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Investment Management

Window on the World

JANUARY 2025

Introduction

Investors are always looking ahead trying to anticipate how economies and markets are going to perform and, as always, the start of a new year is a favourite time to do this – new year clean slate, so to speak! The main event, of course, Donald Trump's return to the White House. His inauguration on 20 January marks the beginning of what likely promises to be an eventful four years, and there has already been huge speculation about what he's planning. For investors, this speculation focuses on his trade policies, especially the potential for higher tariffs, the impact of stricter immigration controls and the outlook for government spending – topics I've already chatted about in previous Window on the World publications.

But before looking forward it's worth looking back at 2024. It was an interesting and undeniably dynamic year for capital markets. So, in this edition I delve deeper into the factors that shaped the year, examine the concept of US exceptionalism, and discuss strategic portfolio positioning as we step into 2025.

2024 capital market returns

	Total Returns (%)			
	1 Month	3 Months	12 Months	YTD
UK Equities	-1.3	-0.2	9.6	9.6
US Equities	-2.4	2.4	25.0	25.0
European Equities	1.9	-1.7	11.9	11.9
Japanese Equities	4.0	5.4	20.4	20.4
Emerging Market Equities	-0.1	-7.9	8.0	8.0
UK Gilts	-2.5	-3.6	-4.1	-4.1
UK Corporate Bonds	-0.6	-0.4	2.1	2.1
UK High Yield Bolds	0.7	1.8	10.7	10.7
US Corporate Bonds	-1.7	-2.9	2.5	2.5
US High Yield Bonds	-0.4	0.2	8.2	8.2

Source: Bloomberg, as of end December 2024. Total Return figures, in local currency

US equity markets took the lead once again, delivering an impressive return of more than 20% for the second year in a row. And while some political developments caused volatility during the year, they didn't disrupt a broadly improving global economic performance. But it was the U.S. economy that stood out, demonstrating remarkable resilience. A backdrop of falling inflation, looser monetary policy, and sustained enthusiasm for advancements in Artificial Intelligence (AI) provided strong support for equity markets worldwide – so, it won't be a surprise that equities outperformed bonds in 2024.

Government bonds, and bonds more broadly, faced a tougher environment. While inflation fell during the year in most countries the rate of decline was far slower than many investors had expected. Consequently, as investors adjusted expectations for the pace of central bank interest rate cuts, yields rose, resulting in negative returns for UK Gilts. In contrast, credit markets fared better, with both investment-grade and high-yield bonds generating positive returns due to higher starting yields and tightening credit spreads.

In the equity space, U.S. markets were again propelled by mega-cap technology stocks, with the "Magnificent Seven" delivering a staggering 48% return and adding $6 trillion to market capitalization. At times it felt like this was the only game in town, but broader market participation improved slightly, with sectors like financials (+28%) and utilities (+20%) also posting robust double-digit returns. Small-cap stocks, which have been out of favour, lagged, but did achieve a solid 11% annual return and were buoyed up by the outcome of the US election and expectation that the domestic US economy will benefit.

European equities began the year on a strong note as economic activity picked up, but momentum waned in the second half. This was due to a combination of weaker export demand, largely driven by a poorly performing Chinese economy, and growing political instability in France and Germany, which further weighed on sentiment. Unsurprisingly, equity market returns lagged behind the US.

Japan sometimes seems to tread its own path, which is different to other economies, but it emerged as the second-best performing equity market of the year. Conviction in ongoing corporate reforms and optimism surrounding the potential end of deflation were key factors that pushed the market higher. And this was despite a summer slump, caused by the Bank of Japan raising interest rates.

In the UK, optimism surged after the July general election, which saw the Labour Party secure a strong majority. However, sentiment cooled after the November budget, which limited further gains in the year's final months. This left the UK market ending the year with large-cap equities returning just under 10%, having been supported by an economic recovery following a technical recession in late 2023.

