ANNUAL INVESTMENT OUTLOOK

JANUARY 2025

STONEHAGE FLEMING

NOW AND FOR FUTURE GENERATIONS

OPPORTUNITIES AMID A CROWDED CONSENSUS

EXECUTIVE SUMMARY

- The investment outlook for the year ahead is set against a backdrop of robust economic conditions and heightened US optimism. Risk assets have responded, with equities delivering a second year of strong returns
- Widespread expectations for US exceptionalism have been emboldened by the election win of President-elect Trump. Tariffs are expected to be more painful for Europe and China, where pessimism is pervasive
- The global economy is entering a new phase of the post-pandemic expansion, characterised by complexity, volatility and geopolitical change. The potential for investment volatility may be overlooked by investors
- Having rejected the widespread recessionary outlook of 2022-23, we approach the investment consensus today with a healthy dose of caution, and investigate how it might veer off course:
  - Our analysis does not lead us to the conclusion that the US economy is on the precipice of recession or sustained market decline, but the possibility of a 2025 growth scare appears to be widely underestimated
  - There is little doubt that Europe is facing multiple crises, which underpin our caution towards European assets, yet a catalyst for widely held pessimism to moderate is under close watch
  - The time may come for a bold, contrarian approach to Chinese equities which rewards such investors, but a clear (yet still absent) structural catalyst will be needed to sustain market leadership
- Higher US equity valuations in isolation do not constrain returns over the short term, but with growth expectations elevated, investors' tolerance for disappointments is likely to be low. This means volatility can be expected to rise this year, and earnings growth will need to do the heavy lifting
- The absence of clear recessionary flags, or resurgent inflation, implies that robust real earnings growth can continue to support US equities over the long term. Opportunities for enhanced returns can be accessed through strategies which look further than yesterday's winners
- Our multi-asset strategies, which aim to deliver compound returns in excess of inflation over market cycles, are positioned as follows:
  - Equity allocations remain close to a 'neutral' setting overall, following disciplined rebalancing on market strength in 2024, enabling further adjustments this year as market conditions develop
  - Equity strategy blends investments in mega-caps, exhibiting strong earnings and price momentum (i.e. US AI-centric technology), with decisive allocations to global quality businesses and differentiating smaller companies
  - Diversifying asset classes, such as government bonds, physical gold, long / short active managers and insurance-linked 'catastrophe bonds' aim to provide uncorrelated positive returns in aggregate, creating a robust portfolio composition in the event of market volatility

INTRODUCTION

The investment outlook for the year ahead is set against a backdrop of robust economic conditions and heightened US optimism. Global growth remains healthy (chart 1[1]), inflation has largely normalised, and interest rates are falling. Corporate earnings growth has been impressive, led by US mega-cap technology once again. Broad risk assets have responded accordingly, with global equities, particularly the US market, delivering a second year of double-digit returns (chart 2[2]), while corporate credit trades at historically tight spreads to Treasury bonds. The incoming US administration intends to reduce taxes and regulation for businesses, creating a 'sugar high' for consumers, businesses and investors at the end of 2024.

Chart 1: Global growth supported by resilient service sector

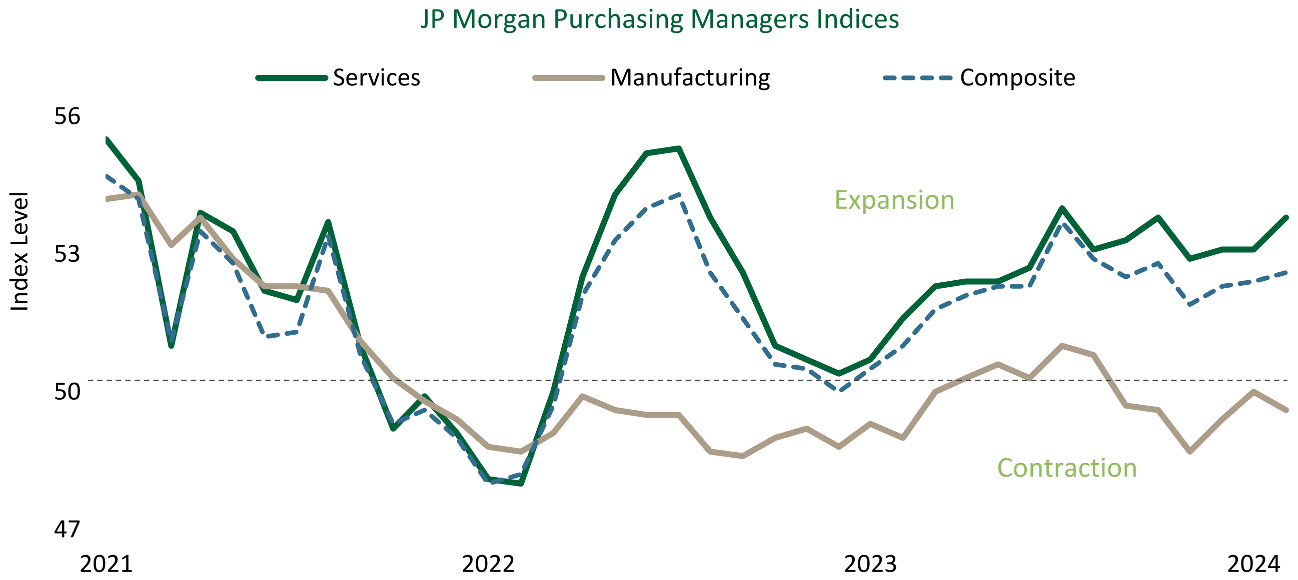
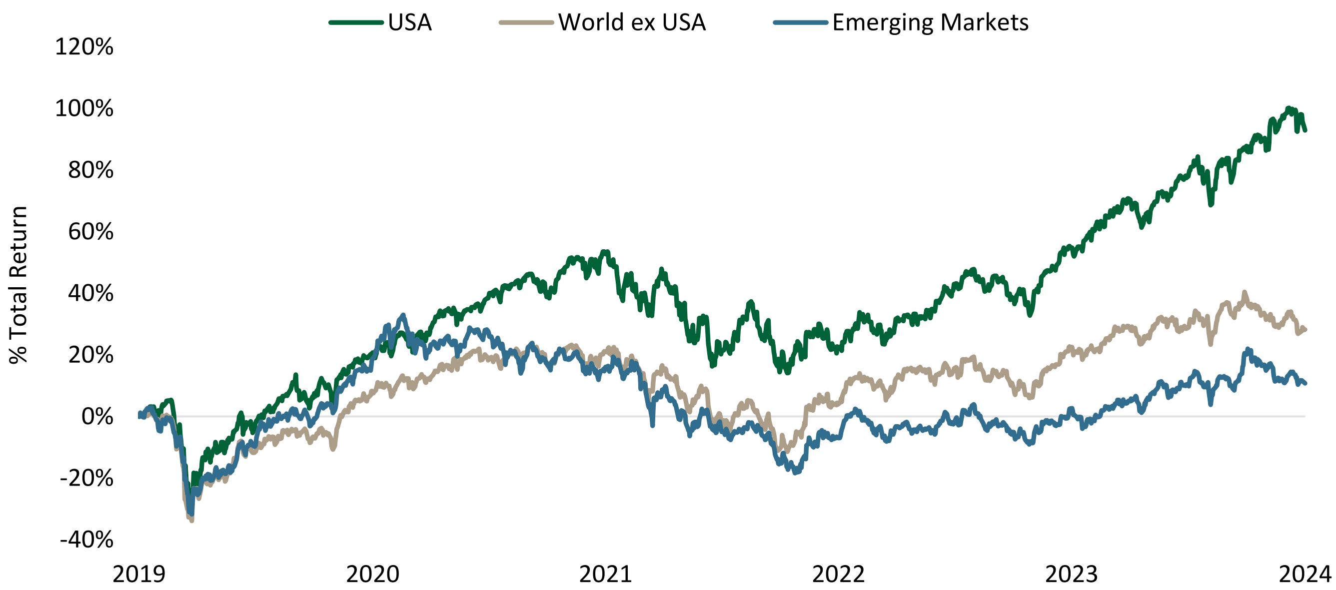


