RATHBONES

WEEKLY DIGEST

THE HEAT IS ON
By John Wyn-Evans, Head of Market Strategy
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It's getting sweaty here in London and reaching boiling point on the Continent. And the weather is pretty hot too. But so far, markets are keeping their cool.

Yes, we are approaching some big events in the coming week that are jangling nerves and have the capacity to shape economic outcomes well into the future. We're hopeful for some 'great deals' to bring some calm when the pause on US 'reciprocal tariffs' ends on 8 July (and 11 July for China). Although political reality will probably mean continued drift into government indebtedness from pending American and British legislation, that shouldn't come as a surprise for bond investors.

The UK government faces a potential backbench revolt over its welfare reforms, and we are now just over a week away from the deadline for Europe (and other countries) to reach some sort of trade agreement with the US before more punitive tariffs kick in. And in the US, too, President Trump wants his One Big Beautiful Bill Act (or budget to you and me) to be voted through Congress before the end of the week to allow him to celebrate it on the 4th of July.

Approaching the tariff deadline

On the tariff front, I was reminded again last week that tariffs are, in fact, nothing new and have been a background factor in trade for years. I have written in the past about how Canada's protection of its dairy farmers turned me into an international cheese smuggler. Their tax on imports of, for example, Parmesan cheese, if above the agreed quota, is an eye-watering 245%. It's the same for UK Cheddar.

On reading the Times obituary of Bad Company founder and guitarist Mick Ralphs, though, I discovered another unwelcome tariff from the past (since rescinded, although some articles I have read subsequently refer to it being a complete ban on imports). To quote: "Despite his indifference to 1950s pop, [Ralphs] was fascinated by American-made electric guitars, which were unavailable in Britain at the time due to hefty import tariffs". According to legend, Hank Marvin of the Shadows was the first person to bring a Fender Stratocaster to the UK, a red-bodied beauty that inspired many of the famous British guitarists who developed their skills in the early 1960s.

It's probably not worth getting too deep into the weeds on tariffs this week. But we should be prepared for a constant flow of speculation and rumour. One of the main points of contention in talks between Europe and the US could be Europe's Digital Services Tax (DST) proposal, a 3% tax on profits from things that don't cross borders or get sold physically, such as online advertising or data. Because it targets mainly US technology companies, President Trump sees it as a direct assault on the US. Indeed, over the weekend he 'forced' Canada to abandon its 3% DST that was due to kick in at midnight on Monday. This came after President Trump threatened to call off all trade negotiations and even impose punitive tariffs of his own (although no figure was given).

There are two ways to spin this. The obvious one is to say that Trump, to use his own phrase, "holds all the cards" and that Canada caved in. The second way is to say that the DST was never going to fly anyway (it was hotly opposed by business groups in Canada) and that Prime Minister Carney had been holding it as an ace up his sleeve to offer as a negotiating currency when needed. I guess it depends on your political affiliation as to how you want to see it. Anyway, I'm sure there will be more of these mind games in the days to come. Often, the important thing with Trump is the optics of having been seen to have made a great deal.

Still, on the basis that investors rarely discount the same shock twice, it seems improbable that any lingering disagreements will upset markets to the extent they did in early April and everyone seems to be resigned to (if not necessarily overjoyed with) a minimum 10% global tariff and an average that will settle in the mid-teens. The next hurdle to get over will be to see where the weight of the tariffs falls in the supply, distribution and consumption chain and how that affects profit margins and consumer behaviour. We should get more insight as the second quarter corporate reporting season unfolds in a couple of weeks.

Political turkeys do not vote for Christmas

Moving on to fiscal matters, this week's vote on the UK's welfare bill and those that will be needed to ratify the One Big Beautiful Bill Act (OBBBA) in the US have some similarities, a key one being that the whip hand might be held by lawmakers who are more concerned with keeping their own jobs than doing the right thing for either country's finances in the long term.

I'm not going to venture into the debate about what constitutes the inability to seek work, but I think it is broadly accepted that the current welfare incentive structure is suboptimal and acting as a cap on labour force growth. However, it's also clear that a large number of Labour MPs are more worried about the flak that they might receive in their constituencies and the risk of losing their seats. And then there are those who are not happy with the leadership or who are dissatisfied with their role in government – let's face it, there just aren't enough government posts to go round when you win a landslide election. Ironically, these MPs might be accelerating the demise of the government by rebelling.

