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MARKET OUTLOOK 2025

TIME TO BE WARY?

Once again investors can look back on a year that defied most forecasts: There were warranted concerns about a US recession and equally justified expectations of substantial Fed easing. The first never occurred – the US economy continued to expand at a healthy clip – and the Fed only eased moderately, acknowledging at least the sharp drop in inflation from its peak. What does 2025 have in store? With Trump readying his team for a second term, projections are fraught with even greater uncertainty than usual. Here are our key points:

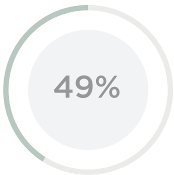
- The global expansion will continue, albeit unevenly
- Inflation trends will diverge but could remain sticky in the US
- Equities should continue to do well in a context of solid nominal growth but are currently priced for perfection and hence vulnerable to a temporary set-back early in the year
- Normalized yields will deliver solid carry while the Trump policy mix will be supportive of the USD

2024 in review: performance of major asset classes

Assets and Markets		Year-to-date
Equities World	USD	22.4%
S&P 500	USD	29.3%
EuroStoxx 50	EUR	12.9%
FTSE 100	GBP	11.4%
Swiss Market Index	CHF	9.2%
Nikkei 225	JPY	18.4%
Equities Emerging Markets	USD	10.8%
China - CSI 300	USD	16.2%
India - SENSEX	INR	14.5%
Pakistan - KSE-100	PKR	74.7%
USD Investment Grade	USD	3.5%
US Treasury	USD	2.6%
US Investment Grade	USD	4.8%
US High Yield	USD	9.4%
Emerging Market Sov USD	USD	10.2%
Gold	USD	28.9%
Oil (Brent)	USD	-3.3%
USD (trade weighted)	USD	4.5%
EUR	1.058	-4.1%
GBP	1.278	0.4%
CHF	0.879	-4.2%

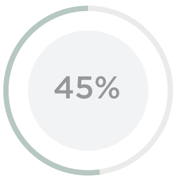
Source: Bloomberg as of 9 December 2024

Recommended portfolio allocation for 2025
(indicative positioning of USD global balanced mandate)



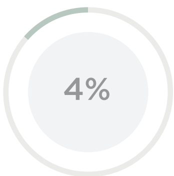
EQUITY

Region/Sector	Allocation
US	34%
Europe	6%
Japan	3%
EM	5%
ROW	1%



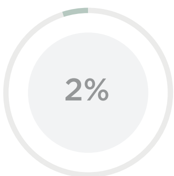
FIXED INCOME

Region/Sector	Allocation
Treasury/ABS	19%
Investment Grade	14%
Subordinated Bonds	4%
High Yield	4%
Emerging Markets	5%



ALTERNATIVES

Region/Sector	Allocation
Gold	4%



LIQUIDITY

Region/Sector	Allocation
Cash	2%

OUR BASE CASE SCENARIO
Global expansion to continue

Driver	Comment	Trend	Risk Implications		
			on	neutral	off
Global GDP growth	No US recession, global expansion to continue	→	•		
Global inflation	Disinflation stalling in US	→		•	
Global policy rates	Diverging central bank policies with fewer Fed rate cuts	↘		•	
Global liquidity	Declining but supported by lower pace of Fed QT	↘		•	
USD trade-weighted	USD at risk once global turns up	→		•	

The global economy is expected to remain on an expansion trajectory with a similar rate of growth to this year (3.2%). **Regional differences,** owing to respective positions in the cycle and prevailing local conditions, **may become more accentuated, especially considering that the incoming US administration has reiterated its intentions of imposing far-reaching trade tariffs.** Europe, already challenged by various structural woes, appears particularly exposed, as is China, which in the past two years has relied heavily on exports to prop up a flailing domestic economy. While not slayed, **inflation has been tamed in most economies.** While there is a lingering risk of a second wave, not least due to the policy agenda of the new US government, most central banks currently have some additional room for easing going into 2025. Importantly, **fiscal spending will decline only moderately** as some economies try to prop up growth while others seek to address pressing concerns such as low productivity and energy transition and, not least, to shore up their defense capabilities in a more hostile global environment. Fiscal sustainability will be a recurring concern but necessity will prevail.