Chart 2: Consecutive 20%+ years for US equities



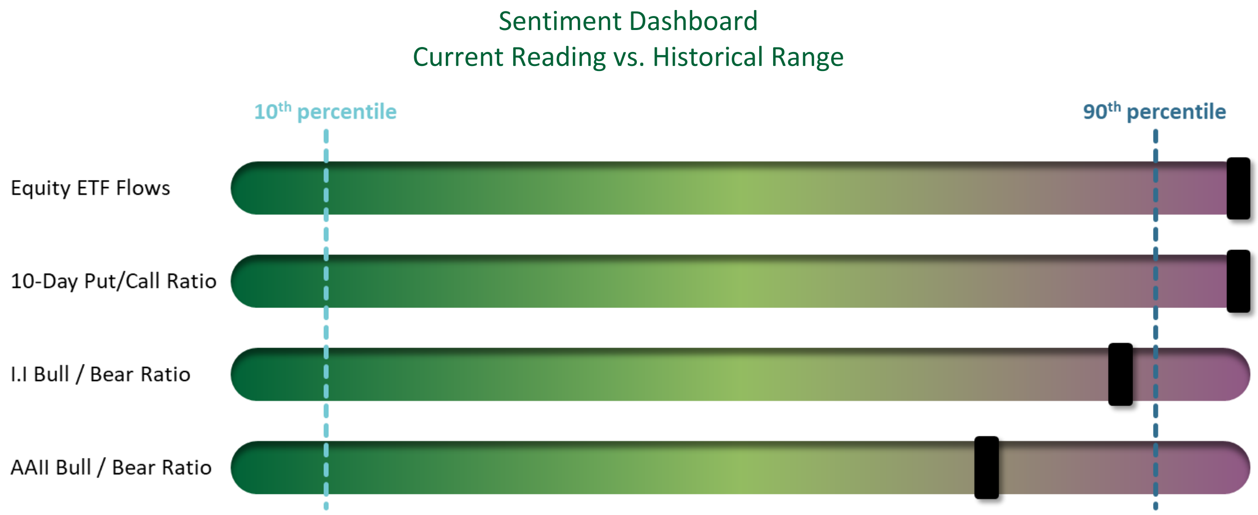
[1] *Source: Bloomberg, 31 December 2024.*
[2] *Source: Bloomberg, MSCI AC World Index, USD, 31 December 2024.*

In stark contrast to popular opinion 12-18 months ago, the investment community is virtually united in its constructive 2025 outlook for the USA. At that time, conventional wisdom was that higher interest rates would suffocate the household sector much like they did in the early 1980s, causing a US economic recession. Many investors and economists underestimated the impact of pandemic fiscal stimulus, which had created sizable excess savings, and supported discretionary consumer spending despite high inflation and interest rates.

Today, the 'consensus investor' makes a convincing case for continued US economic resilience combined with persistent disappointment from Europe and China. US recession fears have been put out-of-mind, and expectations for ongoing US exceptionalism have been emboldened by the election win of the business-boosting President-elect Trump. Incoming tariffs are broadly expected to be more painful for Europe, whose biggest economies are battling political crises, and China, where economic momentum remains uninspiring despite recent stimulus packages.

Having rejected the widespread recessionary outlook of 2022-23, supporting ongoing equity allocations throughout, we approach the widespread rosy narrative with a healthy dose of caution. Sentiment has rallied to high levels (chart 3[3]) and expectations for 2025 corporate earnings are ambitious. Could anything go wrong?

Chart 3: Investor optimism raises the bar for 2025



The logic of the popular constructive view is hard to fault. Buoyed by superior technological innovation, productivity, consumer dynamism and return on capital, US exceptionalism has been a formidable driver of equity returns for approximately 15 years.

There is little evidence that these return-enhancing attributes are reversing, supporting our continued bias to US equity markets for long term growth. In addition, the structural challenges in Europe and China are indisputable, and meaningful reform, given the political and social constraints, remains scarce.

However, the global economy is entering a new phase of the post-pandemic expansion, characterised by complexity, volatility and geopolitical change. With sentiment and valuations rising over the course of 2024, the potential for macro and investment volatility may be overlooked by investors.

In this year's Annual Investment Outlook, we investigate how the consensus outlook for the global economy might veer off course, and what this means for our multi-asset investment stance.

