

# MONTHLY DIGEST

## BALANCING THE SCALES

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**There's much for investors to worry about, including possible plot twists in the tariff soap opera. But there's much to help them sleep, such as the potential from companies adopting artificial intelligence.**

The scales used by investors to weigh the positive and negative influences on financial assets are often finely balanced: just a small shift one way or the other can change the course of markets. But observation over long periods tells us that the scales are rigged in favour of more positive outcomes. Investors should always bear this in mind when investing for the long term.

In this month's commentary, we look at how some of the biggest weights on both sides are influencing performance.

### What keeps investors up at night?

It's a tale as old as time. What investors find most unsettling is uncertainty. This leads to the slightly counterintuitive outcome that even when bad things happen, markets can go up as long as investors don't think things will get even worse.

The headlines have been full of tariff threats this year, with sentiment sinking to its nadir at the beginning of April when President Trump unveiled his 'Liberation Day' list of what he planned to impose on different countries. Remarkably, though, the MSCI World index of global equities has risen since then: it's up 26% from an 8 April low and regularly reaching new all-time highs.

This largely reflects the fact that, one by one, the US's trading partners have been making deals. The UK was one of the first, submitting to a 10% tariff rate for the majority of its goods exports to the US. Since then, Japan, South Korea and the European Union have agreed to a 15% rate. The main holdout countries remain (at the time of writing) India and China, although talks are continuing. With no agreements in place, the US has imposed higher tariffs on some economies, including Taiwan (20%), Canada (35%) and Switzerland (39%). The general assumption is that these will be negotiated lower.

Following such deals, the average tariff rate for goods imports to the US appears to be settling somewhere in the high teens. This is many times higher than an average of 2.7% at the year's start, but

### QUICK TAKE

- US tariffs are much lower than announced on Liberation Day, but could still surprise
- Trump looks unlikely to fire the central bank Chair, which could have meant much lower rates
- Equity valuations look stretched in the US, but mainly not elsewhere
- AI adoption could boost productivity and stock values in the long term

less than the potential average rate in the high twenties set by the Liberation Day announcement. At least businesses and investors now know where they stand.

The next imponderable is who will foot the bill. Despite Trump's apparent belief that foreign exporters are on the hook, the burden will actually fall largely on the US private sector, split between companies and consumers. For example, Procter & Gamble, the household goods company, has projected that tariffs will cost it around \$1bn over the coming year. To compensate for this, it has announced plans to raise prices by 5% on around a quarter of its products in the US. We think that US companies and households will be able to absorb the higher prices without pushing the country into a recession.

However, it's disconcerting that Trump has threatened 50% tariffs on Brazil out of displeasure at the charges brought by the Brazilian state against former President Jair Bolsonaro, whom he considers – to his approval – a fellow 'strong-man' right wing leader. What else could he be tempted to use them for?

### Trump vs the Fed

Our next worry is central bank independence. Trump has regularly threatened to sack Federal Reserve Chair Jerome Powell, replacing him with someone more malleable, who will cut interest rates more aggressively. The market reaction to such suggestions is universally negative. US equities, bonds and the dollar have simultaneously sold off in response – a reaction usually associated with troubled emerging market economies.

"What's the problem?" you might ask. Surely lower interest rates are a good thing? Not if they are inappropriately low for the

The value of investments can go down as well as up and you could get back less than you invested. Past performance is not a reliable indicator of future performance. This information should not be taken as financial advice or a recommendation.

economy and lead to higher inflation. Turkey show an extreme example of what can happen when a central bank is captured by the leader of a country. This was all the more problematic because President Tayyip Erdogan had the notion that the cure for the country's inflation problem was not higher, but lower, interest rates. As a result, since 2021 the Turkish lira has fallen from 8 to the dollar to 40; the yield on its 10-year bond has surged from 12% to 30%. For now, at least, Trump seems to have understood the message from the markets that sacking Powell would be a step too far. But Powell's term as Chair expires next May; his choice of successor will be important.

