Q2 2025 Market Update

The Perspective Investment Strategies had a strong second quarter, recovering the losses suffered during the first quarter. This was achieved despite increased geopolitical risks and the break out of conflict between Israel and Iran. The conflict had minimal impact on financial markets, other than the oil price which rose 11% to $78pb before falling back below $70pb following a pause in hostilities. The US$ fell approximately 7% in Q2, following a drop of 6% in Q1 as sentiment towards the US$ as a safe haven asset weakened and investors continued to be concerned about the potential impact of tariffs on the US economy, within the context of softening inflation.

Asset Class Returns (GBP)

EQUITIES	Performance
MSCI World (ACWI)	4.70%
FTSE 100	2.57%
S&P 500	4.24%
Eurostoxx 50	4.21%
Nikkei 225	10.95%
MSCI Emerging Markets	4.93%

BONDS	Performance
UK Gilts	0.94%
UK Index Linked Gilts	0.66%
UK Corporate Bonds	1.90%
Emerging Market Debt	-3.76%

PROPERTY/ COMMODITIES	Performance
Global Property	-3.72%
Gold ($)	4.89%
Oil ($)	-9.84%

With concerns around US tariffs and geopolitical tensions in the Middle East easing, at least for now, the stage appears set for further gains in equities, particularly in the US. In contrast, commodities are likely to continue underperforming, while cautious central bank policy and, in some regions mounting fiscal concerns may limit the performance of government bonds.

After taking a hit at the beginning of April following Trump's "Liberation Day" tariff announcements, equities were the strongest performing asset class in GBP terms in Q2. The Nikkei 225 outperformed, increasing 10.95% on the quarter and reversing its marked drop in Q1. UK equities had the weakest performance at 2.57%, falling short of its strong performance in the previous quarter.

UK bond markets posted gains in Q2 following the declines registered in Q1. Gilts rose by 0.94%, fully reversing the loss from the previous quarter while corporate bonds delivered a more robust gain of 1.90% to add to the modest increase recorded in Q1.

Global property prices fell by 3.72% on the quarter following a decline of 1.38% posted in Q1 2025. Yields are being weighed down by the prospect of higher-for-longer US interest rates despite the potential for rates to fall in Europe and UK this year.

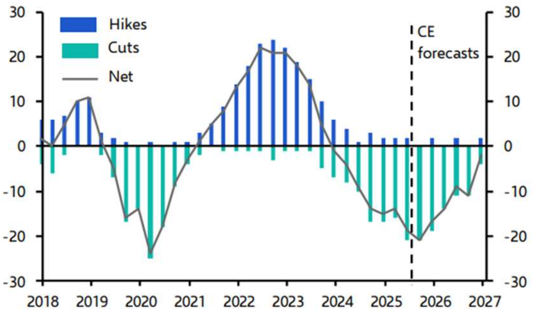
Brent crude oil prices fell by -9.84% in Q2. Prices started the quarter at ~$75pb, and fell throughout April, reaching $62 in early May. In response to the Israel-Iran conflict, oil prices saw a risk premium of ~$10-15pb and rose again, peaking at $78.8pb on 19 June. With tensions between the two countries having now subsided, prices have retreated once again and further gains in oil prices are likely to be constrained given excess oil supply.

Economic Outlook – Global economy to weather geopolitical headwinds

Global – World economic growth is set to slow in the next two years, as Trump's policies weigh on US activity and fiscal policy proves less supportive of growth in China. US tariffs will weigh on global trade but as long as countries limit their retaliation and China is able to reroute most of its exports, the overall hit to global exports should be fairly modest. Inflation should continue to moderate, giving central banks leeway to press on with interest rate cuts. But a tariff-induced rebound in core goods inflation in the US is likely to keep the Fed on the sidelines for the remainder of 2025.

So far, tariffs have had a negligible impact on US activity and price pressures, but both tariffs and immigration curbs are expected to weigh on US GDP growth in the coming quarters. Meanwhile, looser fiscal policy will provide a prop to growth in Germany, but not enough to lend a meaningful boost to expansion at the euro-zone level. Nonetheless, the relatively limited impact of tariffs in most non-US Developed Markets (apart from Canada) means that the US economy's outperformance will come to an end.

