Summer 2025

market outlook.

Brought to you by the Investment Management Team

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The UK Economy

Despite attempts to shift blame onto the opposition, Labour is reaching the end of its grace period with the UK public after twelve months in office. Chancellor Rachel Reeves' announcement to tighten fiscal rules in the name of long-term economic growth has already seen partial retreat, with proposals to cut social benefits and cap pensioner entitlements shelved. These reversals have formed the basis of investor speculation around the upcoming budget and how it will balance political pressures with economic realities.

The UK economy continues to show cautious resilience in Q2. The labour market is under moderate strain, with unemployment rising slightly due to increased employment taxes, trade policy uncertainty, and subdued business sentiment. However, consumers remain healthy: household savings are high, debt levels are manageable, and the housing market (though soft) is adjusting. While inflation remains above target, signs of easing are emerging. Softer pay growth and waning pricing power among firms have helped reduce the risk of it becoming entrenched, with pressures expected to moderate further into 2026. As the Bank of England edges closer to rate cuts, sentiment across equity markets and among investors could see a welcome boost.

The UK is taking steps to revive its financial services sector. After years of regulatory tightening, that arguably weakened global competitiveness, the government is now focused on reform. Priorities include streamlining regulation, boosting FinTech and digital finance, improving access to global markets, and fostering a more inclusive and skilled financial workforce. These reforms are supported by a resilient pound, underpinned by interest rate differentials and steady capital inflows.

Despite ongoing domestic challenges, UK markets are performing strongly, thanks to the FTSE 100's global exposure, diverse sector composition, and historically attractive valuations compared to peers. The UK has also managed to avoid much of the tariff-related noise that has befallen other global economies since President Trump took office and has made notable progress on trade deals with the EU, India, and especially the U.S. (which offer the potential to expand exports, spur economic growth, and strengthen investor confidence).

The European Economy

European markets delivered a stronger-than-expected performance in the first half of 2025, supported by a combination of fiscal announcements, improved sentiment, and very low starting expectations. However, the rally seems rooted in temporary relief rather than durable recovery. With key positives like post-election clarity and defence spending largely priced in, momentum may be hard to sustain through the second half of 2025, with Europe seemingly the only region to refrain from pricing in tariff uncertainties.

Fiscal policy and increased investment in defence and infrastructure have provided near-term support, particularly to sectors like aerospace and industrials. In Germany, these measures helped offset some domestic weakness, but the broader economic picture across the region remains fragile. Growth data continues to underwhelm, manufacturing is sluggish, and structural challenges remain unresolved. Given that much of the recent performance has been sentiment- and policy-driven, rather than fundamentally supported, there is little visibility on what might carry the rally forward.

The European central accommodative stance cutting rates from 4.50% to 2.15% since May 2024 has provided some support, but its policy flexibility is increasingly constrained. Notably, the euro has appreciated nearly 14% year-to-date, driven by strong capital inflows despite widening interest rate divergence with the U.S. a reversal of typical currency dynamics. The stronger euro now poses a headwind to eurozone exporters, and without a pivot in U.S. monetary policy, the ECB faces limits to further easing.

The recently agreed EU–U.S. trade deal has helped ease transatlantic tensions in the near term, but its longer-term implications are less clear. While the U.S. reduced auto tariffs to 15%, the EU made broader concessions, including eliminating its own 10% auto tariff and committing to significant U.S. energy imports. The lack of enforceable detail raises questions about the deal's durability and impact on Europe's trade balance. With few new growth catalysts, or structural headwinds, particularly in autos, one should remain cautious on European equities, and indeed the market seemingly ignoring the pricing in of tariffs threats year to date.

The US Economy

As we expected, U.S. markets rebounded sharply from their post-Liberation Day lows. President Trump's tariff threats, once viewed as destabilising by investors are now interpreted as tactical opening gambits rather than policy certainties. Investors have become accustomed to policy reversals, pauses, and reductions behaviour now colloquially summarised as "TACO" (Trump Always Chickens Out); a pattern that's helped temper volatility and spark recovery rallies with each trade breakthrough or pause. Proposed tariffs of 10% and 15%, aimed at countries with trade surpluses and deficits with the U.S. respectively, remain unenforced, leaving room for continued negotiations. Separate agreements with Canada, Mexico, and China, alongside ongoing diplomatic discussions, signal a broader shift toward easing global trade tensions. Yet, in a familiar pattern, implementation has once again been postponed following the 1st August deadline.

While markets priced in what they believed to be a likely prospect of interest rate cuts from the Federal Reserve this year, policymakers have held interest rates at 4.25-4.5%, maintaining a data-dependent stance. This resolve has also held firm despite continued bouts of pressure from President Trump to cut rates. Policymakers have cited the uncertain impact of tariffs on inflation and broader economic indicators. While tariffs have introduced short-term volatility, inflation has remained contained, likely due to firms front-loading imports or absorbing cost pressures through margin compression. Although price pressures may still arise further along the supply chain, forward-looking indicators such as the Producer Price Index (PPI) suggest that these pressures remain subdued for the time-being.

Broad economic fundamentals continue to demonstrate resilience. In Q2 2025, the U.S. economy expanded at an impressive, annualised rate of 3%, marking a sharp turnaround of the 0.5% in Q1 which was fuelled by aggressive front-loading of imports ahead of tariffs. The labour market, while cooling slightly, remains near historic strength, and real wage growth is supporting consumption evidenced by robust retail sales figures. This ongoing consumer strength provides a crucial offset to external uncertainties stemming from trade policy and reinforces the Fed's measured approach to monetary policy.

