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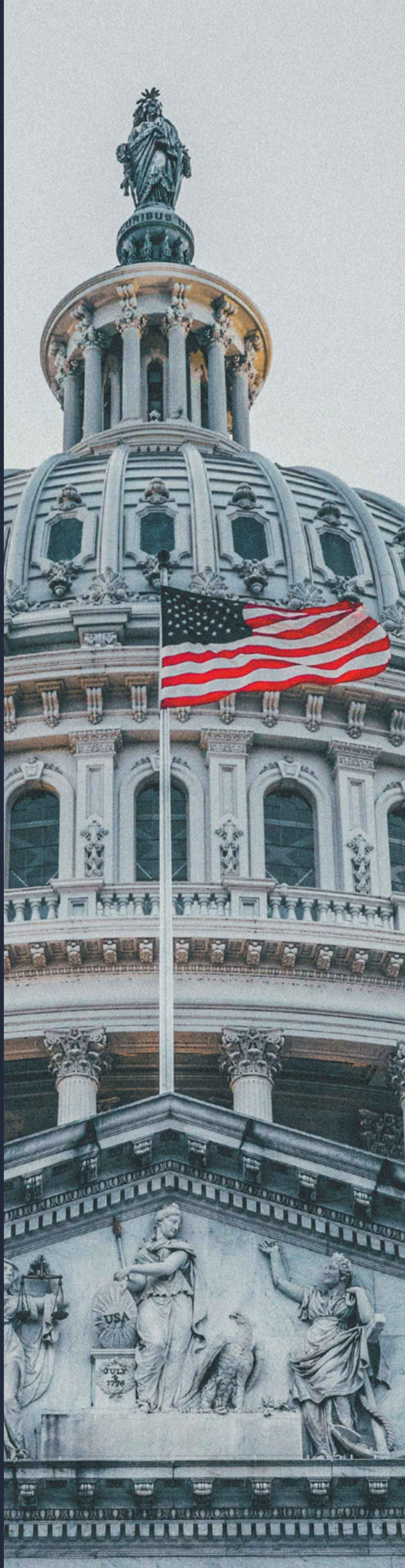

CIO Outlook - Q3 2025

Are Safe Havens 'Safe'?

FROM DR DAN APPLEBY
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This last quarter, just like the first, was eventful. “Liberation Day” tariffs began what turned out to be a tumultuous time for stocks, particularly in the US. Meanwhile, unfortunate events in the Middle East have escalated into conflict between Israel and Iran. Market pricing suggests that these tensions will stay regionalised.

Taking Liberation Day first. President Trump announced a universal 10% tariff on nearly all countries, with higher, country-specific “reciprocal” tariffs on nations with trade surpluses against the US, most notably China. Significant market volatility ensued, including rising US government bond yields, which likely prompted Trump to widely pause the reciprocal tariffs. This flop-flopping has resulted in a new phrase: Trump Always Chickens Out, or TACO. Stock markets recovered because of TACO, but US bond yields remain elevated. The lasting difficulty for businesses is that it’s hard to know exactly where trade policy will be in the coming months.

But so far, corporate America looks robust. The S&P 500 on aggregate grew earnings by 7.6% year-on-year in the most recent quarter. Hence the ‘Sell America’ trade gaining traction among investors was perhaps overdone. There does still lie a question mark over the exceptionalism of US stocks – in which investors simply allocate to US equities as they outperform all others – as in 2025 to date global markets ex-US have generated better returns. Meanwhile, US bonds and the dollar have weakened, two asset classes that have, historically, been safe havens in times of uncertainty.

A weakening dollar has been unusual given that US rates have been in a state of higher for longer. And on rates, the biggest issue for America in the coming weeks is the potential passing of the ‘Big Beautiful Bill’, a tax cutting bonanza that would add trillions of dollars to the deficit.

Alongside this, there is trouble emerging in the US jobs market. Trump has turned his attention to immigration, and in doing so has caused significant unrest across the country. Reduced immigration on the back of a tight jobs market risks sparking inflation, something that may make the Federal Reserve (Fed) maintain its current level of the base rate. Yet the dollar is weakening even as US rates remain high, meaning UK investors owning US assets are suffering from currency losses. Therefore, diversification remains the core theme of 2025 as uncertainty emanates from the US.

TACO and Tighter Immigration

Donald Trump's presidential campaign was clear in that he was going to use tariffs – even naming himself "Tariff Man" – and clamp down on illegal immigration. For a nation that was frustrated with stubborn inflation and becoming increasingly disgruntled by rising immigration pressures, the now-president was largely elected on the basis he would fix these issues.