Global: world trade to suffer from Trump 2.0?

Source: Bloomberg, HBZ

US: time for capex to pick up

Source: Bloomberg, HBZ

In 2025, **US growth should moderate,** as parts of the consumer segment will have exhausted their ability to spend freely. However, **a recession is not in the cards.** Solid private-sector balance sheets, lower interest rates, and the effects of years of fiscal expansion under the outgoing president will keep growth close to potential. What is more, **many of the policies of the new administration,** such as the extended tax cuts and deregulation, **will be reflationary and supportive of growth.** Capital spending should also rebound, as many corporates appear to have waited for the elections before committing to new projects. **The disinflationary trend may have stalled, but the Fed still has some room for easing,** as annual headline inflation, which peaked at 9.1% in June 2022, has declined to 2.6% and even the stickier core has halved. At the same time, chair Powell stated clearly that the **Fed is in no rush** and will therefore pause at some stage to assess the impact of new government actions on the economy. Measures such as tariffs and the deportation of undocumented migrants could put upward pressure on prices, and the Fed does not want to have to reverse course.

Eurozone: weak growth prospects

Source: Bloomberg, HBZ

EM: China weighed down by property sector

Source: Bloomberg, HBZ

European economies will continue to battle with old challenges and face new ones, first and foremost in the form of expected US tariffs. With its main economies, Germany and France, underperforming, **the eurozone is once again close to stagnation.** Confronted with lower growth but also easing inflation, **the ECB will cut its policy rates further. The UK economy should perform better;** this, however, may also slow the pace of easing by the Bank of England.

Similarly, **China will have to deal with outright US hostility on the trade front, while its economy will continue to be weighed down by years of excessive investment in real estate,** which has seriously dented consumer confidence. While trade issues are usually solved by negotiation, the opening salvos from the incoming Trump administration are not encouraging. Moreover, both nations increasingly look at each other through the lens of inevitable rivalry for global supremacy, making pragmatic deals even harder to achieve. Faced with tariffs and, as a result, a lower contribution of exports to overall growth, the Chinese authorities may finally resort to much **more consequential fiscal stimulus measures,** which so far they have only deployed in a targeted, piecemeal way.

The rest of the world will not escape the vagaries of a more inward-looking US either. Especially **export nations can easily end up in the sights of the new administration.** Canada and Mexico, for example, have already been singled out as targets for higher tariffs, largely though, it seems, to exert pressure in other areas of interest (illegal immigration and drug smuggling). Asian economies with a large traded sector will likewise risk the wrath of the US, especially if they are used to circumvent more onerous tariffs inflicted on Chinese goods. Therefore, **more domestically-driven economies should fare better.** In this respect, India stands out as the best-performing large economy among emerging markets. This is unlikely to change in 2025. The regional dynamics should also continue to favor the GCC countries, where the appetite for investments seems insatiable.

OUR RISK SCENARIOS
Much worse or much better

Theme/topic	Comment	Risk Implications		
		on	neutral	off
Growth/inflation	Inflationary policies under Trump (tariffs, tax cuts, anti-migration)			•
Growth/earnings	US recession, margin pressures from higher wages etc			•
Financial stability	Excessive US/G7 debt levels to spook bond markets			•
Political risk	US-China relations, Middle East, Ukraine			•

Our downside scenario is based on deepened antagonisms in the global economic and financial system, emanating from a confrontational US government, but also resulting from tit-for-tat responses to US tariffs by other nations. In such a case, everyone would be worse off. Domestically, the US could face a recession if hardliners within the Trump government were to prevail and succeed in implementing highly disruptive policies. Large-scale deportation of undocumented migrants could push activity in many services sectors and in agriculture to breaking point. Such supply shocks in the US, but also elsewhere, could rekindle inflation to the point that central bankers could no longer sit on the sidelines. Finally, the slow-burning issue of excessive public debt levels in many developed nations could erupt again, less likely in the US given the sheer size and global role of the US Treasury market, but possibly in Europe.

