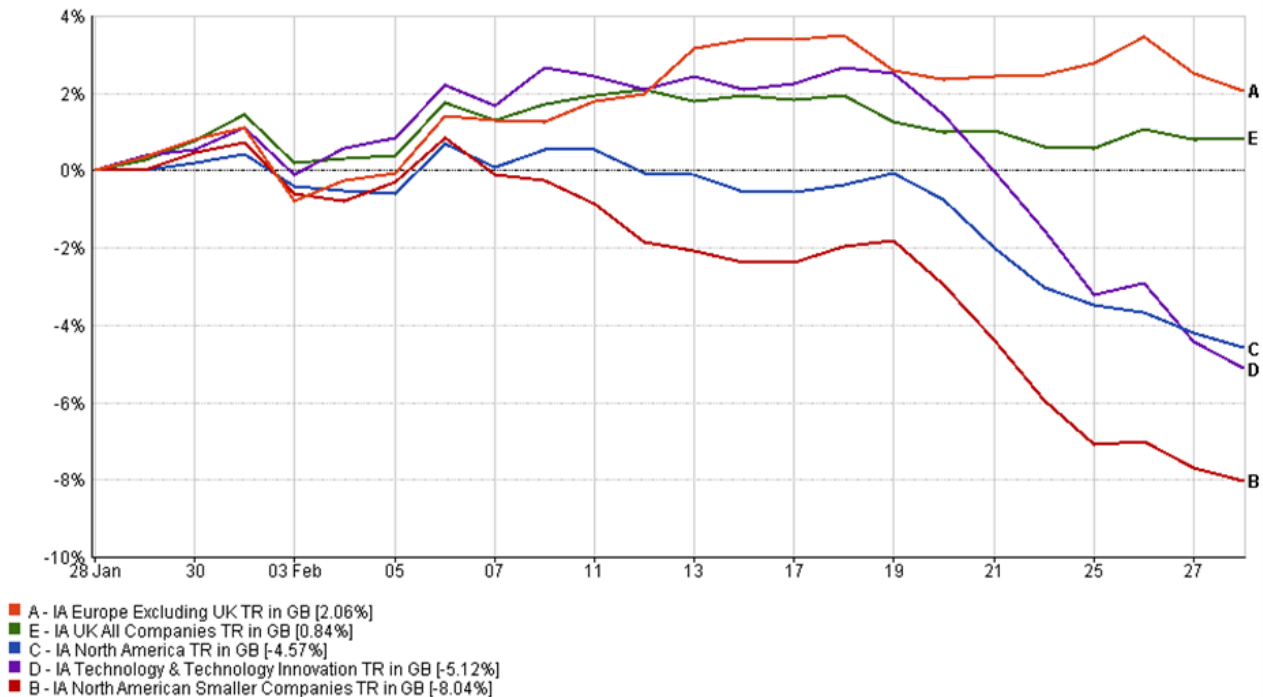


## Market Matters - with Tom McGrath

### Mood music has turned sombre

Even before Friday night's shambolic press conference between Trump and Zelenskiy, the mood of investors had turned decidedly sombre. In stark contrast, it wasn't so many days ago that the US market had hit a new high, and investors felt mighty optimistic about the outlook. There was almost a naive belief that the new President could keep the economy firing on all cylinders, and the DOGE cuts and a lower oil price would help keep the lid on inflation despite the tariff plans (that may or may not happen). And then, in no time, we would get more tax cuts to boost corporate profits and a deal with Ukraine over minerals that would bring peace to Europe. Unfortunately, a new reality is settling in that brings us to question the validity of that bullish narrative. Caution has replaced optimism with equities suffering sharp drops in the tech space and bonds staging a meaningful rally. Not even some pretty decent results from Nvidia and an inline inflation print could stop the overall falls in US markets last week.



