Brewin Dolphin

Quarterly Update – Q1 2025

Performance Summary

The first 3 months of the year gave us reassuring signs that our active and differentiated investment strategies could both outperform index benchmarks in rising markets, as well as in falling markets. As we ended the final month of the first quarter global equities were already nearly 8% lower (in sterling terms), whilst portfolios were broadly flat. Whilst we believe the events of the past few days will only help to accelerate the long-term redistribution of capital, the fallout from President Trump's Liberation Day tariff announcement has sent global equity markets lower, dragging our investment strategies into negative returns as we finished our reporting period on the 5th April.

Quarterly Recap

Between January and March, news flow was dominated by the deteriorating finances of various Western governments, with many countries (including the UK) destined for higher taxes and spending cuts in their coming budget announcements. Government bonds globally deteriorated to reflect the worsening economic outlook, whilst the possibility of tariffs from the Trump administration kept central banks on edge regarding the risk of rising inflation. Interest rates still managed to fall slightly in the UK and Europe at the start of the year, which has helped to (temporarily) stabilise the government bond market.

In addition to the market scrutiny of government finances, cracks were beginning to appear in the somewhat evangelical idea of Artificial Intelligence. The announcement of an AI model created in China (DeepSeek) requiring less than 6% of the computing power of its US equivalent created a degree of uncertainty around the future returns from investing in data. This uncertainty has been compounded by Microsoft pulling out of a number of datacentre leasing contracts, and Amazon's GPU spot pricing (rental cost) reducing steadily throughout the year. These behaviours suggest there is already excess capacity for Artificial Intelligence datacentres in the market. Globally investors are starting to question the level of investment in data infrastructure already committed to by the largest technology companies, as well as the future profitability of these endeavours.

As we approached the end of the reporting period, on the 2nd April President Trump announced his global trade tariff plan. With very little rationale or logic regarding the calculations, the size and scale of the tariffs were considerably above expectations and stock markets globally corrected, with the biggest losses felt in the US technology sector. Within a few days the global stock markets lost nearly $10trn in value, as the odds of a global recession jumped markedly. As the days and weeks have passed since the original tariff announcement, the White House administration has tempered and amended their original rates, disregarding certain sectors (such as smartphones and electronics) entirely from import tariffs and providing almost all countries with a 90 day reprieve to negotiate with the US on trade, on a lower 10% baseline tariff rate. Whilst there are multiple theories as to why President Trump has backtracked on the original plan, it is most likely due to the sharp deterioration of the government bond market, which significantly increases the administration's refinancing and borrowing costs.

The notable outlier from President Trump's backsliding was China, who instead have been hit with export tariffs of 145%. China have retaliated in-kind with additional tariffs on US goods and services, igniting a significant trade war between the world's two largest economies.

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Portfolio Positioning

Making significant strategy changes in this environment would be incredibly difficult, considering both the unpredictability of President Trump's policies and the speed at which stock markets can change in value. As an example, on the day President Trump reduced his original tariff announcement the US equity market jumped 9.5%, more than the value of every company in the UK stock market combined. This increase in percentage terms is currently the 8th best single day move in the US equity market in its entire history (despite the average tariff rate in the US remaining at a 100 year high). This simply highlights the importance of picking the right investments and remaining invested.

Diversification has been the best strategy for protecting capital throughout the past 4 months, ensuring that client portfolios are not overly exposed to one asset class, sector or geography. Conversely, diversification has been extremely detrimental to portfolios over the past few years, as markets have been increasingly concentrating in one region (US) and sector (technology). We believe this is the start of a longer-term trend whereby investment capital will move away from these areas and reduce what is currently the most concentrated global equity market in history.

In addition to higher levels of diversification, we continue to hold a larger allocation to quality investments. If the global economy is tipped into recession this year, those companies with more resilient revenues will provide decent capital protection, as markets begin to deal with profit warnings from companies that are either economically sensitive or have significantly elevated expectations. We remain overweight in both our government bond exposure, as well as in areas of the equity market that are less vulnerable to a recession (such as healthcare, consumer staples and physical infrastructure).

Taking a longer-term view, we believe there remains a significant opportunity in what are now very small and unloved areas of the global stock market. With interest rates unlikely to fall back to zero given the ongoing inflation concerns, valuations (what you pay for a company) and the quality of balance sheets (the amount companies have in debt) will become an important component (again) of investing in equities. We continue to invest in many areas of the global stock market that are extremely undervalued relative to history and offer a great opportunity for patient investors. Global asset allocators have largely removed their exposure to insignificant sectors such as small and medium-sized companies, investment trusts and some of the smaller regional equity markets. This means a very small reallocation to these markets will have a profound impact on the returns. We have already seen some of this start to occur, with the cheaper markets of the UK, Europe and Asia outperforming the more expensively valued US market since the start of the year by a considerable margin. Ultimately, as globalisation moves into reverse, the value of a well-run and more localised business should start to meaningfully increase.

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Looking Forward

Making accurate predictions over the next 3 to 9 months has become increasingly difficult as more information is released regarding the intentions of President Trump. Ultimately President Trump's actions have increased the probability of a global economic recession in 2025, and as a result stock market volatility will remain heightened until we know the scale and extent of the economic slowdown. It is difficult to see a quick solution to the trade war between China and the US, and the tariffs implemented on the rest of the world will likely see world leaders attempt to reroute US trade to other countries in order to offset their own country's economic damage. Russia have dragged their heels on any temporary ceasefire to establish an end to the war in Ukraine and instead have stepped up their advances in order to secure more territory before negotiations take place. The potential bright spot geopolitically has occurred in Europe, where leaders (including the UK) are rallying together to implement long overdue spending increases in defence and infrastructure, which should filter through into their economies.

We expect markets to remain volatile as we progress through the Trump agenda and believe the elevated risk of an economic recession continues to warrant high quality, diversifying investments within our portfolios, such as government bonds and physical assets. Higher inflation will continue to hold back any sizeable interest rate cuts, particularly in the US, which in turn will make valuation and income more important. Without clearer signs of the capacity requirements and future profitability of Artificial Intelligence, there is a continued risk to the parts of the global stock market that are heavily exposed to this theme. The era of rapid globalisation has been firmly put in reverse by the US administration, and as a result investors will be looking beyond the largest companies in the world who have benefitted from multiple decades of increasingly frictionless trade. With valuations of these more domestically focussed companies currently at multi decade lows, there is a real opportunity to make sizeable returns (again) in small and medium sized companies, as well as traditional economy sectors such as healthcare, staples and industrials, all of which should suit our active management approach and ability to stock pick.

Disclaimer

IMPORTANT NOTE

The value of your investments can fall and you may get back less than you invested. Past performance is not a guide to future performance.

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