RATHBONES

WEEKLY DIGEST

WEAPONS OF MASS DISTRACTION

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3 JUNE 2025

The world is a very noisy place at the moment, and it's increasingly designed to be that way. It doesn't seem to matter where you go or what you do, someone or something is always trying to attract your attention. The proliferation of media outlets only increases the competition, potentially distracting us in the short term from longer-term goals.

This is certainly true in financial markets, where headline writers compete to amplify even small price movements into something more meaningful, something that I have often described as a price movement in search of a story. Maybe clickbait is more apt today. When in doubt, it usually pays to lean on the phrase employed by stockjobbers back in the days of trading on the Stock Exchange floor. If a share price was rising for no apparent reason, it was "more buyers than sellers" (or the other way around if a share price was falling)!

It's always worth bearing in mind, and apologies for repeating this yet again, that some of the bigger downward movements in markets, especially the very short and sharp ones, can be driven by forced selling. This tends to be from funds or individuals that have borrowed money to leverage their investments or from funds that adjust their exposure based on the levels of market volatility. They can be more aggressive with their bets when volatility is low but have to rein back when it increases. The use of options and other derivatives can exacerbate movements. One of our key roles as asset allocators is to ascertain how much the "tail is wagging the dog" and how much is the impetus of the dog itself. Thus, we can hope to avoid making the mistake of reducing equity exposure just before a meaningful bounce, but every instance has to be judged on its own merits.

Thankfully, markets have been a little less volatile since we published the last Weekly Digest, although there has been plenty of news (and quite a bit of noise). Unsurprisingly, the emphasis has once again been on tariffs, but it's interesting that investors have increased their immunity to tariff threats as exposure to this particular 'virus' has accumulated. We have noticed this before with various shocks, whether they be geopolitical or natural. For example, Russia's presence in Ukraine has become almost accepted as the status quo and the basis for future peace talks. Terrorist attacks have, over the years, had a diminishing impact on markets. Mutations of Covid-19 became less worrisome than their predecessors. Even so, I worry that some sort of catastrophic cyber-attack could be the event that jolts everyone out of their complacency. Shoppers are already up in arms about being unable to buy their undies online from Marks & Spencer.

With all of these geopolitical risks out there, and seemingly on the rise, we've updated our *Peace of Mind in a Dangerous World* report, which outlines our process for monitoring these risks, and our road map for how we would deal with them if any were to come to fruition. If you're concerned about what these risks could mean for your financial security, as most of us undoubtedly are, please have a read of this report by clicking on the link above.

TACO, anyone?

Meanwhile, the latest back-and-forth on tariffs was the US threat to impose a blanket 50% rate on the European Union. In the event, there was a swift phone call between President Trump and Ursula von der Leyen, the President of the European Commission, and the spat was quickly deescalated with the existing tariff pause reinstated. Both sides had the means to diffuse the situation and they did, although neither capitulated completely. It would only be reasonable to expect more of this sort of posturing as all the counterparties move towards an agreement and this could continue to play out well past the currently scheduled pause expiry date of 8 July (or 11 August for China).

Then there is the "TACO" factor to take into account. This is the latest acronym doing the rounds and stands for "Trump Always Chickens Out". It's been a reliable rule to work with so far, as Trump has failed to follow through on any of his more extreme threats and seems happy to accept a less aggressive deal as long as it looks as though he has made one to the benefit of his country (and his approval ratings). However, it has also been pointed out that the more it looks as though it is easy to get Trump to capitulate, the higher the potential for him to stand firm to show that he is not a patsy. That could elevate volatility again and, I would assert, is not a risk currently priced into markets. Alternatively, this could be construed as Trump using the negotiating tactic of anchoring terms to a high level and then settling for what he really wanted in the first place, although the extreme nature of his threats sometimes goes well beyond what could be considered credible.

We have also seen an intervention on tariffs by the US judiciary. The US Court of International Trade ruled that tariffs imposed using the International Emergency Economic Powers Act are illegal. This was then put on hold by the Court of Appeals, which allowed the government to continue to collect tariffs. The President still has other means to impose tariffs, but there is some hope that they will now come under much greater scrutiny by Congress. There is some irony in the fact that the same process, which the Republicans were only too happy to support at the time, stopped Joe Biden from forgiving all student loans during his presidency.

Even so, whatever happens in the short term, our opinion remains that the average level of global tariffs imposed by the US on its trading partners will be higher than 10% when all is said and done, up from around 2.7% previously, and the highest level since the 1930s. That can only create inefficiencies in global supply chains. The outstanding questions are how the costs will be apportioned between US consumers, companies that import into the US and those that export to the US and who can do what to mitigate them? That won't be clear for a while yet.

