Not a week for the faint hearted

President Trump appears to be taking a leaf out of tech oligarch Mark Zuckerberg's book by adopting Facebook's early approach to business, "move fast and break things". Well, the geopolitical environment is certainly changing rapidly with the potential to break down and reshape global economic blocs.

In his book, "The Art of the Deal", Trump asserts that it is important to control the narrative, especially when you don't hold the cards, so to speak, and this week there has been a huge shift in narrative, but it has been driven by Europe.

With the US indefinitely pausing all military aid to the Ukraine and as its "America First" policy piles pressure on Europe to match its military spending, European leaders have rallied together and unanimously agreed to increase defence spending and continue unwavering support for Ukraine.

The "ReArm Europe" plan proposes mobilizing up to €800 billion to that end, but maybe more significant in this evolving narrative are the financial mechanisms within. Measures such as the suspension of EU budget rules are key, alongside the redirection of existing EU funds, leveraging the European Investment Bank and €150 billion in loans for joint defence projects.

In addition, Germany has embarked on a fiscal policy overhaul with plans to create a €500 billion special fund dedicated to infrastructure projects and exempting a significant proportion of defence spending from the constraints of the debt brake.

Culturally and fiscally prudent as a result the hyperinflation experienced by Germany in World War I, the debt brake was introduced in 2009 to prevent excessive government borrowing and mandates a structural deficit of less than 0.35% of GDP. The result has been a German debt-to-GDP ratio far lower than its other European counterparts, and it now seems as though this will be unlocked to provide fiscal stimulus to Europe where previously economic growth has been elusive.

These events are significant, and we have yet to mention tariffs and indeed tariffs are not the only dynamic shifting trade relations of late. There is huge impetus on ensuring that this economic impulse is spent on European goods and services and consumers are beginning to boycott American brands, particularly the Canadians. We were delighted by a story this week which captured a Canada goose and a bald eagle facing off:

To discuss tariffs in more detail seems futile, as the rhetoric shifts daily. When it comes to policy and market volatility, I always remark that most political decisions are reversible. As was evident with Liz Truss, and as appears to be somewhat evident with Trump already halting half of the 25% tariffs on Mexico and Canada. This was not in response to capital market moves, he adds.

There has been much volatility in capital markets as a result but while these are significant changes, the ultimate impact will be gradual, and the ultimate impact will emerge over many years.

Referring back to the prevailing narrative, which has been centred around developments in Europe but also includes a more positive spin on China with hopes for further economic stimulus, not to mention their AI technological developments, the view is that there is now an opportunity to invest and diversify away from the US which was the only economy showing some potential for growth.

The result has been some sharp changes in asset prices. Equities have fallen quite heavily in the US, and global markets are broadly lower but European defence and industrial stocks have been posting double digit gains. Chinese stocks have performed well, driven by technology companies which trade at a discount to their American counterparts.

In Europe, equity gains have been at the expense of the bond market and bond yields have risen in anticipation of greater borrowing requirements. This is logical, the government borrows and spends in the economy. As debt-to-GDP ratios rise, questions will mount about the sustainability of government debt. Over time government borrowing costs may rise and currencies may flounder.

For now, higher yields mean stronger currencies and the Euro has appreciated against the dollar and the dollar has weakened broadly. European leaders want to reposition the Euro an alternative reserve currency to the US dollar and, while that may be a difficult contest based on economic resilience, evolving trade flows play into the fundamental requirements for nations to hold reserve currencies.