Hence, the fact that Liberation Day happened should be little surprise, although the high level of the reciprocal tariffs did catch financial markets off guard. In a similar way, Trump did promise he would tackle illegal immigration, but the heavy-handed nature of this has shocked many.

To recap what has happened, Trump launched what he calls the "largest Mass Deportation Program in history," focusing on cities like Los Angeles, New York, and Chicago. It has led to widespread Immigration and Customs Enforcement (ICE) raids and sparked nationwide protests. While border crossings have decreased to historic lows – reportedly down 93.5% in April compared to the previous year – the aggressive deportation tactics are suggesting labour shortages are emerging in key industries like agriculture and hospitality. If this continues, a supply shock to the jobs market may lead to rising inflation in the coming months due to higher wages being passed on to consumers.

But let's start with the good, or so-called hard data, given that it is actual recorded economic activity. For all the talk and turmoil on tariffs, US inflation, less the volatile food and energy components, actually undershot expectations in May, printing 2.8% and under the 2.9% estimated. This is significant given this is the first full month when higher tariffs were in place. Figure 1 shows that consumer prices are still dominated by services inflation, and within this, rental costs are the largest contributors to the still-above-target 2% inflation figure post-Covid. However, observed rents are continuing to ease outside of those measured in the official US inflation data, such that this services component has further room to decelerate over the second half of 2025. Slightly more concerning is the rising food component, but more on this later.

Figure 1: Contributions to US consumer price inflation.

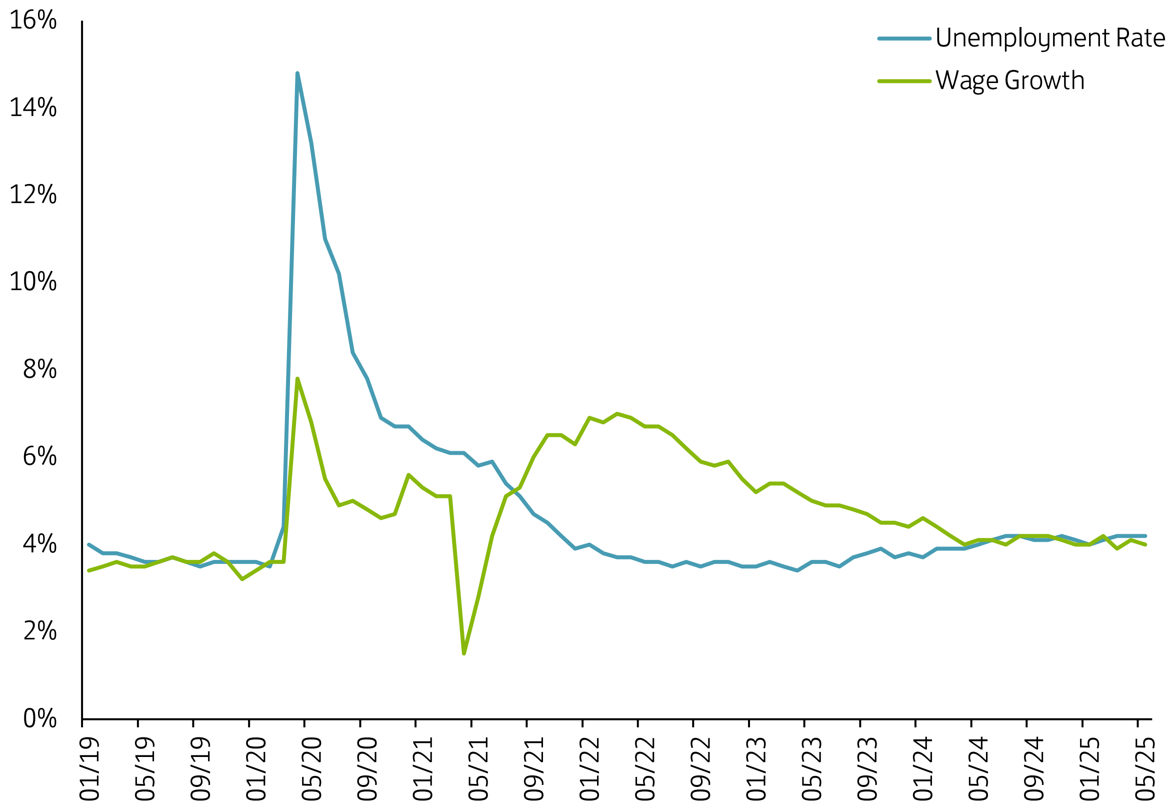
Source: BLS, Bloomberg

May's inflation is only one data point, although Trump has shown a repeated willingness to pause tariffs to allow for negotiations to take place. It is therefore reasonable to assume that tariffs have reached a peak and may even be reduced as trade negotiations progress. This will support further easing in prices.

