<u>Short Term Pain, Long Term Gain?</u>

There's been a flurry of geopolitical rumblings and pockets of emerging market economic volatility this week. The United States initiated extensive air and naval operations against Houthi targets in Yemen over the weekend to help stabilise a significant global trade route through the Red Sea. President Trump went further, issuing a warning to Iran that the country would be held directly responsible for any further attacks carried out by Yemen's Houthi rebels.

This marks the most significant US military action in the Middle East since President Donald Trump's second term began earlier in the year. With Europe now embarking on a huge defence spending spree, which has this week been approved by the lower and upper house of the German parliament, President Trump may be able to flex a little more muscle in matters relating to its own international relations.

On the other side of this escalating conflict, Israel brought the relative calm of a ceasefire to an abrupt end with air strikes of its own in Gaza following Hamas' refusal to free hostages. The price of crude oil has moved higher as a result but remains at the low end of its four-year range.

There was a sharp decline in the Turkish stock market and a depreciation of the Lira following the arrest of Istanbul Mayor, Ekrem İmamoğlu, a prominent opposition figure and potential challenger to President Erdoğan. The arrest has sparked widespread protests, and the government has imposed bans on public gatherings and restricted access to social media platforms in response.

It was also a bad week for Indonesia where the stock market fell in dramatic fashion by over 7% intraday prompting the Financial Services Authority to permit companies to engage in stock buybacks without shareholder approval to help stabilise the market. Bank Indonesia also intervened in currency markets to stabilise a depreciating Rupiah.

The catalyst for this shift in sentiment is a government plan to have the military play a wider role in state institutions, alongside broader fiscal concerns, but the country is already feeling some economic pressure brought about by changing international trade dynamics and serves as a good example of what might be yet to come.

The imposition of U.S. tariffs on Chinese goods has led to an influx of Chinese products, intensifying competition for Indonesian exporters and squeezing profit margins for domestic manufacturers.

The initial response to US tariff policy has been uproar, but as other economies begin to experience a taste of the same medicine – increasing competition from China – they are also growing more concerned about protecting their own economies. So, while the expected outcome of a second Trump presidency is a redistribution of global trade, the reality may instead be a broader spread of protectionism.

Developed markets are relatively unaffected by the events in these smaller economies and appear to be in a holding pattern in anticipation of what comes next. April 2nd will mark an announcement regarding the next phase of US trade policy and the evolution of reciprocal tariffs. The prevailing narrative is beginning to accept these developments with the understanding that the purpose of the trade war is to create a more level playing field so that the benefits from trade are more evenly distributed.

For now, the view from the White House is that reform is necessary, and short-term pain may be required to achieve long-term gain. Developments in Europe, however, could be the inverse with the short-term gain of fiscal expansion but questions remaining over the longer-term picture.

Economist, Jean Medecin, offers an opposing view to the recent excitement around Europe suggesting some of the gains may ultimately be matched by weakness in the currency. "Defence is a necessary but mostly useless sector and defence spending is not a recipe for economic efficiency nor citizens wellbeing. It therefore does not call for a stronger Euro."

And while big government spending may create inflationary pressures calling for higher rates, he argues that the European Central Bank is a prisoner of its fiscal dominance and thus committed to lower interest rates (its high debt levels require low service costs). A deteriorating balance of payments and lower interest rates are both negative for the currency.

The complementary force in favour of recent asset price dynamics is the financial woes of the United States, but there are numerous factors that could swing sentiment back in the other direction:

- The probability of recession remains low
- We could see a reversal of frontloaded imports which could swing US GDP estimates back into strongly positive territory
- Earnings reporting for the first quarter may be resilient and we may see some early signs of A.I. revenue with Open AI, for example, now offering agents for $20k per annum
- Scope for fiscal policy to enter the rhetoric in the coming months

In contrast to the EU, the US acts as a single entity with a clear plan defined by Treasury Secretary Bessent. It may be difficult to execute but it may be more credible than the Eurozone's weak governance rules which are systematically meant to be broken.

Central banks will play a key role in reducing debt servicing costs which last year reached their highest level since 2007 for OECD countries. This week the Bank of England and the Federal Reserve held interest rates steady. This was very much expected. While stagnant UK economic growth may merit further interest rate cuts, they are not expected to come at a pace of more than one per quarter, and we have already been indulged in February.

The direction for US interest rates is far less clear and the expectation of no change was more in response to diverging data and uncertainty than steady-as-she-goes. Trade policy has so far driven economic growth data lower, inflation expectations higher and employment data could be rolling over.

With a dual mandate of stabilising prices and promoting maximum employment, it is unclear as to which of these factors will have the greatest impact on monetary policy from here. However, Chair Jerome Powell, may have given us a clue in bringing back the term "transitory" in regard to some of the inflationary impacts of tariffs.

There is very much a "wait and see" feel to the current environment, and for all Trump's bluster he is now coming up against legal challenges to his executive orders and Department of Government Efficiency efforts which may result in a period of political stagnation.

For all these macroeconomic developments, we must not forget the microeconomics, i.e. that companies continue to invest, innovate and evolve as they always do. There have been some interesting developments coming out of China this week with BYD, the electric vehicle (EV) maker's new battery system capable of charging a 400km battery in just 5 minutes. This is comparable to the time it takes to refill a petrol/diesel vehicle and therefore significant.

On top of that CATL, a large Chinese producer of EV batteries, launched the world's first Lithium Iron Phosphate battery which increases the potential range for EVs to c. 1,000km. We think this could be time to consider building a position in scarce electrification metals again and bolsters the thesis that China provides the only real competition to US technology dominance.

Where are markets up to?

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

20/03/2024 - 20/03/2025 Data from FE fundinfo 2025

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	+1.30%	-3.21%	-0.95%	+2.44%
Balanced	+1.71%	-5.30%	-2.64%	+0.99%
Adventurous	+2.03%	-6.40%	-3.74%	+0.18%

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