[3] *Source: Strategas Research Partners, 20 December 2024.*

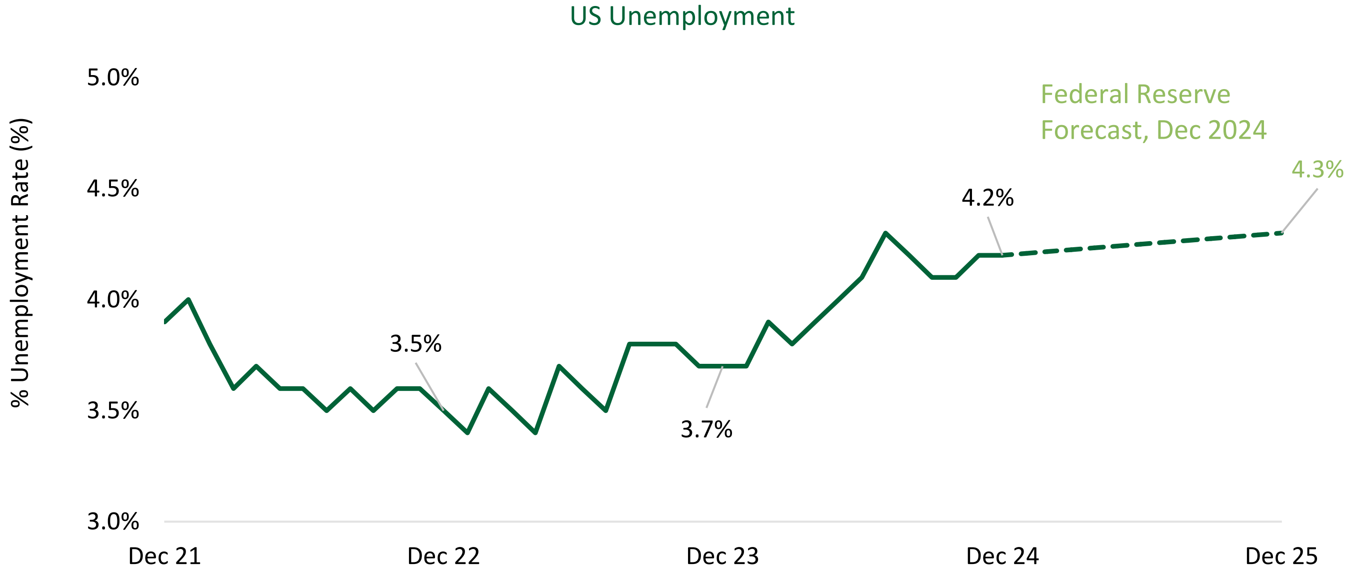
Section 1. Assessing the Global Economy

1.1 Are investors too sanguine on the US economy?

There is a lot to like about the US economy at the end of 2024. Real GDP growth was running at 3.0% per annum during the six months ending September 2024[4], and the Atlanta Fed GDP Now, which estimates Q4 growth based on incoming data, was at 3.2% in mid-December[5]. Equity markets are up, creating a strong 'wealth effect', and the forthcoming Trump administration is eager to keep it that way.

Having reduced interest rates by 1% in the second half of 2024 to 4.5%, the Federal Reserve recently articulated their assumptions for 2025. Growth is expected to remain solid "*with a median projection of about 2% over the next few years*[6]" and inflation expectations have been revised up. They expect 2025 core inflation to average 2.5%, an increase from their assumption in September by 0.3%. Unemployment, which has risen 0.5% in the past year, is assumed to rise just 0.1% in 2025 (chart 4[7]).

Chart 4: Could US unemployment rise more than widely expected?



The rationale behind the Federal Reserve's assessment is not complicated; the incoming Trump administration is assumed to implement expansive fiscal policy, mass deportations and higher tariffs, all of which are inflationary. Meanwhile, American 'animal spirits' are palpable, reinforcing the consumer spending that has driven the US economy in recent years. Yet there is considerable uncertainty surrounding this hypothesis. The real economy effect of fiscal expansion will take time, the infrastructure and state willingness to support substantial deportations is not obvious, and higher tariffs would only interrupt the recent trend of lower inflation.

> It may well be the case that growth reaccelerates and inflation remains sticky, but this scenario relies on a set of assumptions based on President-elect Trump's agenda and constraints.

Two years ago, we argued that "*the important question is how inflation can fall rapidly and recession be avoided? The answer lies in the labour market*[8]." Today, the same economic principles apply; sustained price pressures are primarily determined by the balance of labour demand and supply. With this in mind, it is not obvious that inflation cannot continue its downward path in the coming months.

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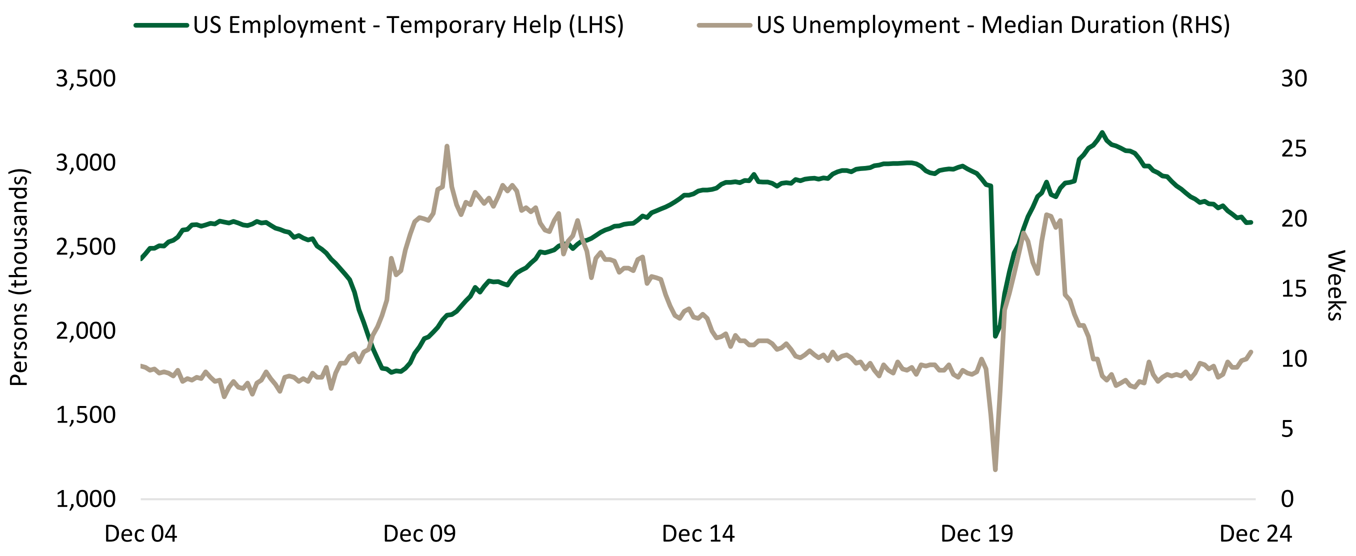
[4] *Source: Bloomberg, 30 September 2024.*
[5] *Source: Bloomberg, 18 December 2024.*
[6] *Source: Federal Reserve Chair Powell's Press Conference, 18 December 2024.*
[7] *Source: Bloomberg, Federal Reserve, December 2024. Dotted line represents Federal Reserve expectation.*
[8] *Source: Stonehage Fleming 2023 Investment Outlook, January 2023.*

