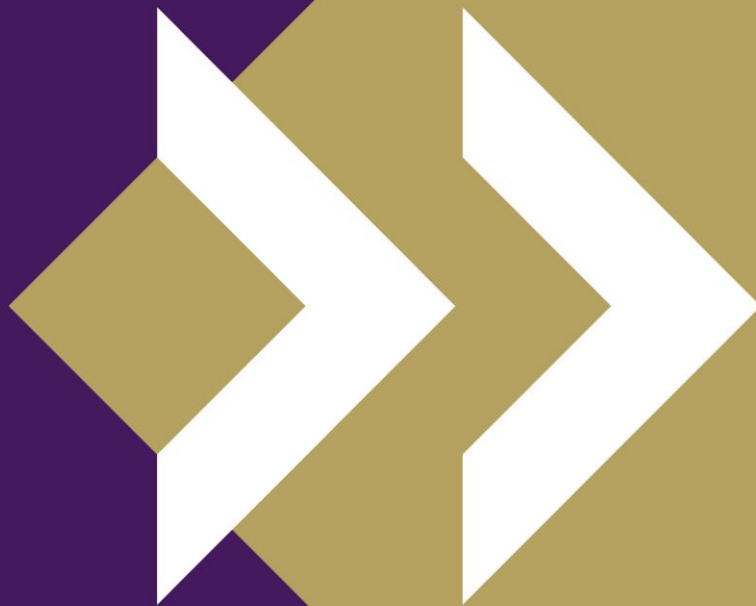


Market Update

Q1 2025



Events and macro environment

Donald Trump has once again dominated investors' attention over the past three months. The Trump-centric excitement of Q4 has quickly given way to apprehension in Q1, with bond and equity markets experiencing successive sell-offs. Investors are increasingly anxious about three primary concerns.

Firstly, successive rounds of tariff announcements have reignited fears of a global trade war, sparking inflation worries and shaking markets. While Trump's threats are no shock, the sheer scale and abruptness of these actions have blindsided investors. Moreover, the White House's chaotic strategy — announcing tariffs only to backtrack days later — has left markets unable to price in a stable trade policy.

Secondly, Trump's attitude towards the economic consequences of his actions has amplified investor unease. Disrupted supply chains and surging import costs are already squeezing consumers and businesses, and, historically, every 5% tariff increase erodes corporate profits by 1-2%, threatening both economic growth and earnings. With stagflation looming, Trump's dismissal of recession risks as mere collateral damage has further eroded investor confidence.

Even more alarming is the crumbling post-Cold War security order. The assumption that the US would uphold global stability has disintegrated, as Trump flirts with isolationism and threats against NATO allies. Europe and the UK, forced into a defensive stance, are scrambling to rebuild long abandoned military capabilities. With America's role in upholding the rules-based global order now over, the world is witnessing a return to "might makes right" geopolitics, which markets are attempting to adjust to.

Concurrent to these pressing issues, interest rate policy remains a pivotal factor, as it did throughout much of 2024. The Federal Reserve held rates steady in Q1, underscoring their concern over sticky inflation. In the UK, despite a single rate cut in mid-Q1, economic activity has contracted, weighing heavily on the outlook for the country. So far, the UK has avoided the direct crosshairs of Trump's tariff crusade, but the broader global uncertainty and anaemic domestic economy offers little comfort.

Europe has emerged as a rare bright spot. The European Central Bank has made progress in its fight against inflation, cutting rates again in Q1. With rates nearing the ECB's 2% target, investor sentiment has shifted. The landmark €1 trillion German infrastructure and defence spending package has further buoyed confidence, offering a significant fiscal tailwind. While trade tensions with the US remain a risk, Europe's prospects are markedly improved compared to the frankly dismal 2024.

China, too, is showing tentative signs of recovery. After grappling with deflation and plunging consumer confidence, economic activity has picked up. Credit growth has accelerated, providing early indicators of renewed momentum. However, inflation remains subdued, and investment levels are still weak, suggesting that the path to sustained recovery will be gradual.

Nearby, Japan's trajectory remains modest but positive. The country continues its journey towards economic normalisation following decades lost to deflation, supported by strengthening wage growth and rising inflation. Corporate profits, capital expenditure, and consumer activity are all trending upwards. Nevertheless, looming US tariffs on automakers and steel exports threaten to disrupt this momentum, however, investors are broadly positive on the outlook for the country.

The first quarter of 2025 has been defined by extreme volatility, geopolitical upheaval, and the growing influence of political risk. Nevertheless, there are reasons to be optimistic; resilient economies, responsive fiscal measures, and

easing inflation in pockets of the world suggest that while challenges persist, there are exciting opportunities for investors.

Bond Markets

The first quarter of the year opened with a significant sell-off in government bonds, driven primarily by concerns over inflation. Whilst bond prices have recovered to some extent, inflationary pressures remain a major issue, particularly in the UK. Worries about the fiscal outlook and the risk of stagflation – a scenario characterised by stagnant growth, persistent inflation, and high unemployment – have weighed heavily on sentiment. The UK faces challenges, including record government borrowing and a projected £300 billion in bond issuance for the year, alongside negative economic growth. Some respite was found in inflation falling to 2.8% at the end of the quarter, however, the country’s fiscal position remains precarious.

