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Investment review – End Q1 2025

March 2025

The past quarter has seen financial markets buffeted by heightened global trade and geopolitical uncertainty, with a few more question marks appearing over economic growth, inflation and the course for interest rates than a few months ago.

It has been the US president's haphazard and unconventional approaches that have been disrupting markets and mindsets – this confused and complicated scene has required some near-term vigilance, yet also called for a calm stance and a need to keep a longer-term perspective in focus, particularly since the overall economic impact and inflation picture is not expected to alter materially. Overall, despite several near-term challenges, we continue to view financial conditions generally as remaining quite supportive for businesses, consumers and investment risk-taking and expect asset price volatility to subside once greater policy clarity materialises.

US economic growth softening in the near-term… but should be short-lived

Certainly, recent forward-looking activity indicators have begun to point to a softening of global growth prospects: business and consumer sentiment have weakened in some countries, and indicators of economic policy uncertainty have risen markedly around the world. Meanwhile, geopolitical tensions and conflicts continue to create an additional layer of unpredictability for financial markets. Putting things into context, however, global economic growth is only expected to cool a little: it should stay reasonably close to 3% both this year and next, not far from the pre-pandemic average, even with a short-term hit to the US economy stemming directly from tariff and trade disruption.

But some care is needed over short-term data: a drag on net trade from tariff front-running and a surge in US imports is likely to see the US economy contract when figures are released for the first quarter of 2025. However, a swift reversal in the second quarter can be expected, including a rebound in business and consumer confidence. Donald Trump's current focus is on the more controversial aspects of his 'America First' agenda, but his pledges of lowering taxes and reducing regulation have yet to be fully unleashed – these should provide a more positive influence on sentiment, as could a more orderly (rather than chaotic) unveiling of new policies.

Altered inflation outlook

One particular area of complication arising from the fickle and clumsy rollout of revised US trade policy is the future inflation outlook. The US Federal Reserve ('Fed') has recently revealed amendments to its economic projections, forecasting slower growth and higher inflation by the end of the year, highlighting concerns about the near-term damage being done by tariffs and spending cuts on the economy.

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Yet the Fed has also noted the resilient nature of the US economy, which it sees as progressing at a steady pace, with solid labour market conditions. So, at this stage, these are all relatively modest tweaks to projections that should not have investors scurrying for cover – indeed, the market reaction to the Fed's latest growth and inflation amendments has been one of calm so far.

Less synchronised monetary policy

As things currently stand, slightly weaker economic activity should bear down on underlying inflation pressures, allowing the global monetary easing cycle to continue this year. But interest rate moves are becoming less synchronised of late and central banks clearly face some tougher decisions in the months ahead.

The Fed's actions in particular are being very closely monitored – does it take more notice of likely subdued economic activity brought about by tariffs and cut interest rates further or does it prioritise the control of higher inflation by raising rates, even though these are already sitting at levels above the Fed's assessment of where long term neutral policy rates should be? There is a danger that, having been caught out somewhat by the out-sized post-Covid inflationary spike, the Fed will not want to make a similar mistake again and could therefore adopt a more pre-emptive, rather than reactive, stance to rising inflation, something that would likely cause market nerves to jangle again. The good news, at least for the time being, is that in its latest messaging the Fed has conceded that inflation is likely to run hotter than it anticipated at the end of last year, but not high enough to change its pace on rate cuts. A 'wait-and-see' stance is therefore currently favoured by the Fed in the face of elevated policy uncertainty, although it is still signalling two 0.25% cuts this year.

Meanwhile, the European Central Bank, having reduced interest rates twice already this year, has more scope to manoeuvre to aid a still struggling eurozone economy. The positive impacts of recently announced higher spending on defence and infrastructure projects will take time to feed through and a 2% eurozone interest rate is entirely possible, and may be necessary, by the year end. Closer to home, the Bank of England is walking a narrow path, although the stickier aspects of inflation, including wage settlements, are unwinding and further rate reductions can also be expected this year. Of the major central banks, only the Bank of Japan is currently expected to progress with interest rate hikes as it continues to remove the loose policy levers that have allowed inflation, wage growth and economic activity to rise.

Better growth still in Asia and the US

We still expect the US and Asian economies to contribute the most to global economic activity, although even in Asia the country-specific impacts on growth from tariffs and re-routing of trade are adding complexity and complications to accurate forecasting. The eurozone continues to be plagued by structural and political headwinds that are likely to restrict its growth, but at least Germany's recent willingness to borrow and spend its way out of its current malaise sends a more encouraging signal of hope further down the line. In the UK, meanwhile, the tight fiscal position and lack of room to manoeuvre, plus the lingering drag from previous ultra-high inflation, mean that the economy seems destined to remain in the economic slow lane for some time.

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Stockmarket positioning

So where does all the current uncertainty leave things for investors? In all likelihood, the episodic waves of market volatility that investors have already endured in 2025 can be expected to continue until greater policy certainty is unveiled and more reliable data is available. However, the risk of being whipsawed by recent price movements is high, so our preference is to sit tight within stockmarkets, maintaining exposures at the upper end of strategic ranges, and ride out this period of uncertainty.

Disruption for the market leaders

Two recent news reports emanating from China neatly sum up that the future of the world's economy does not just revolve around America and that there are threats to some of behemoths that have been dominating its stockmarket performance. January's news of DeepSeek's claim that it had created an AI chatbot for a fraction of the cost of the incumbent start-ups, threw AI darling Nvidia and other technology-related companies into a tailspin; recently, Chinese electric carmaker BYD's claim that it has developed an ultra-fast battery cell charging system, capable of adding almost 500km in range in the same time it takes to refuel a petrol or diesel car, has similarly contributed to Tesla's share price retreat this year.