Chart 8: Number of Rate Cuts/Hikes by Major Central Banks

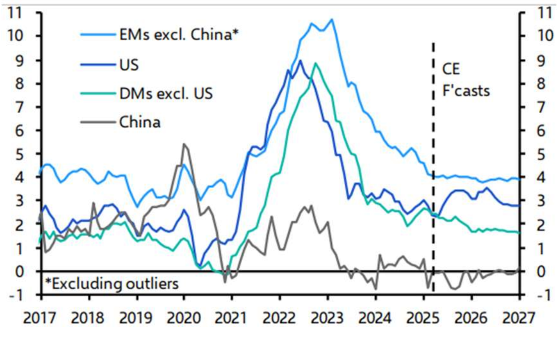


In China, although official GDP figures show growth around the 5% target, activity as measured by Capital Economics' China Activity Proxy (CAP) has slowed sharply. Growth is expected to fall further to 3.5% this year, given that tariffs are just one of several headwinds facing exporters, and fiscal policy measures are unlikely to provide any meaningful uplift to domestic demand.

Among other Emerging Markets, we are particularly optimistic about India's growth prospects. The economy began the year with robust momentum in Q1 and, despite a dampening effect from tighter fiscal policy, growth is likely to outpace other EMs. In addition, India so far remains insulated from US tariffs, limiting their negative impact.

Headline inflation is close to target in many Developed Markets. While core inflation remains elevated in some cases - particularly in the UK - a further cooling in labour markets is expected to ease price pressures in due course. The US is a notable exception, where upcoming tariffs are likely to push core PCE

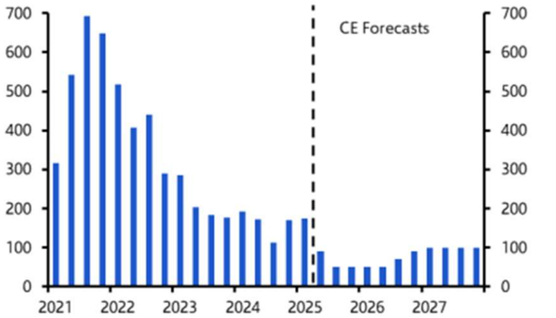
Chart 6: Headline CPI Inflation (%)



inflation slightly above 3% later this year. (See Chart 6.)

A key upside risk to inflation is a renewed escalation in the Israel-Iran conflict, which could drive oil prices to $100 or above and keep them elevated. In such a scenario, headline inflation in developed markets could be around 1 percentage point higher this year. However, with the US-brokered ceasefire currently holding, this risk has receded somewhat.

Chart 12: Change in Payrolls (000s, Monthly Ave)



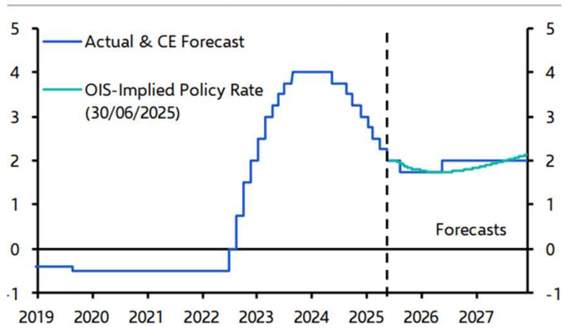
With inflation more contained, most central banks will press on with rate cuts in the coming quarters. Although the peak of the global policy loosening cycle has likely passed, most central banks are still expected to lower rates in the second half of this year, with the Federal Reserve the exception in holding off rate cuts until early 2026. (See Chart 8).

US – GDP growth came in at 2.0% y/y in Q1. While tariffs are expected to have only a modest effect on economic activity, GDP growth is still projected to slow to around 1.5% annualised. Tariffs are anticipated to lead to a one-off increase in the price level, rather than a prolonged period of elevated inflation. Nevertheless, with core PCE inflation forecast to rebound to just over 3% later this year, and staying above target, the Federal Reserve is expected to remain cautious about the risk of second-round effects, particularly if labour market conditions remain tight. Given this backdrop, the Fed is expected to keep rates on hold throughout this year, with two 25 basis point cuts projected in 2026.