Importantly, the US labour market has cooled meaningfully in the past two years. As Federal Reserve Chair, Jerome Powell, outlined: "*a broad set of indicators suggests that conditions in the labour market are now less tight than in 2019. The labour market is not a source of significant inflationary pressures*[9]." Could it weaken further, catching investors and the central bank by surprise? Notably, several leading indicators of labour demand have continued to soften in the fourth quarter of 2024, such as the median length of unemployment and workers at temporary help agencies (chart 5[10]).

Chart 5: Labour market softening keep inflationary pressures in check



In this unique economic cycle, it is worth remembering that there is a strong feedback loop between the labour market and consumer spending. In a rather predictable way, fewer job vacancies and higher unemployment dents consumer confidence and constrains spending, weighing on corporate revenue growth. It is also unsurprising that the housing market is in the doldrums after 18 months of elevated interest rates. Homeowners are faced with significantly higher mortgage rates compared to recent years, squeezing discretionary spending, and the construction of new homes has declined markedly.

Economic growth is also vulnerable to geopolitical and financial shocks, related to proposed Trump 2.0 policies. President-elect Trump has proposed tariffs on key trading partners such as Canada, Mexico and China, whilst also threatening multilateral tariffs on all US imports. To some extent, such threats may represent a negotiating tactic to secure improved trade terms and political concessions from China, and are unlikely to come to full fruition. Investors have also been encouraged by the appointment of Scott Bessent to Treasury Secretary, who argued that tariffs will be "layered in gradually[11]" to minimise any adverse economic impact. Yet it is difficult to consider a broad rise in protectionism as anything other than a headwind to growth in the short term.

> Our analysis does not lead us to the conclusion that the US economy is on the precipice of recession or sustained market decline, but the possibility of a 2025 growth scare appears to be widely underestimated.

With the incoming administration representing a source of major policy uncertainty, we consider a moderation in US growth and inflation, with elevated volatility in investor sentiment, as the most likely environment for 2025. Therefore, investment strategy is engaged but not overcommitted with risk assets (following another strong year of returns) while pursuing differentiation and diversification through overlooked market segments such as fixed income and alternative investments. We cover the implications for investment strategy in further detail in section two.

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[9] Source: Federal Reserve Chair Powell's Press Conference, 18 December 2024.
[10] Source: Bloomberg, November 2024.
[11] Source: Bloomberg, 25 November 2024.

1.2 Could Europe turn a corner?

As growth optimism is dialled up in the US, the consensus mood towards Europe remains despondent. Following another year of disappointing growth and investment returns, reasons to be downbeat are not hard to find.

It is worthwhile reminding ourselves why Europe has not enjoyed the post-pandemic economic boom witnessed in the US. Firstly, European consumers were far more cautious with savings accumulated during the pandemic. Secondly, the region, led by Germany, is highly sensitive to the manufacturing cycle, which entered a sharp decline in 2021 as wholesalers responded to high inventories. Lastly, the European recovery was derailed by the Russia-Ukraine war in 2022, which ignited energy and food inflation and suffocated consumption and investment growth.

Energy costs are a good example of why Europe is experiencing a growth gap with the US. Whilst energy costs have fallen substantially since mid-2022, the region continues to be dependent on imported gas, which makes the cost of electricity much higher than other major economies. Today, European retail and wholesale gas prices are between three to five times that of the US.

Europe is suffering from the consequences of long-term under investment, constraining potential growth rates, as former ECB President and Italian Prime Minister, Mario Draghi, stressed last year. His report[12] on European competitiveness argued for an additional EUR750-800 billion of EU spending, boosting productivity and innovation. Yet this will require political willingness, collaboration and fiscal expansion, currently all in low supply. The two largest economies in the region are politically rudderless, as the new French Prime Minister, Bayrou, battles to form a stable and productive government, and Germany gears up for a February election.

Is there a glimmer of optimism out there? Certainly, it is likely to be another challenging year for Europe, as these structural headwinds persist and higher trade policy uncertainty weighs on growth. Yet, the potential for an economic improvement is not as far fetched as it may seem. With sentiment remarkably low, a modest improvement in consumers' spending patterns, supported by subdued inflation rates and assertive ECB rate cuts, could combine with a stabilisation in the political backdrop in the coming months.

> There is little doubt that Europe is facing multiple crises, with fierce competition from Chinese industry, protectionism from the US, and domestic political pressures which could culminate with a Le Pen French leadership in 2027. These crises underpin our caution towards European assets, yet a catalyst for widely held pessimism to moderate is under close watch.

1.3 Chinese stimulus – is enough being done?

The Chinese stock market surged, following a surprise package of fiscal and monetary policies at the end of September last year. Having flatlined since, the local market remains c. 25% higher than its mid-September low point[13]. Following three years of disappointing post-covid recovery, could this be a sign that, such measures are set to reignite the Chinese economy?

It is clear that China has entered a period of slower growth compared with the early 2000s, following the bursting of its debt-fuelled real estate bubble. Much like Japan in the 1990s, the economy is wrestling with deflation, debt, demographics and a lack of consumerism. More broadly, China continues to struggle with a replacement 'industrial strategy' given that what has worked until now will not deliver the same growth in the future.

