

TRANSCRIPT: EPISODE 363

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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. Today we're unpacking the rollercoaster that has been Q2. This year I'm Staci West, and today I've joined by Darius McDermott and Juliet Schooling Latter, who will attempt to break down tariffs and shifts in global investor sentiment and whether US exceptionalism may be coming to an end. So, Darius, Juliet, thank you for joining me. Lots to cover.

Darius McDermott (DM): Afternoon Staci. Happy to be here as always.

Juliet Schooling Latter (JSL): Yes, indeed.

SW: Said with a smile on his face, the weather has truly gotten to him.

[INTERVIEW]

SW: So Q2 kicked off with a sharp market sell off, followed by then a fairly swift rebound. But what triggered this volatility and then what has helped kind of steady investors' nerves since then?

JSL: Well, we just need to look across the pond for the answer to that question. Sorry, Staci. It was of course Donald Trump's Liberation Day tariff announcement at the beginning of April.

DM: We can't hold Staci responsible for that, though, to be fair.

SW: I appreciate that.

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JSL: Yes. I was wondering how often I could get away with mentioning Trump during this <laugh>. But yes, I mean, we all knew that it was coming, but I didn't think many of us imagined that the tariffs would be so high or so extensive and they were slapped on every country the US trades with an even some that it didn't <laugh>

SW: And in such dramatic fashion.

JSL: Indeed. Yeah. And then obviously there was the tit for tat escalation between China and the US taking tariffs to over a hundred percent. But Trump's reasoning was that this would encourage companies to manufacture in the US again rather than overseas. But, you know, firstly, it takes years, if not decades for companies to make these changes. And secondly, tariffs are highly inflationary and can potentially lead to recession because the problem is that not only does the price of goods go up and hence the consumer buys less, but also the picture becomes rather murky for companies and they don't know how much they can sell at higher prices. And so they naturally halt any planned expansion and sort of sit on their hands. So there was chaos and the stock market and bond markets sold off goods on route to the US halted their progress. But US businesses warned Trump that there could be empty shelves in a matter of weeks. And so just a few days later on April the ninth, he announced this pause on tariffs and markets then back.

DM: Yeah, very little to add, other than we knew Trump would equal volatility in not just his behaviour and his uttering on social media, but of course we with stock markets, and you are right, there's anecdotal evidence about US supermarkets telling Trump to do something otherwise there would be real difficulties. But also just markets went down violently after the original news.

And in markets sell off, people sell equities and they buy government bonds. So the yield goes down and the price goes up. Now, the US government bond yields did go down for the first 48 hours or so after the liberation days announcement. Then they started doing something quite odd, which was the yield started going up and hit the price going down. This is not normal in a risk off environment. And I think as much as the anecdotal evidence about US retailers telling Trump to backtrack, I think the bond market had a swift word in his ear as well as bond market. Always a very strong indicator if things are going wrong in an economy, and you would think tariff equals recession equals rate cuts, but actually rates or yields on government bonds were going up that is most unusual in a risk off environment and may lead to us talking about US exceptionalism or whatever.

But the US government bond market, which is the sanctuary in times of risk off actually only lasted for 48 hours and then started becoming a risk on asset much to the general concern about bond investors globally, but certainly within the US.

SW: Well, let's just stick with the US then for a bit because it has been this poster child, if you like, for outperformance in recent years. It's something like three fourths of the MSCI World index. We've talked about it before, but now given Trump and the volatility and what we've just discussed, do we think that dominance may be fading even more and are we gonna see the end of this US exceptionalism or is it say blip on the radar?

DM: I mean, US equities always trade at a premium to other developed markets because they have better earnings growth generally. And broadly it's a much more high growth market with the obvious sectors being technology and technology related services where the US dominates. Our colleague believes NVIDIA shares are actually cheap on probably a forward PE of under 20 for a global market leader, even in a tariff based world. So I think it's way too easy to say exceptionalism is over sound like a broken record on all of these

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podcasts. I look at valuations and at a index level, US market is still expensive versus its own long-term history, whereas other markets are not looking so expensive.