28/01/2025 - 28/02/2025 Data from FE fundinfo2025

So, let's unpick why this shift in sentiment has occurred and see if it's time to ditch the argument of US perma-exceptionalism and run for the cover of cash, bonds and cheaper equity markets like the UK and Europe, which have delivered significant outperformance over the last month. As far as I can work out, the caution centres around a growing concern that tariffs will be implemented as described and will be both inflationary and damaging to economic growth. For the first time in a long time, the word 'stagflation' has been used to describe the threat to the US economy.

This fear is partially supported by data, which you can find in the latest economic releases to support this new narrative.

Case in point were the consumer confidence and sentiment surveys, which suggest that the initial euphoria surrounding Trump's return has now begun to evaporate, and that US citizens are bracing for higher prices, with long-term inflation expectations hitting 3.5%, the highest since 1995. The spike, primarily and unsurprisingly driven by Democratic respondents, also coincides with a sharp drop in the consumer sentiment index, which fell to 64.7 from 71.7. Buying conditions for big-ticket items have weakened, and more than half of consumers now expect unemployment to rise.

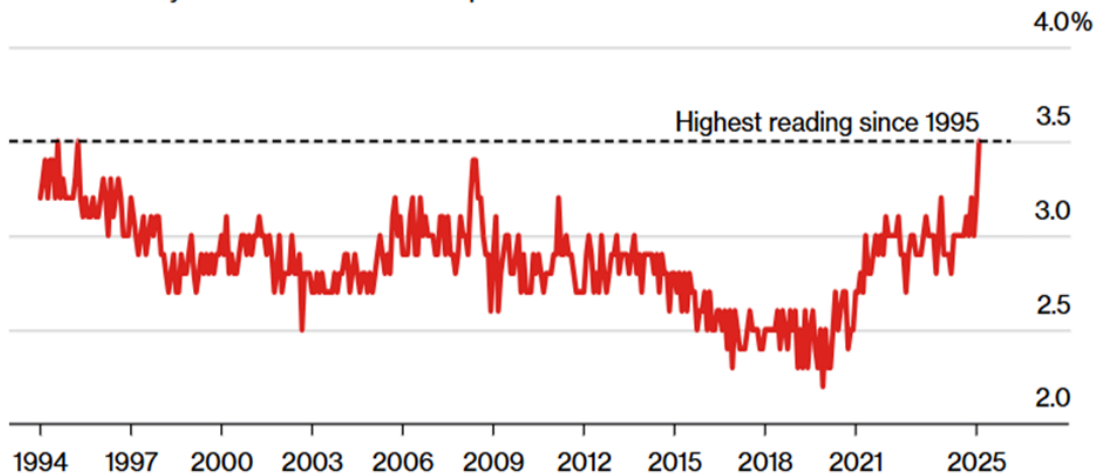
The cause of the angst has to be tariff concerns, with Trump's on/off negotiation style adding to the uncertainty. That might be a good approach for cutting a deal, but it is deeply unsettling for businesses trying to plan for the future, and I have no idea how many expansion and hiring plans are just being put on hold until they get clarity on what the future might look like.

The same hesitancy must surely apply to individual households, governments, and central banks, including the Fed, which has said that while rate cuts remain on the table, they won't move hastily if inflation expectations become unanchored.

