

QUARTERLY INVESTMENT REVIEW

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"In times of rapid change experience can be your worst enemy."
John Paul Getty

"Sooner or later every generation is shocked by the behaviour of interest rates."
S. Homer and R. Sylla, *A History of Interest Rates* (1977)

"Government is basically unfixable."
Elon Musk

Equity and bond markets advanced during the third quarter recovering from the turmoil following the introduction of tariffs in April. The MSCI World was up 7.3%, and the US 10-year bond rose by 1.3%. In the currency market the dollar continued to weaken and is now down 9.9% for the year. Reflecting this move Gold has risen by 47% year to date.

Bonds have been a poor investment over the last decade. The ten-year rolling return from US Treasuries to January 2025 was minus 1.3%, the worst performance on record. This resulted from a combination of the exceptionally low interest rates that prevailed during the 2010s, and the return of inflation five years ago. Every month over the last four years inflation has been above the Federal Reserve's 2% target. Alongside this poor performance Government debt has been ballooning. US National Debt exceeds \$37 trillion, equivalent to about \$279,000 per household (based on 132.6m households). For comparison the median net worth per household is about \$192,700 (the mean is about \$627,900). President Trump's One Big Beautiful Bill which passed into law in early July exacerbates the problem. It is estimated that the Bill will increase the US fiscal deficit by a further US\$3 trillion over the next decade. This from a President that campaigned in last year's election to improve the fiscal position. Elon Musk's attempts to rein in Government spending through the DOGE project have fizzled out, and the Administration has returned to running a budget well beyond its income. President Trump's attacks on the Federal Reserve Chairman, Jerome Powell, and threats to take away the Central Bank's independence have undermined faith in US bonds even more. In Europe the situation is even worse. Both the UK and France have appalling debt profiles which continue to deteriorate. These problems derive from the seemingly inescapable weight of entitlement spending and interest costs, aggravated by generous healthcare provision in the face of deteriorating demographics. The UK now spends twice as much on debt interest as education. France last managed to balance its budget in 1974. Nor are these chronic problems the result of low tax collection. Most European populations are over-taxed, and it will be difficult to squeeze more out of over-burdened taxpayers. The top 1% of UK income taxpayers already pay for 28.5% of the income tax paid. In terms of controlling spending both the UK and French Governments have failed in their attempts to reduce their expenditure, being forced to reverse even small reductions in social benefits. The continuing risk for government bonds in all these spendthrift countries is that when their governments cannot tax, they start to print money to pay the difference, thereby debasing their currency and eroding the value of their bonds. In effect it is default by another name.

Such precarious governmental finances would seem to be an unfavourable backdrop for equity markets, but they have shrugged off concerns. Since President Trump's tariff announcement in April this year the S&P500 has added \$35 trillion of value, equivalent to half the GDP of the US. Much of this increase is related to the technology sector. Since the release of ChatGPT in November 2022 markets have become obsessed by the view that AI (Artificial Intelligence) will lead to a surge of productivity and profitability. The largest companies are investing gargantuan sums to try and secure this, and it has led to an extraordinary increase in the market capitalisations of the beneficiaries. Nvidia's market cap, for example, has risen from \$308 billion to \$4.4 trillion in three years. Besides being the centre of AI, America also benefits from much more competitive energy prices, courtesy of the fracking revolution, which has helped both businesses and consumers. Unlike the US Government the S&P companies have much healthier balance sheets and with the economy expanding steadily these companies are extremely profitable. They are generating excess cashflow and a lot of that is returned to shareholders through share buybacks. Together with flows from retail investors \$7-8 billion dollars of liquidity flows into the US market every day. In most bull markets cashflow is absorbed by IPOs, as entrepreneurs take advantage of a strong stock market to list their companies. But this has not happened this time. Half the market consists of index tracking funds which cannot buy new issues because they are not yet part of an index. The rest of the market is very short term focused (the so-called pod shops), or too price sensitive to pay the high multiples that the current market is enjoying. So, the IPO market is moribund, and the flows that would have been diverted to new issues have remained bottled up in the existing index. As a result, the S&P resembles a cash machine which recycles much of the cash it produces back into the market. This is a perfect recipe for a bubble, but it will take higher interest rates or weak earnings to break this dynamic.

Globally markets are in a classic inflationary boom. Fiscal and monetary conditions in all major economies are loose. The US has abandoned DOGE and embarked on an aggressive stimulus package, further fuelled by the Federal Reserve starting to cut interest rates. In Europe nearly all countries are expanding their fiscal deficits, with a particularly significant boost in Germany, accompanied by the ECB also cutting rates. Japan is discussing its own fiscal easing whilst keeping its interest rates well below inflation. China has a budget deficit of 10% this year, while its interest rates are at record lows. These loose financial conditions are reinforced by low energy prices. A further boost is the falling dollar, which is highly stimulative for Emerging Markets. Markets reflect this. The financial, industrial and commodities sectors are outperforming, and Emerging Markets are outperforming Developed Markets. The fall in the dollar is encouraging investors into other parts of the world. The euro, for example, has gained 13.3% against the dollar this year. President Trump's rhetoric, particularly on withdrawing the US defence umbrellas from Europe, and tariff actions may necessitate a deeper unity between European countries, creating a less nationalist and more pan-European approach. This could result in significant cross-border consolidation in sectors such as defence, financials and telecoms to create European champions which invest locally and compete globally. National interests make this hard to achieve but there have been tentative moves in this direction,

and a precedent from the 1970's that proves this can be accomplished is Airbus, which was formed as a strategic response to Boeing. For Emerging Markets, the weaker dollar is crucial due to it leading to lower import costs and rate cuts which improve growth. Investors have been and are underweight, so this year's strong performance is partly adjusting that, as investors reweight to this neglected area. Furthermore, Emerging Markets have followed far more orthodox policies than elsewhere so the foundations for strong economic growth and stock market performance are in place.

Entering the final quarter of 2025 there is a sense that markets are complacent. The strong performance of gold reflects this, particularly as a haven against a blow up in European sovereign bonds. After such a strong market there are pockets of overvaluation, and any disappointment on growth or AI would leave markets vulnerable, particularly in the US. However, while bonds enjoy more yield than previously, the returns remain unattractive, and cash is being slow roasted by Central Banks fixing interest rates at negative real yields. This background is forcing investors into stock markets where there remains a strong earnings story. While these conditions endure markets are likely to continue to rise.

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