# <u>Rare Earths are China's Trump Card</u>

For the UK through May there was improving economic data, consumer and corporate sentiment surveys, and positive trading momentum from many economically exposed companies - think construction, retailers, hospitality and travel. Generally, UK Economic data releases have surprised to the upside in 2025.

The one area of weakness remains the labour market where companies are not replacing leavers and slowing hiring. This is leading to a rise in unemployment which this week rose by 0.1% to 4.6%. This uptick in unemployment follows April's policy changes, which included an increase in payroll taxes and the national minimum wage, part of Chancellor Rachel Reeves' latest Budget.

Wage growth also appears to be rolling over, with average weekly earnings excluding bonuses rising 5.2%, below expectations and down from 5.5% previously. Growth in private sector pay has been particularly subdued, with recent public sector pay deals providing only modest support.

UK consumer spending is also showing signs of fatigue this week. Retail sales growth in May slowed to just 1% annually, the weakest pace this year. According to the British Retail Consortium, lower consumer confidence is seeing shoppers cutting back on discretionary purchases, particularly fashion and high-ticket items.

This possible turn in momentum coincided with the government's 2025 Spending Review and whilst Chancellor Rachel Reeves doubled down on the Labour Party's commitment to meet fiscal rules by 2027, a swathe of spending was announced which leaned towards stimulating economic growth.

A quick roundup: 90% of new spending is focused on the NHS with day-to-day healthcare funding increasing by £29bn. Defence spending will target 2.6% of GDP by 2027. There is a go ahead for the Sizewell nuclear power plant in Suffolk, which will power 6 million homes at a cost of £14bn but will not be operational for a decade. Broadly, there is more money for health and defence at expense of other departments. £39bn will also be spent over ten years for social housing:

Annual cadence in funding levels for the Affordable Housing Programme 2026-27 to 2035-36

| | Prev.Plan | New Plan | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2026 | 2027 | 2028 | 2029 | 2030 | 2031 | 2032 | 2033 | 2034 | 2035 | 2036 |
| **Annual Funding** | **2.3** | **2.6** | **3.0** | **3.5** | **4.0** | **4.1** | **4.2** | **4.2** | **4.3** | **4.4** | **4.5** |
| y/y chg | | 15% | 15% | 15% | 15% | 2% | 2% | 2% | 2% | 2% | 2% |
| **Cumulative** | **11.6** | **2.6** | **5.7** | **9.2** | **13.2** | **17.2** | **21.4** | **25.6** | **30.0** | **34.4** | **38.9** |

Source: H M Treasury and Barclays Research

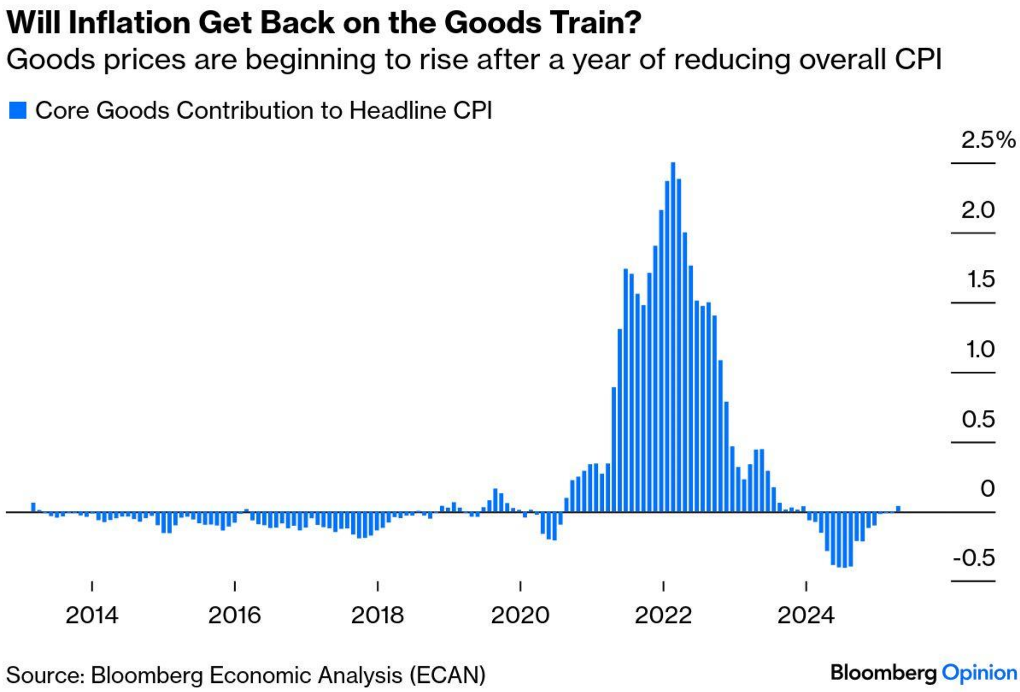
Exports to the US fell by a record £2bn in April (since records began) forcing the Office for Budget Responsibility to slash its 2025 GDP growth to 0.7%. This should have been expected given the frontrunning of imports in the US which led to their dire Q1 GDP growth figure, and something we alluded to in our weekly update on 25th May and during the first quarter. Not surprisingly these circumstances are having the opposite effect on the US economy which in the second quarter is growing at 3.8%.

