Current Positioning
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The past month summed up

The genie of tariffs cannot easily just be put back in the bottle – the resulting dent to the US's reputation means we are looking for opportunities beyond the world's largest economy.

The rationale

Our core view is that the economic and market outlook has deteriorated as a result of the Trump administration's on-off threats in relation to tariffs. While the retreat from the seemingly arbitrary tariffs of the so-called Liberation Day, and the recent mild thaw in Chinese relations, may have settled nerves in equity markets, there is a risk that the damage may already have been done. The President's impulsive behaviour in managing the economy will likely mean more frights to come.

Indeed, there are plenty of data points to support this assertion – not least what investors are saying themselves. We often take note of the Bank of America Fund Manager Survey which has become particularly bearish of late – it shows the fourth highest recession expectations of the past two decades with a record number of global investors intending to reduce their US stock allocation. This might not tally with what has happened to US stocks in recent weeks following a de-escalation in Trump's approach to tariffs and trade, with retail investors continuing to pour money into their home market. The S&P 500 index has recovered to close to where it was earlier in the year. This might indicate a slight dislocation or delay in acting on their sentiment in the survey – whatever, no one wants to look foolishly optimistic at present.

Relief rally

Relying on markets for guidance, however, is no guarantee of success and emotions can swing wildly. Theory would have it that markets tend to be efficient at accessing and acting on publicly available information and therefore at setting efficient prices for securities. The reality is sentiment and confidence can be equally powerful in informing short term reactions whilst markets are populated by actors, both human and digital, with different aims, time horizons and who react to different information or data impulses. These range from fundamentally driven longer-term investors (like ourselves) to those more inclined to make a quick buck on short term charts or data signals.

The S&P seems to have performed a round-trip relief rally on improving news flow, with most tariffs now at 10% and those on China falling back to 30% from 145%. However, the world has not returned to where it was beforehand and Trump's unpredictable behaviour means that the present more settled situation could be upended by a new tweet or new plan just as quickly. Tariffs have been postponed rather than cancelled and so whilst a recession might be less likely than it was a month ago, it's definitely more likely than it was three months ago.

There remains a gulf between the hard (backward-looking) data and sentiment surveys. Employment, spending and inflation readings for April are all relatively benign, but sentiment is anything but. The US economy is highly dependent on its consumers and that is the area of most concern. The University of Michigan's preliminary May sentiment index declined to a weaker-than-forecast 50.8, the lowest in three years and its fifth straight month of declines. It isn't any better for businesses – the Institute of Supply Management said its manufacturing purchasing managers index was at 48.7 in April, a second month indicating contraction.

Dollar decline

Which brings us back to US exceptionalism. To reiterate an oft made point, we work in a world painted in shades of grey. So, while we still think that the US has many facets that predispose it to greater economic success and growth than other regions of the world, it's losing its sheen and there is no more obvious manifestation of that than in the decline in its currency. The Dollar Index, which measures the US currency against a basket of others, has dropped 7.5% this year. Whether the US government is complicit in this or not (some say they are angling for a lower currency because that makes the US more competitive and makes imports more expensive) the fact is that the market considers the US a lot less reliable than it did.

Another clear marker for the decline of the US is in its credit rating. Those of us old enough can remember when US Treasuries were essentially the definition of the safest assets. That viewpoint has been junked as the country's deficit has mushroomed and on the unpredictable behaviour of the Trump administration that says it wants to lower government borrowing but its actions often seem to go against that. The end result is that Moody's last week downgraded the US's credit rating to Aa1 from AAA.

Not so defensive

Overall, the prospects for US equities have dimmed from the shining beacon of January. Valuations are again near their peaks following the recovery of recent weeks, with the potential for sterling-based investors to lose further value because of a currency that's under pressure. What to do in such a situation? Investment managers tend to look closely at correlations – that is the link between certain bits of data and assets and how they move either together or in the opposite direction. Normally in a time of economic flux, equities would decline in value whereas bonds would tend to rise. This hasn't played out quite so neatly this time round. Indeed, the most troubling time for investors came earlier in the year when equities were sliding but US Treasuries also came unstuck due to concerns about US policy (which vindicated our decision to be circumspect on US government debt in recent months).

The unusual behaviour of the US government has also had an effect on what might be called defensive equities – those that perform better in tough economic times. Normally at the top of this list would have been pharmaceutical and healthcare stocks, on the basis that whatever the economic conditions people still need medical treatment. Not so much in recent times, with threats from the US president to rein in earnings of pharmaceutical companies weighing on their potential just at a time when they should be doing better. After Trump signed an executive order to direct lower prices on medicines, the S&P healthcare sector lost about 5% of its value.

Emerging Markets

Are there any positives in this state of flux? In a world of relative opportunities, the short answer is "yes", and with the prospects for the US dimming somewhat, they are brightening for emerging market investments. One of the clearest indicators that the tariff debacle has been having a real-life effect on companies is in expectations for their earnings. Overall, the Bank of America global earnings revision ratio has dropped from 0.76 to 0.53 – its lowest in five years. But looking below the surface the prospects in developed markets have suffered much more than those in emerging markets. In the US they slid a massive 0.7 to 0.37 whereas in emerging markets overall there was a relatively slight decline from 0.68 to 0.61.

The potential also seems to be more widespread throughout emerging regions than for some time. In Latin America for example, countries could benefit from their proximity to the US, lack of trades surplus and the benefits of weakening dollar. Furthermore, real GDP in Brazil, South America's largest economy, expanded 3.4% last year on the back of improved domestic demand. Argentina, long marked out as an economic basket case, is expected to have relatively low inflation of 30% this year, down from 211% in 2023, and some are predicting economic growth of more than 4% in 2025. Even in China, which we have in the past noted has significant difficulties, retail sales were up 4% in the first two months of the year compared with the same period in 2024, while industrial production was up 5.9%. With the recent toning down of the tariff war, investment banks such as UBS and Morgan Stanley both have increased their expectations for Chinese growth for this year.

Conclusion

Whilst the headline risks have diminished since last month, it is too early to sound the all-clear and take a more constructive view on equities in general. However, the 15-year trend that saw the US became the only game in town looks to have crested. With tariff intensity abating we have an opportunity to adjust the composition of our equity holdings, shaving some of the assets in our US portfolio and investing the proceeds into emerging markets, where valuations and opportunities are improving. We still maintain our defensive position given economic murmurs and ongoing fiscal ill-discipline underlined by our holding of shorter-term debt and assets such as gold and our diversifying trading strategies. We remain vigilant in these unsettled times and ready to adapt to significant shifts in the market firmament.