So what I think the market showed after the Liberation day volatility, investors were just starting to think about something else other than just the US. That's not to say that they're giving up on the US, I don't think anybody would be, well, you'd be very brave if not stupid, to move all your money out of the US but if people just think incrementally, I will put the next pound or dollar or Euro or yen into different assets, then we might see a bit of a rerating some other assets as well.

JSL: Yes. At the risk of getting fined for mentioning Trump again, I do think he has done quite a lot of damage to the US and that's not just my opinion, but you know, at a recent conference, an economist spoke about the permanent damage that tariffs have wrought in the perception of the US with investors a little bit mistrustful and wanting to diversify as Darius said, and just a little bit less keen to do business with US companies.

And that in turn has sort of damaged the dollar a bit, which has sold off. So, you know, all in all, it's not a very pretty picture, but you know, it's early days. We have to, it will take months or even years to see how this plays out. And we'll have to sort of closely monitor inflation, unemployment CapEx numbers to determine the full impact. But as Darius says, you know, the US is still home to exceptional companies and they will still thrive. But all in all, I think we should embrace a bit of broadening out because other markets have sort of been starved with capital in recent years.

SW: And do you think that we're going to start to see this kind of regional rotation, if you like, with investors taking maybe some profits from the US or as you said Darius looking forward looking to different areas like Europe or the UK for example?

DM: Yeah, I think that that is the hope. The US stock market has been so dominant now really since the GFC in 2008/09, and people have given up on other regions. It's like, why put a pound in Europe when you go put a pound in the US? And historically you've made really strong returns. And I think we've touched on before, I think a lot of that US only is the only place to invest. There's also do distorted a lot of passive performance where the big just keeps getting bigger and the inflows just keep coming because of passive investing. I don't know the up to date figure, but at the start of the year, the Magnificent Seven were 37% of the S&P 500. That's seven stocks at nearly 40% of the entire index. So that tells you something whether it's exceptionalism or a number of other factors.

So hopefully we will see a broadening out as we've touched on, and even if there has been a pause on the tariff announcements, the general consensus is that tariffs will sort of end up between 10 and 15%, whereas before Trump they were 2%. That's a meaningful difference, even if it's not the high numbers quoted on Liberation Day. And as Juliet said earlier, that the effect of that it will not be happening in the first half of this year and maybe not even the second half of this may. Maybe it becomes an issue for the years ahead. So yeah, there's a lot going on with Donald Trump's economic policies and I'm sure we'll touch on some of his global policies as well, which are also causing uncertainty. And yeah, I don't think US exceptionalism is over, but it maybe on pause for the moment

SW: And we have seen Europe for example, leading the pack for Q2 in terms of performance, Europe and Latin America as well. So what's behind the kind of strong quarter, if you like, for these regions? Is it renewed interest or something else more particular?

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JSL: Well I think this is partly the broadening out that we've just been talking about. You know, investors taking a look around and thinking, well, actually what else is out there? And that valuations are quite a bit cheaper in some areas. In Europe, valuations were low. Germany then sort of unexpectedly announced that it's gonna spend more on infrastructure and defence. So that has helped. And then combined with the falling interest rate environment and also the, you know, there's the possibility of peace in Ukraine which would reduce energy costs. And I think those are some of the factors that go towards its sort of strong performance year to date.

DM: Yeah and just to add to that, it's not just Germany. I mean Germany have announced this increased spending, but under encouragement from our friends in the Americas, Europe has to spend more on defence as well. And we've seen a particularly strong rally in European defence stocks on the back of that. That's probably been the major European driver this year so far.

Latin America, well, not really sure if I'm perfectly honest, but a weaker dollar always helps emerging markets and the dollar has definitely been weaker. Also, I think Brazil is used to having high interest rates, but I've believe I've started to cut a little earlier because they're economies are in slightly better position and it's just a very unloved area. 20 years ago it would've been a specialist investment that Latin America funds, maybe even 25 years ago, very popular. Nobody buys them anymore. So just sometimes being less hated than there were the day before with some weak dollar exposure has possibly helped Latin America. But not an area I can claim any huge expertise, I'm afraid.