In particular, the Chinese property market remains a heavy burden for economy. In October 2024, residential buildings sales were 22% lower than the previous year, and buildings under construction had fallen by 13%[14]. With real estate representing c. two-thirds of Chinese households' wealth, it is no wonder that the appetite to spend and invest is rock bottom (chart 6[15]).

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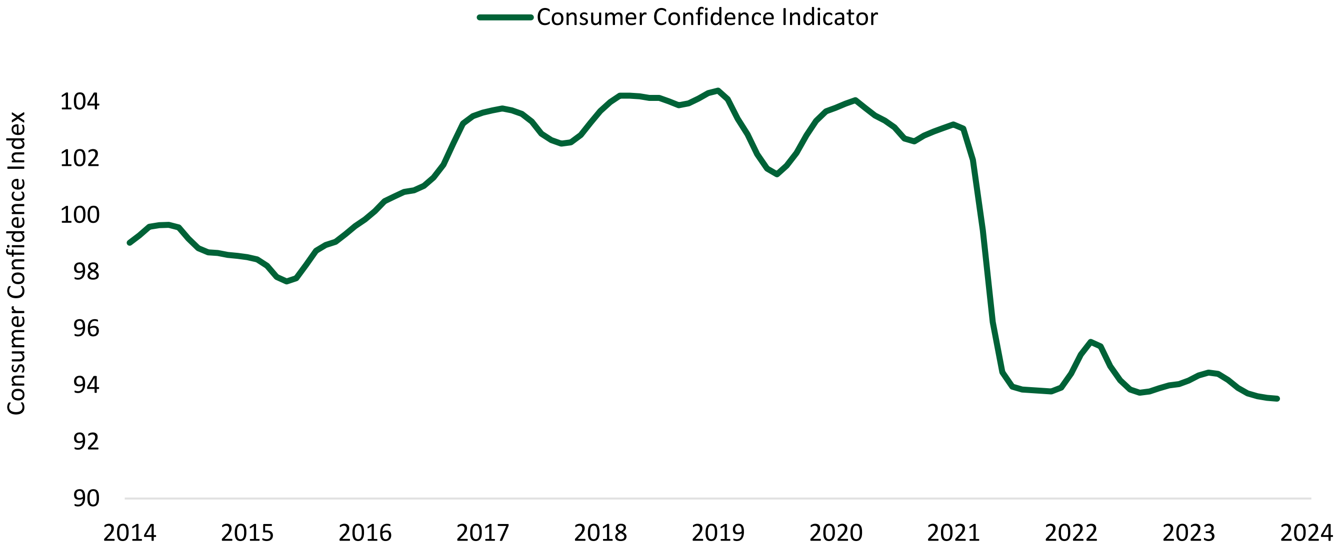
[12] Source: Mario Draghi, "The future of European competitiveness – A competitiveness strategy for Europe", September 2024.
[13] Source: Bloomberg, CSI 300 Index, CNY.
[14] Source: Factset, China's National Bureau of Statistics, October 2024.
[15] Source: Factset, September 2024.

Chart 6: Chinese consumerism is dormant



Whilst recent stimulus measures appear effective in stabilising the financial and economic system, game-changing policies remain lacking. Fiscal support for the property market has been delivered through reduced mortgage rates and deposit requirements, but it does not address the overhang of unsold inventory. Absorbing unsold homes onto the government balance sheet would bolster confidence and represent a strong statement of intent. Structural reforms are also very tentative, if they exist at all. In particular, Beijing needs to install a convincing social security safety net that would tackle chronic underconsumption and fear-driven savings in the household sector.

The contrarian argument is that China is a resourceful nation and the Chinese authorities will do whatever it takes to restore their economy as the powerhouse of Asia. With valuations, sentiment and expectations historically low relative to the US, emerging market equities could be set for an inflection point after c. 15 years of underperformance.

> The time may come for a bold, contrarian approach which rewards such investors, but a clear structural catalyst will be needed to sustain market leadership. With no such catalyst, against a backdrop of rising protectionist and geopolitical threats, a cautious yet open-minded approach is prudent.

Section 2. Multi Asset Investment Strategy

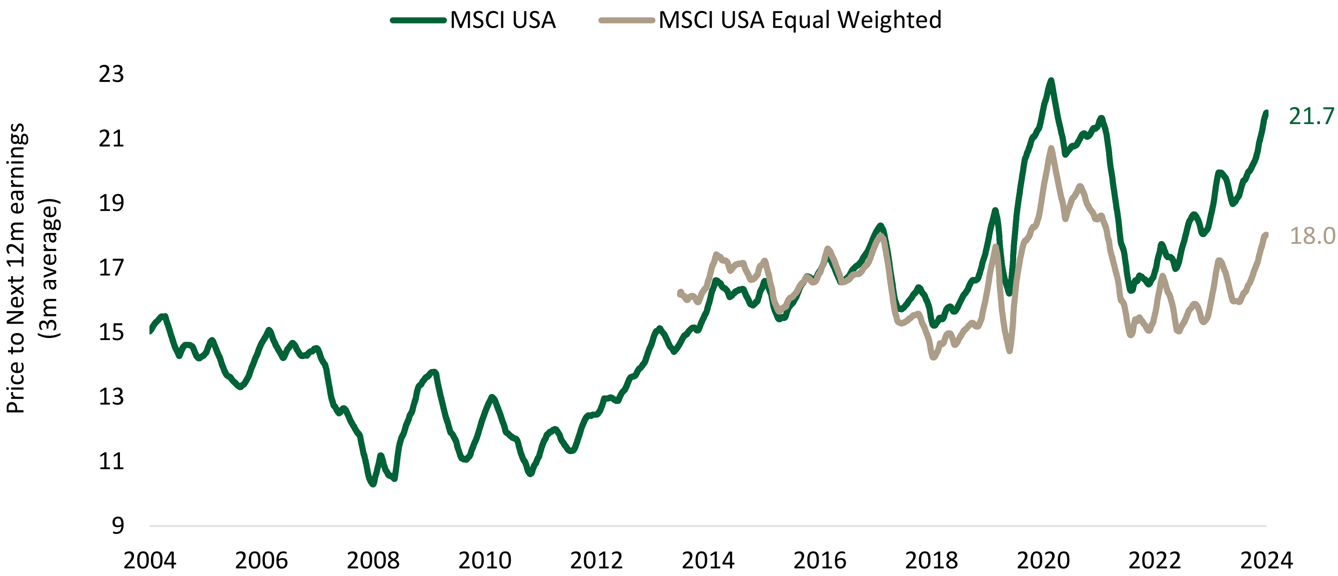
The economic environment described in section 1 has important implications for capital allocation. US growth optimism has surged, global policy uncertainty is high and the potential for volatility seems underappreciated. Our multi-asset strategies, which aim to deliver compound returns in excess of inflation over market cycles, are positioned as follows:

