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Second Quarter 2025

It was a positive quarter for global markets, which did not look likely in early April when President Trump's tariff announcements rocked investors and governments worldwide. While news on tariffs was scheduled, the high levels and reasoning behind them shocked investors who scrambled to reduce risk, fearing a significant hit to economic growth. Tariffs had been decided based on countries' trade surpluses with the US, as the administration seems to view trade as a zero-sum game where it must be in balance or surplus with every nation otherwise it is 'losing'. This meant that the announced levels were particularly high for many poorer countries who export cheap goods but cannot afford to import higher-value American products.

There was a swift sell-off in equity markets over the following days, with the MSCI World index falling by 11.3% and extending the weakness seen in March. The VIX measure of implied market volatility hit its highest level since the pandemic, the US dollar weakened and, perhaps most worryingly, US Treasuries then faced selling pressure with yields on the benchmark 10-year note rising from 4% to 4.6%. This suggested wavering confidence in the US economy and the administration as a reliable partner, and the Treasury move arguably encouraged Trump to start walking back some of his rhetoric on trade including a 90-day pause before tariffs would be implemented. This settled nerves and reduced near-term uncertainty, and most subsequent developments represented a scaling back of levels and coverage of the levies compared to the initial announcement. Investors viewed these positively, encouraging a recovery in equity and bond markets which persisted for the remainder of the quarter, and the consensus would appear to be that tariffs are a manageable threat to the economy and to inflation.

In June, focus shifted to the passage of a new US fiscal package, which is expected to widen the deficit despite incorporating the revenue from tariffs which has become an important funder of proposed tax cuts. The US Treasury market has stabilised in recent weeks after the turbulence of early April but the US dollar has remained weak, reversing the trend of recent years when dollar strength reinforced the strong performance of American equities.

In Q2, US equities recovered strongly from their sharp fall at the start and the S&P 500 index gained 4.1% in GBP terms. This compares well to other Western markets, but performance in Japan and some emerging markets was stronger, the latter helped by the weakness of the dollar which eases financing constraints. The MSCI World index rose by 4.4% in GBP terms during the quarter.

In Europe, there was some continuity from the first quarter as at the 2025 NATO Summit in The Hague in June, Allies made a commitment to investing 5% of GDP annually on defence- and security-related costs. This was prompted earlier in the year by indications that the US may not provide as steadfast support as it has done in the past. In addition, the European Central Bank reduced interest rates twice during the quarter, having also cut twice in Q1, to take deposit rates to 2%.

The Bank of England also reduced rates, but only once, and it is unclear whether it will be able to do too much more this year as inflation still looks rather sticky. Unlike on the continent, there is no boost from fiscal policy as the Labour government's spending plans now look uncertain and tax rises may be required. The UK gilt market remains jittery after the Liz Truss episode in 2022 and investors in this market are not minded to give the government leeway on unfunded spending.

The outbreak of open hostilities between Iran and Israel, with support from the US, had little impact on financial markets apart from creating volatility in oil prices. While the WTI crude spot price ended June almost 9% higher than it started, an interim spike of 23% was largely reversed after US actions resulted in a pullback from the brink. Global stock and bond markets have tended to not be unsettled by geopolitics in the Middle East in recent years, and that was the case again despite these worrying developments.

Outlook & Portfolio Strategy

We feel some caution is warranted at present, given the strength of the stock market recovery over the past ten weeks contrasts with the persistent uncertainty around trade and the global economy. It must be remembered that Trump is strongly in favour of tariffs and whatever ends up being the final picture, it will be an environment more restrictive to trade than existed before April. There is very likely to have been a hit to the US economy, as businesses have had to put investment and other decisions on hold pending clarity on the situation, reflected in many leading companies being unable to give firm guidance as part of their quarterly results in April. Economic data has been robust, but it would not be a surprise to see some weakness ahead as inventories are used up. As we move further into the summer, we will get a better indication of the impact of uncertainty on business planning, hiring and activity during the volatile first few weeks of this quarter – whether from economy-level data or individual company reports. The market as a whole seems to think that a general tariff level of 10-15% can be digested with little economic impact.

While the US administration is applying pressure on the Federal Reserve to reduce interest rates, the case does not look compelling as inflation has not been reined in satisfactorily. It looks more likely that any evidence of a growth slowdown could prompt a rate cut, but this could be a few months away. Yields of fixed income investments have been range-bound for a couple of years, and this may continue – but the coupons available and the possibility of capital growth if there is a meaningful slowdown make bonds an important part of our multi-asset portfolios. Our Alternatives allocation in these portfolios was also helpful, outperforming bonds as most strategies were able to navigate the environment well, aided by dispersion in returns between equity markets, styles and sectors.

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