Both stories have added to the heightened market volatility of late, particularly highlighting vulnerability in some US 'mega cap' companies that need to continue to maintain their competitive edge and deliver outsized earnings growth to justify, in most cases, their fancy valuations. These recent Chinese curved balls will not be the last and, paradoxically, they may not actually be bad news for the more established US players in the long run: if Chinese (and other) new entrants improve efficiency and enable cheaper access to the likes of AI or advancements in the adoption of electric vehicles, then it should fundamentally increase accessibility and overall demand. In turn, this should provide increased market opportunity for both incumbent businesses and newcomers alike to share.

As we have regularly noted, we are happier to let underlying active managers decide about the risk and reward pay-off in the higher echelons of the US stockmarket – most of our managers have underweight positions, which means our overall US market exposure is typically less expensive than the market as a whole, gives more diversified exposure to companies and sectors, yet does not compromise on either quality or growth potential. Even our dedicated global AI fund has a diversified, global approach with the underlying composition of portfolio companies evolving too as AI's application evolves and reaches a wider audience beyond those businesses with the deepest pockets.

Corporate health and acceptable valuations intact

The recent market retrenchment, led mainly by the US, suggests that much, if not all, of the potential negative impact from Trump's policies on growth and inflation may have been priced in. Generally speaking, we expect US corporate earnings growth to remain resilient and still to lead the developed world pack both this year and next. Indeed, valuations, particularly outside of the technology-related giants, remain reasonable, if not cheap, after the recent shake-out versus expected revenue and profits growth.

"...the future of the world's economy does not just revolve around America..."

Looking ahead, we expect a more diversified stockmarket allocation, both in terms of market capitalisation and sector coverage, to be a more successful strategy than hugging leading market indices. We also believe that active managers are best placed to capitalise on the value and longer-term growth opportunities typically created during periods of heightened market uncertainty. It is also worth noting that attractive income yields are available in all markets – these can help dampen some of the volatility associated with equity market investment, continuing to reward investors who are willing to stay the course.

A healthy broadening of stockmarket interest

It has been difficult fighting against the US market heavyweights in the past two years, but investors' recent reduced faith in US exceptionalism does mean, however, that other markets are starting to get more of a look in: we see the early signs of some regional 'levelling up' as no bad thing, and perhaps an indication that market participants will also soon be ready to pay more attention to investment fundamentals again, including valuation, the quality of business franchise and reliability of corporate earnings, considerations that have often been rather neglected in recent years. Our continued biases towards the US and Asian markets reflect our conviction in their stronger medium-term economic activity and longer-term growth potential, but we are far from ignoring the potential for recovery or mispriced opportunities in Europe, including the UK, and the more promising outlook for Japan. We are pleased to be participating in some of the relative market strength they are currently enjoying and will keep an open mind about modifications to exposure as data become more concrete.

The dollar being buffeted too

Weakness in the US dollar has been an additional headwind so far this year for sterling- and euro-based investors, impacting the value of US investments and those closely linked to the US currency. However, it is probably helping to address some of the imbalances that are associated with the US trade deficit, making US goods cheaper for overseas buyers and aiding America's export markets. We are now seeing some stabilisation and do not expect dollar weakness to persist based on the relative strength of the US economy, divergent interest rate policy and the impact of Trump's economic program. Given the recent weakness in the dollar there is scope for a meaningful reversal in the coming months. Elsewhere, lower interest rate trajectories and economic weakness in the UK and eurozone are likely to restrain the pound and euro, whilst we view Japan's reflationary environment as being capable of finally lifting the yen from the doldrums.

Raising some cash from within fixed interest exposures

We said at the turn of the year that the inflation and monetary policy outlook might prompt us to reconsider exposure to fixed interest markets, and that is one area where we do feel it is appropriate to make some change.

Corporate debt (credit) markets are pricing in a more perfect trajectory for business health at a time of greater uncertainty and we believe investors are now being less-adequately rewarded for taking risk in corporate debt versus equivalent government bonds, which themselves appear, in the short term at least, slightly more vulnerable to higher inflation and policy uncertainty.

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We are therefore taking some risk off the table in fixed interest markets by selling a strategic bond fund that has higher exposure than other fixed interest investments to both government and corporate debt markets, and also has greater sensitivity to interest rate and inflation movements.

Once the current uncertainty passes and a path for reduced interest rates – which is still our central case – becomes clearer, we will be happy to re-commit any cash raised to the fixed interest asset class. However, if the outlook remains muddled or the medium-term inflation risks appear to be climbing still, then the option to increase the allocation to alternative investment funds, as we did successfully in 2022, remains.

Other than for more adventurous risk mandates, which have no fixed interest exposure, we are therefore happy to hold some cash as a short-term measure until the outlook is clearer, satisfied that it will guarantee a positive return for investors rather than the possibility of being exposed to further near-term turbulence. Having some cash on the sidelines therefore gives us some optionality during this uncertain period, without sacrificing much return.

A bump in the road, not deep potholes

There is still ample time for markets to be reassured by any one of a combination of more resilient economic and/or corporate data, stimulative actions by central banks and some change in Trump's current mercurial tactics, but we are monitoring developments closely and stand ready to further adjust positioning if it is appropriate to do so. In general terms, though, we view the current trade uncertainties as more of an economic bump in the road than as creating deep potholes that could do more permanent damage. Before too long, the journey for investors should have fewer diversions and become a little more comfortable as the road ahead for inflation, interest rates and economic growth turns in a more favourable direction.

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