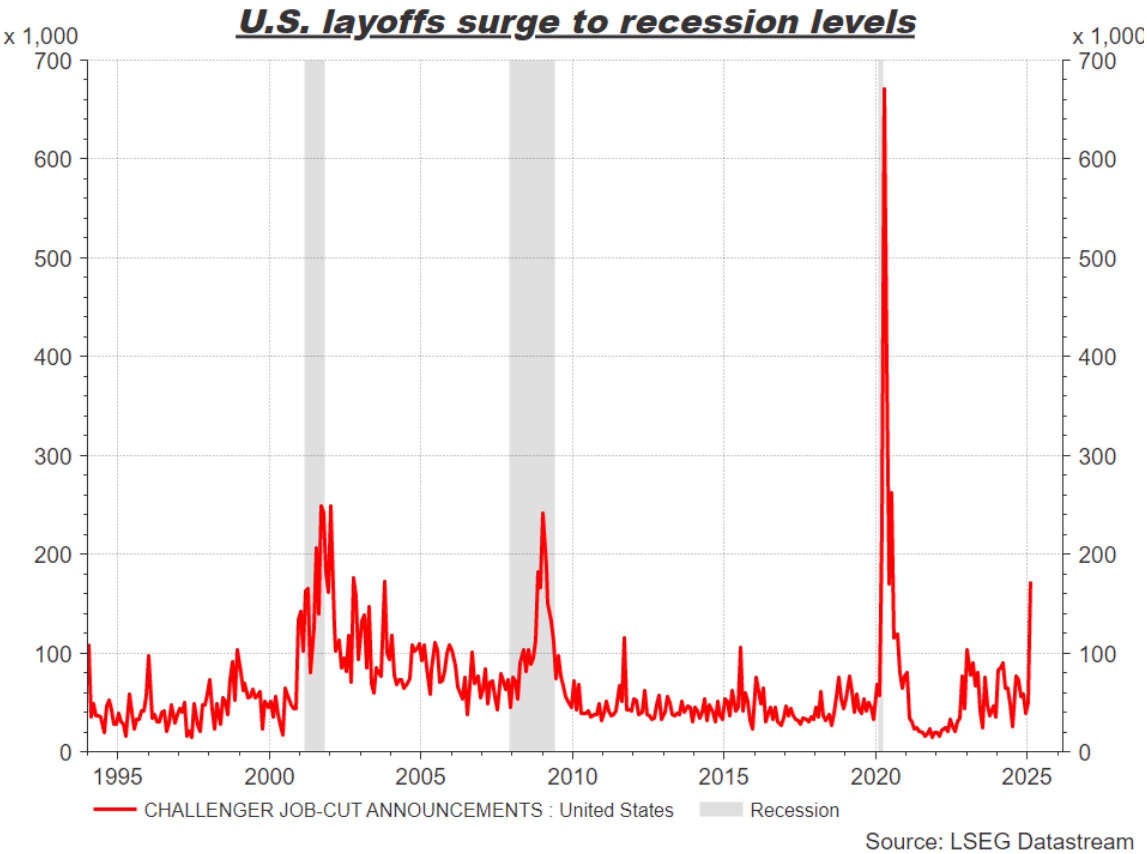
This structural shift is expected to drive flows into Euros over time as will the debt issuance, assuming the yield is attractive to international investors. The pound has also strengthened, likely to be a beneficiary from loose fiscal conditions of its main trade partner.

These events have been exacerbated by the shifting tide in the US. The most significant data release from across the pond has been the Atlanta Fed's GDP Now which aims to give a weekly up to date estimate for what the GDP in the currency quarter will be. It has swung violently to the downside, suggesting the US economy will contract by -2.8% in the first quarter, a number which a week later has already been revised higher to -2.4%.

Short term, forward looking, fast moving indicators like these are subject to greater volatility and noise and with events occurring at pace we warn of their reliance. It is likely that something in the data is responding to the shift in activity owing to tariffs and the most likely effect that is taking place right now is the frontloading of importing goods into the US ahead of tariffs coming into effect.