## US Long-Term Inflation Views Jump to Nearly 30-Year High

Americans expect higher prices as Trump pushes forward with tariffs

Five- to 10-year consumer inflation expectations

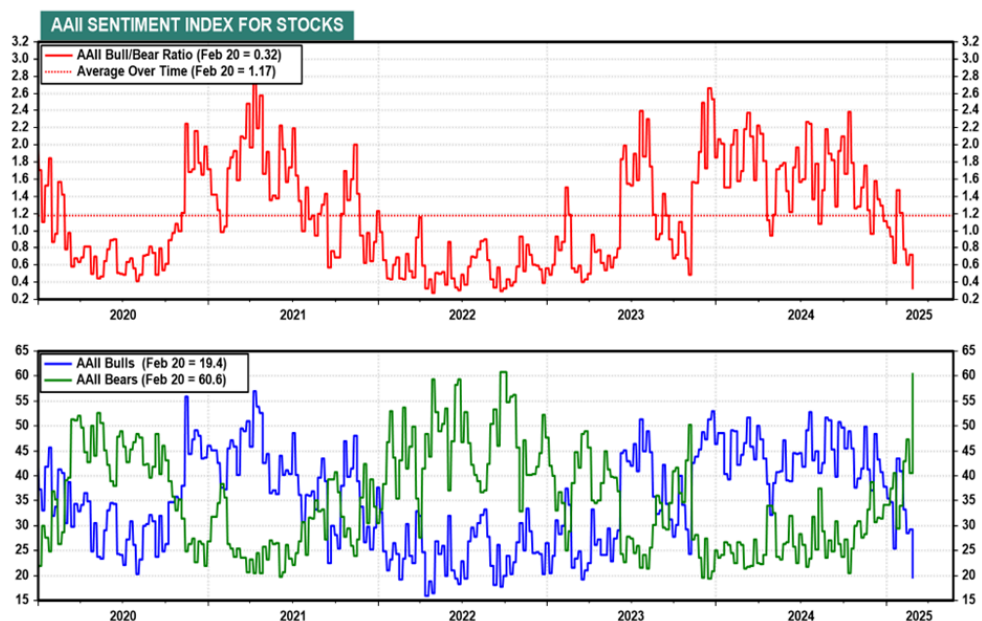


Source: University of Michigan

Meanwhile, business activity slowed in February, and existing home sales slipped, reflecting the strain of high rates. Thankfully, Friday's inflation report contained some good news on this front, and it was probably the main reason US markets managed to rally into the close on Friday night. Core PCE, the Fed's go-to inflation measure, rose just 0.3% in January, with the annual increase holding at 2.6%, its lowest since early 2021. Key details suggest underlying inflationary pressures may be easing. Core services prices (excluding housing and energy) ticked up only 0.2%, signalling progress toward the 2% target.

Unfortunately, the report also contained evidence that the consumer has begun to retreat, as we saw the most significant drop in spending in over two years, as households chose to boost savings instead. This added weight to the argument that economic growth might not be as robust going forward as generally assumed. Throw in the fact that the US trade deficit widened sharply in January, as imports surged ahead of anticipated tariffs, and we actually saw a negative estimate of current GDP! The latest Atlanta Fed's GDPNow model now sees first-quarter GDP contracting at an annualised 1.5%, a sharp reversal from the 2.3% growth expected just days ago.

Perhaps it is no surprise then to see the most significant reversal in investor sentiment since the war between Russia and Ukraine outbreak in 2022. According to data from the Association of Individual Investors, the percentage of those with a bearish disposition has now shot above 60%, with only around 20% optimistic about the future. Warren Buffet's quote, 'Be fearful when others are greedy, and greedy when others are fearful', came straight to mind when I saw those figures, and certainly, if you had bought equities in 2022, the last time we had bears above 60%, you would have done very well indeed.



Source: LSEG Datastream and © Yardeni Research.

For a while now, I have argued that this bull market in US equities can continue, provided the economy can keep growing. I admit to being a little concerned at the deterioration of various growth metrics, but I think it is too early to call time on this phase of economic expansion. Much of my optimism comes down to the employment picture, and my interpretation of recent data is that the job market still looks healthy. In the consumer confidence survey, over half of respondents said jobs are available, and those finding it hard to get work remain a minority. While more people now expect fewer jobs in six months (possibly due to concerns over government job cuts from the DOGE program), current job availability remains strong. Indeed, income expectations are steady, with most people expecting no change, and in January's PCE report, we saw a 0.9% rise in nominal incomes. Crucially, household pay is high enough to support consumption as and when things settle down, and accumulated wealth has never been higher in the US.