Imports have already declined following the Q1 surge to avoid tariffs, and a further decrease of around 4% is anticipated over the coming 12 months. The effect of tariffs on US exports has thus far been muted, despite the trade-weighted dollar weakening, since most countries have implemented only modest retaliatory tariffs on the US.

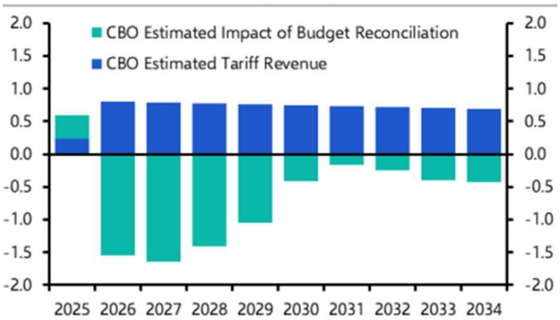
As GDP growth softens, payroll employment gains are expected to decline to below 100,000 per month. (See Chart 12). With immigration restrictions continuing to constrain labour supply, the unemployment rate is expected to remain low, peaking at only around 4.5%.

Chart 23: ECB Deposit Rate (%)



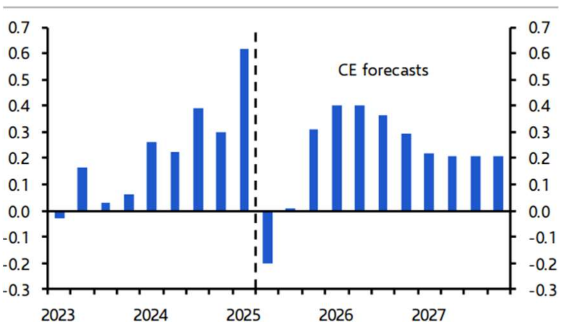
On the fiscal side, Congress passed the budget reconciliation which is expected to cost around $2.5 trillion over the next decade. Some of the extra spending, however, is due to be offset by additional revenues generated from tariffs reducing, deficits after 2030. (See Chart 13.)

Chart 13: Federal Budget Impact (% of GDP)



Euro-zone – The economy expanded rapidly in Q1 largely thanks to a surge in exports to the US from Ireland and Germany. However, the subsequent drop in those exports in April is likely to weigh on Q2 growth. With higher US tariffs dampening external demand, growth is expected to slow further in Q2 and Q3, before gradually picking up thereafter. (See Chart 18.)

Chart 18: Euro-zone GDP (% q/q)



Later this year, the lagged impact of lower interest rates should continue to support the most rate-sensitive parts of the economy, such as housing investment. Meanwhile, the household saving rate is likely to keep falling from its elevated level, supporting consumption growth even as real income gains slow.

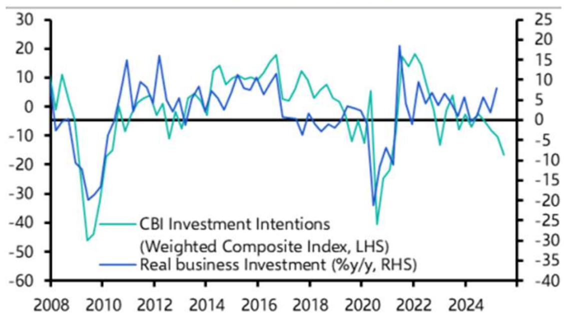
Headline inflation has already fallen below the ECB's 2% target and is expected to continue declining to around 1.5% over the next couple of years. Barring any major shocks, the ECB appears to be close to the end of its easing cycle. One further rate cut is anticipated in September, bringing the deposit rate to 1.75%. Over the longer term, however, interest rates are more likely to rise than to fall further. (See Chart 23).

UK - Real GDP rose by 0.7% q/q in Q1, but the acceleration mainly reflected export shipments brought forward ahead of the 10% US tariff that took effect in April, rather than any underlying improvement in domestic momentum. US tariffs are not expected to have a material direct impact on UK GDP, but softer overseas demand means that net trade will be a drag on growth in both 2025 and 2026. Additional headwinds to UK growth stem from the continued drag from April's increase in employers' National Insurance contributions, as well as weak business confidence weighing on business investment. (See Chart 35.)

