NO EASY ANSWERS

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TABLE OF CONTENTS

Editorial	5
The macro backdrop: the US and the rest?	6
Investment strategy: no easy answers	9
Fixed income: carry is king	12
Equities: navigating growth, policy uncertainty, and US market trends	15
Commodities and FX: an end to USD strength?	18
Key markets: finding their way	21
Special topic: Trump 2.0. What will the next years bring?	24
Market data summary	27
Disclaimer	29

Dear Reader

With the much-anticipated slowdown or even recession in the US failing to materialize, 2024 turned out to be a good year for investments. The resilience of US growth also meant that the Fed eased less than expected while the bond market adjusted to the robust economic conditions.

At the start of the new year, all eyes are on the return of Donald Trump to the White House. He has promised to shake up not only the US, but the world. Until the recent tariff announcements, investors showed limited concern for his boastful claims. Far from it, they seemed to be embracing much of his agenda, as vague as it may be. Markets may still trip up, but currently sentiment is so strong that it is hard to bet against it. While we do not dismiss concerns about valuations and structural challenges, we remain constructive for the coming months. After all, businesses continue to deliver strong earnings and cash flows. Meanwhile, normalized bond markets offer levels of yield not seen in recent years outside periods of market stress.

The second coming of Trump is also the focus of our Special Topic. Will the US enter a new golden age or are we seeing the emergence of an utterly self-serving regime dominated by a few business tycoons? Only time will tell.

With so much change in the air, we expect 2025 to be a year of surprises and correspondingly higher volatility. As always, feel free to reach out to us to discuss the fast-evolving market environment.

Yours sincerely

Dr. David Wartenweiler, CFA
Chief Investment Officer

THE MACRO BACKDROP

The US and the rest?

The world has been bracing for the arrival of Trump 2.0. Shortly we will know how disruptive the new president will be. We think pragmatism will prevail, but even in this case, the US economy risks overheating. Quite the opposite is true for Europe. China finally will have to make some hard choices.

Key points

- Fed on the sidelines as US economy at risk of overheating
- Europe stuck in quasi-stagnation
- Hard choices looming for China

Trump to challenge US exceptionalism

US growth exceptionalism has been built on multiple pillars, with openness and global engagement, robust institutions, and the rule of law only the most obvious. Could this change under the new president? Possibly, but not necessarily. We believe that Trump's objective is first and foremost to look good and thus that he will shrink back from jeopardizing either the economy or the stock market or both. His policy agenda of higher tariffs, lower immigration, tax cuts, and deregulation is inflationary by nature. However, with the economy firing on all cylinders, his main goal should be to avoid an overheating. For its part, the Fed, the guardian of financial stability, has already signaled less room for monetary easing amid a tight labor market and sticky inflation. Markets in turn have lowered their implied rate cut expectations to barely more than one in 2025.

Europe on the ropes?

The eurozone economy is once again skirting stagnation, with both Germany, historically the engine of European growth, and France mired in protracted weakness. While the traditional laggards, Italy and especially Spain, are currently punching above their weight, they are not big enough to drive the region as a whole. One major challenge is structurally high energy prices which, given that price pressures are mounting again, may also limit the ECB's ability to provide additional monetary stimulus.

China ponders its options

China wants to maintain real growth of around 5% in 2025, a relatively high rate for an economy of this size and level of development. The country seems less sure about how to achieve this. The coming months will tell whether the piecemeal approach favored so far – here some monetary easing, there some fiscal measures, with targeted support for individual sectors – will do the trick or whether more muscular efforts will be required. Many believe that the Chinese leadership will want to see whether the threatened additional US tariffs are in fact imposed before recalibrating its economic policy. A shift toward a consumption-led growth model makes eminent sense in an increasingly hostile world but may be difficult to achieve without some drastic measures.