It is possible that the drop in consumer spending was not only a temporary aberration caused by tariff concerns but also severe weather conditions that significantly impacted consumer spending. Unseasonably cold temperatures and snowstorms affected large parts of the country, making people reluctant to go out and shop. Additionally, the wildfires in Southern California that led to the evacuation of approximately 200,000 residents would also not have helped. Recent falls in bond yields and drops in the cost of longer-term debt, including mortgages, could help improve the spirits of many, and I sense when we can eventually get past all the back and forth around tariffs, possibly with the result not as high as the current expectations, we could well see spending reaccelerate. Monday's release of the Manufacturing Index for February could also shed some light on the general state of the economy, but 'hands up' it is time to keep a very close eye on the growth numbers as any sign of us slipping toward a recession will challenge equity market valuations.

### UK News - Starmer the Charmer

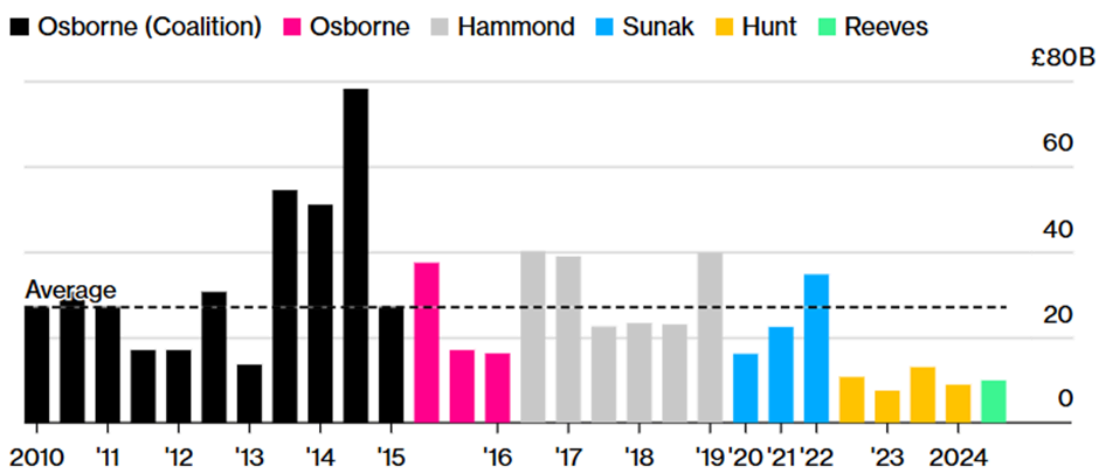
UK Prime Minister Keir Starmer emerged from his meeting with Donald Trump claiming a diplomatic win; despite failing to secure a US security guarantee for Ukraine. But who needs substance when you've got spectacle? Starmer, apparently channelling his inner courtier, 'charmed' Trump by playing directly to his ego, an approach Zelensky would have been well advised to mimic. His masterstroke? A hand-delivered invitation from King Charles III for a second state dinner; an unprecedented move (at least, according to Starmer). Trump, never one to turn down a lavish event in his honour, eagerly accepted, waxing lyrical about Britain, specifically its golf courses.

In the joint press conference, Trump praised Starmer, calling him a 'very tough negotiator' (which, in Trump-speak, could mean anything from actual respect to mild amusement). The US President also threw the UK a bone, suggesting a quick trade deal to avoid tariffs while hinting at a compromise over the Chagos Islands. At best, this was a PR boost for Starmer, giving him a brief reprieve from attacks by Nigel Farage and Reform UK, who have questioned his ability to handle a Trump-led America. Whether Starmer achieved anything beyond stroking Trump's ego is another matter entirely. Still, it is possible that we can avoid any nasty tariffs, which might explain why the UK stock market is quietly continuing to make good progress this year.

