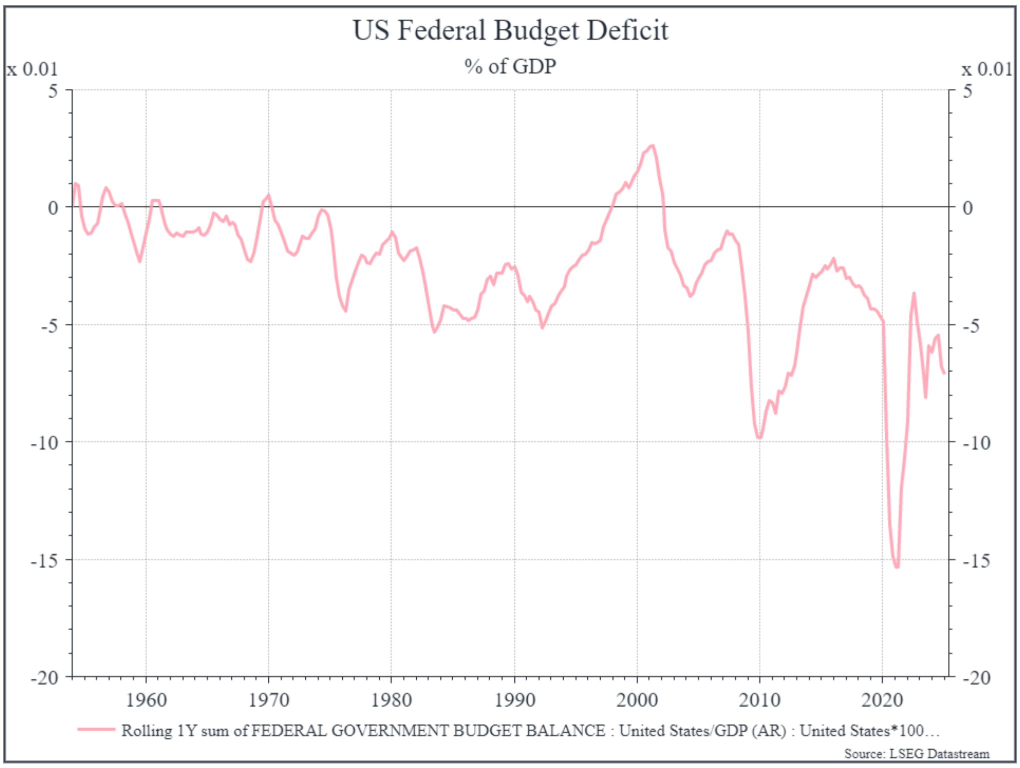
Focus on the Bond Market - AAT Observatory, 22nd May 2025

Last week, Moody's, one of the leading credit rating agencies, downgraded its rating on US sovereign debt by one notch (on a 21-notch scale!). We wanted to dig into this in a bit more detail.

Rating agencies have traditionally held a bit of a hybrid role in the financial system. They are private companies and do the same analysis that many other financial institutions do. But it's still a signal and ratings agencies have historically had greater sway, not least because many investors are required to consider their ratings when deciding what instruments they can potentially buy. So, in theory, a downgrade from one of the major ratings agencies might carry more weight than you'd expect. And we did see the cost of borrowing rise for the US government after the announcement.