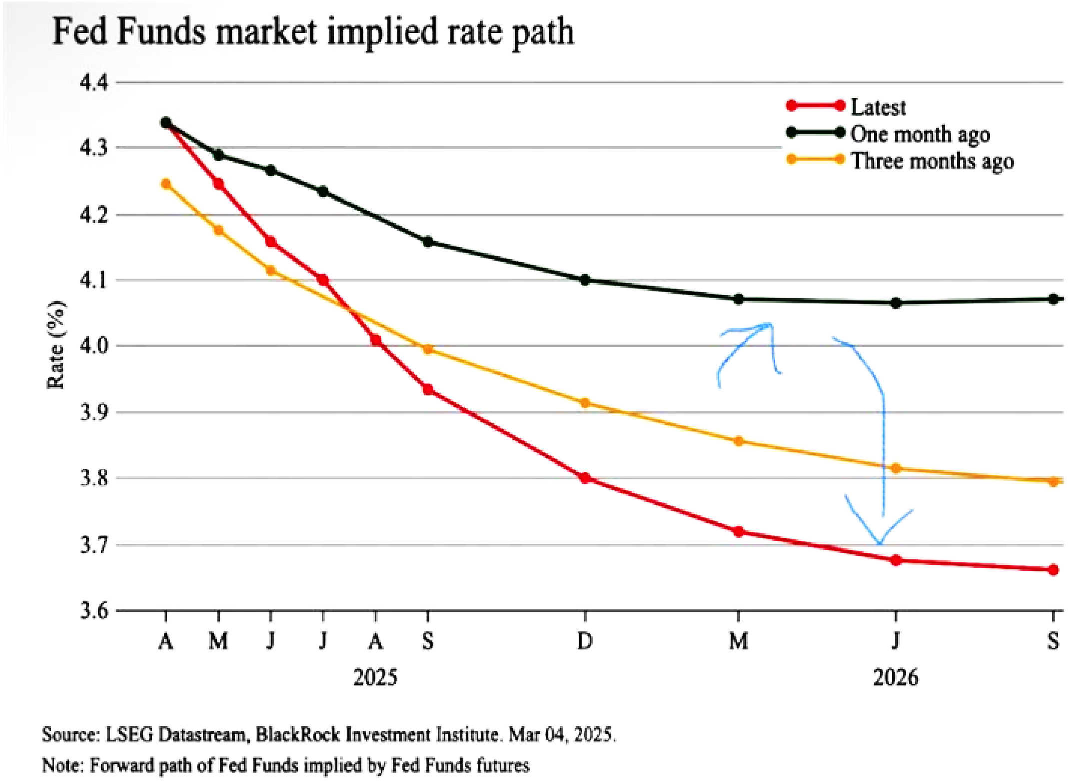
Structural imbalances are evident in the US trade deficit, which reached $131.4 billion in January and has exceeded $100 billion in several months over the past year. Some argue that this is not solely the effect of frontrunning tariffs but also reflects an overvalued dollar and declining competitiveness, compounded by China's manufacturing dominance. I would argue it is safer to assume the former for now.

US employment data has also been weakening, and the nonfarm payroll data today did not help to improve its outlook. Much of the employment data is yet to reflect the effects of the Department of Government Efficiency but the US layoffs do, and the outcome is bleak.



These factors make for a difficult interest rate outlook for the US. Trump's policies are likely to result in greater inflation but, at the same time, the economy appears to be slowing and the labour market weakening. With a dual mandate and this dichotomy in the data, a wide array of forecasts are feasible and as such we expect Powell to sit on his hands until things develop further.

However, the bond market has responded and expectations for rate cuts are moving rapidly higher:



Contrary to the expectations of many, the recent surge in US Treasury yields has proven to be short-lived, confounding many market participants. The 10-year yield, which reached 4.79% in mid-January, has since retreated to 4.26%.

The consequence is further downward pressure on the dollar, but we fail to see how these will materialise if inflation persists which will be the primary effect of tariffs in the short term. This is readily becoming evident in the PMI data which has been strong across the board but notably in US non-manufacturing where price levels came in hot at 62.4, ahead of the forecasted 56.2.

On the other side of the coin, the ECB has cut rates and remains loose in its monetary policy and the Bank of England is expected to cut rates up to six times this year. While interest rates in Europe could remain higher as a result of inflation and potential growth in response to economic stimulus, some hold the view that the net effect of tariffs will outweigh the impact of stimulus.

It is worth considering some of the counterpoints to the narrative and we maintain some scepticism. Economist Jean Medecin points out that often governments expansionary approaches, even under the cover of the concept of industrial strategy, are doomed to fail: “They don't provide lasting growth acceleration, they don't support sustainable public finances (every example of countries which have put their finance in order, from the UK in the 80's to Canada in the 90's to Germany and Japan in the 2000's, have done it through austerity policies), and more importantly they don't boost productivity hence wealth levels.”