JSL: Yeah, I mean I think commodities have done quite well over the past month, which has probably aided them. But also as you know, as Darius says, I mean Latin America was just was one of the worst performing sectors last year. So it was really oversold going into 2025. And that just goes to show that actually can be a better strategy to buy last year's losers than chase those which have already done really well.

SW: Well, talking, talking about losers, I'm going to move on to small caps <laugh> anyone who's listened to this podcast knows that we are a fan of UK small caps but they are not short of their challenges, especially in the last three, five, maybe plus years. And we had Scott McKenzie from Amati on the podcast recently who was telling us about why there's signs of improvement and how he's feeling really positive about the strong potential for UK small caps. So my question is, do you agree? Do you see a turn in UK small caps? What is happening with valuations and investor sentiment? This is your chance.

DM: Well, I think when we talk to small cap fund managers and small cap brokers, which we do on the back of our interest in the VT Chelsea range of funds that we run, the thing that's been happening in small cap is there's been persistent selling, persistent selling of UK small cap funds and institutions just selling down. And that is now probably for the best part of the decade post the Brexit vote. People didn't want UK companies, let alone the smaller and less liquid.

Jules and I know small cap normally outperforms in most regions over long periods of time, and we're now in a sustained period, particularly in the UK of underperformance. But the US also had US small cap also had a big post-Trump election rally when a lot of small cap funds were up a lot on the promise of lower taxation and lower regulation and all that good stuff. But then as you know the president-elect became the president and Trump's tariffs became louder voice US small caps also sold off again.

So yes, we're bagging the drum, but we are aware that there has been a couple of larger sort of pension fund institutions just starting to buy UK small cap. So if it just stops selling, going from, you know, being, sell pressure on small caps to maybe a small incremental buyer, I think that could be the catalyst for, fingers

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crossed - because this is a podcast not a video - for a strong rerating. And when it comes, we don't know, but all being well with it. Other parts of the economy, which I know we're gonna touch on later, small cap could be fit to burst real deterioration in economies, which of course is a possibility.

JSL: Yes. Well it's sort of exciting. It looks like it's finally coming to fruition. We've been banging on about UK small caps, as you say, Staci here for quite some time now. But in just just back in March they were at the widest discount to their long-term average of any major market at sort of over 24%, but that's now moved to just 14%. So it's actually been one of the top performing sectors now over the past three months, as Darius said. You know well we talked about the diversification away from the US and the domestic pension funds Darius mentioned. And there's private equity sort of snapping up bargains also, and the other thing I suppose is UK smaller companies tend to be more domestic facing, so less to fear from tariffs.

And they tend to thrive as interest rates come down. And we've seen two cuts this year, but I think we are, as Darius mentioned, sort of cautious on the outlook for the UK economy. The impact of the government's, various tax increases are coming into effect with a lot of sort of wealthy individuals leaving the UK and higher national insurance for companies meaning sort of potentially smaller wage increases or staff cutbacks and, and reduced profit margins. So you know, the jury's out where we're sort of hoping we're on our way with that one.

SW: To be discussed next podcast, I'm sure <laugh>. But yes, we couldn't possibly finish without talking about inflation and interest rates because central bank policies are still so front and centre in a lot of what we're talking and writing about for those who are regularly on FundCalibre. So with inflation easing in places like the UK and the Euro zone, are we finally seeing rate cuts expectations firm up? What should we expect?

JSL: So, you know, interest rates in the UK and Europe, they have been coming down, which is good news. I mean, I wouldn't expect them to return to the lows we've seen in recent years. That was more of an anomaly. If you look back over history, you know, rates at current levels actually aren't that high. In fact in Europe, inflation has now, you know, fallen below 2% and interest rates currently stand at 2% after the latest cut. But in the UK data just out this morning shows that, you know, inflation's still a bit sticky here at sort of 3.4%. So the jury's out really on whether we will see any more rate cuts this year.