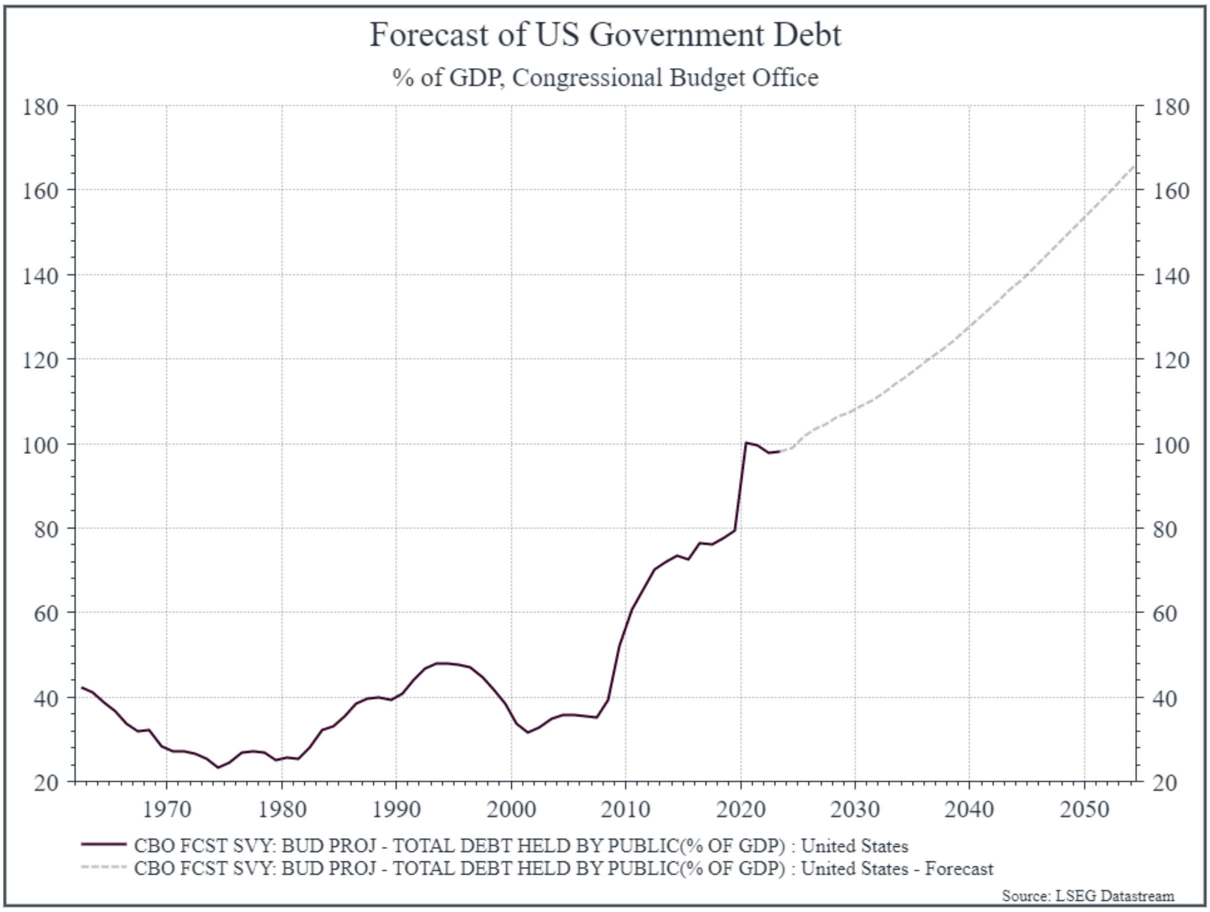
But it's worth noting that that hasn't always been the case. Another major ratings agency, S&P, downgraded US debt from its highest level back in 2011, while the third, Fitch, did the same in 2023. In the past, investors have generally looked past the ratings downgrades and bond yields barely reacted. If anything, Moody's was the outlier for not having downgraded the credit rating on US debt.

Is something different this time? It's too soon to tell, but the downgrade comes at a time when US government debt is in focus for a couple of reasons. At a headline level the federal budget deficit has been deteriorating over the past twenty-five years (see chart below).