The 0.9% fall in payroll employment in the year to May shows that firms have cut their hiring plans in order to contain their labour costs. This has contributed to a looser labour market, with the unemployment rate rising from 4.1% late last year to 4.6% in April. It is only a matter of time before wage growth slows from the recent rates of 5.5% to a rate of 3.5% - a pace more consistent with the 2.0% inflation target.

CPI inflation is expected to remain near May's 3.4% level for the next few months but then is

Chart 35: Business Investment Intentions & Actual Business Investment



set to rise to 3.8% in September. Beyond this, the easing in wage growth should contribute to

CPI inflation falling to 2.0% in late 2026 and below 2.0% in 2027. As such, the Bank of England is likely to continue cutting interest rates by 0.25% a quarter, from 4.25% now until they reach 3.00% in 2026.

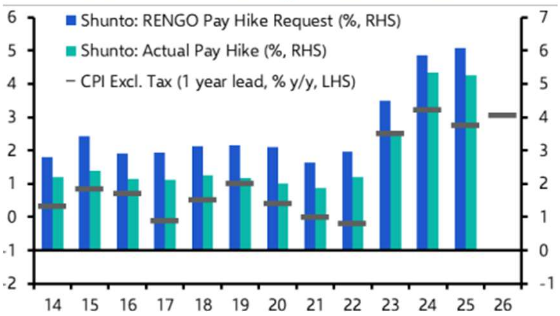
Fiscal policy is also set to tighten. To maintain a £9.9bn buffer under her fiscal rules, the Chancellor may need to raise up to £22bn in the autumn Budget, most likely via higher taxes. This prospective fiscal drag would add another headwind to growth and support more rate cuts.

Japan – GDP rose by a strong 1.7% y/y in Q1 supported by the surge in export volumes as firms tried to front run tariffs at the start of the year. Growth is set to soften in the coming months, with Japan's economy forecasted to expand by just 0.9% this year.

Downside risks to growth stem from the recent surge in inflation to a two-year high, which has weighed heavily on consumer confidence. In addition, the reversal of last year's temporary income tax cuts is set to reduce real household incomes this year, following strong gains in 2024. On the upside, there is still scope for the household saving rate to decline further, which could help sustain robust consumer spending and support GDP growth.

The labour market remains extremely tight, with firms reporting the most severe labour shortages since the early 1990s. Given higher inflation, another substantial increase in wages appears likely in 2026. (See Chart 29.) Companies should be able to afford higher labour costs given that trade tensions are not expected to significantly affect profitability.

Chart 29: Shunto Pay Hikes & Inflation



The recent rise in headline inflation to around 3.5% has been driven largely by an acceleration in food inflation, which is unlikely to be sustained. That said, the Bank of Japan's measures of underlying inflation have also risen with inflation excluding energy and fresh food projected to remain above the Bank's 2% target for the foreseeable future. As a result, the BoJ is likely to raise interest rates before the end of 2025 and, with real rates still deeply negative, the policy rate may reach 1.5% by end-2027.

China – Official GDP data showed China's economy maintaining solid growth of 5.4% y/y in Q1. However, Capital Economics' China Activity Proxy (CAP) suggests a weaker pace of expansion at 3.7% y/y. (See Chart 57.) Growth is projected to decelerate to 3.5% as US tariffs weigh on exports and fiscal support fails to boost domestic demand.

Chart 57: CE China Activity Proxy & Official GDP (% y/y)

Even with US tariffs expected to settle around their current 40% level, China's GDP will be just 0.3% lower over the next two years as the trade-weighted depreciation of the renminbi and rerouting of exports via third countries limits the impact of higher US tariffs on exports.

Consumer spending seems to have picked up in recent months, but that is likely a temporary boost due to the consumer goods trade-in scheme. Despite officials pledging to support consumption, there has been little follow through in terms of policies that would sustainably increase demand. Meanwhile, the recent uptick in retail sales has been offset by weaker investment, primarily due to a deeper drop in property investment. Manufacturing investment continues to grow at a solid pace, but overcapacity is expected to persist, causing deflation to extend into 2026.

