KEYSTONE

Tariffs and Trade Wars, what to make of it all?

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The sharp gains in equity markets that followed the re-election of Donald Trump as the 47th President of the United States in November last year has steadily evaporated over recent weeks following his inauguration. Markets are taking time to recalibrate to the new risks posed by his aggressive trade policies combined with a remarkable shift in the geopolitical landscape. We recently sat down with some of our preferred investment partners to discuss the important questions playing on investor's minds. Below is an extract from our conversation with James Douglas-Withers and James Ward, Investment Directors at Rathbones.

Q. VOLATILITY IS BACK WITH A VENGEANCE. WE WERE EXPECTING TRUMP 2.0 TO BRING ABOUT SOME STRUCTURAL CHANGES BUT THE SCALE AND SPEED OF CHANGES HAVE LEFT MARKETS REELING. HOW HAVE YOU NAVIGATED THIS TURBULENCE IN MARKETS?

JD-W. Overall we're positioned quite neutrally, neither risk-on or risk-off. Unpredictability has been the main theme so far from Trump 2.0, and we don't think there's a huge amount to gain from regularly changing our total equity exposure in response to what we think the administration might do next.

However, we have made some tweaks to where we've been investing. For example, we've turned more optimistic on the prospects for stocks in Europe motivated by the historic changes in European fiscal policy proposed in recent weeks, which in turn have been driven by developments

in US politics. While there will certainly be challenges for implementation, the sheer scale of the spending being discussed means that we think the growth outlook on the continent has improved, making equities there look more attractive given the big valuation discount relative to the US.

On the other side of the coin, we have been underweight emerging market equities for some time, and are maintaining this stance post-election. A key reason is that we expect emerging markets to be particularly exposed to heightened trade tensions and uncertainty under the Trump administration. Even away from China, countries that had benefitted from re-routing of trade flows during Trump's first term, such as Vietnam and Mexico, seem as though they will be in the firing line this time around.

Q. DO YOU BELIEVE THE FULL IMPACT OF TARIFFS ON GLOBAL TRADE ARE NOW BAKED INTO EQUITY PRICES OR SHOULD WE ANTICIPATE MORE PAIN BEFORE THINGS IMPROVE?

JW. It certainly doesn't seem as though the full impact was baked in at the beginning of the year. I think many investors believed that most tariff threats, and particularly those towards countries that have traditionally been seen as US allies, were primarily a negotiating tactic, which was logical based on the experience of Trump's first term.

I think what we've seen over the past few weeks reflects shifts in how investors are thinking about tariffs. First, they have seen Trump threatening measures that are more aggressive than those proposed on the campaign trail. All else equal that raises the stakes for potential economic damage. Second, they have also experienced the unpredictable nature of tariffs announcements. In and of itself, the uncertainty created by this could be economically damaging too.

Given these developments, it makes sense for investors to be a bit less optimistic on equities, so I don't think a full-blown trade is fully priced in yet. But nor should it be. The unpredictable nature of Trump suggests that there's also a material possibility that a deal with Canada and Mexico is reached in the months ahead. That could ease the uncertainty that has been weighing on markets of late.

Q. HAVE YOU HAD TO REVISE YOUR INFLATION EXPECTATIONS, AND DO YOU BELIEVE CENTRAL BANKS HAVE THE SCOPE TO DEAL EFFECTIVELY WITH THE FALLOUT FROM A GLOBAL TRADE WAR?

JD-W. We have been of the view that inflation is set to be structurally higher and more volatile in the 2020s than the 2010s for some time now. Our expectation is that several factors, including (but not limited to) continuing deglobalisation and global economic fracturing, will keep inflation above where it was in the ten years prior to the pandemic. The early experience of the second Trump administration seems to be validating our view. The President's approach to trade policy and international co-operation has been more aggressive than many expected so far.

Most major central banks should have the scope to bear down on any inflationary impact from a global trade war by raising interest rates if necessary, so we're not anticipating a rerun of the 1970s inflation. But they won't be able to prevent inflation entirely, and any action they take will have real costs in the form of weaker economic growth. Ultimately, a trade war will probably result in a higher inflation and lower growth environment than otherwise would be the case.

Q. MANY ARE NOW FEARING THAT A RISK OF A RECESSION IS IN FACT VERY REAL. WHAT ARE YOUR THOUGHTS?

JW. An imminent US recession is not our base case. While it is true that some of the latest economic data in the US has been weaker, we're also conscious that some temporary factors, such as winter storms and front-running of potential tariffs (particularly gold imports), may downplay the underlying strength of the economy. Our own recession model, which relies on indicators that have historically been the best early warning signals, doesn't suggest one is round the corner. Overall, it puts the probability of a US recession in the next year or so to be only a bit higher than the long-run historical average.

That said, we are cognizant of emerging risks to the outlook. In particular, it could be the case that a downturn caused by a tariff-imposed trade shock/uncertainty, or one driven by dramatic government layoffs and spending cuts, which both have limited historical precedent, renders usual warning signals less effective. Consequently, we're paying especially close attention to alternative data sources, such as more detailed unemployment data, than we might have done in the past.

