Capital Markets 1Q25 Update

Fixed income yields 2025: higher-for-even-longer
Rate cutting cycle is expected to continue in major economies over 2025, albeit at a slower pace. Potential geopolitical and fiscal risks set to keep the yields elevated.

Beyond the Magnificent 7
Amid high valuations of the tech megacaps, focus likely to shift to more diversified approach. Equal-weighted S&P 500, Financial sector, and smaller-cap peers may be well-positioned for the upcoming market moves.

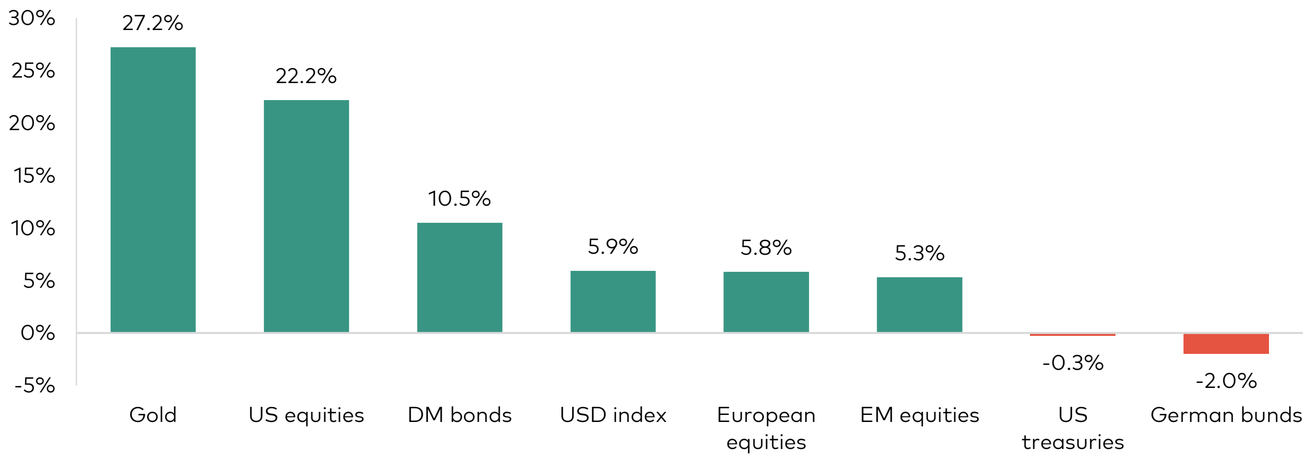
AI: time to deliver
2025 set to be the ultimate stress test for AI. When the hype of expensive valuations meets reality, AI will have to deliver results. Industry earnings will be closely watched over the year.

Geopolitics 2025: navigating the unknown
Potential tensions in US-China relationship alter supply chains, benefiting emerging markets (particularly India and Vietnam). Rising global defense spending opens investment opportunities.

Summary

- Global monetary dynamics are shaping markets, with the Fed balancing rate cuts against inflation risks and Japan signaling a policy pivot. These shifts create nuanced opportunities across fixed-income strategies.
- The shift in equity leadership reflects a maturing market where smaller-cap and sector-diverse strategies provide resilience against overexposure to mega-cap technology stocks.
- AI's economic integration is moving beyond initial hype, with real-world applications in healthcare, logistics, and energy infrastructure redefining industry benchmarks for efficiency and innovation.
- Geopolitical transformations highlight growth in advanced defense systems and cybersecurity while driving trade realignments that elevate opportunities in emerging economies.

Price performance of select assets, 2024 (negative sign of bonds & treasuries means that yields increased)



Source: Bloomberg
Note: Figure illustrates performance of follwing indices: Gold – Gold spot price, US equities – Dow Jones US Total Stock Market Index, EM equities – MSCI Emergin Markets Index, European equities – STOXX All Europe Total market Index, USD index – DXY, DM bonds – S&P Global Developed Markets Corporate Bond Index, German bunds – iShares Germany Government Bond UCITS ETF EUR, US treasuries – iShares US Treasury Bond ETF

Fixed Income

Monetary easing and fiscal dynamics drive market outlook

While the Federal Reserve is expected to continue its rate-cutting cycle (albeit at a slower pace), inflationary pressures linked to fiscal policy, tariffs, and immigration reforms could constrain further easing, with core PCE inflation expected to stay above 2.5%. In contrast, the European Central Bank may cut rates to 2.0% to stimulate growth amidst low inflation. The Bank of Japan appears as a policy outlier, likely to increase rates.