Will there be any more? I'm not sure. It's a question of sort of watching and seeing what the data tells us.

DM: Yeah, I mean we're in mid June recording this, the jobs and inflation data, I think in the UK and I'm sure in the Europe US as well in Europe, we determine I'm on the less likely to be many rate cuts unless we hit this potential severe recession and very quickly. So I think there is a downturn, but that doesn't necessarily mean recession and that doesn't necessarily mean severe interest rate cuts. So yeah, bonds are still fair value at the moment. You know, the government part of the bond, certainly in the UK, the gilt is yielding a fair amount. The spread, which is the extra yield you get over the government bond for lending to companies is not so attractive. But if you add them both together, they're not like screaming buys, but they're certainly fair rates of return on most fixed income at the moment. And if rates do happen to go down, then you should get a capital kicker as well.

SW: And let's finish with something a little bit forward looking. So for both of you, as we head into the second half of this year, what is your biggest potential risk, but also your biggest potential opportunity that you see for investors?

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JSL: Well risks that could take up quite some time. I think there are many at the moment. You know a lot of them geopolitical you know aside from war, which is, I don't think it's helpful to dwell on or attempt to predict there's the hit to global growth from tariffs, which, you know, could derail mar markets. And you know, also the oil price sort of ticking higher is also a negative.

But on the opportunity side we are in an era of heightened volatility, which does create buying opportunities. The end of the 90 day pause on tariffs is rapidly approaching so July the 9th. So markets kind of seem to be ignoring that at the moment, but I think there could be buying opportunities as we get closer to that because, you know, agreements they've largely not been agreed. Even the UK's deal is sort of still being thrashed out.

I think possibly emerging markets could be a surprise winner as they benefit from a weaker dollar and the diversification away from the US that we've talked about. And I still like Japan where corporates and consumers are sitting on a lot of cash. And domestic and foreign investors are underweight Japan where valuations are relatively cheap. So yeah, I think those are sort of two potential opportunities.

DM: Yeah. If I start by just keeping thinking simple, we knew Trump would equal volatility and that continues to be the case. Yes. We've talked about tariffs, as Juliet says we are in a potential phase of the Middle Eastern conflict widening, not narrowing with the recent attacks on Iran by Israel that saw a big spike in the oil price, which again is takes away from potential growth. And I don't think Donald Trump knows what he's gonna say from one minute to the next. So I got, you know, it's almost impossible for us to know other than Trump equals volatility get used to it.

SW: At least for another three and a bit years.

JSL: And obviously, you know, as ever you know, in this sort of high tax world, maximise your tax free options, you know use your ISA investments when this volatility arises and you know, there's a sell off it's an opportunity to add to something like your ISA and remember, you know, it's about the long term.

SW: And Darius, are you gonna finish us with an opportunity?

DM: I think the volatility we had around liberation day and then the pause shows exactly my key simple message, which is about long term. If you had been brave enough to start reducing risk into that sell off, we didn't know what was gonna be the catalyst for a sharp bounce. But again, it was Donald Trump and a change of heart and markets are very quickly recovered most of those losses.

So I think the opportunity, like Jules has said, you know, don't be afraid to buy the dips that volatility will create. I think we're done to the back teeth talking about UK smaller companies. I just think all in all the world looks pretty uncertain. I think balance I have a nice bit of gold in my portfolio, which not to say it because it's done very well, but it has done very well. I just think having a mix of assets and balance and definitely some cash. I'm not saying go into cash, but if I was thinking of doing my ISA or an investment today as we are in mid-June, I might just sit on the cash and see if a better investment opportunity comes later on in the year.

SW: Well, on that note, we will leave it for another three months. Thank you both for joining me today for quite a lot of US chat, but that was to be expected. Thank you both.

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JSL: Thanks Staci.

DM: Thanks Staci.

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