What is more pressing now is a potential for a labour shortage given the Mass Deportation Program underway. It comes at a time when the jobs data in the US has cooled significantly from what was a very hot market after the pandemic (Figure 2). Wage growth took a particularly long time to fall, which in turn placed upward pressure on services inflation. It has since settled above pre-pandemic levels.

Labour shortages leading to a supply-side shock pushing wages higher would not be welcome news to the Fed. Nor President Trump if this does lead to rising inflation given his election win can, in part, be placed on a nation that was frustrated with high inflation during the last administration.

Figure 2: US labour market conditions shown by the unemployment rate and the average hourly wage growth year-on-year.



Source: BLS, Bloomberg

If this Mass Deportation Program does begin to stoke inflation from the supply side of the labour market, Trump may be forced to relax his anti-immigration agenda. Or TACO all over again.

Maybe we can look at TACO another way, one where Trump's tactics are more like releasing a dog among pigeons. A dog with a bark worse than its bite. Unlike a cat, this dog is trained to return quickly once enough pigeons are spooked into action. Regarding trade, the interpretation is that Trump is using this scare tactic to bring countries to the negotiating table. It has worked to a point; the UK, as an example, has already signed a trade agreement. If this Mass Deportation Program puts off further illegal immigration, then Trump will no doubt claim a win and state a fulfilling of a campaign promise.

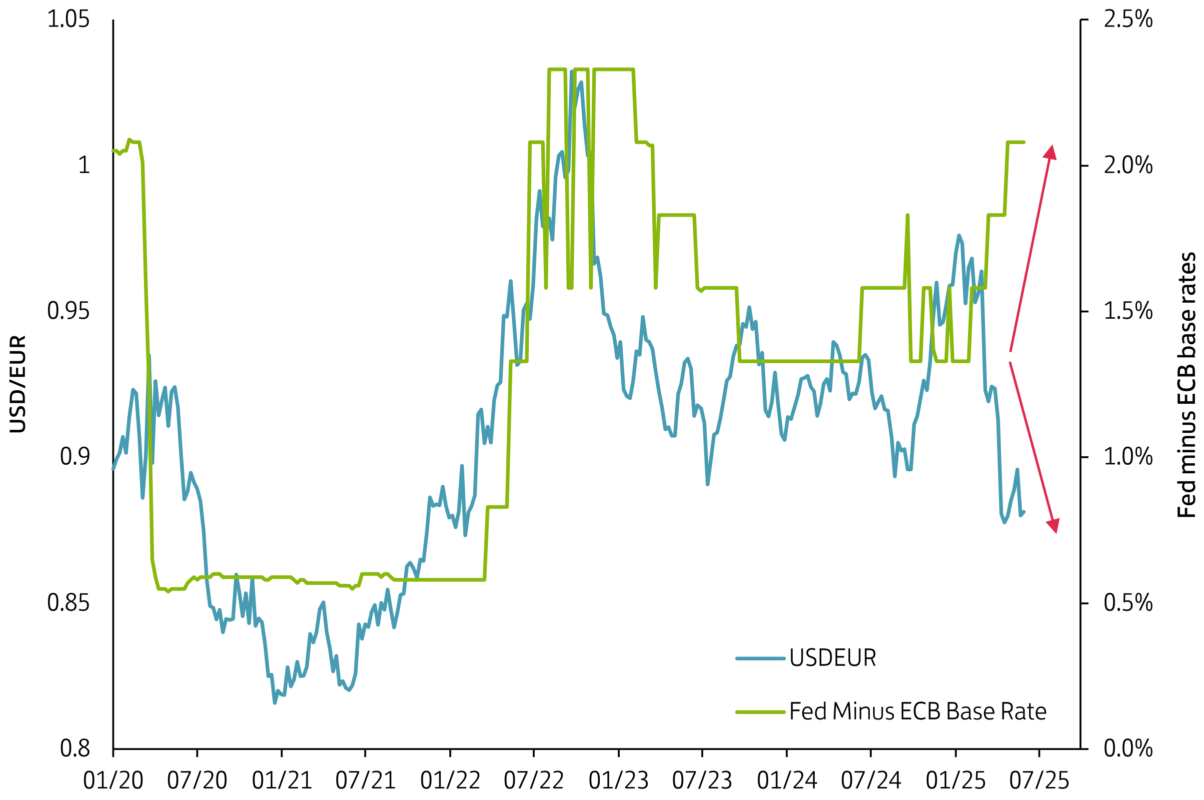
For now, it's evident that tariffs will persist in some form, regardless of how many trade agreements are signed. Businesses, however, have been frozen into inaction until the situation stabilises, potentially leading to deflation in the longer term as hiring and investment slows. Additionally, if Trump's immigration bark does turn out to be worse than his bite, the persistence of cheap labour is a deflationary force on the jobs market. Ultimately, it will fall to the Fed to manage and balance the effects of these unpredictable policies.

