Portfolio & Market Update

May 2025

Introduction

Following a volatile April and the effects of 'Liberation Day', a change in tone from the Trump administration contributed to an uplift in the markets, as investors realised that the anticipated tariffs would likely be less severe than initially feared.

US equities experienced a notable rebound, while bonds experienced increased volatility alongside the significant tax bill proposed by Donald Trump.

There are legitimate reasons for optimism regarding the US market, however. This earnings season has produced strong results, underscoring that American companies are at the forefront of the ongoing technological revolution.

Markets rose after the US and China agreed to a 90-day suspension of tariffs. However, mixed signals within the US administration have led to new uncertainty. Despite the temporary truce, the overall level of tariffs imposed by the US on other countries remains at its highest since the 1930s.

Markets

In May, the more conciliatory stance adopted by the Trump administration prompted investors to reassess their outlook on US equities, which emerged as the top-performing asset class in our investment universe.

The period was characterised by a typical 'risk-on' sentiment, though volatility remained elevated. Bond yields rose, driven by concerns over the fiscal positions of major economies, which led to price declines. Meanwhile, inflation in Europe continued to decline, moving closer to levels aligned with central bank targets.

US

The US equity market ended the month on a strong note, despite elevated levels of volatility. Notably, the S&P 500 delivered its best monthly performance since November 2023, posting an impressive return of 5.24%.

The Federal Reserve maintained interest rates at their previous level, adopting a wait-and-see approach as it weighs up the potential impacts of trade policy against the underlying strength of the economy. Until there is greater clarity on the economic outlook, it is expected to remain cautious.

Meanwhile, bond markets encountered two adverse events: the tax bill introduced in Congress and the US rating downgrade. Consequently, US Treasuries recorded a negative return of 1.04% for the month.

UK

The FTSE 100 posted another solid month, delivering a return of 3.82%, which capped off a strong start to the year.

In May, the UK was at the centre of a flurry of diplomatic activity. A trade agreement was reached with India, aimed at easing market access for UK exporters. While the scale of bilateral trade between the two nations may not make this a game-changing deal, it sent a clear signal that the UK remains open for business.

More significantly, the UK signed a trade agreement with the United States, which helped roll back some of the most restrictive trade barriers introduced during the Trump administration, while allowing the UK to maintain its regulatory standards.

Furthermore, the UK established a new framework for its relationship with the European Union, covering key sectors such as fisheries, defence and access to funding.

Meanwhile, the Bank of England cut interest rates by a further 0.25%, continuing its efforts to support the domestic economy.

Europe

European markets continued the positive momentum seen since January, with the MSCI Europe ex-UK index rising by 2.77%. Investor sentiment was buoyed by positive developments in trade negotiations, reinforcing hopes that Europe could mitigate the impact of a broader global trade conflict.

GDP growth was notably strong at the start of the year, largely driven by front-loaded demand as businesses accelerated purchases in anticipation of potential tariffs.

Inflation, while still above the European Central Bank's (ECB) target, continued to move closer to the desired level. In response, the ECB cut its main interest rate and signalled that a further rate cut is likely in June.

Japan

Japanese equities joined the global risk rally in May, with the TOPIX index gaining 2.90% in GBP terms. However, this performance unfolded against a backdrop of heightened volatility in the domestic bond market, where long-dated government bonds faced sustained selling pressure. Weak domestic demand for longer-duration debt, coupled with investor concerns over the Ministry of Finance's debt management strategy, created challenging conditions.

Some relief came when authorities announced a reduction in long-dated bond supply, which helped stabilise financial markets. Nonetheless, while Japan's economy remains weak and continues to face external risks, including US trade protectionism, there is a normalisation in place. Political uncertainty further clouds the outlook, leaving investors without a clear sense of future policy direction.

Asia & Emerging Markets

Asian equities posted a strong performance in May, with the MSCI AC Asia ex-Japan index rising by 4.47%. The softening of the US rhetoric on tariffs targeting Chinese goods sparked a rally that extended throughout the month. This benefits both equity and currency markets by reducing volatility.

The weakening of the US dollar also provided a significant tailwind for emerging markets, easing the burden of servicing US dollar-denominated debt.

Despite the temporary relief offered by the US administration, much of Asia remains vulnerable to the broader implications of the US-China trade conflict, given the region's deep reliance on Chinese imports and supply chains.

Fixed Income

In contrast to the strength seen in equity markets, global bond markets delivered negative returns in May, with the Bloomberg Global Aggregate Index declining by 0.75%. The sell-off was driven by rising fiscal concerns in the US. Moody's lowered the U.S. government's credit rating, and demand for long-term government bonds was weak - both of which caused interest rates to jump in the middle of the month.

Bond markets experienced heightened volatility throughout the month, as investors had to navigate between three opposing forces: persistent inflation pressures, slowing growth and mounting fiscal challenges.

Sovereign yields rose across most developed markets, though performance varied significantly according to fiscal health.

Countries with weaker fiscal positions, such as the US, UK and Japan, underperformed, while peripheral European markets like Spain and Italy proved more resilient, benefiting from improved fiscal credibility.

Outlook

Although trade tensions have eased, we continue to adopt a cautious investment stance. At Flying Colours, we have long been wary of sovereign bonds, despite the traditional view of these as risk-free assets.

Although current valuations look appealing, we're cautious about the increasing amount of new debt being issued, as it's putting strain on the market's ability to absorb it. As a result, we are maintaining a lower allocation to sovereign bonds than in the past.

European markets have shown continued strength, supported by recent geopolitical developments. We will closely monitor how the situation evolves, recognising that market reactions can often be more volatile than the underlying economic fundamentals.

At Flying Colours, we are committed to continuously monitoring both the economic outlook and market signals to ensure our portfolios remain aligned with the best interests of our clients.

Our investment strategies are focused on the long-term, managing risks over the extended horizon, rather than reacting to short-term trends that could be detrimental to our investors. Our goal is to achieve well-managed, risk-adjusted returns, consistent with our investment philosophy and in the best interests of our clients.

Glossary

GBP: Pound sterling.

Federal Reserve: Central bank of the United States.

GDP: The total monetary or market value of all the finished goods and services produced within a country.

Tarriff: A tax imposed by one country on imported goods and services from another.

Risk-on: Risk-on-risk-off is a market dynamic where asset prices shift based on investor risk appetite. In risk-on situations, investors have a high-risk appetite and during risk-off, investors are more risk-averse.

S&P 500: A stock market trading index that tracks the performance of 500 leading companies listed on the US stock exchange.

MSCI Indexes: Stock indexes that track the performance of the stocks included in them. Often additional context is added in e.g. MSCI Europe ex-UK index covers Europe but excludes the UK.

European Central Bank (ECB): The central bank for the euro. Its main task is to maintain the euro's purchasing power.

Global risk rally: When investors globally are more willing to take on risk, and therefore prices rise for riskier assets.

TOPIX: The Tokyo Stock Price Index is an important stock market index for the Tokyo Stock Exchange.

Bloomberg Global Aggregate Index: A flag-ship measure of global investment grade debt.