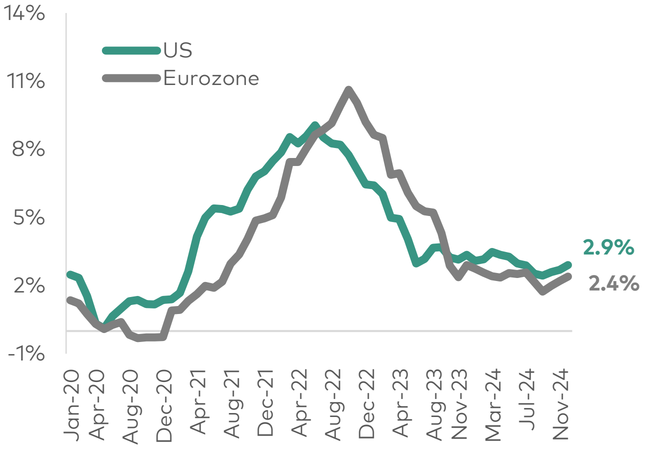
The fiscal landscape in the US remains supportive, with potential extensions of the 2017 tax cuts and other policies likely to stimulate short-term growth but may increase fiscal deficit and inflationary pressures, which could affect monetary policy and economic momentum. However, the divergence between US and European economic performance could widen, given differing fiscal and monetary dynamics.

In the fixed-income sector, US Treasuries, especially short-duration bonds, are attractive as 2-year yields are expected to drop more than 10-year yields, offering a good entry point with current yields at 4.29%. Emerging market sovereign bonds in countries like India, Mexico, and South Africa offer high yields of 6%-9%. Corporate bonds, both investment-grade and high-yield, provide opportunities for steady income with varied risk levels, considering potential economic shifts and inflation risks.

Investment implications for 2025

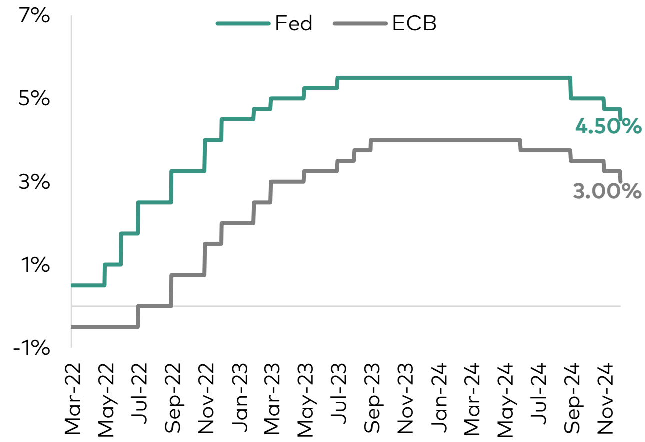
Investors should adopt a diversified approach, balancing high-quality government bonds with income-generating corporate and securitized credit. Emerging market bonds offer opportunities for yield, but foreign exchange risks necessitate effective hedging strategies. Active management will be crucial in navigating volatility, identifying undervalued opportunities, and addressing policy-driven risks. Fiscal and monetary policies will likely evolve unpredictably, reinforcing the need for flexibility and a focus on quality within fixed-income portfolios.

US and Eurozone inflation (headline CPI)



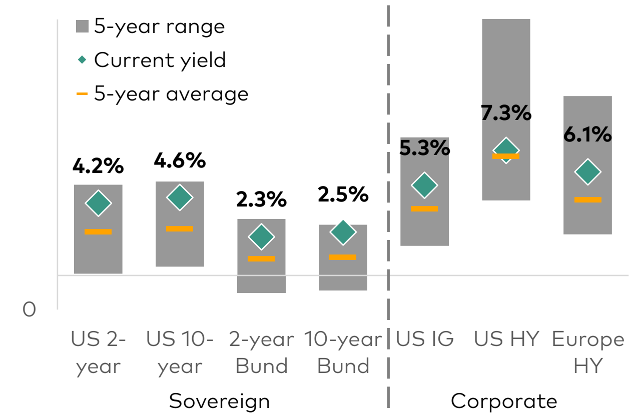
Source: US Bureau of Labor Statistics, Eurostat

Fed and ECB interest rates



Source: Fed (upper bound), ECB(deposit facility rate)

Yields on different fixed income securities, %



Source: Bloomberg
Note: IG corresponds to corporate investment grade category. HY corresponds to corporate high yield category – higher risk than IG.