Thus Downing Street has been forced into its second fiscal U-turn of the month, the first having been on winter fuel allowances for pensioners. Together, these climbdowns will cost the government (by which I mean taxpayer) around £4.25bn. That accounts for almost half of the 'fiscal headroom' that the Chancellor left herself after last year's budget. With bond yields having increased and a threat of lower growth forecasts, that headroom could have evaporated completely, especially if the Office for Budget Responsibility downgrades its productivity growth forecasts to account for recent poor trends. The outcome is probably going to be higher taxes in the next budget, although there are fewer soft targets than ever to go for now. Prepare for more speculation about hits to wealth and savings-related vehicles.

On Saturday, the latest version of the OBBBA passed the procedural vote that takes it forward to the Senate floor for debate and a series of votes on its provisions. Once those are complete, it will be passed back to the House for final approval. There is a battle royal going even within the Republican Party between the more conservative 'fiscal hawks' and those Senators who are, once again, more interested in their own wellbeing. For example, 'blue-state' Republican Senators (that is those holding seats in what might be considered Democrat territory) managed to negotiate a higher cap on State & Local Tax deductions. This plays well in the richer Democrat states of, for example, New York and California.

But whatever small details are refined, or concessions made, on either side of the Atlantic, the brutal truth is that government spending is rising, at least partly to appease voters, but nobody wants to pay for it. This is also a factor in France today, where the latest efforts to raise the pension age from sixty-two to sixty-four are probably not going to be successful. Both the US and the UK are relying to some degree on forecasts for spending and revenue many years hence to justify their actions today and to keep an appearance of the books being balanced.

There's a reason why yields on longer-dated government bonds are rising and it's the threat that current borrowing trends are not sustainable. I doubt that there will be a 'reckoning' this week, but this is something that we are monitoring closely when thinking about longer-term portfolio construction and, crucially, financial planning.

For this week's economic highlights, see below on page 3.

ECONOMIC HIGHLIGHTS

UK – The final reading of first-quarter GDP confirmed growth of 0.7% from the previous quarter (even if later data suggests that this pace will not continue). The composition was a bit better than in the preliminary report, with higher consumer spending growth (+0.4% vs +0.2%) and less of a boost from business investment (which will have been distorted by tariff front-running demand from the US). Bank lending data for May confirmed the underlying pace of growth to be unexciting, with the £0.9bn rise in consumer credit (consensus forecast £1.0bn) being lower than the £1.9bn increase in April and the average gain of £1.3bn over the past six months. More positively, after the distortions created by the changes in stamp duty, housing demand did appear to pick up, with mortgage approvals for house purchases rising for the first time in five months.

US – Personal income declined by 0.4% month-on-month in May, worse than expected, but largely down to one-off influences, including a decline in Social Security payments after a one-off boost earlier this year. There was also a decline in payments to farmers who had earlier benefitted from the Emergency Commodity Assistance Program. The underlying increase was 0.2%. Compensation (+0.4% m/m) and interest income (+0.2%) rose, with falls for rental income (-0.4%) and dividend income (-0.3%). Consumer spending declined by 0.1% vs expected growth of 0.1%. The important PCE measure of core inflation (excluding volatile food and energy components) was 2.7% (0.1% more than forecast). This will continue to deter some Federal Reserve members from pushing for earlier interest rate cuts.

Europe – The latest European Commission confidence surveys had one bright spot, with the Services measure rising from 1.8 (revised up from 1.5) to 2.9. This is a series that has averaged a reading of 9.1 since its inception in 1995, and so it's clear that Europeans are not given to wanting to appear too optimistic. Indeed, their optimism peaked at a reading of 35 in 2000 and has never been above 20 since. Famously, the same organisation's consumer confidence index has never had a positive reading since it started in 1985. In that case, better to look at levels relative to history and changes in trend rather than absolute levels. On that basis, there are tentative signs of a turn for the better.

China – Growth in industrial profits remains in the doldrums at -1.1% year-on-year and -9.1% year-to-date compared to the same period last year. That's testament to overcapacity as the government continues to throw capital at its manufacturing base. With the threat of weaker exports to the US in future, China needs either domestic consumers or non-US buyers of its goods to take up the slack. If consumers do not comply (and they are showing minimal signs of doing so), then more of China's goods will find their way into other markets, possibly at a discount, creating a disinflationary impulse. The latest official PMI survey of business activity reinforced the lack of momentum in the economy, with the Manufacturing PMI at 49.7 and the Services PMI at 50.5 (with 50 being the demarcation line between growth and contraction).

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