Table 1: Real GDP growth (y/y in %)

	2024F	2025F	2026F	Short-term trend
United States	2.7	2.1	2.0	↘
Eurozone	0.8	1.0	1.2	→
Germany	-0.1	0.4	1.0	→
United Kingdom	0.9	1.4	1.5	→
Japan	-0.2	1.2	0.9	→
China	4.8	4.5	4.2	↘
India	6.4	6.4	6.5	↗
Russia	3.7	1.5	1.4	↘
Brazil	3.3	2.0	1.9	↘

Table 2: Consumer price inflation (y/y in %)

	2024F	2025F	2026F	Short-term trend
United States	2.9	2.5	2.5	↘
Eurozone	2.4	2.0	2.0	↘
Germany	2.5	2.1	2.0	↘
United Kingdom	2.5	2.5	2.2	→
Japan	2.6	2.2	1.8	→
China	0.3	0.9	1.2	↗
India	4.8	4.8	4.3	→
Russia	8.3	7.3	4.9	↗
Brazil	4.4	4.4	3.8	→

Source: Bloomberg, HBZ

INVESTMENT STRATEGY

No easy answers

Equity markets rallied hard into the US elections but thereafter shed much of their gains before resuming the uptrend early in the new year. Meanwhile, the sell-off in rates may still have legs. What comes next will depend not least on whether we are in an equity bubble or at the beginning of a new era.

Key points

- Bubble or not, investors need to address concentration risks in US equity portfolios
- Bond yields becoming increasingly attractive
- Trump policy decisions will drive markets in 2025

Bubble or beginning of a new era?

There are growing concerns that the strong performance of equity markets over the past two years has pushed them into bubble territory. We could discuss at length what a bubble is and whether we are in one. However, we want to make a different point. We are in the middle of another period of accelerating innovation, epitomized by the fast rise of artificial intelligence and associated technologies. Many of the high-flying stocks have risen on this wave, delivering great returns but at the cost of above-average valuations. The question really is whether these above-normal growth rates can be sustained. The answer is probably for some time, but certainly not forever. Investors therefore need to pay attention to concentration risk, which is most evident in the US market. One solution is to adopt different weighting mechanisms, moving away from market cap weights to equal weights, for example. Another option is to diversify into cheaper markets, but this may be difficult to justify as long as the US is booming. Finally, there are other asset classes to consider. Bond yields have normalized to a great extent and, while there may be further upside risks on long-term rates, a yield to maturity of 5.5% for investment-grade corporates is not too shabby. After all, that is around two-thirds of the annualized S&P 500 return since the beginning of the century.

Our positioning

Currently, we are sticking to a neutral allocation in equities, with a dynamic risk overlay to limit the downside should markets correct more substantially. Attracted by the high running yields presently on offer, we are also targeting a neutral allocation to fixed income. Despite continuing strong performance, we are holding on to gold, which we value as a portfolio diversifier and USD hedge.

What we are watching

With the return of Donald Trump, we will scrutinize major policy decisions by the incoming administration. These will greatly influence economic and market developments this year and beyond. Rich valuations, especially in the US, are keeping earnings squarely in our focus, as only robust corporate results will sustain equity markets. Lastly, although the yield curve has returned to its normal, upward-sloping shape, large US issuance and stubbornly high inflation could create renewed upward pressure on yields and trigger a repricing of assets across the board.

Seven stocks dominate the S&P 500

Source: Bloomberg, HBZ

FIXED INCOME

Carry is king

Investment-grade and emerging-market credits continue to present resilient opportunities for yield-seeking investors, balancing strong fundamentals and sound valuations with selective risks and regional disparities. Investors need not chase yield at all costs.