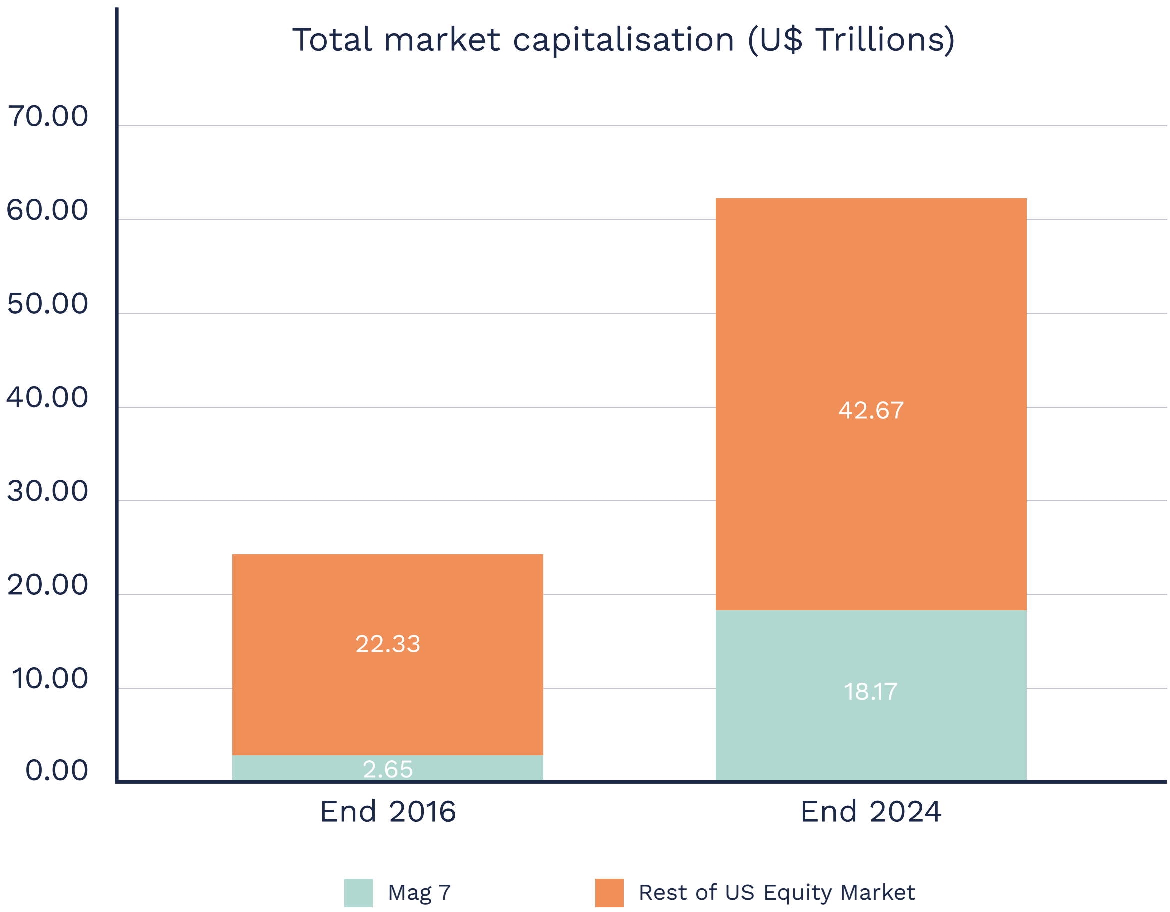
Emerging markets presented a mixed picture. China faced ongoing challenges but benefited from more cohesive policy measures in the second half of the year, resulting in stronger performance and driving an 8% overall return for Emerging Market equities in 2024.

A closer look at US exceptionalism – market and economic dominance

US equities have now delivered two consecutive years of returns exceeding 20% – a feat last seen during 1998 and 1999. Those with long memories will recall this period as a precursor to the bursting of the TMT (technology, media, and telecom) bubble and the ensuing bear market. This similarity raises some obvious questions, but the robust performance of the US economy and its equity market has also reignited discussions about the phenomenon of US equity and economic exceptionalism.

At its core, US exceptionalism reflects the belief that the United States is inherently unique, often viewed as superior in terms of its economic and technological leadership. This stems from the country's market-driven economy, liberal innovation ecosystem, and entrepreneurial culture, all of which have fuelled its superior performance. Today, the US equity market comprises nearly two-thirds of global stock market capitalization, underscoring its dominant position.

It can be argued that the factors behind what many see as US exceptionalism has enabled the meteoric rise of the largest US technology companies. The so-called "Magnificent Seven" – Apple, Amazon, Google, Nvidia, Microsoft, Meta, and Tesla – whose combined market capitalization grew from $2.7 trillion eight years ago to more than $18 trillion by the end of 2024. These companies now account for nearly one-third of the total US equity market, up from just 10% eight years ago.