Equities

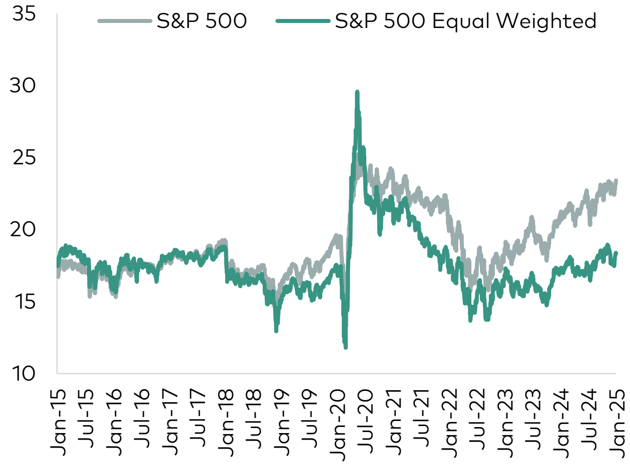
Magnificent 7 vs. S&P 493: a shift in market leadership

Over the past two years, the US equity market has been dominated by the "Magnificent 7", a group of mega-cap technology companies that includes Apple, Microsoft, NVIDIA, Amazon, Alphabet, Meta, and Tesla. These companies accounted for more than half of the S&P 500's total returns in 2024, fueled by their leadership in artificial intelligence (AI), cloud computing, and digital transformation. With an average forward P/E ratio of 34x compared with 22x for the S&P 500 Index, profit-taking from the Magnificent 7 may increasingly be a source of funding elsewhere at lower valuations. As this dominance is expected to moderate, this will open up opportunities for other sectors and smaller-cap companies. In 2H24, the US equity market began to show signs of broader participation. Nearly 45% of S&P 500 companies outperformed the index, compared to only 20% earlier in the year, signaling a shift away from reliance on the Magnificent 7. This broadening trend reflects growing investor interest in sectors and companies previously overshadowed by the tech giants.

Why the shift matters for investors?

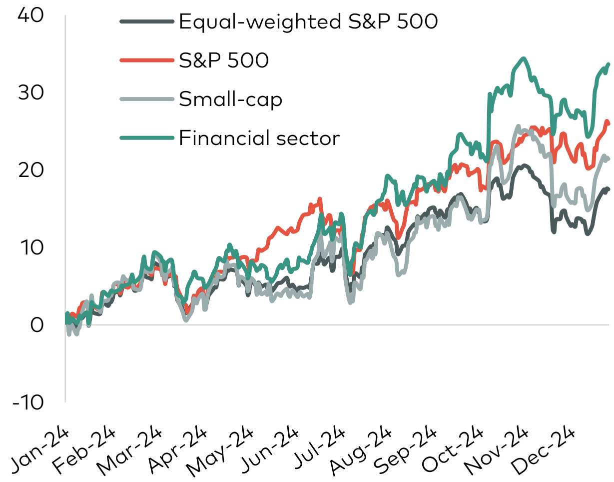
For investors, the moderation of the Magnificent 7's dominance is a double-edged sword. While it opens doors to diversification and new growth opportunities, it also demands a more strategic approach to portfolio construction. The ability to identify high-quality opportunities across a broader range of sectors becomes essential, as relying solely on mega-cap tech stocks may no longer deliver outsized returns. For instance, financials are poised for significant growth, with earnings projected to rise by 12% in 2025, driven by elevated yields and the prospect of tax cuts. Additionally, small-cap stocks are trading at a 20% discount to their historical averages, presenting a compelling opportunity for long-term investors, particularly during rate-cutting cycles, which have historically favored small-cap over large-cap stocks.

Forward P/E



Source: Bloomberg

Total return of select ETFs, 2024



Source: Bloomberg

ETF	Description
S&P 500 Equal Weight (RSP)	Provides exposure to an equal-weighted S&P 500 index, reducing reliance on mega-cap stocks and benefiting from broader market participation.
Small-Cap ETF (VB)	Broad-based ETF offering exposure to small-cap stocks, expected to benefit from easing monetary policy and undervaluation compared to historical averages.
Financial Sector (XLF)	Targets financial companies projected for double-digit earnings growth in 2025 due to increased loan demand and favorable interest rate dynamics.