Fortunately, these forecasts are yet to include the slightly more buoyant month of May, but with the fiscal situation on knife edge, the perception is that significant tax increases are now inevitable in the

Autumn budget. It's also evident that the Bank of England will increasingly be relied upon to absorb any economic shock after. Markets anticipate a 0.25% interest rate cut in August, with a growing probability of a further cut before year-end.

The big data point this week for the US was inflation which came in below expectations with momentum driving it towards the Federal Reserve's target level. This has called for President Trump to criticise Fed Chair Jerome Powell for not lowering rates and saving the US government on its debt interest bill.

What's holding the Fed back is the questionable effects of tariffs which are only apparent in half the inflation data and the full effects of which are not yet fully understood. Not only is it not yet in the data, but there is a lag for companies to actually follow through with raising prices and these same companies had built up significant inventory to work through ahead of Liberation Day. The Fed will be in a holding pattern until the data develops over the next couple of months.

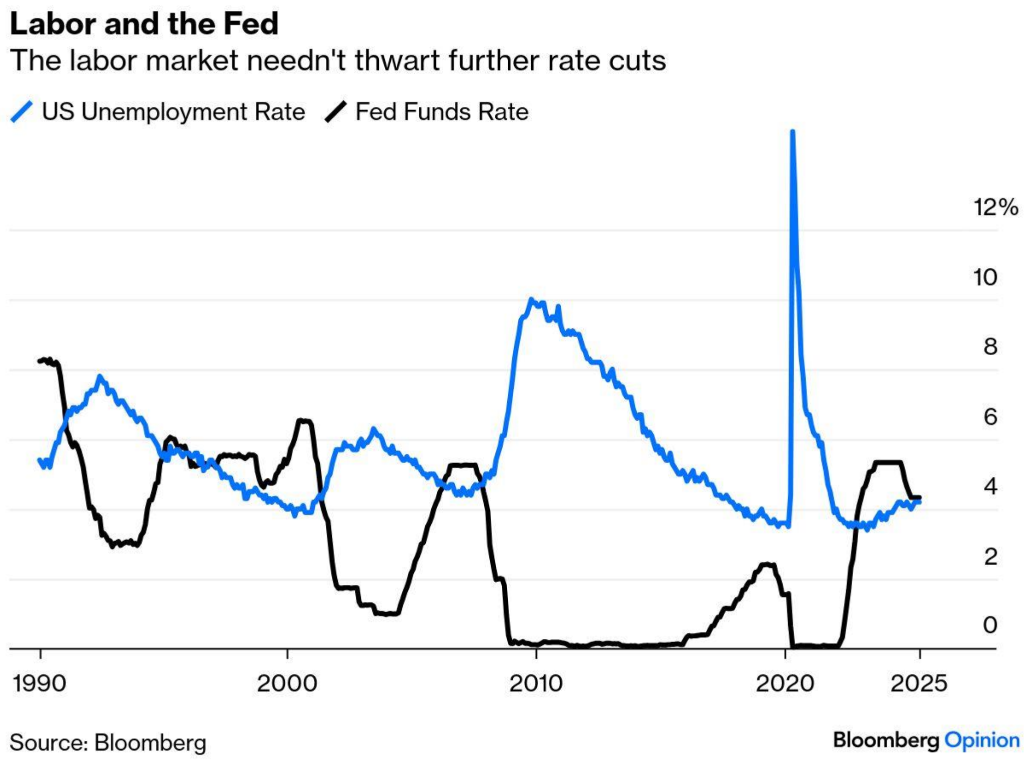



President Trump has hinted that he "may have to force something" to get interest rates lower. This comes after Treasury Secretary Scott Bessent's name was thrown into the ring as a replacement for Powell. The problem for Trump in this eventuality, would be finding someone who could replace Bessent, the one prominent Republican who has been able to calm capital markets amid turmoil this year. It is therefore unlikely we'll see any material announcements on this front any time soon.

There is also little push from the other component of the Fed's dual mandate, the US Labour market, which appeared resilient following nonfarm payroll data last Friday. Under the surface, there may be some weakness beginning to creep in with the Household Survey reporting a fall of 696,000 in total employment.

The Household Survey directly interviews individuals, counting each person as employed only once, while including self-employed and agricultural workers who are not captured by payroll figures. The headline unemployment rate was unaffected because and equivalent number of people exited the labour force entirely. A key data point to watch in the months ahead.

The effective Fed Funds Rate is now slightly above the unemployment rate, when for 15 years after the Global Financial Crisis it had been much lower. If unemployment ticks higher, history suggests interest rates will tumble. But that isn't happening yet:




Unfortunately, the other negative surrounding sentiment towards the US is the ongoing political upheaval which this weak culminated in the National Guard being sent into Los Angeles to deal with protests. This was subsequently deemed illegal by federal judges only to be temporarily turned over by the appeals court. Is there a pattern emerging here? To add to the internal conflict a senator was forcibly removed from a press conference, the reasons for which are yet to be understood but again reflect a Republican Party that is using overly aggressive, authoritarian tactics.