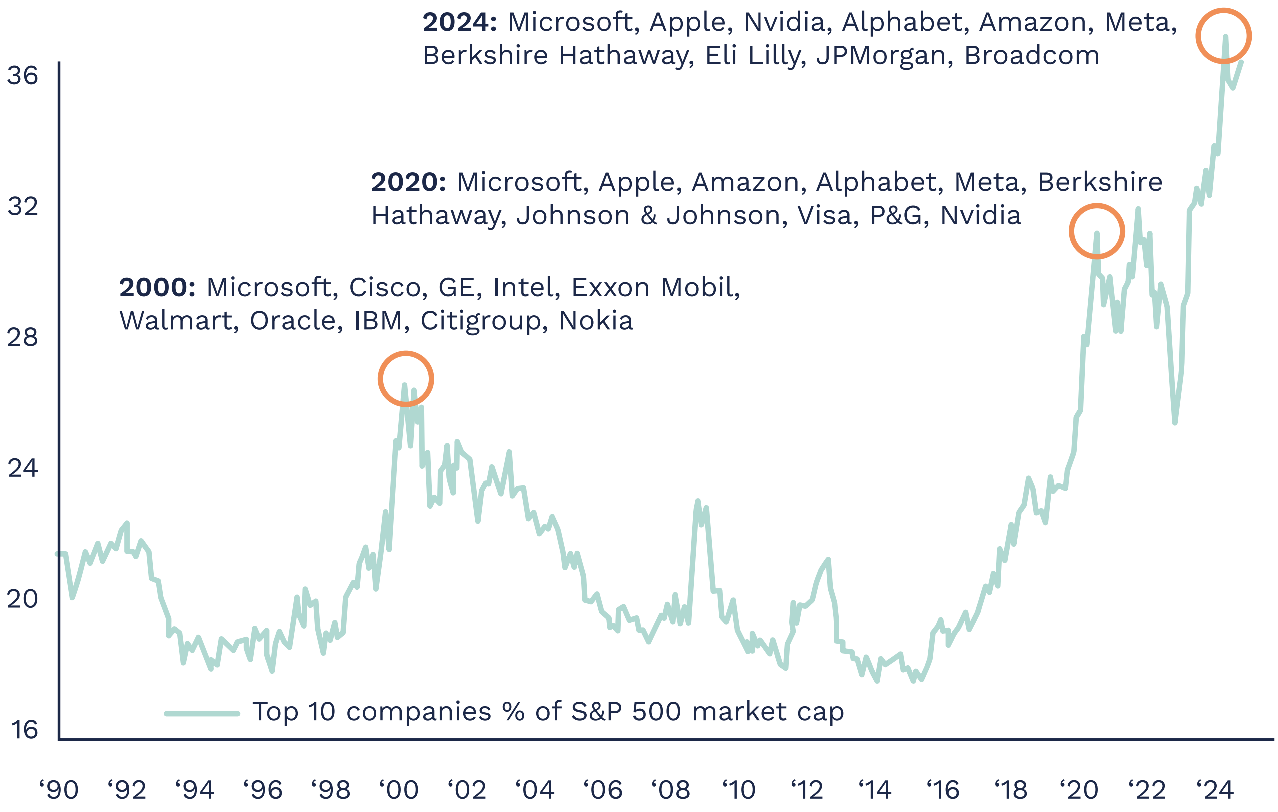


These firms, often leaders in their respective industries, have enjoyed extraordinary growth over the past two decades, with some operating as quasi-monopolies. Most recently, their appeal has been amplified by investor enthusiasm for Artificial Intelligence (AI). Leveraging their substantial cash flows, these companies have made significant investments in AI to maintain and expand their market leadership.

However, this has led to a notable concentration within the US equity market – a trend that history suggests is unlikely to persist indefinitely and one that mirrors the market of 1998/99.