This year's fiscal loosening has been front-loaded, as most of the 1.8 percentage point widening in the combined fiscal deficit budget planned for 2025 has already occurred. Under current plans, bond issuance will decline over the remainder of the year. Given the usual lag between bond issuance and fiscal outlays, government expenditure may rise slightly in the near term, but fiscal policy will provide less support to growth as the year progresses.

Asset Allocation Views

Bonds – US treasuries lagged in Q2, having been at the epicentre of the global market tumult in early April. By contrast, most other DM fared well. Swiss, Italian and Euro-zone bonds were the high performers with returns of over 7% in USD terms that were driven largely, though not solely, by currency appreciation against the dollar. Looking ahead, US Treasuries are expected to continue offering modest returns, while most other government bonds are also set to underperform. Furthermore, with the US dollar projected to strengthen, returns on non-dollar-denominated bonds could deteriorate further.

Corporate bonds – Corporate credit spreads surged after "Liberation Day" but have largely retraced to previous lows. However, investment-grade corporate bond yields (currently c5 %) are well above their 10-year average and offer an attractive income opportunity for investors seeking stable returns. Despite relatively low credit spreads over Treasuries, fundamentals remain solid: companies maintain strong balance sheets, issuance is subdued, and inflows into IG bond funds are robust. With the Federal Reserve potentially easing later this year, these bonds may also benefit from capital appreciation. The asset class offers a compelling combination of current yield, credit quality, and potential upside — making them attractive for investors in an environment of modest growth and low recession risk.

Equities – Stock markets, especially in the US, had a tricky start to the quarter as President Trump's tariff announcements raised fears of a global trade war. In most cases, the markets bottomed out and recouped their losses after Trump paused the country-specific tariffs. With the worst seemingly over, US equities should perform well during the rest of 2025 due to reduced policy uncertainty, improving risk sentiment, and continued AI progress. Japan's market may benefit from a tech-heavy focus and higher inflation while weaker currencies and a positive risk environment should support equity returns in the UK.

Emerging market equities – EM equities have broadly outperformed their DM peers recently. While this is unlikely to continue, EM equities should fare well in absolute terms, though commodity exporters may struggle. Of note is that China's tech sector has started to catch up with its global peers, thanks in part to the DeepSeek breakthrough but also because the authorities have adopted a more constructive attitude towards the private sector. Outside China, local currency returns converted to US dollars will be reduced if the US dollar strengthens as expected.

Commodities – Commodity market trends in Q2 reflected existing patterns, with precious metals surging and most other commodity prices moving sideways, at least in aggregate. Oil prices ended the quarter lower after significant volatility related to the escalating Israel-Iran conflict. Tensions have now eased, as has volatility, so the focus is shifting back to physical market fundamentals. With Chinese demand unlikely to rebound and OPEC+ policy bringing more oil supply into the market over the next 18 months, oil price gains will be limited.

Industrial metals – Benchmark metals prices have risen in the US due to the doubling of US tariffs on steel and aluminium. This has contributed to a tightening in physical markets outside of the US too, lifting prices globally. Over the longer term, however, prices are likely to fall given the new supply expected to come on stream in China, alongside a lack of improvement in demand while China's construction sector continues to retrench.

Precious metals – Gold prices rose throughout Q2 as the traditional drivers of lower interest rates and a weaker dollar reasserted their influence. The geopolitical and macroeconomic backdrop are also supportive of gold prices. However geopolitical tensions may fade and should this lead to increased investor risk appetite, safe haven demand may soften.

Final Word

As financial market volatility has now reduced to normal levels, we are undertaking a strategic review of the portfolios to ensure they remain robust in the changing economic environment. This will lead to a rebalancing of risk in both the equity and defensive positions within the portfolio. We are looking to reduce our exposure to growth stocks in favour of more defensive value holdings whilst introducing corporate bond exposure and reducing our duration in gilts. This will ensure our portfolios remain robust and well positioned to capitalise on future opportunities in markets as they arise.

Scot Laing (Chartered FCSI)
Managing Director
Sources: Capital Economics; Bloomberg; FE Analytics
Publication Date: 10/07/2025