Are Safe Havens 'Safe'?

On the topic of the Fed, it has been steadfast in its wait-and-see mode as its base rate has been held at a recent high of 4.5%. Much to Trump's dismay, and efforts to influence, the Fed hasn't cut rates since December, before his inauguration. If deflationary pressures do start to materialise, it is highly likely the Fed cuts, and does so at pace.

The problem for the dollar is that the currency has weakened as other central banks such as the European Central Bank (ECB) have cut rates even as the Fed has held steady (Figure 3). Usually, a widening interest rate differential acts like a magnet, drawing investors and their money toward the higher-yielding currency, causing it to appreciate relative to others. A weakening dollar under this circumstance is highly unusual, and even more so as it is the world's reserve currency and arguably the number one safe haven asset.

Figure 3: Interest rate differentials of the Fed and ECB's base rate and the impact on the corresponding currency exchange rate.

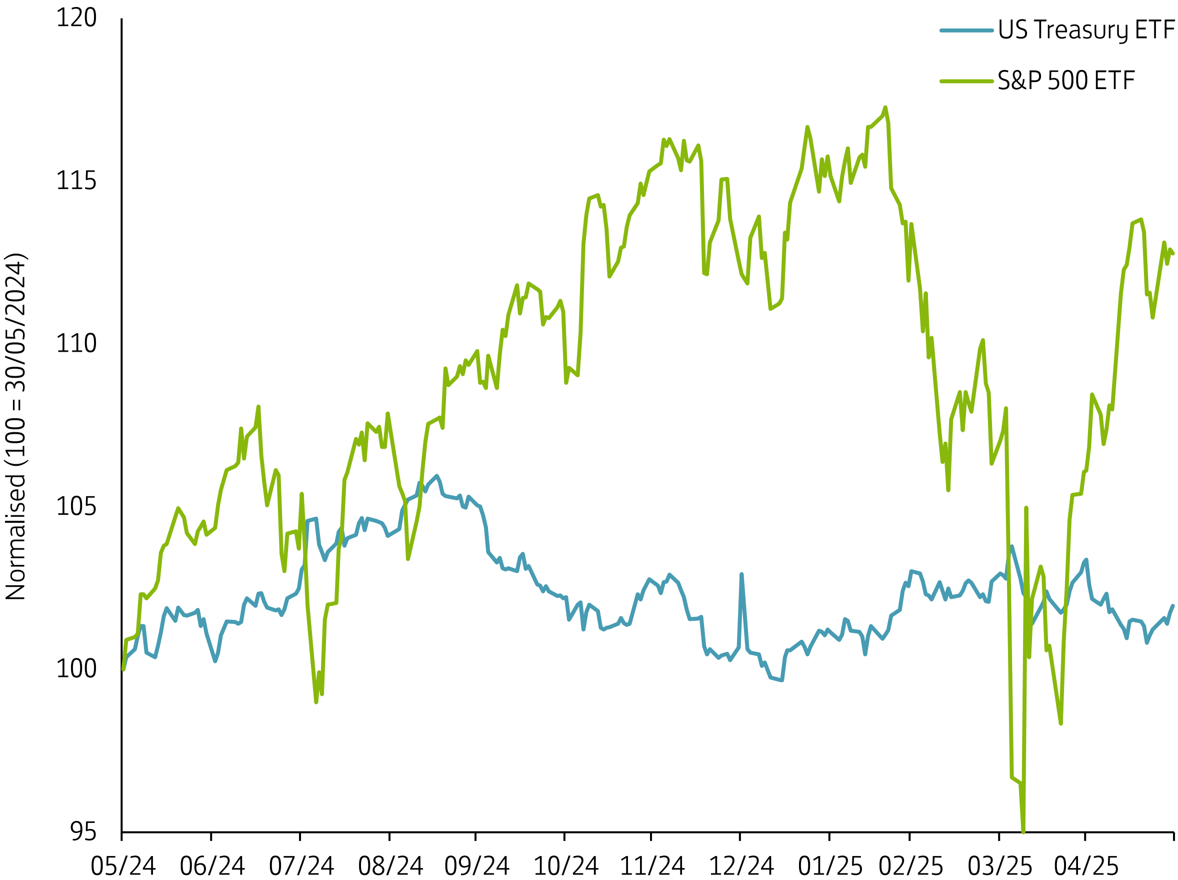


Source: Bloomberg

Investors buy safe haven assets during uncertain times, expecting it to maintain or increase in value when markets become volatile. Stable currencies such as the dollar, alongside gold and government bonds, are typically regarded as these safe bets, but not always. For example, during the inflation shock and subsequent aggressive central bank hiking cycles during 2022, government bonds fell as much as stocks.

So far, the Bloomberg dollar index has fallen over 10% in 2025. But it isn't just the dollar as US government bonds have also taken a dip (Figure 4). On a price basis, the US Treasury exchange traded fund (ETF) tracking the broad government bond market has dropped over 1% this year. Since the eve of Liberation Day and the shock it caused, the US ten-year government bond yield has risen ten basis points, which again implies bond prices have fallen.

Figure 4: Returns of two ETFs tracking the S&P 500 and the US government bond market.



Source: Bloomberg

When it comes to US government bonds, investors have another risk on the horizon: the One Big Beautiful Bill. This is a sweeping package, already passed by the House, that permanently rolls over huge portions of the 2017 Tax Cuts and Jobs Act. In short, the bill's blend of permanent tax cuts would significantly expand the debt load, prompting higher yields as markets adjust to increased supply. Taking the bill in its current form, current estimates suggest it would add $3trn to the deficit, adding total debt to around 125% of gross domestic product over the next decade.

With many risks on the horizon in the US, the two often dependable safe haven assets in US government bonds and the dollar do not appear to be all that safe. At least during this market. This is particularly acute for UK investors who must convert sterling into dollars to buy any US financial asset. In doing so, investors gain exposure to the underlying asset, and the dollar. Hence when the dollar falls, so does the value of the portfolio, all else equal.