- Equity allocations remain close to a ‘neutral’ setting overall, following disciplined rebalancing on market strength in 2024, enabling further adjustments this year as market conditions develop (see 2.1)
- Equity strategy blends investments in mega-caps, exhibiting strong earnings and price momentum (i.e. US AI-centric technology), with decisive allocations to global quality businesses and differentiating smaller companies (see 2.2)
- Diversifying asset classes, such as government bonds, physical gold, long / short active managers and insurance-linked ‘catastrophe bonds’ aim to provide uncorrelated positive returns in aggregate, creating a robust portfolio composition in the event of market volatility (see 2.3)

2.1 US equities – what comes next?

For the past two years, US equities have benefitted from a strong recovery in real earnings growth and an expansion in valuation multiples. Growth optimism has been focused on mega-cap technology stocks – the 'Magnificent 7[16]' – whose revenues and valuations have surged on AI enthusiasm. However, in recent months the broader market has also re-priced to higher valuations, reflecting widespread positivity for the coming year (chart 7[17]).

Chart 7: Mega-cap technology has lifted US equity valuations



Higher valuations in isolation do not constrain returns over the short term, but with growth expectations elevated, investors' tolerance for disappointments is likely to be low. This means volatility can be expected to rise this year, and earnings growth will need to do the heavy lifting.

Goldman Sachs forecasts a 10% return for the S&P 500 in 2025, arguing that "*when global equities have a high valuation, the next 12-month returns are generally only good if earnings revisions are positive.*[18]" With this in mind, multiple expansion cannot be assumed to underpin long-term superior US equity returns at the start of 2025.

Yet, our analysis of equity market history highlights how above average valuations should be considered in the context of the macroeconomic environment. Chart 8[19] captures the median annualised return of US equity markets, categorised by the rate of inflation, using data since 1945. It offers some important takeaways, including:

- real earnings growth drives total returns over the long term
- real earnings growth typically only contracts during periods of recession
- valuation matters more when inflation is either very high or very low

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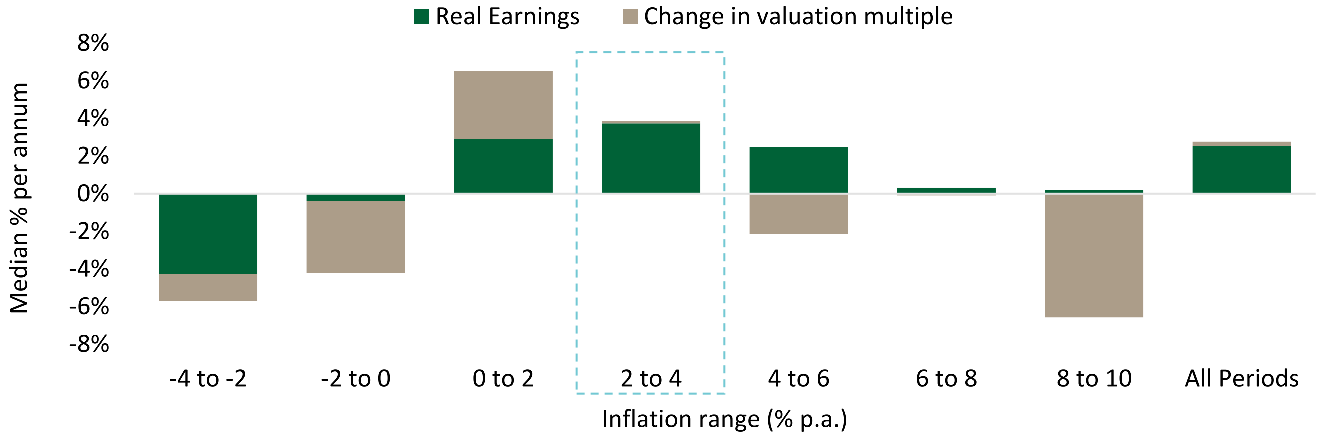
[16] Apple, Amazon, Alphabet, Microsoft, Meta, Tesla, Nvidia.
[17] Source: Bloomberg, Price to next 12m earnings ratio, 3-month average, 31 December 2024
[18] Source: Goldman Sachs Global Research, "2025 Outlook: Year of the Alpha Bet", 18 November 2024
[19] Source: Bloomberg, Shiller data, US CPI Inflation, SFIM calculations, December 1945 to September 2024.