Key points

- Remain selective in credit selection
- Focus on idiosyncratic risk
- Prefer duration risk to credit risk

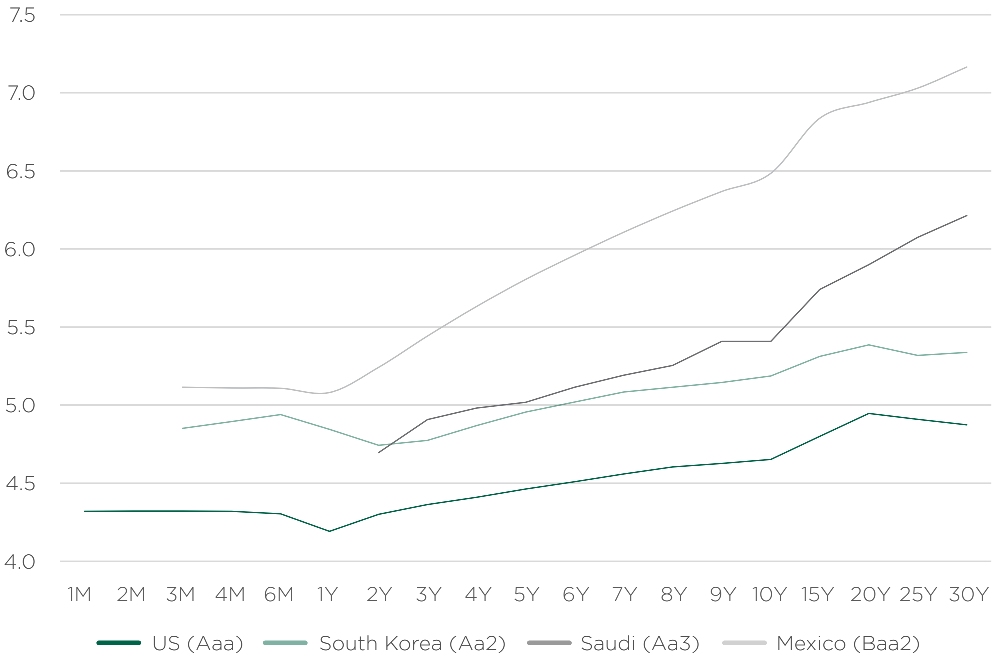
Investment grade: a resilient opportunity

Investment-grade (IG) credits continue to offer compelling opportunities for investors, supported by strong fundamentals, sound if not cheap valuations, and robust market technicals. In Europe, IG spreads are hovering near the tight end of their target range, driven lower by their attractive yields and supportive central bank actions. Meanwhile, US IG spreads are tight and expected to remain so, as optimism about tax and regulatory changes is offsetting concerns about trade and fiscal risks. Demand is bolstered by low supply levels, particularly in financials and select corporate credits. Inflation trends in both the US and Europe are moderating, encouraging central banks to proceed with rate cuts (with more downside in Europe than in the US), which is enhancing demand for longer-duration quality bonds. The return of the yield curve to its normal upward-sloping shape is also likely to attract interest from investors who have been hugging the front end of the curve and focusing on short-dated government paper. Although fiscal and geopolitical risks are here to stay, markets are confident that they will remain manageable. The outlook for IG credits thus remains positive, offering solid returns with limited downside risks.

Emerging markets: solid fundamentals with volatility and dispersion

Similarly, emerging market (EM) credits are positioned for another year of solid performance, supported by robust fundamentals and attractive technicals, despite some macroeconomic challenges. Global growth is projected to moderate slightly, with Emerging Asia (ex-China) maintaining the strongest momentum. In Latin America the outlook has improved, driven by the recovery in Argentina. As for US monetary policy, high-for-longer rates and a strong dollar represent two important headwinds, particularly for EM inflation dynamics and local currencies. Central banks must navigate the evolving economic environment carefully to manage inflation risks while sustaining growth. Although rather expensive, investment-grade EM credits remain undervalued versus their US peers, offering compelling yield opportunities. Moreover, pronounced regional and local differences persist, with vulnerabilities in countries exposed to trade tensions or fiscal problems (e.g., Mexico). Asian corporates are likely to benefit from a resilient fundamental backdrop, though segments of China's market may face pressure from US policies. Selective positioning in EM IG credits thus offers attractive carry for yield-oriented investors. There is little reason to venture into lower-rated credits until the current uncertainties have dissipated.

Quality EM issuers offer attractive pick-up versus US Treasuries (YTM in % p.a.)