### **At a stretch**

Another concern is equity valuations, especially in the US. The 12-month forward price/earnings ratio (PE) for the S&P 500 index, which looks at expected corporate earnings for the coming year, is around 22. This is historically high and potentially unsustainable. Even so, a couple of factors might help calm nerves.

The first is that valuation is a dreadful tool for predicting market timing. Equities can remain either over or undervalued for long periods of time.

The second is that investor valuation of companies has become more sophisticated, with much greater emphasis than before on the underlying profitability and cash-generating abilities of companies as well as the longevity of those profits. Moreover, as economies and technologies have evolved, profits can be generated on a much smaller asset base than in the past. Think robots and intellectual property instead of smokestack industries, perhaps allowing sustainably higher returns on capital.

Another point to consider is that high valuation is largely a US phenomenon. For investors concerned about valuations, other regions' markets might offer better value. This is even if we allow for the mix of industry exposure – no other market offers quite the same bite into technology and innovation as the US, after all. Bearing this in mind, we spread our net globally when trying to catch investment opportunities.

### **Geopolitics on the worry list**

Finally, geopolitics. Sadly, this has become an ever-present feature on the worry list. The range of threats is wide in nature – and worldwide. The latest is the US's deployment of two nuclear submarines after aggressive statements from Russian politician Dmitry Medvedev about the war with Ukraine. And yet, markets have consistently bounced back from a number of escalations in recent years. We recognise that it's impractical to construct portfolios based a singular potential event, so we address the risk through our quality-biased stock selection and our exposure to diversifying assets.

### **Sleeping more soundly**

Despite the above list of concerns, there's much to be optimistic about, at a time when many equity indices around the world are

at (or close to) all-time highs. We often emphasise the fact that equities amount to a solid long-term investment by showing clients a chart labelled with all the crises that have occurred over the decades. Yes, there are dips along the way, but the trend is upward.

Right now, what makes investors most optimistic is the adoption of AI. Empirical Research, a US broker-dealer and investment adviser, has measured the performance of companies that it calculates have spent the most time discussing AI in a substantive way on earnings calls. It concludes that, since the beginning of 2023, more than half of the returns of the S&P 500 have been derived from companies exposed to the AI theme. Is this sustainable? And is this healthy? One concern amongst investors is that the vast amount of capital expenditure committed to AI won't generate enough profit to justify this. But there was certainly no sign of a slowdown in spending in US companies' most recent quarterly earnings results.

It's worth bearing in mind that the internet and the smartphone enabled applications and even whole industries that might not otherwise have been possible or even imaginable. Likewise, the benefits of AI might come from uses that most of us have not even thought about yet. The wider adoption of AI, to the point where it becomes business-as-usual, should allow increases in productivity to flow through the economy.

Another supportive factor for financial assets at the moment is loose financial conditions. Goldman Sachs's index of US financial conditions, made up of bond yields, credit spreads, equities and the dollar, sits close to the low end of the range established following the sharp tightening of 2022.

On the subject of financial conditions, the good news is the broad scope for most central banks to reduce interest rates if required. The European Central Bank is the most advanced, having cut its deposit rate from 4% to 2% over the past year. The Federal Reserve and Bank of England have been more reticent, with the benchmark Fed Funds rate dropping from 5.25%-5.5% to 4.25%-4.5%. But the Fed's 'Dot Plot' of members' rate expectations is falling consistently towards 3% in the years ahead. The interest rate futures market sees the rate dipping below 3% by the end of 2026.

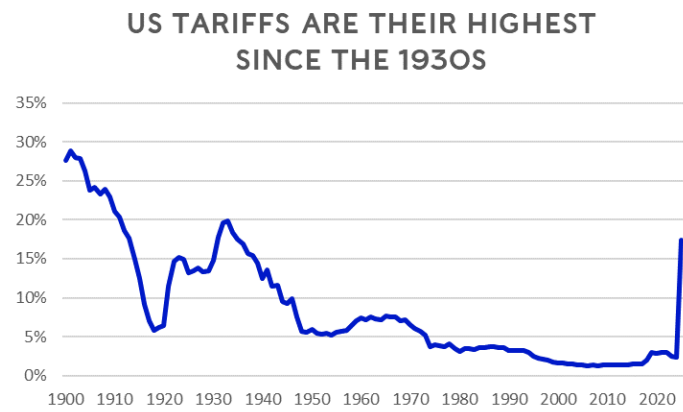
In the UK, the Bank of England's base rate been stuck at 4.25% since May, 1% lower than its peak. Sticky services inflation has kept it from cutting more aggressively. But the futures market sees a very high probability of a quarter-point reduction in August, with a fall to 3.5% by next summer.

