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Investment Management

Window on the World

DECEMBER 2024

Introduction

As 2024 comes to a close, it's traditional to look ahead to the coming year and see what our crystal ball reveals. But firstly, how do you sum up the world in 2024?

It's been a very mixed year; there have been elections around the world with ones in the US, the UK, France and India to name a few - from which we can see the political mood of nations is changing. There continue to be wars and suffering, which we hope will end in 2025, and our weather is increasingly volatile, with storms in the UK seemingly causing evermore havoc. On a brighter note the Olympics in Paris this summer brought out the very best in nations, and the artificial intelligence revolution has the potential to bring huge benefits to mankind. Medical research has given the world drugs that can counter obesity and with them come high hopes of both personal and economic benefits In the investment world there was really only ever one story in town – Nvidia – and although the Magnificent 7 drove markets it was Nvidia's results that markets held their breath for.

As our attention shifts to the opportunities and challenges that 2025 may bring, the investment industry directs its substantial resources to forecasting the next 12 months, but crystal ball gazing typically yields limited success. The most effective way to achieve our long-term investment goals are by focusing on the bigger picture rather than attempting to predict short-term shifts. That said, it's still valuable to assess the landscape and consider how 2025 aligns with our long-term market outlook.

Recent years have been shaped by the outlook and expectation for inflation, interest rates, and to a lesser degree political factors. These themes will still be very present and may continue to dominate in the year ahead, but we suspect their influence may fade somewhat when it becomes apparent both may not change significantly – instead the key focus is likely to be dispersion! We expect regional differences in both fiscal and monetary policies, leading to a broadening of market returns, in other words the Magnificent 7 will no longer dominate markets and other companies will find themselves in the limelight. Not only this but we feel there are likely to be more varied performances across economies too.

For investors, there are reasons to be optimistic. The broad economic environment is expected to remain supportive of equities, while bond yields are likely to stay higher than they have been for years, creating promising opportunities.

However, there are always uncertainties and as we head into the New Year this uncertainty is focused on U.S. policy— the unpredictable nature of Donald Trump and lack of certainty over what he may or may not implement introduces a range of potential outcomes, and with them risks which should temper some of the optimism.

Donald Trump's second term as President is likely to be a defining moment for investors, impacting markets not just over the next 12 months, but throughout his four-year term and beyond.

While many factors are at play, Trump's core focus will be on "America First" policies, aimed at strengthening the economy, and we sense he'll see the U.S. equity market as a key gauge of his success. For this reason, our base case anticipates continued resilience in the U.S. economy and an extension of the current business cycle.

Fiscal Support will provide a boon to global growth

We expect 2025 to be a year marked by fiscal support, though this will vary by country.

In the U.S., we anticipate the extension of expiring tax cuts and likely additional tax measures to boost consumer spending. The planned Department of Government Efficiency (DOGE), led by Elon Musk, is tasked with finding efficiencies and reducing bureaucracy in Government. These efforts, in theory will reduce the cost of Government, which should be a boost for businesses. This, supported by strong consumer activity and favourable labour market conditions all point towards a stronger US economy. However, an element of caution is required because this is a new department and Elon Musk's style of management may not work so well in Government.

Back here in the UK, fiscal policy is expected to offer support, with the October budget outlining fiscal loosening of around 1% of GDP over the next 12 to 18 months. And China seems set to pursue fiscal easing as it seeks to stimulate its economy and boost consumer confidence, which has been weak amid a nationwide property market correction.

Political instability in France complicates the country's fiscal outlook, despite the pressing need to reduce its deficit – forging political alliances can be difficult and often fluid. Germany has elections in the New Year, and there is a possibility that a new government may relax the so-called "debt brake", which is designed to control the countries deficit by limiting government debt. The brake was established in 2009 so perhaps a review is overdue - This would likely be a significant and positive development for the German economy and the broader European region, potentially justifying a higher allocation to European equities.

Central Banks will ease policy, but the degree of easing will be limited in the US and UK

The majority of central banks are expected to continue cutting interest rates throughout 2025, although the pace of reductions will vary by country and region.