Source: Bloomberg, HBZ

EQUITIES

Navigating growth, policy uncertainty, and US market trends

Global trade uncertainty was only higher during President Trump's first presidency, but we continue to see a favorable growth environment for US equities. Arguably, certain segments are better positioned than others to benefit from possible policy changes.

Key points

- Stay overweight in US equities
- Tilt towards sectors and styles that have low sensitivity to global trade and are winners in deregulation
- Expect higher volatility driven by policy uncertainty

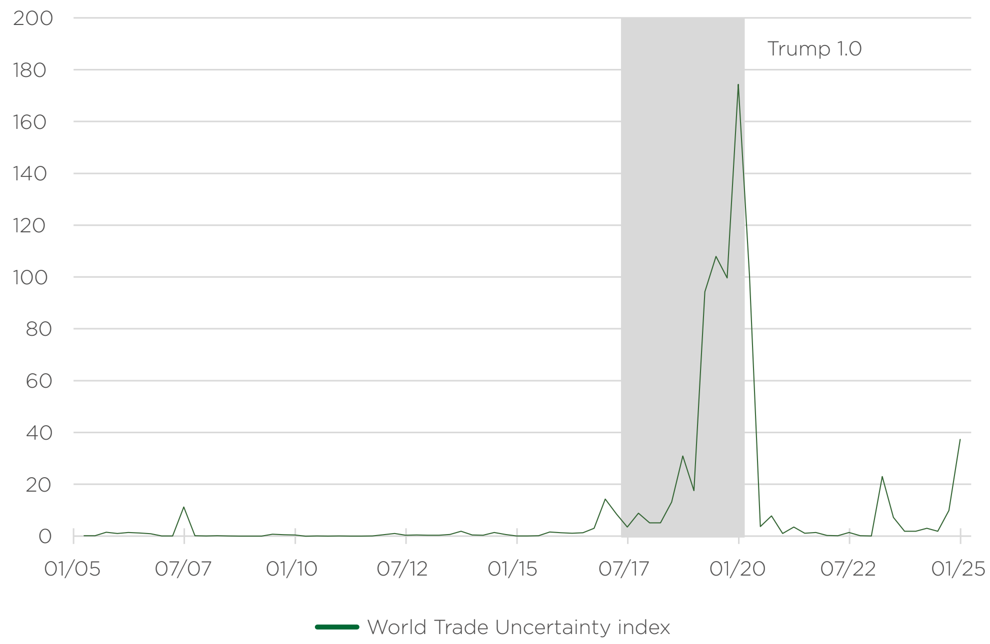
Modest end to 2024

The final quarter of 2024 began with equity markets treading water, which transformed into a strong rally after the US elections, fueled by expectations of pro-growth policies proposed by the incoming administration. However, the rally reversed abruptly when investors realized that the Fed might not cut rates as quickly as anticipated given the structurally inflationary nature of Trump's economic agenda.

How to position for 2025

To answer this question, we had a look at the previous administration period. The fact is, for example, that interest rate expense alone on US government debt increased from around USD 87 billion to USD 139 billion between January 2017 and December 2024, leaving much less room for policy mistakes. Nevertheless, in our base case, we believe that equities will perform well overall, with clear differences between certain sectors and styles. During the first Trump presidency, IT and consumer discretionary were the leading sectors. In terms of style, this meant that growth, momentum, and quality fared well while value underperformed. Moreover, large companies outperformed small ones. Assuming that growth-friendly policies such as tax cuts and looser regulation are only moderately offset by increased trade uncertainty and that interest rates decline, albeit only gradually, sectors that benefit from sustained demand, lower capital requirements, and lower sensitivity to global trade should remain well supported. In concrete terms, sectors such as IT, consumer discretionary, communications, and financials (especially banks) stand to benefit the most. On the other hand, potential changes to the healthcare system, greater potential for trade frictions, and longer periods of elevated interest rates make the environment less favorable for the healthcare, materials, and real estate sectors. At the style level, we expect growth, quality, and momentum to outperform value, while we expect large companies to continue to increase their market dominance on the back of further deregulation. The cash-rich business models of the largest companies will allow stock buybacks, acquisitions of competitors, and more resilience towards only slowly falling rates, while smaller companies often generate less free cash flow and face more constrained borrowing. We therefore expect large companies to continue to outperform smaller ones in the absence of any major anti-trust actions.