However, a bigger domestic challenge is looming large for the Labour government and Rachel Reeves in particular, and that is the not-insignificant challenge of balancing the UK books. Our Chancellor will likely be scaling back spending and pushing for public sector efficiency as she scrambles to plug a growing hole in government finances. Forecasts suggest she'll miss her key fiscal target, forcing a rethink ahead of the March 26th spring statement. The outlook has worsened in recent months with sluggish growth and rising borrowing costs, eating into the £9.9 billion buffer Reeves left in October. With tax hikes ruled out, spending cuts are the only option.

## Reeves Left Herself Just £9.9 Billion of Budget Headroom

Fiscal margin against current mandate - up to Oct. 30 budget



Source: Office for Budget Responsibility, HM Treasury

Note: Reeves' rule requires day-to-day spending and revenue to be in balance in 2029-30

The move is causing tensions, with Anneliese Dodds resigning over foreign aid cuts and backbenchers uneasy about reductions hitting justice, local government, and work & pensions. The NHS, flagged as 20% less productive than pre-pandemic, is also under scrutiny. Labour's promises of growth and better living standards are now clashing with reality. Reeves' £26 billion payroll tax hike has already led to job losses, while growth policies like Heathrow expansion won't provide immediate relief. With departments modelling cuts of up to 11%, final allocations will come in June's spending review. The shift toward austerity is becoming hard to ignore.

### **And finally that press conference...**

Volodymyr Zelenskyy's long-awaited meeting with Donald Trump quickly fell apart. It turned into a tense exchange that ended with the US president bluntly telling him to 'come back when you're ready for peace'. The message was clear: Ukraine would no longer get unconditional American support, and Trump had little patience for Zelenskyy's resistance to negotiations with Russia.

Trump made no effort to sugarcoat the shift in US policy, warning that without American backing, Ukraine wouldn't win the war. European leaders, who had spent weeks urging Trump to stay the course, were left scrambling as the meeting descended into what one official described as an 'ambush'. Hungarian Prime Minister Viktor Orban wasted no time twisting the knife, declaring that 'strong men make peace, weak men make war'.

Hopes that Ukraine could secure a long-term US security guarantee faded as Trump instead pushed an economic arrangement to give America a 50% stake in Ukraine's resource revenues. 'We're going to have workers there digging, digging, digging', he said, pitching the deal as the best way to ensure continued US involvement. Zelenskyy, who had sought firm commitments from Washington, was met with vague assurances at best. France and the UK had offered to send 30,000 peacekeepers to Ukraine but wanted Trump to pledge US support if those forces came under attack. He refused to be pinned down, telling Keir Starmer, 'I don't like to talk about peacekeeping until we have a deal'.

For Kyiv, the fallout is severe. Zelenskyy had hoped to secure new guarantees from the US but instead left Washington with his position weakened. European leaders are now gathering in London to work out how best to proceed without the guarantee of US support, and it is time for them to step up defence spending.

It's too early to assess the impact on markets, and a massive diplomatic effort will likely be underway to attempt to mitigate the fallout. I still think a deal is on the table, as Trump still wants peace... just on his terms. It was a painful press conference to watch as, on one hand, I felt disgusted by how Zelenskyy was treated, almost being forced to beg the playground bully for his lunch money publicly. And yet simultaneously willing him to do so for the sake of world peace. Some meetings are best held without cameras.

This Market Matters is far too long already, but I will mention the Nvidia results, which I thought kept the AI spending story very much alive. Earnings were a beat, and forward guidance was slightly ahead of expectations, with only a slight slip in margins. If the mood had been different, we might have seen a pop higher in the share price, not an 8.5% fall. For those still paralleling Nvidia to the bubble stocks of the 1990s, may I point out that this AI leviathan is on course for revenue to surpass an annualised \$200bn in the next couple of years as it meets insatiable demand for its chips, and that the forward P/E is around 28x versus the 200x that Cisco hit in March 2000.

**Let's see what this week brings us!**



**TOM MCGRATH**

**Chief Investment Officer & Portfolio Manager**