The notable exception is the Bank of Japan, which is on a different inflationary path and is likely to raise rates a few times in 2025. This could have implications for the Japanese Yen, which contributed to the sharp sell-off in Japanese equities during the summer of 2024. We expect the Bank of England to lower interest rates from the current 4.75%, but not as much as was anticipated a little while back, and for them to settle around 4%. It is now gradually being accepted that a return to the ultra-low interest rates is very unlikely to happen. A resilient UK economy, supported by strong consumer spending, a tight labour market, and fiscal support, reduces the need for more aggressive rate cuts. A similar situation applies in the U.S., where the Federal Reserve will likely continue to reduce rates, but given the strength of the economy, only modest cuts are anticipated. Interest rates seem to be settling towards pre-global financial crisis levels. These expectations will influence our views on fixed income, which we discuss later in this article.

In Europe, we expect interest rates to fall below 2% (from the current 3.25%) by the end of the year with the European Central Bank (ECB) likely to be the most proactive among major central banks in easing policy in 2025. Europe faces a more challenging economic outlook - Growth in Germany remains weak, and the hoped for rebound in manufacturing activity for 2024 appears to have lost momentum. France's political crisis isn't conducive to strong economic growth and across the wider region growth is likely to remain subdued – it had been hoped that Chinese fiscal stimulus would prove beneficial but to date the impacts are expected to be limited. A further source of concern are US tariffs and how this might play out across Europe's industries. Meanwhile, China is actively easing monetary policy and increasing credit availability, in a bid to stimulate the economy and counter the negative impact of the property market that has lost significant value - a trend we expect to continue throughout 2025.

Tariffs, Immigration and trade wars?

A significant source of uncertainty for investors globally is the prospect of the US imposing tariffs which results in a broader trade war.

Donald Trump campaigned on imposing 60% tariffs on Chinese imports and 10-20% universal tariffs on goods from other countries. Since his election win there has been huge speculation about what tariffs may or may not be imposed and how much they might be – the reality is no one knows. But what we can say with some certainty is that if these measures are enacted, they could have several impacts—namely, pushing up prices and consequently inflation in the U.S., which in-turn could put upward pressure on US interest rates. If other countries retaliate with their own tariffs on US goods, a global trade war would quite likely impact both inflation and economic growth negatively.

\ THOSE COUNTRIES WITH THE BIGGEST TRADE SURPLUSES MAY BE AT MOST RISK FROM HIGHER TARIFFS

Exhibit 5: Those with the biggest trade surpluses may be most at risk of higher tariffs
US goods trade balance by country
USD billions (LHS): % of trading partner's GDP (RHS)

Source: Factset, J.P. Morgan Asset Management. Data as of 12 November 2024.

Additionally, tighter immigration policies in the U.S. may reduce labour supply, driving up wage inflation. The potential expulsion of immigrants could also have a negative impact on U.S. growth, with the magnitude of this effect depending on the scale and success of the policy. For these reasons, while Trump's policies are often seen as pro-growth, there are scenarios where his approach could lead to higher inflation and slower growth—an environment that would likely be challenging for capital markets. As a result, we will closely monitor how these policies are implemented throughout 2025.

Opportunities and Positioning

We anticipate a broadening of returns, as we've said, both within and across equity markets, while in fixed income, we expect yields to remain elevated.