Our upside scenario revolves around a pragmatic Trump administration, mainly focused on being successful and making the president look good rather than chasing down ideological and geopolitical rabbit holes. This could translate into more benign tariffs, only moderate expansion of the US budget deficit, and smart use of its international power, which could lead, for example, to a ceasefire in Ukraine. Europe, often slow to react but nevertheless able to act when faced with crisis, could start addressing some of the key weaknesses outlined in the 2024 Draghi report (innovation, energy, and defense). As a consequence, economic performance across the globe could turn out to be materially stronger without unduly reviving price pressures. Central bankers could also become more forthright in accepting moderately higher levels of inflation as their price stability target. After all, the generally targeted 2% is not grounded in hard empirical facts.

INVESTMENT IMPLICATIONS
Diversification still matters

Driver	Comment	Trend	Risk Implications		
			on	neutral	off
Equity valuations	High US valuations limit short-term upside	→			•
Equity earnings	Earnings growth to continue to sound levels	→		•	
Credit spreads	IG spreads average - high yield spreads too tight	↗		•	

For the second consecutive year, global investors benefited from strong returns across most asset classes. Equity investors were once again compensated with outsized gains in the US market, where solid earnings growth and confidence in the unfolding AI revolution propelled the **S&P 500 index to new all-time highs. Investors knowingly turned a blind eye to high valuations, adopting a winner-takes-it-all mindset to the stock market.** This view could well be put to the test in 2025, but this would require a trigger that is not part of our main scenario. Importantly, in 2024 investors were not punished for embracing multi-asset solutions. Fixed income made a decent contribution to mixed portfolios as **interest rates continued to normalize,** dialing back the most extreme inversion of the yield curve in recent memory. In the context of solid growth and resilient corporate margins, credit spreads fell to multi-decade lows – another feature of the markets of 2024 that may be tested next year. Gold was another stand-out asset for most of the year, although revised Fed rate expectations and a return to USD strength capped the upside and cloud the outlook, at least in the near term.