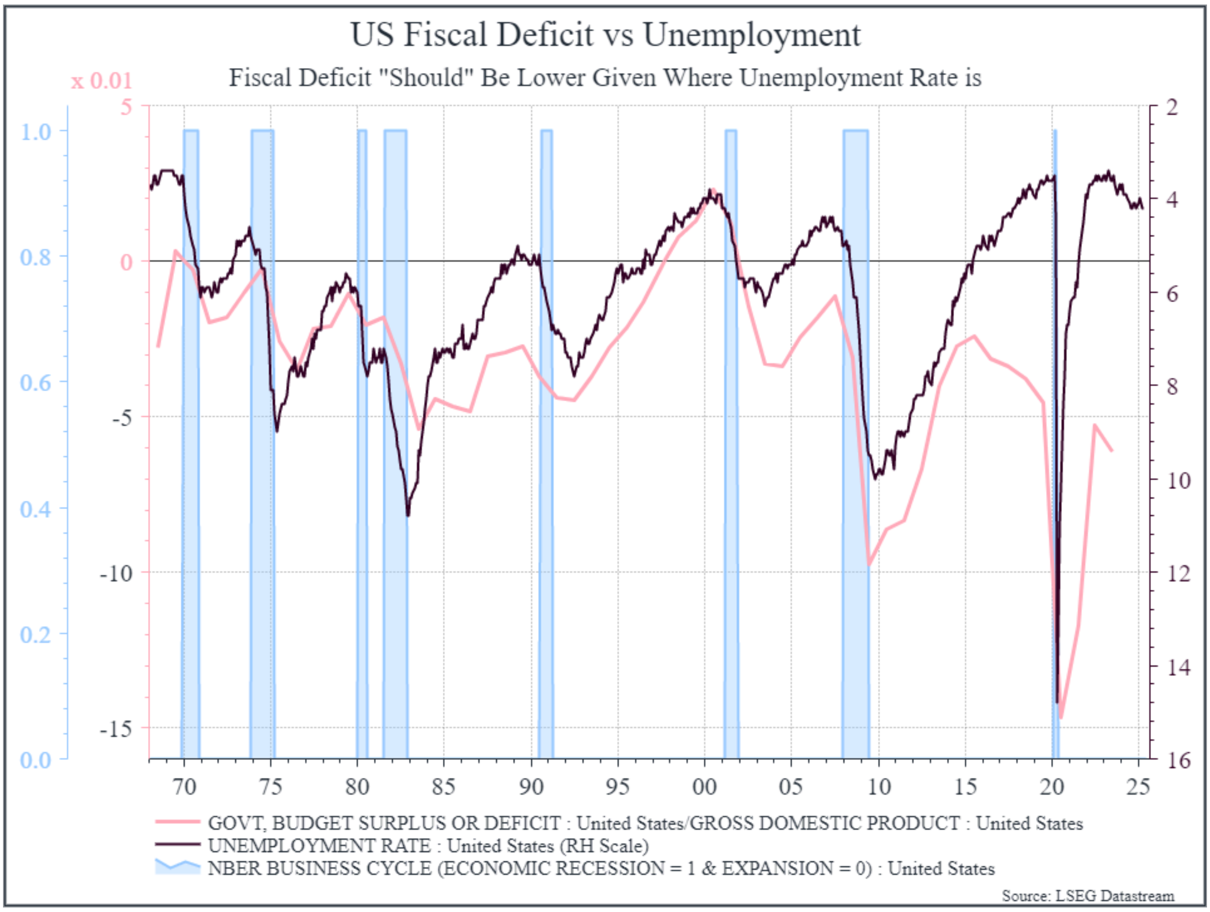


That has caused the overall government debt as a percentage of GDP to rise (see chart below). The chart below also shows the current forecast from the non-partisan

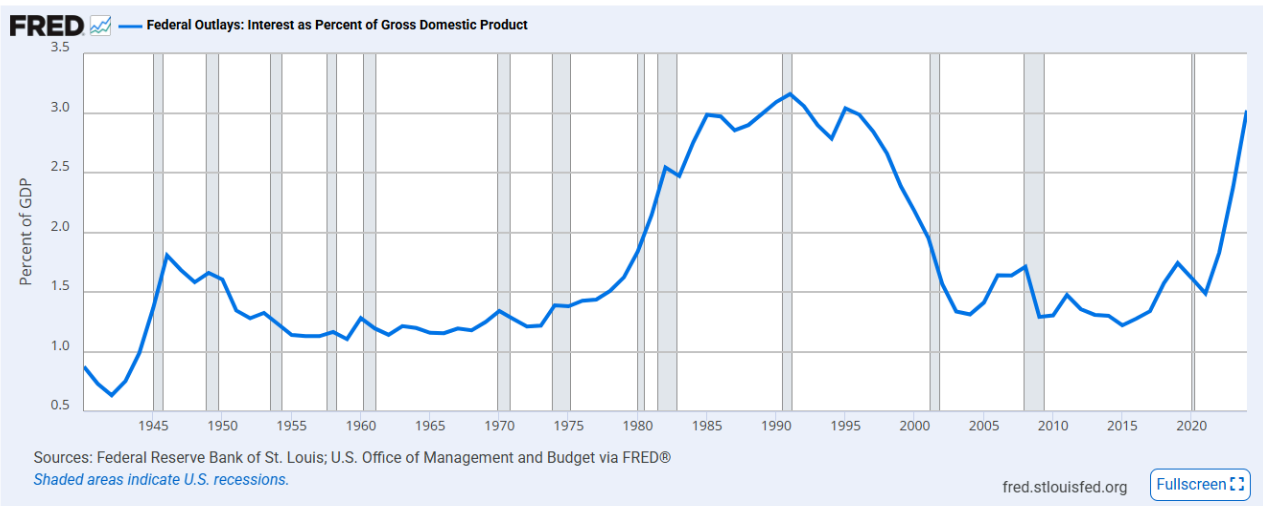
Congressional Budget Office, which expects debt as a percentage of GDP to rise steadily over the coming decades.



It's also worth highlighting that the deficit has worsened at a time when the US economy has been pretty strong. The chart below illustrates the point. It compares the annual deficit to the unemployment rate (the black line) and periods of recession (blue columns). As you might expect, in the past the deficit widened during periods of recession and when unemployment rose. Over the past few years, however, we've seen the deficit continue to widen even though the economy was robust. That speaks to some of the structural challenges that the US government faces - challenges that Elon Musk and Doge were, in theory, trying to solve.