Equities

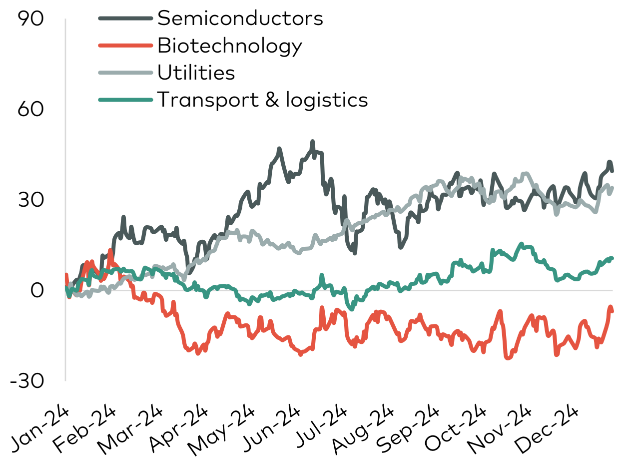
AI: From Concept to Economic Driver

The rapid acceleration of artificial intelligence (AI) continues to transform global industries, driven by advancements in generative models, automation technologies, and AI-powered infrastructure. As we enter 2025, AI's role as an economic catalyst is underscored by surging capital investments and an evolving regulatory landscape. Global corporate spending on AI is projected to surpass US$ 200bn in 2025, fueled by the demand for high-performance chips, cloud computing, and specialized software. AI enhances productivity, enabling businesses to cut costs, optimize supply chains, and create new revenue streams, although these advancements require significant upfront investments. AI's benefits extend beyond the technology sector. Industrials and logistics are using AI to improve operations and supply chain reliability. In healthcare, AI is revolutionizing drug discovery and diagnostics, significantly reducing development timelines and costs. Utilities will benefit as AI-driven data centers double their energy consumption by 2030, increasing the demand for energy and grid optimization technologies. Geographically, AI adoption varies. Asia leads in AI-driven manufacturing, especially in China. Europe focuses on sustainable applications like green energy grids, while the US remains a leader in innovation, particularly in data centers and digital infrastructure security.

Investment Implications

For investors, the AI revolution offers diverse opportunities across various industries. While technology firms and biotech companies are direct beneficiaries, other sectors like energy and utilities are also poised to gain from AI-driven demands. Investors should focus on sectors that either enable or adopt AI technologies, such as semiconductors, healthcare, and energy. However, caution is advised due to the high valuations and potential regulatory and geopolitical challenges that may affect the integration and expansion of AI technologies. As AI continues to evolve, its role as a fundamental economic driver is expected to expand, offering significant opportunities for investment and growth in enabling industries.

Total return of select ETFs, 2024



Source: Bloomberg

ETF	Description
Semiconductors (SMH)	Focuses on companies that produce semiconductors, which are critical components in AI technology, offering exposure to the growth of AI infrastructure and the expanding semiconductor market.
Biotech (ARKG)	Concentrates on biotechnology firms that are using AI to revolutionize drug discovery, providing investment opportunities in cutting-edge healthcare technologies.
Utilities (XLU)	Comprised of companies in the utilities sector that support the increased demand for efficient energy solutions for AI.
Transport & logistics (IYT)	Focuses on stocks from the transportation sector, which includes airlines, railroads, and logistics companies. Benefits from advancements in transportation efficiency and increased global trade, making it an attractive choice for exposure to the essential services that drive commerce.