While US stocks have recovered from events such as DeepSeek and Liberation Day, with the S&P 500 up around 3.5% in dollar terms this year, it remains down almost 5% in sterling terms. Therefore, UK investors buying US stocks in 2025 are sitting on losses due to the weakening dollar.

This isn't to say that this is the end of the dollar as the world's reserve currency, and the 'Sell America' trade regarding US stocks is a bridge too far. We aren't about to see the US government default on its debt either, so it will likely remain the benchmark for being a 'risk-free' asset. But with European and emerging market stocks outperforming the US this year, and cyclical weakness in broader US assets, diversification remains the key factor for portfolios.

A Word on the Middle East

It is always difficult to discuss market mechanisms during wartime given that humanitarian concerns must rightfully take precedence. Nonetheless, we still need to understand the situation through the lens of the market. The hope is for a swift resolution.

From a markets perspective, conflict in the Middle East is usually always an oil story, and therefore an inflation issue for developed markets. The difference to the Yom Kippur War in 1973 and now is that the US is a significant net exporter of oil due to increased domestic production, especially from shale resources. As such, and oil embargo, or generally restricted supply from the Middle East, would be far less of an issue today.

Crude oil did spike around 7% on the day Israel bombed Iranian infrastructure. A week later saw the US hit three key Iranian nuclear facilities in a significant escalation in the conflict. Crude oil rose again, but gave back most of this gain and remains significantly under the price it reached during the height of Russia's invasion of Ukraine. This is essentially a market signalling that the conflict will stay regionalised. Then, crude oil fell further on the announcement that a ceasefire was in place. It is too early to tell if this is the end of the hostilities, yet the oil price is suggesting that it is.

The S&P 500 underperformed the MSCI Emerging Markets Index on the day the conflict began. It was marginal, yet unusual given emerging markets are far more exposed to a rising oil price given their import dependency. It is suggestive again of exhaustion from investors being overly exposed to US assets which were near records heading into 2025.

One final risk comes from rising food prices. Figure 1 showed that this is becoming an increasingly larger proportion of US inflation again. Any restricted flow of agricultural commodities from the Middle East only risks pressuring food prices further. Key fertilisers are transported through the Strait of Hormuz, and wheat and soybean prices spiked on the recent conflict, so further escalation risks a return to the levels last seen during the invasion of Ukraine. For Donald Trump, it is a balancing act of supporting Israel while not fuelling domestic food prices that weighed so heavily on the Democrats' defeat in last year's election. It is a fine line to walk.