Interest expense has been another focus of attention. During the period of very low interest rates between 2009 and 2022, government debt rose but the amount the government spent on interest stayed pretty low. Since 2021, however, we've seen debt servicing costs rise sharply. The chart below illustrates the point. It shows federal interest expense as a percentage of GDP.



The final point is that the US Congress has been debating the President's budget proposal, which looks to at least maintain the annual budget deficit going forward, and potentially increase it.

But most of this has been well-flagged for some years. Investors have generally looked past these forecasts and given the US government credit for its significant strengths - notably the large, wealthy, growing economy, and the US dollar's status as the reserve currency. And the US is hardly alone in having higher debt to GDP. But, with higher interest costs, persistent fiscal deficits and perhaps more uncertainty around policy - investors look to be demanding a higher rate to own US government debt.

What does it mean for portfolios? Overall, this news supports our slightly conservative view at present. We think government finances could come into greater focus in the coming months and not just in the US. For instance, we’ve seen bond yields in Japan continue to move higher in recent weeks.

In terms of our positioning, prior to Moody's announcement we had reduced our exposure to longer-dated US government bonds in favour of shorter-dated euro and sterling denominated instruments. We’re comfortable with our current positioning for now, and we’ll continue to look for opportunities across the investment universe.

More Noise in Markets - AAT Observatory, May 29 2025

Another week where events in the US seemed to dominate financial markets. There were (at least) four separate pieces of news that caught our collective attention - US trade policy (again), Nvidia earnings, press releases from the US central bank and the latest US GDP data for the first quarter of 2025.

First, on trade policy, a US court ruled that the US government had overstepped its authority on some of the tariffs it had introduced. Second, Nvidia showed strong earnings growth, and the company indicated that the outlook for chip demand was even more robust. Third, the US central bank released the minutes of its latest interest rate policy meeting, expressing their concern that we could see slower growth and higher inflation as a result of US trade policy. That's a difficult combination for US central bankers in particular, since they have a dual mandate of maximising employment and keeping inflation under control. But with unemployment still low, policy-makers look likely to be cautious about cutting rates. Finally, first quarter US GDP data was revised slightly at the headline level. But underlying domestic demand grew at a slower pace than had been previously reported.

First on trade, this isn't the first time that a court has ruled that the US administration has overstepped its bounds. But we think that the administration probably still has enough tools available to implement tariffs. So, on the margin, it might be marginally positive news for those who see tariffs in a negative light, but we don't think it will significantly change the underlying dynamic. Nvidia earnings were a reminder that tariffs aren't the only game in town. Spending on AI remains a key driver, and the outlook there seems pretty positive. Two points stood out for us, first - Nvidia did suffer a bit from US policy restricting export of certain chips to China, and second - Nvidia does sell most of its chips today at least to a relatively small number of large customers. At some point, large tech businesses will want to see a return on their investment in AI, but for now, we think it's something those businesses feel they have to do. On monetary policy, it's a more familiar story. Policy uncertainty is making life difficult for central bankers who generally seem to believe that tariffs will constrain growth but raise inflation. In that scenario, and with inflation still above target, caution on further rate cuts seems to be the order of the day. That view seems well understood in financial markets. Currently investors only expect two 25 basis point cuts this year. As for the US GDP release, you might have expected it to be a non-event. We'd already seen the initial release, showing a contraction of 0.3% in the economy in 1Q25. This revised release actually showed a smaller contraction (0.2%), but what caught the attention was the revision in domestic demand. Initially, the data suggested that so-called real final sales (consumer spending and private sector investment) had grown at 3%. The latest release revised that down to 2.5% - still a healthy figure, but weaker than expected.

What does all this mean for markets and portfolios? We come away from this with two contrasting stories. First, the macro outlook remains quite uncertain. Tariff policy has impacted consumer confidence and made life harder for Central Bankers. And the latest GDP release suggests the economy, while still healthy, wasn't quite as strong as we had thought. And that's before we really see the impact of tariffs feed into the numbers. Second, the AI theme remains alive and well, and it should be a significant driver for US equities - where large tech businesses dominate the indices. As usual, expectations are already high, but for now, it looks like we might still be in the early stages of AI-related spending.

From a portfolio perspective, we keep a cautious stance given the macro headwinds, but we remain mindful that there are still some secular trends in markets and the global economy that extend beyond the discussions around tariffs and inflation.