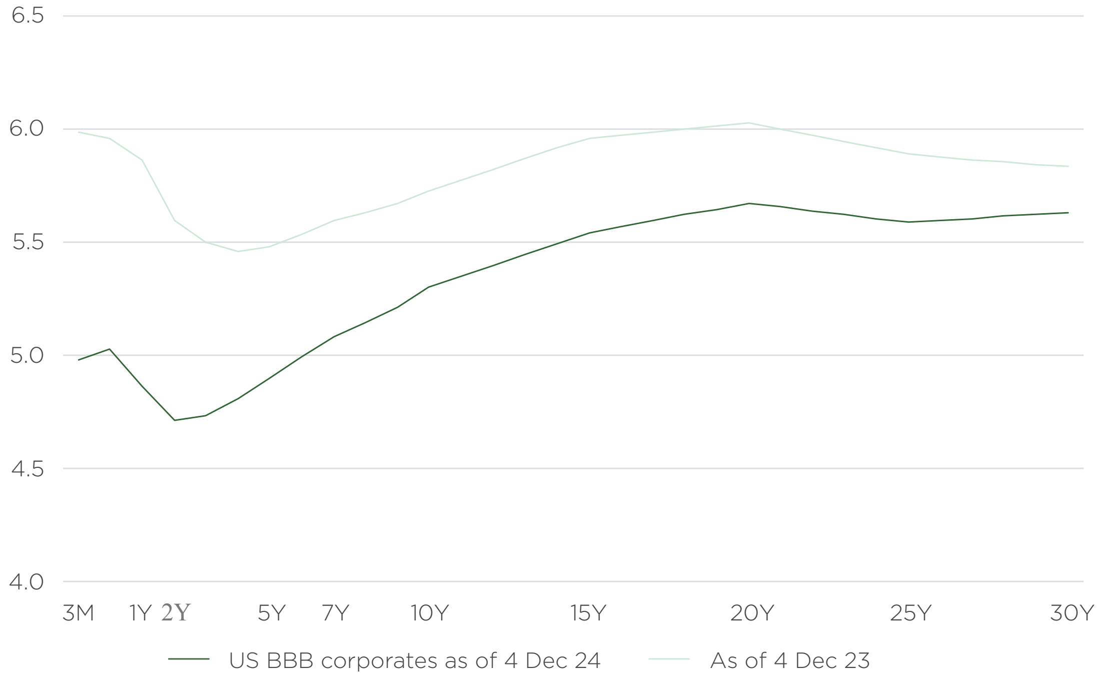
All in all, multi-asset investors enjoyed robust total returns, and even more so in risk-adjusted terms. In all fairness, **they were spared sustained drawdowns. Historically, such events occur with some frequency but are difficult to anticipate.** High valuations of parts of the stock markets and tight credit spreads are two characteristics of the current market context that warrant some prudence, and could well trigger a more material correction, especially in our downside scenario. However, in such a case, risk-free rates across the curve would most likely decline substantially and limit the overall impact on well-diversified multi-asset portfolios.

FIXED INCOME

Carry is king

Over the course of 2024, the shape of the USD yield curve continued to normalize, with much but not all of the inversion removed. As a result, the front end of the curve has become considerably less attractive, and investors seeking to protect their returns have started to take some duration risks. We remain convinced that **investment-grade corporate bonds** offer the best risk/return **to lock in attractive yields for longer.** A focus on carry, income derived from holding bonds, should allow investors to see out the inevitable periods of market volatility and potential mark-to-market drawdowns. In fact, such periods will offer good entry points to roll maturing money market placements into bonds with medium duration. As we are **not seeing any early signs of a material increase in default rates,** the repayment risk for quality issuers remains at very low levels. This also applies to **emerging market bonds,** where we similarly favor investment-grade issuers. Given where we stand in the cycle, high-yield issuers, both corporate and sovereign, appear more vulnerable. We therefore counsel caution in this space. **Subordinated bonds of quality issuers remain a valid alternative** though, combining higher yields with very limited default risks. Finally, **insurance-linked bonds can provide further portfolio diversification,** since their main return drivers are largely decorrelated from market variables.

Fixed income: yield curve favors moderate duration risk



Source: Bloomberg, HBZ

Equities: S&P 500 richly valued

Source: Bloomberg, HBZ

EQUITIES
Mind the cap

This was yet another year in which **investors were rewarded for holding the ever-more concentrated S&P 500,** a market portfolio where a mere seven stocks account for more than 30% of the market capitalization, a staggering USD 16 tn. The power and attraction of the business models of the top US corporations has become such that global diversification achieved little in terms of extra returns, although it does remain important for keeping overall risk in check. With this in mind, we will repeat the message of last year that **investors should seek broader exposure than to a market and an index-weighting mechanism whose performance is so narrowly focused on a handful of stocks.** In US-centric portfolios, it is particularly important to add more breadth, and this can easily be done by following an equal-weighted investment approach for part of the allocation. There are good reasons for this beyond prudence. For one, markets tend to be mean reverting, and the longer extreme constellations persist, the higher the probability that some form of adjustment, not necessarily dramatic, will occur. Currently, forward-looking valuations seem high, so the price-to-earnings ratio for the S&P 500 is almost two standard deviations from the long-term average. That said, based on our fundamental outlook for the US economy, **we continue to favor the US market over much of the rest of the world.** Deregulation, lower taxes, and even some tariffs may be supportive in 2025, while the strong USD will diminish returns from other regions for USD-based investors