Chart 8: Earnings drive total returns when inflation is moderate

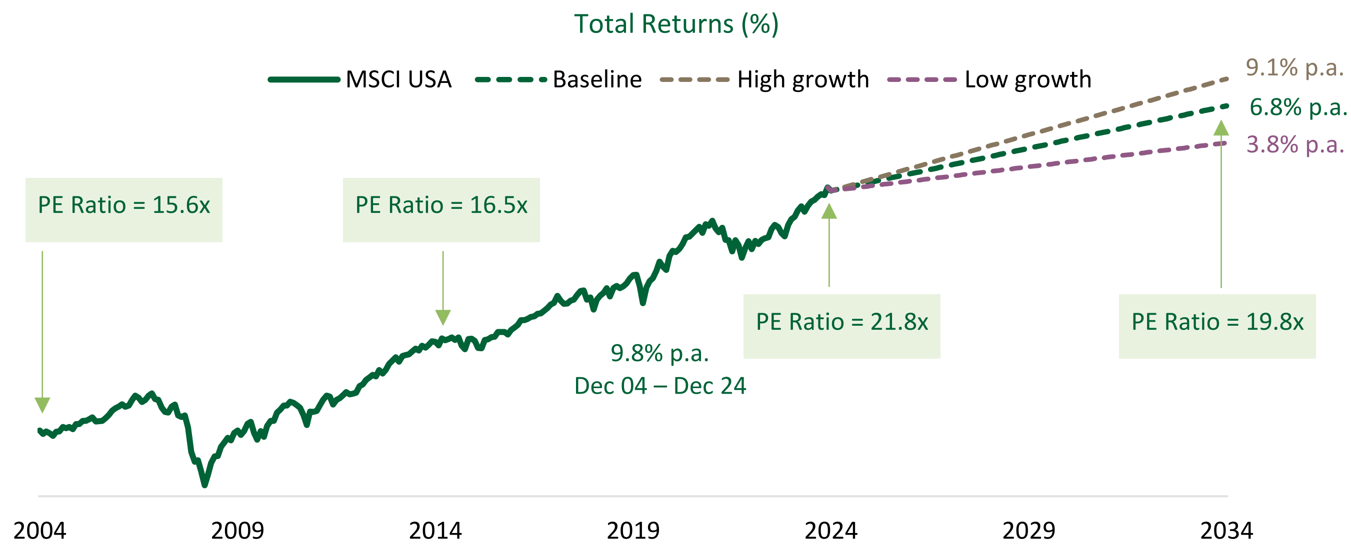


As the above chart highlights, real earnings growth varies according to the economic regime, and typically compounds at a low single-digit rate in favourable conditions. Since the end of 1989, real earnings growth has annualised c. 3.7% per annum.

Looking ahead to the next decade, US equities are assumed to sustain real earnings growth of 3.0-4.0%, consistent with the long-term trend. When combined with moderate inflation (2.0-2.5%), ongoing shareholder yield[20] (1.5-2.0%), and a conservative headwind for above average valuations (-1.0%), US equities can be assumed to deliver 5.5-7.5% annualised return over the long term. This may be a shift down from the c. 10.0% per annum delivered in over the past 20 years, yet it offers a strong foundation for continued inflation-adjusted returns for long-term investors (chart 9[19]).

Without doubt, both higher and lower outcomes could occur. A sizable productivity boost, driven by AI, has the potential to drive margins higher and sustain current valuation multiples. Such a scenario could support total returns of c. 9.0% per annum or more (high growth scenario below). Likewise, economic deterioration or a failure to convert AI investment into revenue growth could spell a deeper valuation reset, with total returns in the low-single digit range (low growth scenario below). Chart 9 outlines the total return trend of the US equity market over the past 20 years, and the likely range for the decade based on our analysis.

Chart 9: US equities likely to shift lower, yet remain well supported by earnings growth



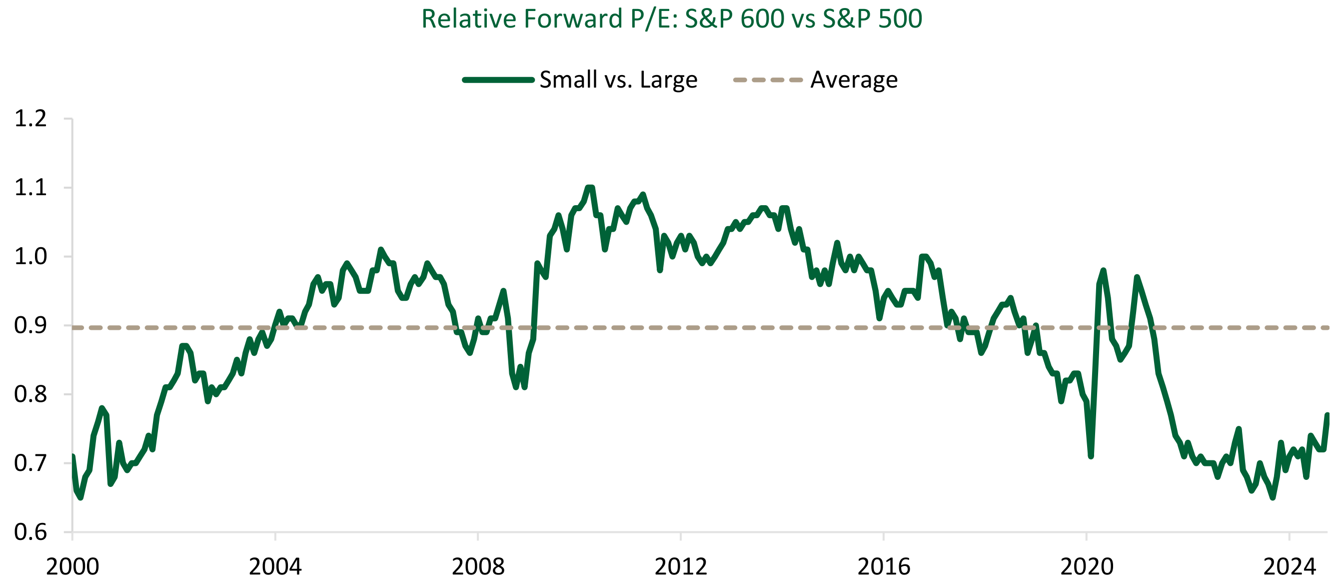
[20] *Defined as dividend yield plus net buybacks.*

A deep contraction in valuations is only probable during periods of macroeconomic extremes. The absence of clear recessionary flags, or resurgent inflation, implies that robust real earnings growth can continue to support US equities over the long term. Opportunities for enhanced returns can be accessed through strategies which look further than yesterday's winners.

2.2 Smaller companies – unloved for too long

The small cap segment of the equity market is one such example. Small caps have endured a difficult two years as higher interest rates have weighed on sentiment and returns. As a result, in contrast to their larger peers, valuations and sentiment for small cap stocks are compelling (chart 10[21]) and earnings growth is expected to accelerate.

Chart 10: Small caps remain historically cheap



Within the small cap segment, there are two salient themes which benefit one of our preferred managers, Driehaus. Firstly, through the US manufacturing renaissance and reshoring drive. Secondly, through companies benefitting from the AI infrastructure build-out.

Over recent years, US companies have increasingly moved their manufacturing capabilities to the US. This has been driven by concerns over supply chain fragility following the pandemic and wider national security concerns, but also by the pull-factor of massive government stimulus, such as the Infrastructure Investment Act and Chips Act, which has created a favourable policy environment to support US reshoring. Following the US election outcome, and the expected deregulation and risks of tariffs, we see continued acceleration in US reshoring policy, benefitting the industrial and technology sectors.