Adding to the constructive narrative, the U.S. has softened its stance on China, not only on trade but also technology, including the decision to ease restrictions on older-generation Nvidia chips. While narrow in scope, this move signifies a shift from confrontation to collaboration. On the heels of January's $500 billion AI investment pledge, President Trump unveiled a new $92 billion AI Action Plan, further entrenching U.S. leadership in emerging technologies. These initiatives provide further momentum for the Magnificent Seven tech giants to maintain their status as drivers of market performance. Investment flows, once diverted amid tariff-related uncertainty, are now making a confident return underpinned by resilient fundamentals and clearly more pragmatic trade dynamics.

The Japanese Economy

Several factors suggest that a cautious approach to Japan may be warranted this quarter. The U.S. and Japan recently reached a trade agreement that reduces planned automotive tariffs from a proposed 27.5% to 15%. The current deal - more favourable than that initially anticipated by investors - triggered a brief rally in financial markets having helped to ease some aspects of global uncertainty. However, while the lower tariff rate appears beneficial, it's a double-edged sword: it has compounded the competitive pressures facing Japanese automakers by fuelling appreciation of the yen. This currency shift may prompt firms to raise U.S. prices to protect profit margins, potentially undermining their market position in Japan.

Prime Minister Shigeru Ishiba's Liberal Democratic Party lost its parliamentary majority in June, causing mounting pressure for his resignation. While Ishiba has denied any intention to step down, a resignation after such a brief tenure could trigger an internal power struggle within a party that is already fending off rising competition from other right-leaning parties. Combined with the potential risk of stalled reforms and delayed policy implementation as this political situation plays out, uncertainty may dampen investor sentiment and introduce greater caution into markets.

Early 2023 marked the start of a strong run for Japanese mega-cap stocks, driven by optimism around the Tokyo Stock Exchange's introduction of new price-to-book rules. However, nearly half the companies on the exchange still trade below book value, making them less appealing to investors. This could lead to a rotation back into smaller-cap stocks, particularly as a stronger yen enhances the purchasing power of Japanese importers, which tends to benefit smaller, domestically focused firms.

Japan is seeing moderate inflationary pressures, even while the headline rate eased to 3.5% in May 2025 from 4% at the beginning of the year. A stronger yen has helped curb energy-related price increases by reducing the cost of imports. However, soft consumer demand and shrinking real wages have constrained businesses from raising prices and complicated their potential revenue growth (total wage growth rose just 1% year-on-year in May but fell 2.9% in real terms). After executing two incremental interest rate hikes (bringing the benchmark rate to 0.50%), the central bank is also now approaching policy from a more dovish stance as it is largely the record stimulus that is supporting the moderate inflation.

Emerging Markets & Asia Economy

As anticipated, the headline-grabbing tariff rhetoric from both China and the U.S. ultimately gave way to a more pragmatic approach. Any signs of progress or pauses in tensions have supported markets. While trade negotiations remain ongoing, the two economies are deeply interconnected, and recent developments provide increased clarity that tariffs will be far less severe than initially feared. U.S. has softened its stance on restricting AI-related technology exports, allowing access to Nvidia's older-generation chips. While this is unlikely to slow China's broader push for technological self-sufficiency, it signals a more constructive tone in bilateral relations.

Though near-term data remains skewed by trade policies and amplified by front running consumption amidst tariff threats, supportive domestic stimulus programmes and compelling valuations continue to drive investor confidence. China is currently drafting its 15th Five-Year Plan (2026–2030), which is set to prioritise technological innovation, economic durability, and sustainable growth. The previous plan was marked by the disruptions of COVID-19; with a less volatile backdrop, the new framework is expected to provide a tailwind for markets.

Trade discussions between India and the U.S. face short term headwinds, notably the introduction of 25% tariffs on select goods. The U.S. and India maintain a strong relationship and negotiations are expected to continue in the coming weeks, with the view to these tariffs being reduced as we have seen previously. However, in key sectors like agriculture which employs nearly half the population, and where India maintains a firm protectionist stance, compromises are likely to remain off the table, a position expected to be recognised by U.S. counterparts. Given U.S. demand accounts for just 2% of India's gross domestic product, the immediate impact on growth could be minor. India's outlook remains strong, supported by reforms, favourable demographics and rising investment flows amongst other factors.

Latin America remains relatively shielded from global tariffs and geopolitical tensions. Earlier concerns over China's rising influence, particularly around the Panama Canal, are now giving way to emerging investment opportunities. China continues to deploy capital in Brazil and Peru, with the ambitious Interoceanic Railway poised to reshape regional trade flows. Broader trends such as re-globalisation, selective decoupling, and strategic infrastructure investment, point to long-term potential across the region.

Fixed Interest

Government bond yields have remained elevated this quarter, although moves have been less pronounced as markets have settled down since the initial tariff shock. Meanwhile, longer dated bonds have underperformed, resulting in a steepening of the yield curve.

The majority of the volatility in fixed income markets has stemmed from government bonds. Spreads on corporate bonds remain tight and have shown little material volatility; they have continued to tighten, although certain areas of the market still offer good value, and investors are still adequately compensated for default/downgrade risk.

Despite tight spreads, starting yields are appealing and are the best indicator of medium-term returns for investment grade credit.

Overall, yields remain attractive, though concerns persist about potential supply and demand imbalances within the fixed income market.

If you would like to discuss this or any other aspect of your portfolio, please do not hesitate to contact us on 01423 501 401, Monday to Friday 9am-5pm or you can email us at info@mzltd.co.uk

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