Outside the US, we continue to favor **Japan, where valuations are less demanding and corporate governance has improved, including cash distributions to investors.** In addition, Japan seems to be less in the focus of the incoming US administration's tariff strategy. This is not the case for Europe, especially Continental Europe, which looks much more vulnerable to US tariffs, and where fundamentals have not improved as much as anticipated. That said, **valuations in the eurozone are much more reasonable, with stocks trading at a 40-50% discount relative to the S&P 500.** We will revisit the case for Europe as the year unfolds and US tariff policy becomes clearer, but years of disappointment keep us on the sidelines for now. **Among emerging markets, India is still our preference,** even when considering high valuations and, more recently, disappointing earnings growth. Fundamentals remain robust, growth is largely domestically driven, and the country has only recently become a major destination for foreign, export-oriented manufacturers. For China, on the other hand, the context is more complicated. The tensions with the US will remain elevated, growth is under pressure for hard-to-fix structural reasons, and comprehensive US tariffs could seriously hamper exports. While major fiscal stimulus would most certainly trigger another market bounce, the medium- and longer-term outlook is not yet very appealing.

In terms of sector allocation, we recommend **overweighting technology,** a sector which is at the core of fast change in the way we live and work. AI will remain a dominant feature, both from a capital investment and an application perspective, and hence will support earnings for key suppliers. The **communications sector** will be one important beneficiary of this trend. **Financials stand to gain** from central bank easing, which will support loan growth, and from deregulation in the case of the US. Health care, finally, has underperformed for a second consecutive year, but structural drivers such as global aging and rising income in EM economies remain in place. Moreover, valuations are more in line with fundamentals.

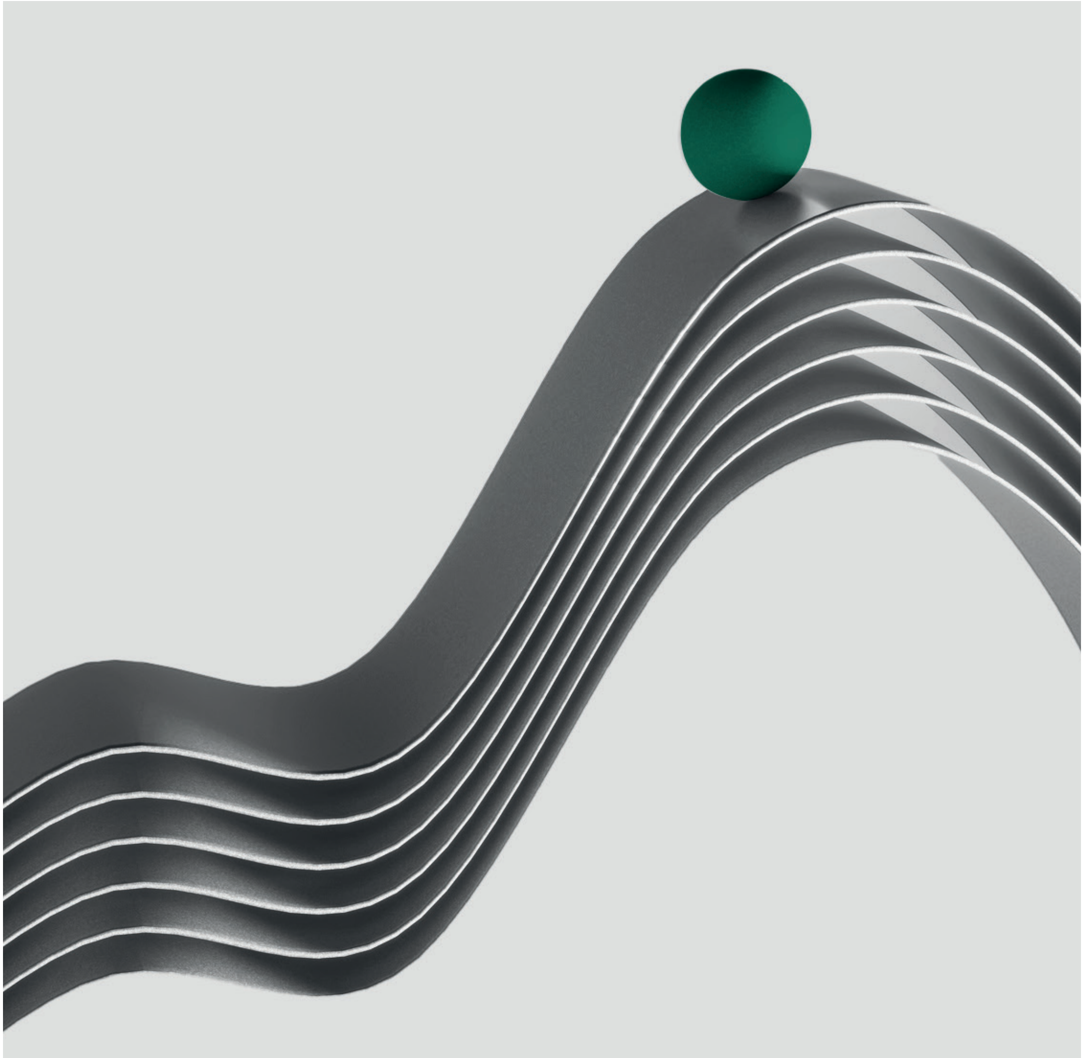
CURRENCIES & COMMODITIES
USD dominant for now