### **Stick to your guns**

Our message this year has been consistent: be braced for increased volatility but stick to your guns as an investor. That might mean retaining existing portfolio exposure; it might mean adding to investments as planned. So far that's played out reasonably well, despite a few setbacks along the way. That said,

The value of investments and the income generated by them can go down as well as up.

we're far from complacent about the outlook. We're continually scanning the horizon for icebergs – sometimes, it feels, in thick fog!



Source: Historical Statistics of the United States Ea424-434, Monthly Treasury Statement, Bureau of Economic Analysis, Yale Budget Lab analysis. Average effective tariff rate on goods imports. Latest update is a projected number as at 1 August 2025.

*For recent economic highlights, see below on page 4.*

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**US** - There's a danger of the US stock market turning into a one-trick pony, with that trick being AI. However, there's some evidence of a welcome broadening out of returns. For the year to date, the total return of the Bloomberg Magnificent 7 index (+7.53%) has been roughly matched by the return from the other 493 stocks in the S&P 500 (+7.38%). We're encouraged to see the equal-weighted S&P 500 index making new all-time highs too. We're entering what has historically been a seasonally weaker period for markets – and it wouldn't be unhealthy to see some of the froth being blown off more speculative plays. But looking longer-term, we see no cause for alarm.

**UK** - The FTSE 100 index reached record highs in July, finally breaking through the 9000 barrier. Considering it reached almost 7000 as long ago as 2000, this has been a slow journey. However, it might surprise readers to know that since the end of 2021 (which coincided with the end of the post-pandemic boom), the UK's flagship index has barely lagged the S&P 500 in dollar terms, delivering a total return of 37.5% vs 39.5%. It has actually outstripped the Magnificent 7 stocks, which could only muster 19% over the period. Obviously, much depends on what starting point one uses. Even so, these numbers demonstrate the relative value to be found in even the less vaunted markets.

**Europe** - We still see potential in European equities, although an upturn in the region's fortunes will not come overnight. The seeds for improved growth have been sown with lower interest rates, a turn in the fiscal mindset towards greater stimulus and an apparent willingness by national governments, EU institutions and regulators to relax their stance to enable greater investment and innovation. European equity markets are much more diversified than their US counterparts. This has allowed them to shake off poor performance from three of the top four companies by market capitalisation at the start of the year: Novo Nordisk (-49%), LVMH (-24%) and ASML (-8%) have all produced poor total returns in 2025. Despite this, the MSCI Europe ex-UK has still delivered an impressive total return of 11%.

**Fixed Income** - The Bloomberg Global Aggregate Bond Index is up 5.7% so far this year, flattered by dollar weakness. The sterling-hedged version has returned 2.7%, with the bulk of returns from the 'carry' – the income from the 'coupon', or interest payable – rather than capital gains. The current 10-year gilt yield of 4.56% is exactly where it was at the beginning of the year. Bonds can offer a safe haven during economic weakness. However, fiscal deficits and what we see as a world of structurally higher and more volatile inflation make us adopt a relatively conservative stance over duration. In other words, we favour investing in bonds with shorter maturities, where we could see more of the benefit of lower interest rates, rather than longer-dated bonds, which are more sensitive to inflation.

All UK Conventional Gilts have delivered a total return of -0.06% over the last three months and -0.4% over the last year. Index-Linked Gilts returned +0.05% and -8.1% over the same periods. Emerging Market bonds produced a total return of +6.1% in sterling over the three months to end July (+13.3% over 12m). Global High Yield bonds delivered +3.9% (+8.1% over 12m) in sterling terms.

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