Global trade uncertainty second highest on record



Source: Bloomberg, HBZ

COMMODITIES AND FX

An end to USD strength?

US exceptionalism underpins the US dollar hegemony. We expect the early days of the Trump administration to be crucial, with little margin for error. Gold remains our favored hedge. Crude has also come back to life, although we are doubtful of substantial follow-through.

Key points

- USD strength to be tested by the Trump administration
- Gold offers portfolio diversification and a hedge against the overvalued USD
- Tighter expected supply gives temporary lift to crude

Stress-test for USD ahead?

Since it reached a temporary bottom in late September of last year, the US dollar has staged an impressive rally, dragged along by the rise of many US assets in growing anticipation of a second Trump presidency. In due course, resilient growth amid sticky inflation had markets revisit their Fed rate cut expectations, which moved forward interest rate differentials further in favor of the USD. Poor fundamentals for other majors, especially the EUR, provided another argument to go or stay long on the USD. USD strength was thus and still is premised on many factors, best summed up under the term of US exceptionalism. The first hundred days of the new administration will put this perception to the test. A pragmatic approach to policy could sustain the rally for longer, widening in the process the gap between the US and the rest further. Excessive or even reckless decisions, on the other hand, would most certainly frighten investors. Highly valued as it is, the dollar could correct sharply, taking other US assets with it.

Gold retains its shine

The end of 2024 was not kind to gold, as USD strength and higher real yields took the wind out of its sails. However, the fundamental case for gold as a portfolio diversifier and hedge against USD weakness remains intact. The fact that gold was able to deliver an equity-like return of 27% in a year when the trade-weighted USD gained more than 7% speaks volumes. Sure enough, the metal started the new year on a strong footing. We continue to expect sizeable buying from central banks, especially in emerging markets, and investors interested in hedging their USD exposure and the risk of a further deterioration in US public finances under the new administration.

Capped upside for crude

Crude oil made an unexpected comeback early in the year as new US sanctions on Russia's so-called shadow fleet of crude carriers may materially hamper the country's ability to sell its output to foreign customers. Meanwhile, the International Energy Agency sees a smaller surplus, which could strain markets in case of supply disruptions or stronger-than-expected global growth. However, most producers, especially national oil companies that need to feed their country's budgets, will jump at the opportunity to sell at higher prices. Any deficit should therefore be covered, quickly capping the price upside.

Gold as a hedge against excessive US government debt

Source: Bloomberg, HBZ

KEY MARKETS

Finding their way

Against the global backdrop of slowing inflation and central bank easing, our key markets have adapted and worked on their domestic challenges. Pakistan has managed a turnaround, the UAE is reaping the fruits of its diversification push, while the UK still struggles to reset.

Key points

- Reforms support stability in Pakistan
- UAE positioned for growth
- New UK government has yet to deliver

Pakistan: turnaround

The past year will go down as the year of a remarkably fast turnaround, a true feat for a country that not too long ago was on the brink of financial collapse. Inflationary pressures have receded to a mere 4.1%, a level not seen since 2018, allowing the State Bank of Pakistan (SBP) to perform a sharp policy pivot by easing its target rate by a full 1,000 bps, with more to come. The new USD 7 billion IMF Extended Fund Facility will have its first formal review in February 2025. During the year, reforms strengthened fiscal consolidation. In fact, a fiscal surplus was recorded in the first four months, albeit aided by outsized profits from the SBP. While oil-related imports grew, rising remittances amply covered the trade deficit and resulted in a current account surplus. The regained stability on the political and financial fronts improved domestic confidence, pushing the KSE 100 index to a dizzying rally of 84% for 2024. The currency managed to hold its own and appreciated modestly against the USD. Pakistan can thus start the year on a stronger footing but with not much room for any complacency.