The dominance of the US dollar is unlikely to end in 2025 despite efforts from the BRIC countries to set up an alternative and recurring concerns about the US federal budget deficit. For one thing, the shallower trajectory of the Fed rate easing cycle will provide important carry support, while the central banks of other majors such as EUR, GBP, and CHF may cut more or to less attractive levels. Among the G10, only the Bank of Japan is talking about raising its policy rate, albeit only very moderately, and this could be enough to give JPY a boost. US tariff policy will be another factor affecting currencies and could well force some emerging markets into devaluating, especially if China were to weaken CNY further. The **key risk of USD dominance is overreach by the Trump administration,** which would undermine confidence in the US institutional framework.

In the commodity space, we see little upside for most commodities in generally well-supplied markets. **Crude oil,** to take one of them, **will remain under pressure** because of OPEC's focus on market share and a US government encouraging more domestic production. Ever since the US weaponized the USD in 2022, **gold has acquired a new quality** which is appreciated by private, institutional, and official investors. Although it has faced recent headwinds owing to the strength of the US dollar, **gold retains investor appeal as a hedge against geopolitical risks and, at some stage, a weaker USD.** Prospects for more upside remain intact.

PRIVATE MARKETS
Attractive but not for everyone

In addition to investment in public markets, asset managers are increasingly proposing **private market solutions** to qualified private investors. These assets, historically the sole domain of institutional investors and family offices, **offer attractive risk/return characteristics and low correlation, but come with serious limitations.** The first is illiquidity, which requires staying power that often exceeds the investment horizon of private individuals. The second is manager selection. Unless investors have access to the top manager, returns can be disappointing, negating the whole purpose of investing in private markets. There are hybrid, so-called evergreen solutions, which try to mitigate the illiquidity aspect, but they often also dilute the return proposition. In private equity, one way to address the concern about long lock-up is to focus **on later-stage investments and secondary transactions,** which usually translate into lower investment risk but accelerate cash flows (return of capital) with still-decent returns on capital invested. Private credit is another area where cash flows to investors are more predictable and occur early in the investment. If all the risks and limitations are understood, an allocation to this asset class makes sense in large portfolios with a long investment horizon and limited liquidity requirements.



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