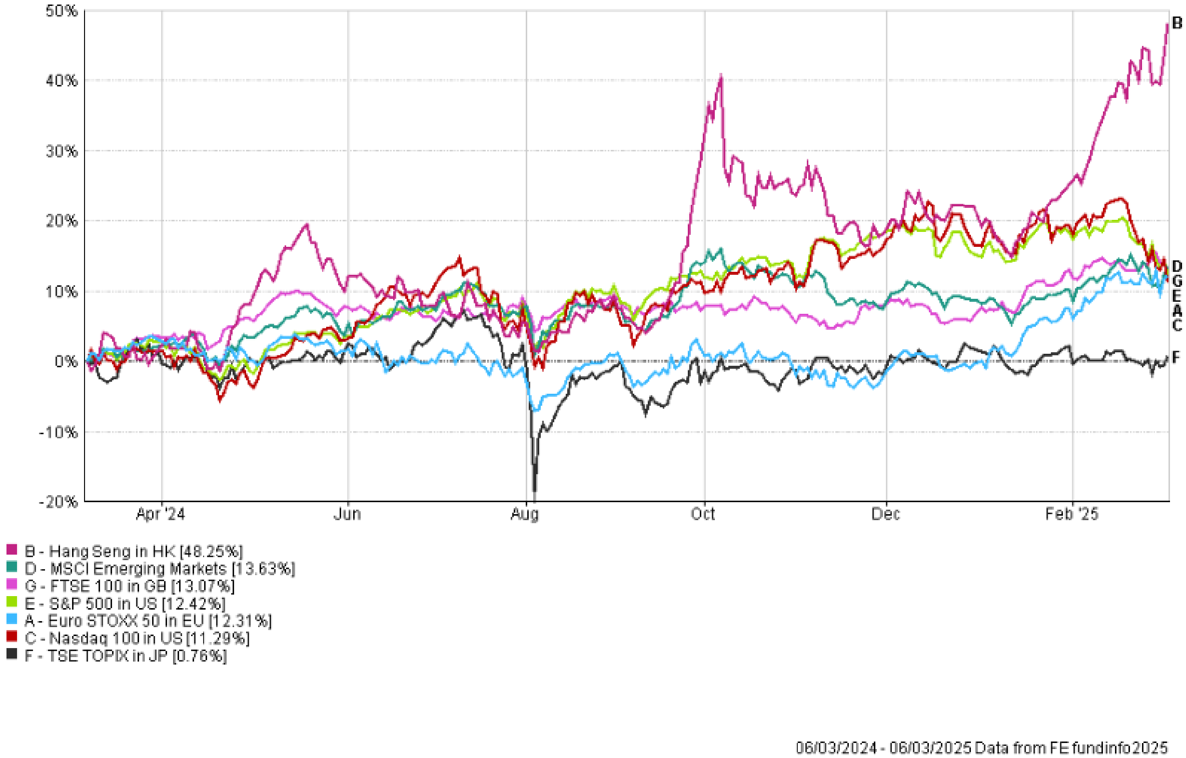
And while debt laden expenditure in Europe excites the senses, there is plenty of investment in the US, with Apple announcing $500 billion to invested over just four years, that’s just one of their mega-tech companies, and TSMC following with $100bn, amongst others. In fact, with the trade policy evolving as it is we may be thinking too much in macroeconomic terms and insufficiently in the micro (at a company level) and indeed corporate capital expenditure decisions may elect for more investment in the US to avoid tariffs.

So, I end with the commonly referenced mantra that history doesn’t repeat itself, but it often rhymes and share the graph below which highlights the recent market moves and compares them to Trump’s first innings. In the end there was a raging bull market, helped by monetary easing and maybe from a better base valuation level but it’s important not to get sucked into the whipsaw.

[Source: ZeroHedge]

Where are markets up to?

The rolling 12 month % cumulative returns in local currency from various indices is shown in the following chart:



Where are the portfolios up to?

The portfolio performance, net of fees, to close of business on Thursday is as follows:

	1 week	1 month	3 months	12 months
Cautious	-2.00%	-3.42%	-2.72%	+1.94%
Balanced	-2.65%	-5.00%	-3.96%	+1.77%
Adventurous	-3.00%	-6.00%	-4.94%	+1.48%

As ever, if you would like to discuss any aspect of your portfolio, please do not hesitate to contact us on service@blythefinancial.com.