In the US, 10-year Treasury yields declined more than was the case in the UK following the sell-off at the beginning of the year. Whilst there has been some disquiet resulting from some lacklustre economic data in the USA, for the most part, the drop in Treasury yields reflects uncertainty surrounding former President Trump’s unpredictable behaviour and frenetic trade and economic policy, and the effect those may have on the country’s economy.



Meanwhile, in Europe, bond yields remained significantly lower than the US and UK peers, as inflation eased further, and rates were again lowered. By far the most significant event of the quarter was Germany’s decision to suspend its constitutional debt brake. Greater fiscal stimulus will result in increased bond issuance, but its relatively low debt-to-GDP ratio keeps its fiscal health stable. Investors have started to price in the impact of aggressive fiscal spending throughout the rest of Europe, however, particularly as major defence spending initiatives are touted.

High-yield bonds and investment-grade credit performed reasonably well over the quarter, reflecting investor confidence in the strength of corporate balance sheets. Additionally, the regular interest payments from these bonds provided a steady source of returns. In contrast, long-term government bonds, known as gilts in the UK, struggled. This is because longer-term bonds are more sensitive to uncertainty around inflation, future interest rate decisions, and the overall economy, meaning investors have been cautious about locking their money away in long-term bonds that could lose value as perceptions amongst investors shift.

Fixed income markets will continue to be shaped by inflation dynamics, fiscal and trade policy decisions, and global economic growth trends.

Equity Markets

The USA's main stock market has dropped nearly 5% so far this year, with tech stocks tumbling over 10%, erasing months of gains. The decline has been particularly pronounced among the so-called "Magnificent Seven" — a group of major tech and AI firms that have been key drivers of market growth. This marks a stark contrast to 2024, where markets surged on expectations of Artificial Intelligence investment, as well as Trump's election-driven policies, including tax cuts, deregulation, and increased onshoring. However, mounting political uncertainty, elevated valuations, and fears of a hostile trade environment have dented that optimism.

Investor sentiment has shifted noticeably, leading to a notable rotation from US stocks to European and UK markets. A recent Bank of America survey revealed that a net 39% of institutional fund managers are overweight in UK and European equities, a significant rise from 12% the previous month and the highest level since mid-2021. Conversely, a net 23% of investors are now underweight in US equities, compared to a net 17% overweight in February. This 40-percentage-point swing marks the largest recorded shift in US equity allocations within a month.

Several factors are contributing to Europe and the UK's relative appeal. Increased defence spending has bolstered companies like BAE Systems, Rolls-Royce, Rheinmetall, and Thales. In addition valuations in Europe and the UK remain comparatively low, offering more attractive entry points for investors seeking value, and Europe in particular has been buoyed by announcements of huge fiscal stimulus packages from Germany.

Despite the UK's downgraded growth forecast per the Spring Budget, an emphasis from the Treasury on fiscal discipline and planned investments in defence and workforce training are providing markets with a clearer economic direction. This sense of stability is likely to further strengthen investor confidence.

Chinese equities have experienced a notable recovery in sentiment and performance. The Hang Seng Index is up 20% year to date, marking a significant reversal after years of underperformance. Stronger-than-expected economic growth and the prospect of additional fiscal stimulus have attracted global investors. Chinese tech companies, in particular, are gaining attention as potential alternatives to their expensive US counterparts.

Japan is continuing its slow march towards normalisation of economic conditions, after decades of deflation and sluggish growth. Wage increases are driving reflation, fostering a more positive economic outlook. Japanese value stocks have led market gains this quarter, despite volatility, as a factor of the weakening US Dollar. Whilst challenges remain, investor sentiment towards Japan remains increasingly positive.

Outlook

The volatility and shifts in investor sentiment during the first quarter of 2025 underscore the importance of a diversified portfolio. By spreading investments across regions and sectors, our portfolios have benefitted from a broader range of returns, moving beyond the concentrated US market.

Our decision to increase allocations to Europe and Asia in Q3 has been particularly rewarding, with both regions outperforming the US year to date. Likewise, our overweight position in UK equities relative to global indices has been supportive. These choices were guided by a disciplined focus on valuations and long-term opportunities rather than short-term speculation.



Recently, we reduced US equity exposure in favour of bonds, securing gains after two years of strong performance. This timely adjustment has worked well, with bond prices rising as US equities fell. Investors can take advantage of yields which are elevated from historical norms, enabling good risk-adjusted returns on a total return basis. This gives bonds a compelling investment case as a diversifier in multi-asset portfolios. Further, diverging fiscal policies and economic outlooks across regions also provide opportunities for active and strategic bond managers to outperform.

Whilst market volatility persists, driven by tariff uncertainties and geopolitical tensions, history shows that turbulent periods often present opportunities for long-term investors. Staying focused on fundamentals, maintaining a diversified portfolio, and resisting short-term noise remain key to long-term success.

Looking ahead, we remain vigilant and proactive. We will monitor economic data, geopolitical shifts, and market performance, making adjustments as necessary. Our commitment is to stay ahead of the curve and seize emerging opportunities, ensuring your portfolio remains well-positioned for the future.

All information sourced from: Financial Times, Trading Economics, Bank of America, Federal Reserve of Atlanta, Bank of England.



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Registered office: Bishop's Court, 29 Albyn Place, Aberdeen, AB10 1YL. Registered in Scotland (SC081852). Phone number: 01224 212222.