CHART 7: US STOCK MARKET CONCENTRATION HIT RECORD HIGH IN 2024

TOP 10 COMPANIES % OF S&P 500 MARKET CAP



Source: BofA Global Investment Strategy, Bloomberg

BofA GLOBAL RESEARCH

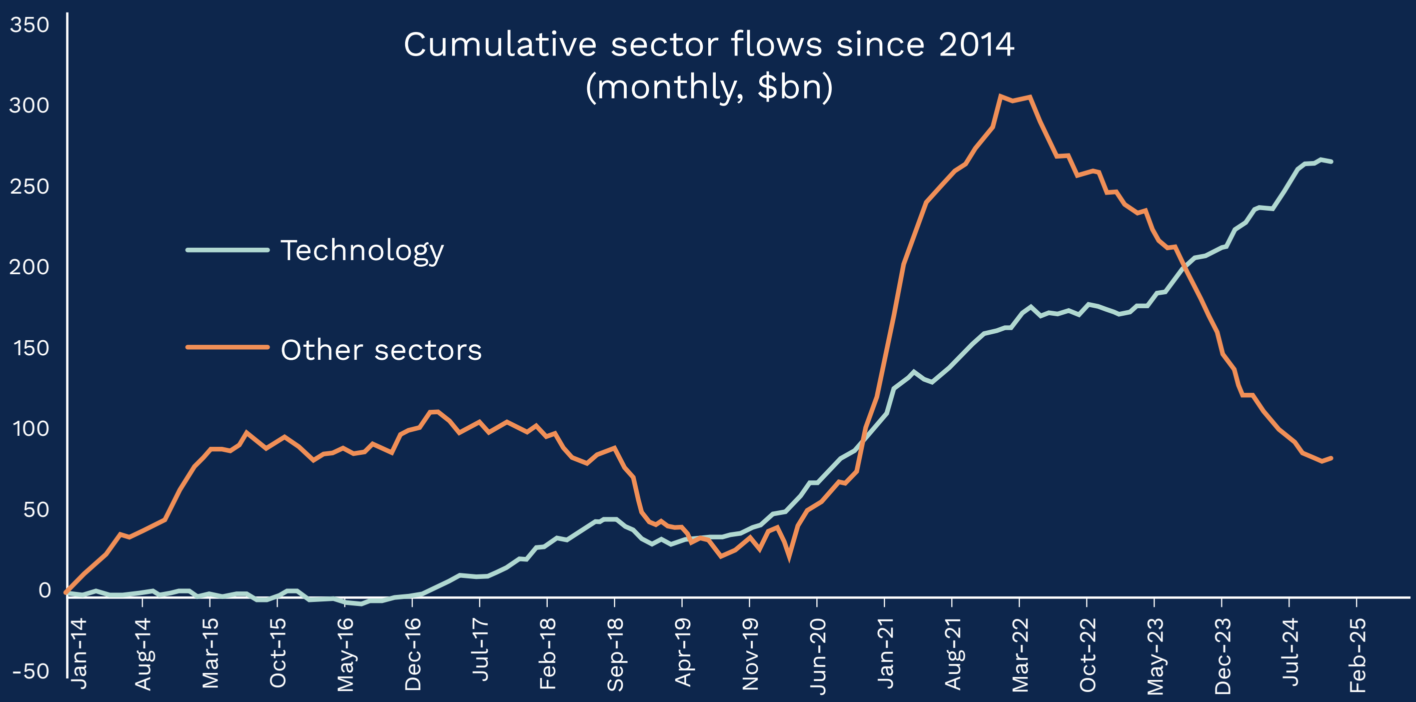
Recognizing this risk, we have scaled back our exposure and maintain an underweight allocation to the Magnificent Seven to mitigate portfolio concentration risks.

The US economy has also outpaced other developed markets and the exceptionalist narrative suggests that this is driven by a robust and flexible labour market that, in turn, results in resilient consumer spending. We expect this structural strength to continue in the medium to long term, compelling other economies to adapt and innovate to close the growth gap.

Given the advantages the US seems to have it's not surprising it's a strong magnet for companies worldwide seeking to list on its stock exchanges. This reinforces its leadership in key industries and continues to foster a culture of innovation and risk-taking. However, despite these advantages, they do not always read across to an obvious investment opportunity and investors should prioritize diversification and valuations when constructing portfolios. And by most metrics, the US equity market appears expensive relative to its historical averages and international peers. Markets like the UK and Europe trade at significantly lower valuation levels, even though a substantial portion of profits generated by UK and European companies come from the US.

Valuations matter, and although higher valuations in the US can be partly justified by superior profit margins and growth potential, some areas of the market look overextended and, consequently, expensive. As such, we anticipate that market leadership will broaden out in the near term, allowing underperforming companies, regions, and sectors to catch up. For us, this underscores the importance of maintaining diversified equity exposure across regions to complement our US holdings.

\ EQUITY MARKET VALUATIONS LOOK ATTRACTIVE IN THE UK AND EMERGING MARKETS



Source: EPFR Global, Haver Analytics, Deutsche Bank Asset Allocation

Portfolio positioning

We maintain a diversified approach to equity markets, with weightings shaped by regional opportunities and valuation dynamics. TThe UK remains a key focus, supported by expectations of continued economic recovery, robust consumer resilience, and the alleviation of political uncertainty. We expect these factors to drive a re-rating in UK equities, enhancing their appeal for 2025. Our portfolios also retain substantial exposure to the US equity market, emphasizing sectors outside of technology where (as discussed) valuations remain more compelling. Despite the concentration risk posed by mega-cap tech stocks, we see opportunities in less-stretched areas of the market.

In Europe, we are monitoring developments surrounding Germany's upcoming elections in February. While the outcome is an unknown, we see a potential relaxation of Germany's debt constraints as possible, which could mark a pivotal shift that creates opportunities to reassess and potentially increase our regional exposure. The politics of France will also be a consideration this year, although the impact for markets is likely to be muted.