Big, beautiful budget bill

The other big news, again from the US, has been the steady passage of the "big beautiful" budget reconciliation bill through Congress. As I mentioned last time, for all the talk of cutting the deficit, there is little evidence of that happening. BCA Research calculates that the fiscal deficit as a percent of GDP, which was 6.4% in the year to September 2024, will rise to 7.7% in the 2026 fiscal year, 8.4% in 2027 and 8.6% in 2028. They do see it falling to 6.1% in the current year, but that only seems to be a function of accounting for future repayments of student loans immediately. There will be no extra cash forthcoming.

Attached to the bill is a sting in the tail entitled Section 899. This calls for taxes to be imposed on non-US companies operating in the US whose home country is deemed to be imposing unfair taxes on the US. It could just be a negotiating tactic again, but the fact that it exists at all is worrisome and undermines the case for corporate investment in the US.

The build-up of debt continues to put pressure on the bond market, and the latest outbreak of jitters has been in Japan. There, the yield on 30-year government bonds reached an all-time high of 3.165%. That might not sound very high compared to what other developed market long-duration bonds have yielded in the past, but Japan only started to issue them in 1999, probably thinking that their debt problem would be sorted out by 2029. Far from it. With four years to go, the government debt-to-GDP ratio is estimated to be more than 260% and higher yields are not helpful when it comes to refinancing. Thus, the Ministry of Finance announced that it would lower the amount of issuance at the long end of the curve in favour of more issuance at the short end (where the yield, and therefore interest payment, is lower – currently 0.77% for 2-year debt). This helped to calm nerves.

And before we get complacent about our own situation, the UK's Debt Management Office has made a similar announcement to help take pressure off longer dated gilts, where the 30-year yield of 5.4% continues to hover around levels last seen in 1998. The US was early to this game. The Democrat Treasury Secretary Janet Yellen started to skew debt issuance towards short-dated bills in October 2023.

There are a lot more ready buyers of short-dated government debt (known as 'bills') for various reasons. It acts much like cash, yields more than most bank deposits, is not volatile and carries very limited risk. Banks have to set aside minimal amounts of capital, if any, to invest in bills. But all this does is keep kicking the debt can further down the road. The debt is not going away.

As we say in our geopolitical risk report, as investors we can't predict the future, but we *can* prepare for it. Meanwhile, it helps to tune out the noise, stay invested and keep our eyes on the long term.

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

ECONOMIC HIGHLIGHTS

UK –Citigroup's UK Economic Surprise Index, which tracks data releases relative to consensus expectations, has been positive lately. At the turn of the year it was all gloom-and-doom, registering a reading of -53. Now it's up to +54. It's hard to pinpoint a single reason, especially when political opinion polls, which now have Reform as the leading party in the UK, suggest deep dissatisfaction with the Labour government. However, one factor could be strong wage growth, which continues to come in higher than inflation. The only problem with that is that it risks creating higher inflation in future and is the main reason why the Bank of England continues to sit on its hands in terms of cutting interest rates. The latest data were April's money supply and lending figures. An increase of £1.6bn in consumer credit combined with a lower build-up of cash deposits suggests willingness by consumers to spend, something that was reflected in April's 5.3% increase in retail sales. Mortgage lending slumped from £13bn in March to a net repayment of £0.8bn, reflecting higher stamp duty from 1 April.

US – The latest first quarter GDP figures revised growth up from -0.3% to -0.2%, but still a contraction. That was down to net trade bringing the figures down amid the massive scramble for imports ahead of tariffs (net imports reduce GDP). Such effects are likely to distort data for months to come. Personal Consumption growth was revised down from 1.7% to 1.2%, suggesting some weakness at the household level. We are keeping a close eye on employment data to monitor the potential for consumer spending. There are signs of an increase in jobless claims, but nothing untoward so far. This week is a big one for employment reports and so could provide more information. The distortions from tariff concerns were reflected in the latest Manufacturing PMI data, where the imports reading fell to 39.3, the lowest since 2009. The prices paid print of 69.4 (above 50 signals expansion) was also of concern. Again, lots of short-term distortions are at play, but we conclude that they must be having an overall dampening effect on economic activity.

Europe – The latest inflation data from the Eurozone came in below expectations, leaving a clear runway for the European Central Bank to cut its deposit rate again this Thursday 5 June, as widely expected. Headline CPI inflation for May came in at 1.9%, with the core rate (excluding volatile food and energy prices) at 2.3%, down from 2.7% in April. The unemployment rate of 6.2%, high as that might seem relative to the UK (4.5%) or US (4.2%) remains at the lowest level it has been since the inception of the euro and start of the current data series in 1999.

China – It remains difficult to detect any signs of acceleration in China's economy. Most of the official data from China comes in one big drop every month which covers retail sales, industrial production and investment (next due on 16 June). We are fed scraps in the interim, largely consisting of various purchasing manager surveys. The latest readings of the official surveys have manufacturing at 49.5 (and therefore contracting) and Services at 50.3 (barely expanding). The private sector Caixin survey for manufacturing came in at an equally dispiriting 48.3. China's economy needs a jolt from government policy, but it is not forthcoming.

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