REEVES
INVESTMENT SERVICES

Market Outlook

Market Views

May delivered the hottest day on record for the month, with temperatures nearing 35 degrees Celsius over the Spring Bank Holiday weekend. Whilst the nation enjoyed the warmer weather by visiting the coast, beer gardens and parks, markets were contending with their own sources of heat in the form of persistent inflation, an intensifying artificial intelligence race and growing political uncertainty.

Iran Conflict

The month of May marked minimal progress in reopening the strait of Hormuz with fresh strikes risking an increasingly fragile truce. US secretary of state, Marco Runia, and the White House special envoy, Steve Witkoff, are leading negotiations for the US which are being held primarily in Doha with Pakistan and Qatar acting as mediators. The objective for the US is to extend the ceasefire by 60 days, reopen the strait and lay foundation for talks on Iran's nuclear programmes. Whether these discussions are successful in achieving these objectives is uncertain, particularly as officials on both sides have stated that a final agreement is not imminent.

Investor sentiment has improved since the beginning of the conflict however confidence for a swift resolution was subdued as American forces carried out recent strikes targeting Iranian missile launch sites and boats in the strait of Humouz. Elevated Oil prices have fuelled inflationary pressure reducing the scope for interest rate cuts, a path that was almost certain prior to the conflict. However, with oil prices having fallen below $100 per barrel in recent weeks, this should provide some support to the inflation outlook.

Investor behaviour has evolved since the start of the conflict, moving away from a "sell now, think later" mentality and knee-jerk reactions to White House commentary towards a more measured approach, with market volatility beginning to ease. Nonetheless, the outcome remains uncertain and as such the Oil price remains elevated and inflationary impacts are being felt across the global economy.

Labour Leadership Battle

Closer to home trouble has been brewing for Labour leader Sir Kir Starmer as his leadership came under scrutiny within his own party concerned over policy U-turns and damaging local election results. One of the main contenders for a leadership challenge is Wes Streeting who all but confirmed his intention following his resignation as health secretary this month. A leadership challenge is a realistic possibility with potential candidates spending the last few weeks gathering support from various factions within the Labour party.

The market has responded negatively to the prospect of a leadership challenge with the 10-year gilt, a proxy for the cost of longer-term debt, peaking at 5.1% levels not seen since Liz Truss's mini budget. Similarly, UK Businesses have aired concerns that infighting will distract the government from enacting real change and addressing challenges businesses are facing such as labour shortages, high energy prices and cumbersome regulation.

Markets have calmed over the past week, however, the situation remains fluid and there are likely to be further developments in the weeks ahead.

Equity Market Resilience and Artificial Intelligence

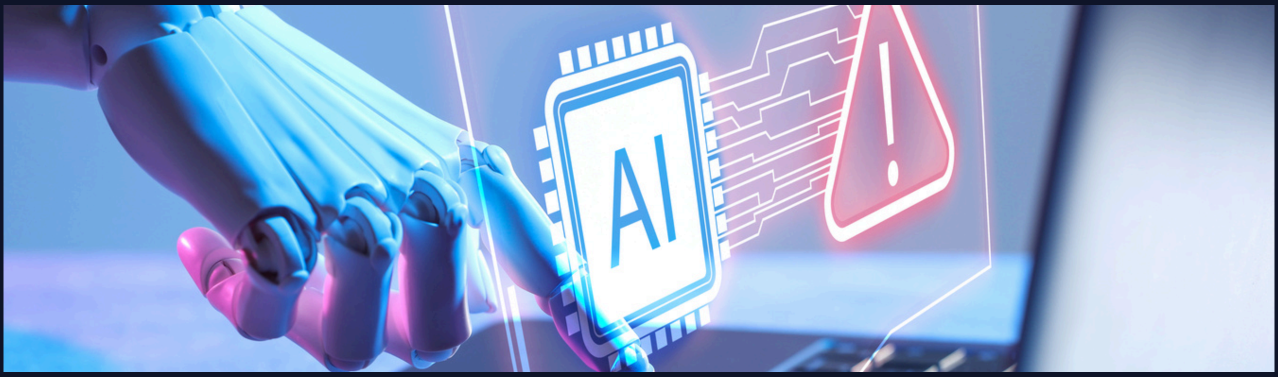
Equity markets have largely shrugged off economic risks from the Middle East and have continued to appreciate for a second consecutive month. Much of the recent market performance has been driven by a small basket of companies linked to the roll out of Artificial Intelligence (AI). As a result, technology-heavy indices such as the KOSPI, Nikkei 225 and NASDAQ have delivered double-digit returns since the beginning of April.