UAE: harvest time

With a strategic location in the Middle East and its vision of a diversified economy coming to life, the UAE is delivering solid and stable growth even compared with its GCC peers. With comprehensive economic partnership agreements (CEPAs) in place with six countries, the UAE's non-oil trade continues to grow. Buoyant tourism and the revived property sectors are further boosting the non-oil sector. The upbeat demand outlook from OPEC could provide a further tailwind as the UAE forecasts real GDP growth accelerating to 4.5%.

UK: how to create growth?

While early in 2024, UK GDP growth accelerated noticeably, the trend subsequently fizzled out. This marked another difficult year for the economy, as Labour's landslide victory failed to lift the mood and activity. Even the modestly expansionary fiscal policy may come to naught as persistent inflation and higher tax burdens risk crowding out demand. While higher inflation restricted the Bank of England to only two rate cuts in 2024, improving price trends could at least open the door for more substantial easing in 2025.

Pakistan: decline in inflation creates room for more rate cuts

Source: Bloomberg, HBZ

SPECIAL TOPIC

Trump 2.0. What will the next years bring?

It is early days for the second Trump administration, but after a flurry of executive orders it is already clear that the new president intends to follow through on much of the agenda presented during the campaign. What will his actions mean for the economy and what will markets make of them?

Key points

- Trump aims to unleash animal spirits
- Markets will judge policies on their results
- Early delivery of agenda key to Trump's success

A new golden age...

At his inauguration, President Trump made the grandiose claim that the US had just entered a new golden age and that his vast agenda of deregulation and America-first policies would be the way to achieve it. His plans aim to unleash the country's animal spirits, which according to him have been stifled by excessive interference and spending. Arguably, some of the proposed actions may well trigger a strong response from American corporates and households. Lower taxes will give everyone more money to spend and invest, less regulation might speed up projects, and tariffs may protect businesses that otherwise would have been uncompetitive. Foreign direct investment may also pick up if it enables countries to avoid punitive import duties. The key test for these and other proposed measures will be twofold: are they delivering on growth and will they keep inflation in check?

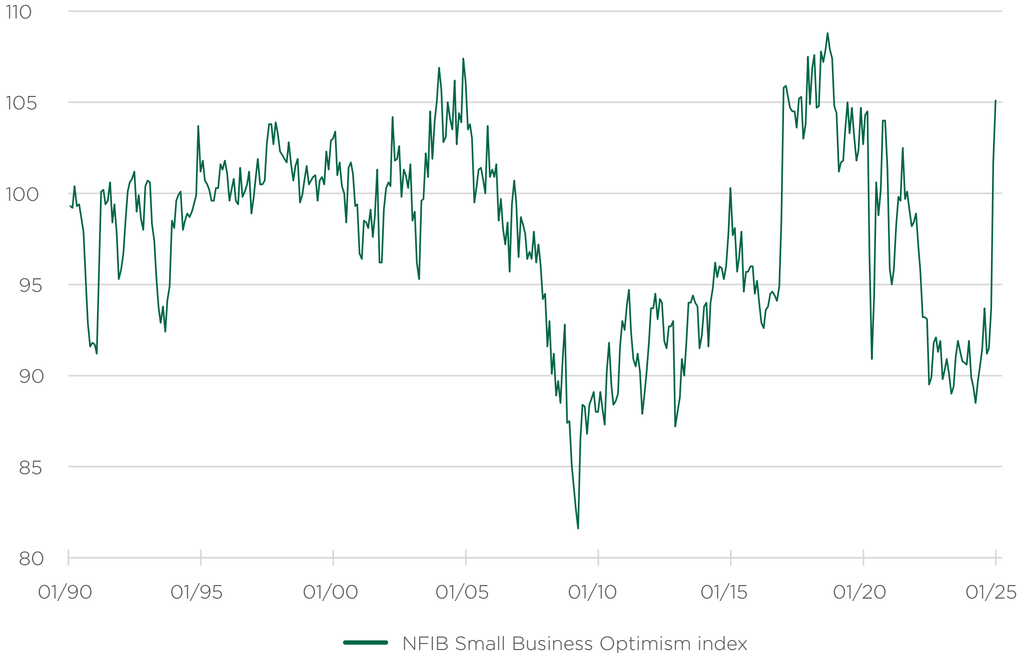
...or crony capitalism?