US-China trade talks have been taking place in Lancaster House near Buckingham Palace this week. For all the talk of China using its US treasury holdings as a negotiating tool, President Xi Jinping has a far more powerful ace up his sleeve.

Beijing controls almost 70% of global rare-earths production and what's more, over 90% of the refining of rare-earths, 90% of permanent magnet production and over 99% or heavy rare earth refining both of which are critical for advanced technology, electric vehicles, wind turbines and defence – think missiles and lasers.

China is flexing its muscle by building a permanent trade infrastructure around rare-earths processing and exports, which would allow it to track and control distribution, giving it lasting leverage. These controls enable China to gather valuable information from firms in developed economies, which must submit detailed product and supply chain data as part of the process, thereby sharpening China's understanding of supply chain dependencies.

This dependence is so significant that China is now viewed to be in a stronger negotiating position, to the extent that the head of the US National Economic Council, Kevin Hassett, suggests Washington is likely to lift export curbs on the most sophisticated artificial intelligence chips.

The problem for investors is that this may leave a trade deal between a rock and hard place. With markets relatively complacent that trade deals will get done we anticipate a re-escalation, even if only a return of the aggressive rhetoric to push things forward.

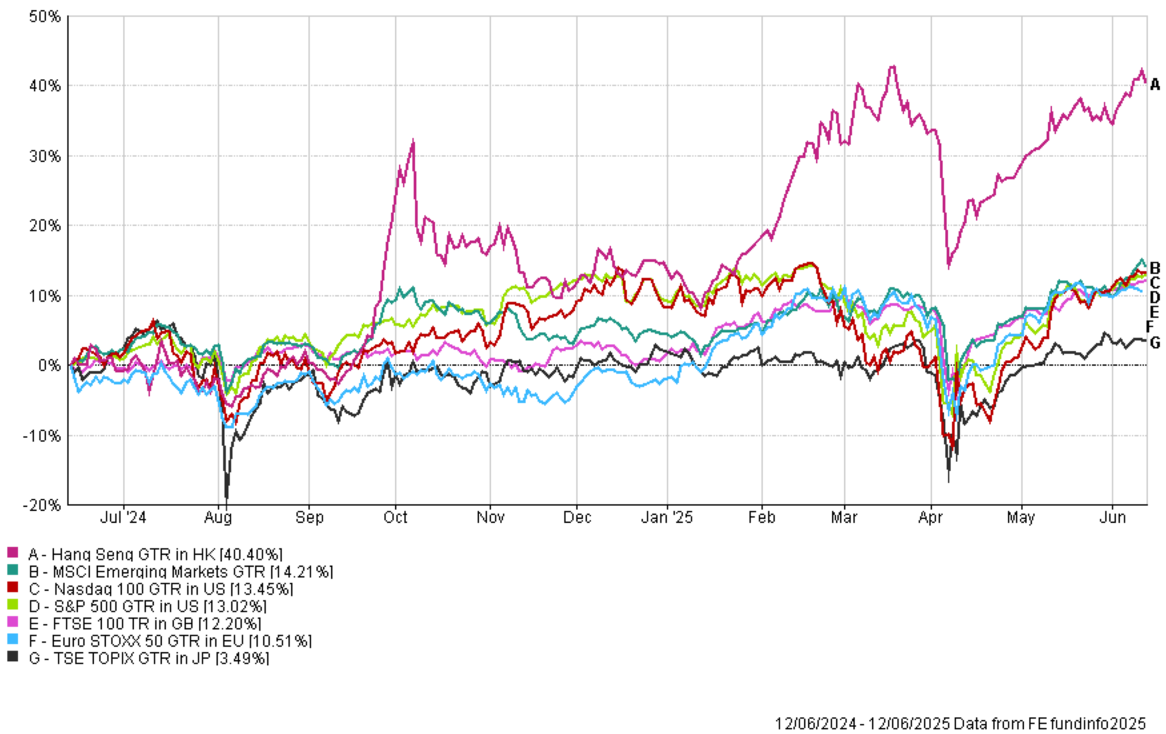
What we didn't anticipate was further escalation in the Middle East. Israeli air strikes on Iranian military and nuclear sites saw crude oil prices briefly surge over 13% before settling closer to just 6% higher. Crude oil has weakened significantly this year in response to the trade war so now there are two opposing forces for the commodity. Airline stocks are also suffering a result, and the gold price is rising.

These attacks are in response to Iran's excessive enrichment of Uranium, and while Israel is reported to be acting alone, President Trump is urging Iran to make a nuclear deal now before there is nothing left. The worst-case scenario is that Iran withdraws from non-proliferation entirely. The situation is developing and points to a difficult couple of weeks ahead for capital markets.

In the short term these events could bolster the US dollar, but if they don't it would be a further indication that there is little confidence in the currency under a Trump presidency.

**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 | +0.57% | +1.01% | +1.99% | +1.94% |
| Balanced | +0.68% | +1.31% | +3.21% | +1.37% |
| Adventurous | +0.76% | +1.62% | +4.00% | +0.92% |

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

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