Q. THE DRAMATIC WEAKENING OF THE TRANSATLANTIC RELATIONSHIP WAS SOMETHING NO ONE SAW COMING. SHOULD POLICIES LIKE 'AMERICA FIRST' LEAD TO A RETALIATION FROM EUROPE (POSSIBLY OTHER REGIONS TOO) BY REDUCING THEIR RELIANCE ON AMERICAN COMPANIES AND PRODUCTS (A PRIME EXAMPLE IS DEFENCE SPENDING IN THE EU), WHAT IMPACT IS THIS LIKELY TO HAVE ON BOTH US & EUROPEAN MARKETS, AND HOW WOULD YOU TAKE ADVANTAGE OF SUCH A SHIFT?

JD-W. The pace with which a new consensus has emerged in Europe to increase public spending on defence and infrastructure and reduce reliance on the US really has been remarkable for a group of countries that usually struggle to agree anything with much speed. To us, this suggests it is worth taking seriously, and we expect it to be a tailwind for European markets.

To be clear, we don't think it will be entirely plain sailing. There will be political and logistical challenges ahead to ramp up defence and infrastructure investment quickly, and some of the initial spending on defence may need to be directed towards foreign (particularly US) firms given

53 Davies Street, Mayfair, London W1K 5JH +44(0)20 7078 4855 help@keystone-capital.co.uk

the lags involved with increasing capacity for domestic production. What's more, with eurozone unemployment at an all-time low, there is the potential for the additional spending to put some upward pressure on inflation.

Ultimately though, we think European stocks will stand to benefit from this volte-face, and we are increasing our allocation to the region. As mentioned earlier, the scale of fiscal expansion alone is enough to believe the economic outlook has improved. In Germany especially, which is the largest economy on the continent, a long period of austere fiscal policy has left it with plenty of room to borrow, but crumbling infrastructure and sluggish growth which has weighed on the bloc as a whole. The move to borrow to invest is a welcome development that should improve the prospects of European firms that generate much of their revenue on the continent.

Q. WHILST THE NOISE AT PRESENT IS ALL COMING OUT OF THE US, ARE THERE OTHER RISKS (SYSTEMATIC OR UNSYSTEMATIC) THAT ARE CAUSING YOU CONCERN?

JW. While China has been in the headlines as the target of President Trump's tariffs, there has been far less coverage of the domestic economy there. Looking past recent export growth (which seems to be mostly driven by tariff front-running) the Chinese economy remains weak, with the government doing just enough to stabilise things, but not spark a rebound in economic growth.

It has been our long-held view that growth in China will continue to disappoint unless policymakers began to address structural issues, and we have seen few signs of this yet. A key problem is that the Chinese government continues to rely on investment-led growth model that has seen diminishing returns over the past decade or so. There have been no major attempts to stimulate the economy by generating more domestic demand for goods and services from households, who are still scarred from the ongoing property market bust. And despite an unchanged GDP target of "around 5%" at the recent National People's Congress, it was clear from the details that policymakers in Beijing aren't anticipating much of a turnaround in the economy this year. As a result, we think investors hopeful of a further recovery in Chinese equities are more likely to be disappointed than not.

53 Davies Street, Mayfair, London W1K 5JH +44(0)20 7078 4855 help@keystone-capital.co.uk

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Q. FINALLY, IT LOOKS AS THOUGH VOLATILITY IS HERE TO STAY, CERTAINLY IN THE SHORT TERM, PERHAPS EVEN THROUGH THE WHOLE TERM OF THE CURRENT US ADMINISTRATION. HOW DO YOU EXPECT TO MANAGE ASSET ALLOCATION TO CONTAIN VOLATILITY IN PORTFOLIOS AND YET CONTINUE TO DELIVER STRONG RETURNS?

JD-W & JW. Building the resilience of our portfolios to heightened uncertainty and volatility has been a key focus for us over the past twelve months. We've approached this in a few different ways.

Monitoring the duration of our fixed income holdings, reflecting the view mentioned earlier that inflation will be higher and more volatile than in the 2010s. More volatile inflation means more volatility for bonds, so shorter duration fixed income holdings can help counter that. But we also know that higher inflation increases the chance that stocks and bonds move together. That suggests long-dated fixed income wouldn't be as reliable an insurance policy as it has been in the past.

Maintaining a strategic holding of gold, which we believe can play an important diversifying role in portfolios. That's especially true now that the key demand driver appears to be geopolitical fracturing and US isolationism, which is prompting central banks and other institutions to diversify their reserve holding away from the dollar.

Holding an allocation in an actively managed macro strategy which can provide portfolio diversification and protection during periods of economic uncertainty or market stress, including when inflation is high.

Ultimately, geopolitical shocks can cause short term periods of volatility. However, this volatility can sometimes prove to be an opportunity to invest at attractive levels. It is worth bearing in mind that equities have delivered impressive returns over the longer term, despite wars and conflicts. It is therefore important as long term investors to remain invested through periods of uncertainty, to benefit from strong returns in the longer term.

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