There are also opportunities in the small cap sector to capture AI exposure through lesser known companies benefitting from the AI infrastructure buildout. So far, losing the AI battle has become an existential threat to hyperscalers as they compete to increase the intelligence of their Language Learning Models (LLMs). While AI excitement has been dominated by US mega cap returns, there are other companies further down the cap spectrum which stand to benefit from this, be they companies supplying hardware for data centres, or crypto mining companies swapping the volatile revenues of cryptocurrencies for steady, reliable cash flows by switching their business models to data centre provision. As perceptions shift to a continuation of this "AI arms race", we see good evidence that capital expenditure for data centres and AI infrastructure can remain sustainably robust.

[21] *Source: FactSet, Dec 2024.*

Following continued investment in AI capabilities, we anticipate tailwinds for small cap technology companies focused on semiconductors, network equipment, cyber security software and data centre suppliers.

The combination of real earnings growth, US reshoring and the AI infrastructure buildout supports a favourable outlook for the small cap sector overall. An actively managed approach is preferred, allocating to select stocks that capture superior earnings growth and strong fundamentals. As we expect small cap earnings to improve, we retain strong conviction in this segment.

2.3 Government Bonds – not to be dismissed

The typical balancing act between global equities and core government bonds, with positive returns for one offsetting weakness in the other, has generally been ineffective for the past three years. In particular, 2022 saw a period of rising bond yields (falling prices), as inflation surged and equities declined.

Bond yields have been volatile this past year, reacting to shifting expectations for inflation and central bank policy. In recent weeks bond yields have been rising (prices falling), as investors have reflected on the inflationary threat posed by President-elect Trump's policies.

Certainly, the scenario where bond yields push higher on unexpectedly radical fiscal policies, much like the UK's mini-budget in 2022, is a risk for 2025. Further volatility in the coming months would not come as a surprise, as investors map the incoming administration's agenda against economic and geopolitical developments. Yet, it is considered a risk now reflected in the more favourable pricing of core government bonds, with 10-year yields rising c. 100 basis points since mid-September, and now trading at 4.6% for US debt (chart 11[22]).

Chart 11: Government Bonds could prove valuable if growth and inflation moderates

With a yield to maturity of c. 2% per annum in excess of current inflation, and the prospect of capital appreciation in the event of economic deterioration, our multi-asset strategy continues to hold core government bonds for both diversification and long-term total return generation.

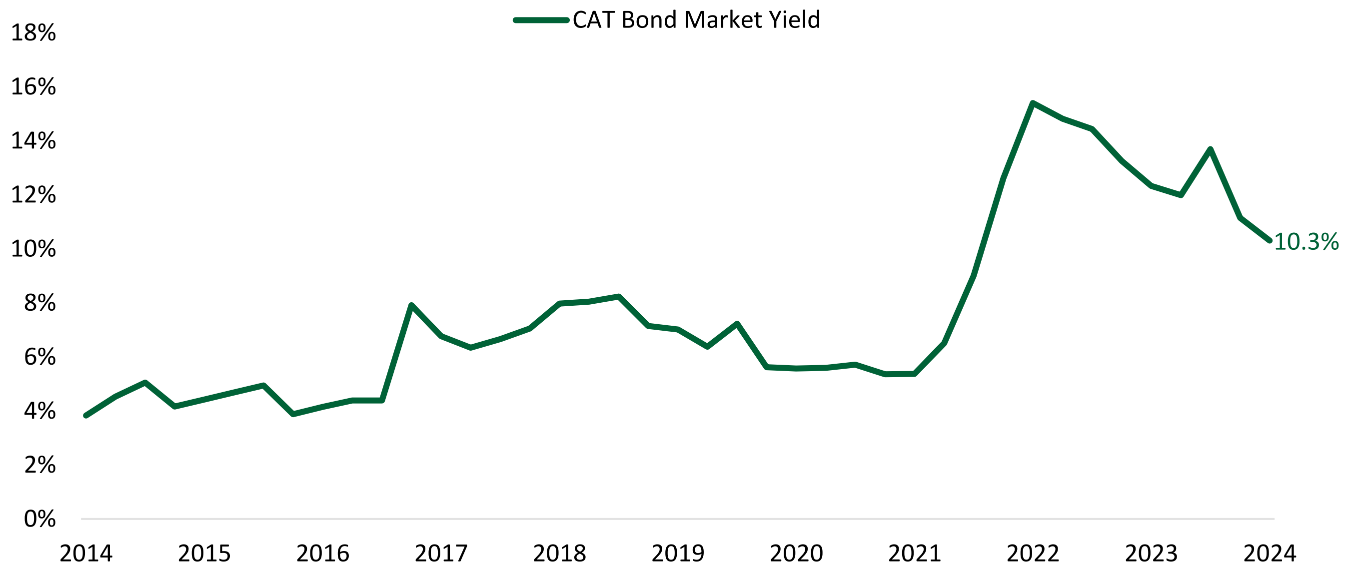
[22] *Source: Bloomberg, 31 December 2024.*

2.4 Catastrophe Bonds – uncorrelated returns

The challenge for investment portfolios primarily driven by economic variables, namely equities and bonds, is accessing investments with alternative sources of risk and return. Catastrophe bonds are a good example of such an asset class, and are integral to our multi-asset strategy. This specialist sub-sector of the insurance-linked fixed income market offers premium income from a diversified portfolio of primarily weather-related risks, such as flood or hurricane activity.

The sector returned c.13.5% in 2024[23], following a similarly strong year in 2023. The investment case for catastrophe bonds has been supported by a surge in yields following Hurricane Ian in late 2022, and yields have remained elevated compared to historical levels (chart 12[24]). 2024 was an active year for insured weather-related risks globally, however the structure of catastrophe bonds with their high attachment points for losses meant the impact for investors was minimal.

Chart 12: Elevated Catastrophe Bond yields support allocation



Our multi-asset strategy continues to allocate to catastrophe bonds as a way to complement traditional asset classes and generate differentiating returns over time. As a risk asset, declines in market value should be expected in the event of specific events, as experienced two years ago. Yet the combination of attractive income compensation and diversification properties support a continued constructive outlook.

Stonehage Fleming Investment Management
Chief Investment Officer Group
07 January 2025

[23] *Source: Plenum CAT Bond UCITS Fund Index, USD, 31 December 2024.*
[24] *Source: Artermis.bm, 31 December 2024.*

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