One of the risks of all these actions is that they will lead to an overheating of the economy, forcing the Fed at some point to reverse tack and resume tightening monetary policy. Moreover, reduced government oversight may further entrench the unequal distribution of wealth and oligopolistic tendencies in certain industries. Were these trends to assert themselves, they would run against some of the key tenets of the Make America Great Again movement and could seriously undermine the president's standing. The fact that many captains of the IT industry were keen to cozy up to the newly elected president must have raised concerns among the Republican party's populist wing.

Time is of the essence

Eventually, markets will judge the president's actions on their merits. Are they sufficiently disruptive to sustainably lift growth or are they so disruptive as to destabilize the country's economic and financial system? In addition, the US still has a formidable network of institutions overseeing the process of governing. Courts in particular may delay or even derail many of the new administration's initiatives. There is also an electoral calendar that is relentlessly moving towards the midterms in November 2026. The incoming president needs to deliver early for his actions to bear fruit. Otherwise, he risks ending up as a lame duck well before the end of his second term.

US small businesses euphoric about Trump 2.0



Source: Bloomberg, HBZ

MARKET SUMMARY DATA

As of 28 January 2025

Equity indices	Last	-3M	YTD	-3Y
		%	%	%
BBG World USD	2,006.7	2.1	2.6	31.2
S&P 500	6,012.3	3.2	2.2	35.7
EuroStoxx 50	5,188.5	4.4	6.0	25.4
FTSE 100	8,503.7	2.6	4.0	13.9
SMI	12,416.6	1.5	7.0	2.6
Nikkei	39,016.9	1.1	-2.2	46.0
BBG EM USD	1,211.6	-4.0	0.7	-2.5
Sensex 30	76,213.1	-4.7	-2.5	33.2
KSE 100	112,630.7	24.6	-2.0	149.9
Hang Seng	20,225.1	-1.8	0.8	-14.1
Brazil Bovespa	124,861.5	-4.8	3.8	11.6

Bond indices	Last	-3M	YTD	-36M
		%	%	%
BBG US Gov	2,303.39	-0.2	0.6	-6.2
BBG US Corp	3,314.22	0.0	0.8	-2.7
BBG US HY	2,716.10	1.8	1.2	13.5
BBG Euro Gov	243.96	-0.5	-0.8	-11.0
BBG Euro Corp	257.25	0.3	-0.3	-1.4
BBG EM Sov	409.31	0.9	0.9	2.2
DB EM Local USD	162.20	-1.0	3.2	0.7

Currencies vs. USD	Last	-3M	YTD	-3Y
		%	%	%
DXY	107.34	3.4	-0.5	10.9
EUR/USD	1.05	-3.5	0.8	-6.5
USD/CHF	0.90	-4.5	0.2	2.7
GBP/USD	1.25	-4.2	-0.7	-7.2
USD/JPY	154.29	-1.7	1.0	-26.0
AUD/USD	0.63	-5.0	1.1	-10.5
USD/CAD	1.44	-3.5	-0.1	-11.3
USD/ZAR	18.76	-6.0	0.4	-17.1
USD/INR	86.34	-2.8	-1.1	-13.3
USD/PKR	278.74	-0.3	-0.1	-36.6
Gold oz	2,733.73	-0.1	4.4	53.0

Interest rates	3M interbank	10Y government
	%	%
USD	4.85	4.55
EUR	2.64	2.54
GBP	5.30	4.59
CHF	0.42	0.46
JPY	0.39	1.20
AUD	4.32	4.42
CAD	4.97	3.20
ZAR	7.65	10.47

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