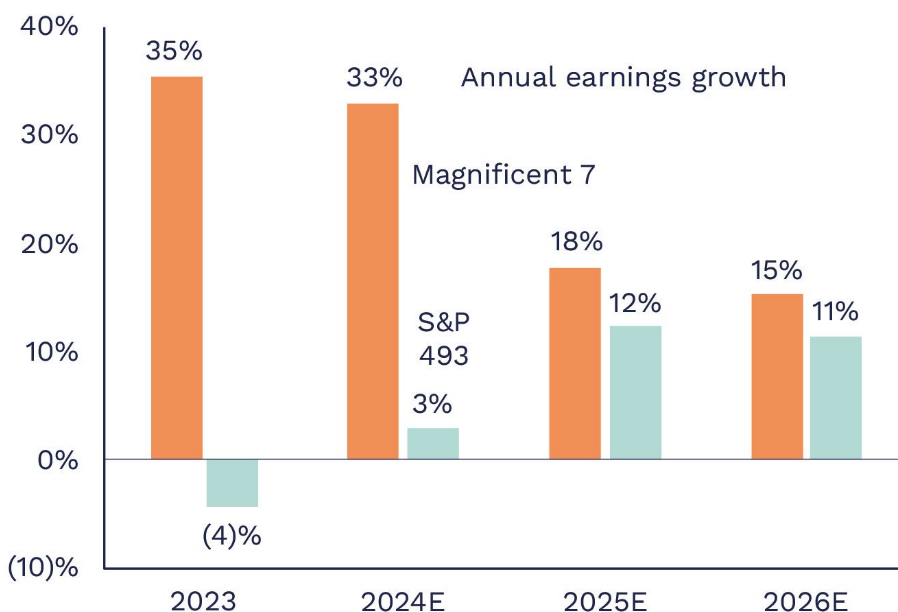
With the U.S. business cycle set to continue and a gradual easing in interest rates expected, spreads on corporate bonds are likely to remain tight. However, given the risks we see to this central scenario, our positioning in this asset class remains focused on the short end of the market, in both investment-grade credit and high-yield bonds. This should help minimise any negative impacts if the outlook doesn't unfold as we anticipate. Should spreads widen it could present an opportunity to invest in longer dated corporate bonds as the year progresses, as well as a chance to rotate away from government bonds.

Within government bonds, we hold both conventional and inflation-linked securities. Although inflation expectations in both the UK and U.S. remain relatively benign, despite upside risks to inflation, we expect these securities to act as effective hedges against a potential inflation spike while offering reasonable value at current levels. Where suitable we maintain a preference for UK Gilts, where yields of around 4-4.5% are available. Overall, valuations in fixed income remain attractive in absolute terms, so we continue to hold a healthy exposure to the asset class across our multi-asset strategies.

We don't think 2025 will be a year in which technology dominates market returns as it has done over the past two years. The strong rally the "Magnificent 7" stocks have enjoyed has driven market valuations for U.S. equities to very high levels, suggesting the market is expensive by most metrics. But when technology is excluded, the rest of the U.S. equity market trades at a more reasonable multiple and is a reason we expect the market to broaden out. Consequently, with a favourable economic backdrop, we expect this environment to support strong revenue and corporate earnings growth, allowing other sectors to outperform. As a result, we have diversified into mid and small-cap U.S. equities, where valuations are more attractive – we're hoping 2025 will be a very good year for small cap equities.

\ WE EXPECT EARNINGS GROWTH TO BROADEN OUT IN THE US, FURTHER DRIVING A BROADENING OUT IN THE US EQUITY MARKET

Exhibit 10: Gap between Magnificent 7 and S&P 493 earnings growth is expected to narrow