Tariffs...and we're back - AAT Observatory, May 16 2025

Last weekend, negotiators from the US and China met in Geneva to try to make progress on reducing bilateral tariffs that had exceeded 100%, albeit with a number of exclusions. The results were better than expected. The two countries agreed to lower tariffs for 90 days - the US cut headline tariffs from 145% to 30% and China cut their headline rate from 125% to 10%. Equity markets, particularly in the US, rose this week, continuing a recovery that really began after the US first announced a tariff delay (excluding China) on April 9th. US equities have risen above where they were on April 1st, before “Liberation Day”.

How should we think about this? We think there are a few points worth making

We’re currently in a better place than we might have feared in the first week in April. The steep reciprocal tariffs initially announced have been reduced, if only temporarily. That should reduce some of the risks around growth and inflation. We think equity investors have reacted to that.

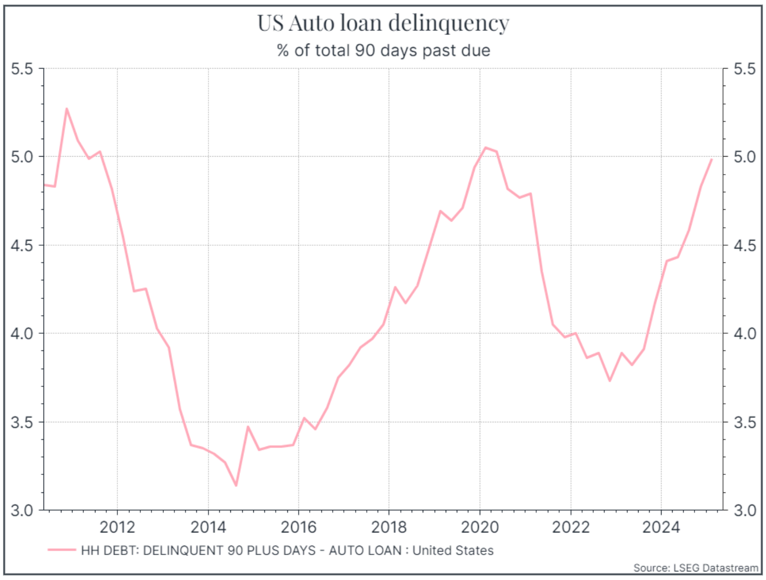
But we don’t think the risks on trade have disappeared. The 90-day pause will end. The early signs are that we might see enough of an agreement for all sides to declare victory, but that’s not guaranteed.

It’s also worth highlighting that even in a benign scenario we’re almost certainly not going back to a pre-April 2nd world. According to estimates from Barclays, the weighted-average US tariff (weighted by trade) is currently around 14% - compared to around 2.5% six months ago. The impact won’t be as profound as we might have feared, but it should still weigh at least a bit on growth and sentiment.

It’s tough to remember at times, but tariffs are not the only story. First quarter earnings in the US were pretty strong and under normal circumstances that would have been supportive for US equities. According to Factset, more than 75% of S&P 500 companies reported better than expected earnings in the first quarter - which is above the long-term average. In terms of growth, it looks like earnings grew around 13% year-on-year (not all companies have reported), the second consecutive quarter of double digit annual earnings growth.

Is the world in a better place than it was at the end of March? On balance, we’d say no. Tariffs are a little higher than we might have feared, although nowhere near where they were on April 15th! And we still think that could have an impact on growth and inflation. Corporate earnings have generally been stronger than expected, even if they didn’t yet factor in any impact from the rise in tariffs and the general policy uncertainty.

Beyond tariffs and earnings, there are a range of issues to keep in mind. Just to choose a couple of topics. We think the US budget debate will get more focus over the coming weeks, particularly around the potential for tax cuts and the size of the overall fiscal deficit. Another consideration is around anti-trust cases against some of the large US technology companies. Any action would likely take a long time, given a long appeals process, but it remains a tail risk that could get greater attention over the coming months. On the macro side, we are mindful that domestic demand in the US has slowed a bit. We continue to see some signs of pressure among lower income consumers in the US, as highlighted by the rising delinquencies in auto-loans (see chart below).



What does it mean for portfolios? During the market uncertainty in April, we didn't make changes to most of our portfolios. The sharp move down and subsequent recovery are a reminder that it's tough to time markets, particularly in very volatile periods.

That said, over the past few days, we've taken advantage of the market recovery to reduce our equity exposure slightly. We've generally diversified our geographic exposure, by reducing some of our longer-duration US treasury ETFs. We've also introduced a minimum volatility equity ETF in some higher risk portfolios that is exposed to companies that have been less volatile than the global equity market. The goal here has been to reduce some of the portfolio risk in the event that we continue to see heightened market volatility, while continuing to participate should equity markets continue to move higher.