Equities

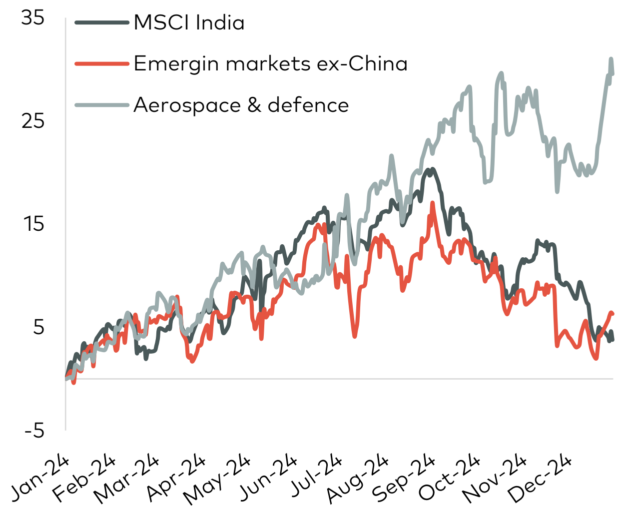
Geopolitics

In 2025, the global geopolitical scene is intensely volatile, influenced by evolving international landscape, energy security concerns, and a growing US-China rivalry. Donald Trump's re-election as president has significantly altered international dynamics, with a focus on technological independence, boosting domestic energy production, and implementing a strong trade protection policy. These changes have reignited trade tensions, especially affecting critical areas like semiconductors, artificial intelligence, and green technology, where the US and China compete closely. Countries like India and Vietnam are turning into key beneficiaries as businesses look to diversify their supply chains away from China, driven by these geopolitical shifts. This movement is part of a larger change in global trade, aimed at reducing vulnerabilities linked to geopolitical tensions and disruptions in trade. The possibility of a severe "Trade War II" is on the horizon, with Trump suggesting new tariffs even on allied countries. If escalated, the tariff war could potentially be causing a significant slowdown in global economic activities and a major disruption in international trade relations.

Investment Implications

For investors, navigating the geopolitical landscape in 2025 involves managing considerable uncertainty. Trade barriers, rising tariffs, and increased defense spending are transforming global markets. Although risks like policy errors, trade conflicts, and fiscal imbalances pose threats to growth and stability, there are also opportunities. Strategic investments in defense technologies, cybersecurity, and emerging markets can provide paths to resilience and long-term gains. Investors who adeptly maneuver through these changes can shield themselves from volatility and seize growth opportunities in an ever-evolving global economy.

Total return of select ETFs, 2024



Source: Bloomberg

ETF	Description
Aerospace & Defense (ITA)	This ETF invests in US companies involved in the manufacture, development, and sale of aerospace and defense equipment. Increased defense spending and heightened security concerns could drive growth in this sector.
MSCI India (INDA)	As India benefits from diversification of supply chains moving away from China, this ETF provides exposure to large and mid-sized companies in India, positioning investors to benefit from India's expected economic growth and increased manufacturing capabilities.
Emerging Markets ex China (EMXC)	Offers exposure to a broad range of companies located in emerging markets worldwide, excluding China. It is designed for investors looking to capitalize on the growth potential of emerging markets while avoiding exposure to China's market, to avoid trade disputes involving China.

Source: Bloomberg

Forecasts for 2025

Fixed Income:

Analysts forecast a decline in yields throughout 2025, both in the US and in Europe. By the end-2025, a 2-year US Treasury yield is expected to touch 3.74% (down from current 4.29%), while a 2-year German bund yield is expected to fall to 1.89% (down from current 2.23%).

Equities:

According to BlackRock Investment Institute, the European market should underperform compared to other regional markets during the next 6 to 12 months. Meanwhile, the outlook remains neutral for the Emerging Markets and UK equities and positive for US, Japan, and China.

In terms of S&P 500 sectors, Charles Schwab analysts expect Financials, and Communications to outperform the rest of the market. Meanwhile, Consumer Discretionary is forecasted to deliver weaker performance as compared to the overall index.

FIXED INCOME

Yield forecasts (%)

	Last	1Q25F	2Q25F	3Q25F	4Q25F
US treasuries					
30-year	4.82	4.48	4.42	4.41	4.39
10-year	4.60	4.27	4.20	4.18	4.16
5-year	4.43	4.09	3.99	3.96	3.93
2-year	4.29	4.04	3.90	3.80	3.74
SOFR	4.30	4.18	3.87	3.69	3.57
German bunds					
10-year	2.53	2.36	2.27	2.28	2.32
2-year	2.23	2.02	1.91	1.89	1.89
EURIBOR	2.68	2.36	2.02	1.97	1.96

Source: Bloomberg

EQUITIES

12-month outlook

S&P 500 Sectors	ETF	Outlook
Financials	XLF	
Communications	XLC	
Materials	XLB	
Energy	XLE	
Technology	XLK	
Consumer Staples	XLP	
Utilities	XLU	
Industrials	XLI	
Health Care	XLV	
Real Estate	XLRE	
Consumer Discretionary	XLY	

Source: Charles Schwab

6-12 month outlook

Regional Markets	ETF	Outlook
US	SPY	
Japan	EWJ	
China	MCHI	
UK	EWU	
Emerging Markets	EEM	
Europe	IEUR	

Positive Neutral Negative

Source: BlackRock Investment Institute

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