We continue to hold a low allocation to Japanese equities, reflecting ongoing concerns about currency risks tied to potential rate hikes by the Bank of Japan. While Japan's emergence from deflation and corporate reforms are promising, the potential for yen depreciation remains a key risk factor.

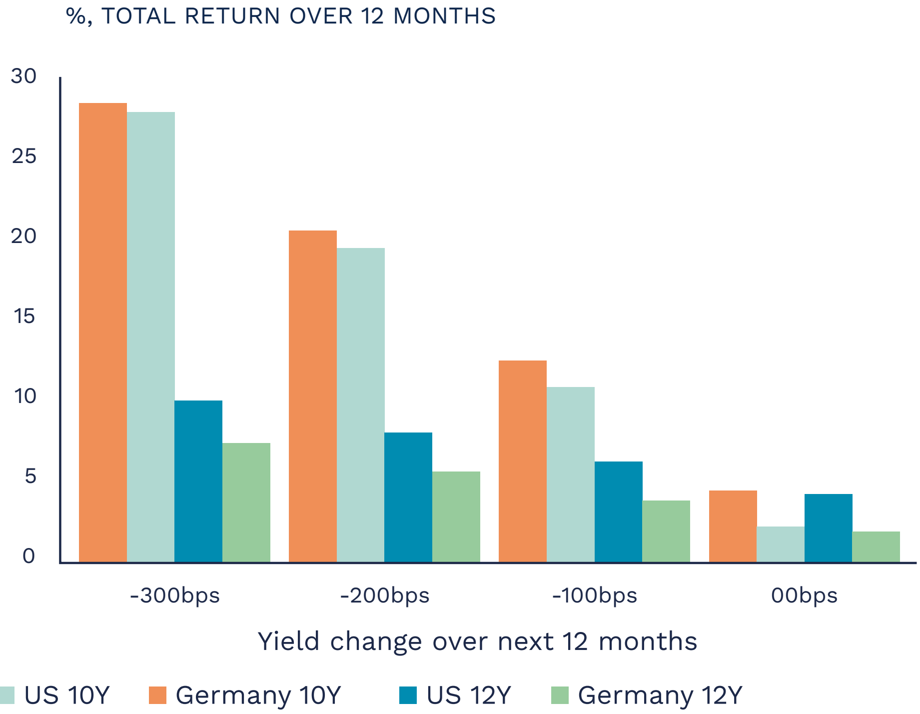
Emerging markets, particularly China, potentially offer significant upside as Chinese authorities implement policies to stimulate growth. This supportive environment is expected to bolster Chinese equities and contribute to stronger performance across emerging markets, but we are conscious that political agendas may be an influencing factor.

Our fixed-income and multi-asset portfolios remain well-diversified, with balanced exposure to government bonds and credit. While absolute valuations in both segments appear attractive relative to historical norms, the persistence of inflation and its impact on monetary policy warrant a cautious approach.

Within government bonds we favour UK Gilts, which offer yields in the range of 4.5% to 5.3%. Additionally, we have selectively added exposure to US inflation-linked bonds, which we view as undervalued given the likelihood of inflation staying elevated relative to the Federal Reserve's 2% target.

EXHIBIT 26: GOVERNMENT BONDS WILL PROVIDE PROTECTION IN A RECESSIONARY SHOCK

GOVERNMENT BOND RETURN SCENARIOS



Source: LSEG Datastream, J.P. Morgan Asset Management. The chart indicates the calculated total return achieved by purchasing government bonds at current yields and selling in 12 months' time given various changes in yield. For illustrative purposes only. Past performance is not a reliable indicator of current and future results. Data as of 12 November 2024.

Our credit exposure spans both investment-grade and high-yield bonds, with a preference for shorter-dated instruments due to tight credit spreads (the difference between government bond yields and credit yields). These allocations not only provide attractive income opportunities but also serve as a buffer for capital preservation in the event of a downturn in economic conditions.

Our strategies aim to balance income generation, growth potential, and capital preservation through a diversified allocation across asset classes and regions. While near-term uncertainties persist, we remain committed to diversification and valuation discipline to capture opportunities while managing risk effectively.

Summary

There's no question the big event of 2025 will be the inauguration of Donald Trump and the policies he chooses to pursue, not just in 2025, but during his four years in office.

As mentioned, speculation has been rife about what he intends to do and how it'll impact the global economy and stock markets. He's an astute politician and will want to deliver on his election promises and reassure Americans they have voted for the right candidate. To this end it seems likely 2025 will benefit from pro-business and pro-market political strategies – but valuations and diversification will be ever more important!

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