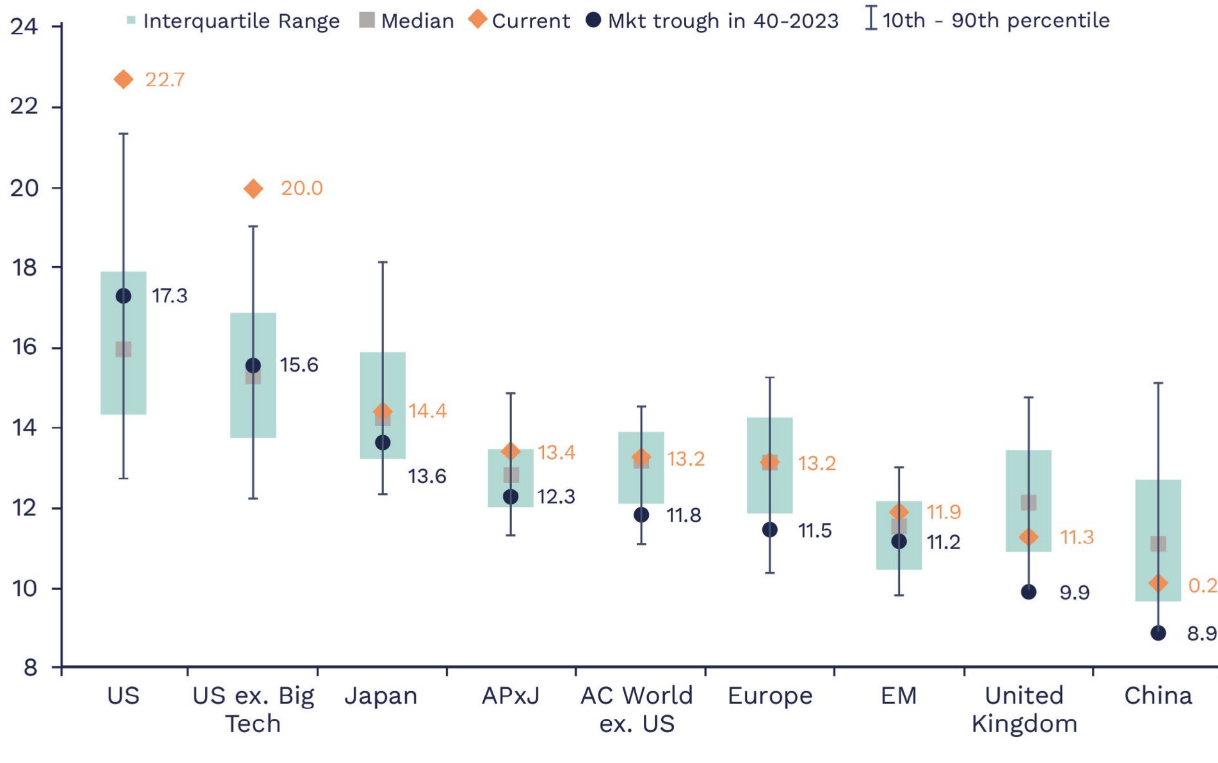
Source: Factset, Goldman Sachs Global Investment Research

As equity regions we like the UK and emerging markets and have taken over-weight positions in both across our portfolios. The UK has an improving economic backdrop, political stability, and attractive valuations providing a positive outlook for UK equities, which also offer a higher dividend yield than most other markets. Within emerging markets, we expect additional fiscal and monetary stimulus to benefit Chinese equities, which we think will provide a boost to the broader Asian region, where valuations are undemanding.

As we've highlighted the outlook for European equities is somewhat less clear, with the region facing risks from tariffs and low growth. While better opportunities may exist elsewhere, the region's cheap valuations and likelihood of aggressive interest rate cuts, could present an opportunity, particularly if Germany relaxes its fiscal policies. In Japan, progress in improving corporate governance has contributed to a re-rating of the market. However, the potential for further tightening by the Bank of Japan could put pressure on the Yen and the stock market, so we are currently running a reduced allocation.

EQUITY MARKET VALUATIONS LOOK ATTRACTIVE IN THE UK AND EMERGING MARKETS

Exhibit 55: All regions have experienced a rise in valuations through 2024
12m fwd P/E, MSCI regions: data since 2003



Source: Factset, Goldman Sachs Global Investment Research

2025 is shaping up to be an interesting and potentially good year for investors, but there are risks and there will be bumps along the way. We expect to see an increase in mergers and acquisitions (M&A), driven by lower interest rates, deregulation, and a robust U.S. economy providing a favourable backdrop for capital markets activity. Additionally, investors always seek out attractive opportunities in areas where valuations are appealing, such as small-cap stocks, hence our recent positioning there. Furthermore, structural growth drivers such as the need to decarbonise the global economy means the energy transition theme remains intact, despite the new President's focus on traditional energy sources. So, despite the huge resource that goes into predicting the year ahead, it's never been easy and inevitably only a very small number of factors will really make a difference, but with a new US President in the White House, 2025 is probably going to be even more difficult to foresee than previous years.

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