Investors have expressed concerns over stretched valuations, and these concerns have merit when looking at history, most notably the dot com bubble in the early 2000's. The difference today is that many of the AI companies are highly profitable businesses generating substantial cash flow which has supported their valuations. That does not mean, however, that all risks are fully reflected in market pricing.

Whilst investors are currently focused on the profitability opportunities presented by AI, they often overlook the physical infrastructure required to support it. Data centre developers are competing for finite grid capacity, industrial cooling systems and transformers, placing upward pressure on the cost of energy, tech hardware and utility infrastructure.

Although AI software may eventually improve productivity and reduce costs across the wider economy, the build out phase is likely to be inflationary. A stone's throw from the Reeves offices, a new data centre is under construction in Northumberland and is forecast to consume as much electricity as the daily requirements of the city of Newcastle, or around three million homes.

While exposure to the artificial intelligence theme can yield positive returns, it carries significant risk. Adopting a balanced approach that recognises both AI's productive potential and its structural challenges is prudent.



Economic Growth resilience

Five of the G7 economies recorded economic growth during the first quarter of the year, with Canada posting flat growth and France contracting slightly. Despite ongoing geopolitical uncertainty and higher interest rates, the global economy has remained broadly resilient.

The UK recorded growth of 0.6% during the first quarter, up from 0.2% in the previous quarter. This comes despite concerns surrounding Chancellor Rachel Reeves' fiscal measures introduced last year, particularly the increased costs facing businesses through higher National Insurance contributions and rising minimum wages.

More recently, the Government announced a temporary VAT reduction for family friendly attractions, children's meals and admission tickets. Whilst supportive for households at the margin, the measures are unlikely to materially alter the UK's broader growth challenges, with concerns persisting around labour market weakness and rising youth unemployment.

The UK remains sensitive to global gas prices and there are signs that the labour market is beginning to soften. As a result, the strong growth recorded in the first quarter may prove difficult to sustain throughout the remainder of the year. However, economic performance and asset market returns do not always move in tandem. Many of the UK's largest listed companies operate in sectors such as banking and energy, meaning the FTSE 100 can perform well even when domestic economic growth is subdued. Should energy prices remain elevated and interest rates stay higher for longer, the index may continue to benefit from its sector composition.

Looking Ahead

- Throughout June – US-Iran negotiations
- 10^{th} June – US CPI data release
- 10^{th} – 11^{th} June - European Central Bank Monetary Policy Meeting
- 15^{th} – 17^{th} June – 52^{nd} G7 Summit
- 16^{th} - 17^{th} June – Federal Reserve Meeting.

Summary

The common thread across these themes is resilience. Despite geopolitical tensions, political uncertainty and concerns over inflation, both economies and financial markets have remained remarkably robust. Whilst risks remain and volatility is likely to persist, investors continue to focus on long-term earnings growth, technological innovation and the ability of businesses to adapt to an evolving economic landscape.

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Investment Committee View

Asset class	Position	Rationale
Government Bonds	Negative	Expect yields to stay elevated or rise further amid inflation, oil/commodity and geopolitical risks, making bonds less attractive.
Credit Fixed Income	Neutral	Returns looked broadly okay, but there wasn't enough conviction to rate it positively or negatively given the mixed macro backdrop.
Property	Neutral	No significant change in the outlook, with income support offset by risks from rates, refinancing, and broader market conditions.
UK Equities	Neutral	Outlook still balanced and dependent on the macro backdrop.
US Equities	Positive	We remain constructive on the US and AI-led growth theme.
Asia Pacific Excluding Japan	Positive	Regional equity exposure remains constructive where the growth/valuation setup looked more attractive
Emerging Markets (EM)	Positive	Emerging markets were positive on a relative basis, with the team seeing room for upside in risk assets and regional opportunities, rather than a strong negative macro case.
Commodities	Neutral	Commodities were neutral because we saw a mixed picture: oil and some industrial/precious metals had upside, but not enough breadth across the complex to make a positive call.
Alternatives	Positive	A useful diversifier and a source of return in a mixed macro environment, especially where relative opportunities looked attractive.

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