "the unpredictability of the global economy" means rate cuts will be "gradual and careful". It reiterated that monetary policy will need to "remain restrictive for sufficiently long" to tame the inflation risk. Market-derived pricing suggests that there will be two more quarter-point cuts this year to 3.75%, although prices can change quickly. Just a couple of weeks ago the expectation was for a year-end rate of 3.5%.

US – The Federal Reserve's (Fed's) policy committee also met last week, but there were no changes there, again in line with expectations. Indeed, market pricing expects no cuts until September now. There are a couple of reasons for this. First, despite a 'rogue' fall in GDP for the first quarter – a function of net imports being boosted by pre-tariff front-loading – underlying 'hard' economic data remains resilient, even if the 'soft' survey data has been weaker. Second, the Fed remains wary of cutting interest rates too soon and too fast in case it lets inflation get a stronger foothold. Survey-based inflation expectations have continued to nudge higher, spurred on by fear about tariff-driven price increases. Here, again, the market has priced out one of the three previously expected quarter-point cuts between now and December. These expectations will probably continue to be volatile and to react to announcements from the White House.

China – China recorded its biggest ever quarterly trade surplus in the first quarter of the year, amounting to $166bn. That comes at a rather inconvenient time given all the concerns in the US about global trade partners "ripping us off". However, exports were boosted by US (and other) importers wanting to front-run tariff risk by building inventories. That might well subside from here (although the latest 90-day tariff pause could spur even more front-running just in case the tariffs are set higher again later). In terms of keeping its own house in order, the People's Bank of China cut its 7-day reverse repo rate by 0.1% to 1.4% and its Reserve Requirement Ratio for major banks by 0.5% to 9%. This frees up more capital to lend and at a marginally cheaper rate but falls short of the sort of aggressive monetary stimulus we have seen in the past. The authorities remain wary of inflating another asset price bubble, with the last one still in the process of painfully deflating. What the country needs is domestic consumption. There are far more goods being manufactured than needed, evident in the latest reading for Producer (factory gate) Prices, which are falling at an annual rate of 2.7%.

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