2025 Observations in Global Markets: Opportunities Amid Market Complexity

In 2025, we navigate an increasingly complex market environment, leveraging our collaborative, bottom-up culture to deliver actionable insights. This year's insights highlight key considerations from our diverse global investment team, offering a differentiated perspective rooted in active management.

Trump 2.0: A Different Economic Landscape

U.S. markets rose sharply in response to Trump's reelection, selectively weighing policy optimism against potential downside risks associated with tariffs or a rising deficit. While Trump's first term was broadly positive for markets, the current setup differs significantly, and we are cautious about drawing parallels to eight years ago.

The Valuation Starting Point Is Not as Favorable

In 2016, U.S. equity valuations were relatively modest, with the S&P 500 trading at a forward P/E of 16.7x. This left ample room for multiple expansion as corporate tax cuts and deregulation boosted earnings and market sentiment. In contrast, today's forward P/E of 21.5x reflects a 30% premium compared to 2016, leaving less room for policy driven upside.

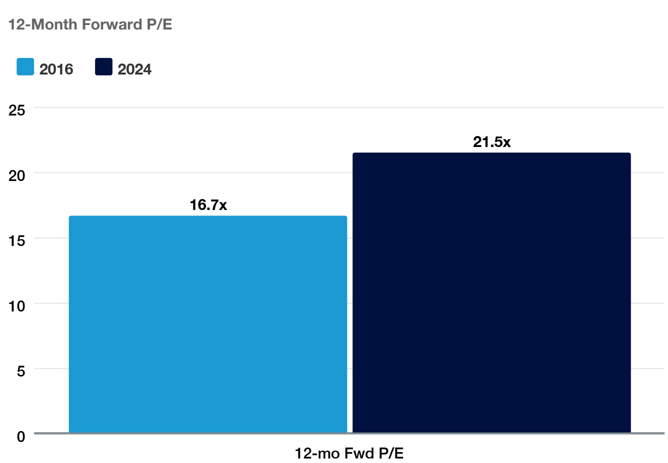
Corporate Taxes Are Already Low

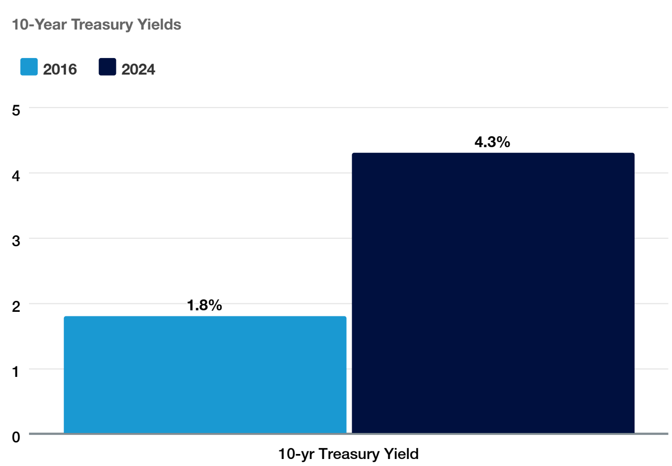
In 2016, the corporate tax rate stood at 35%, allowing Trump to implement sweeping tax cuts that directly boosted corporate earnings and incentivized investment. With the rate already reduced to 21% in 2024, further cuts are unlikely to have a comparable impact, limiting the potential for a fiscal stimulus boost of similar magnitude.

There Is Limited Fiscal Flexibility

In 2016, rates were near historic lows, with 10-year Treasury yields at 1.8%. This environment supported cheap borrowing for businesses and consumers and the flexibility for broad stimulus measures. Today, a ballooning deficit and significantly higher interest rates limit the government's ability to implement aggressive fiscal measures without exacerbating debt concerns or risking a resurgence of inflation.

THE 2024 ENVIRONMENT IS DIFFERENT THAN 2016

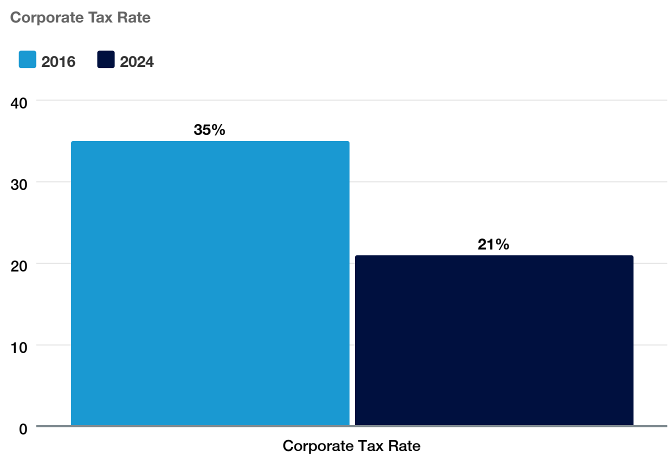


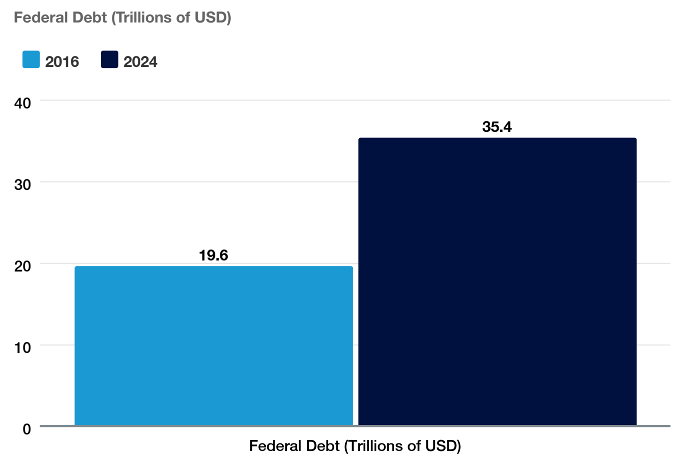


Corporate Tax Rate

Federal Debt (Trillions of USD)

THE 2024 ENVIRONMENT IS DIFFERENT THAN 2016 (continued)





Source: Bloomberg and U.S. Department of the Treasury

The Impact and Likelihood of Tariffs Is Uncertain

Tariffs were a central feature of Trump's first term, but the current economic realities are notably different. Eight years ago, Trump's aggressive trade policies were implemented against a backdrop of low inflation and low rates, creating room for bold actions. Today, elevated price levels are a key concern for voters and policymakers alike.

Given this reality, we question if Trump's tariff posturing may now be aimed more at pressuring China and other foreign countries into negotiating favorable trade terms for the U.S. Importing disinflation by leveraging excess global capacity could ease current price pressures. However, the impact of sweeping tariffs remains uncertain.

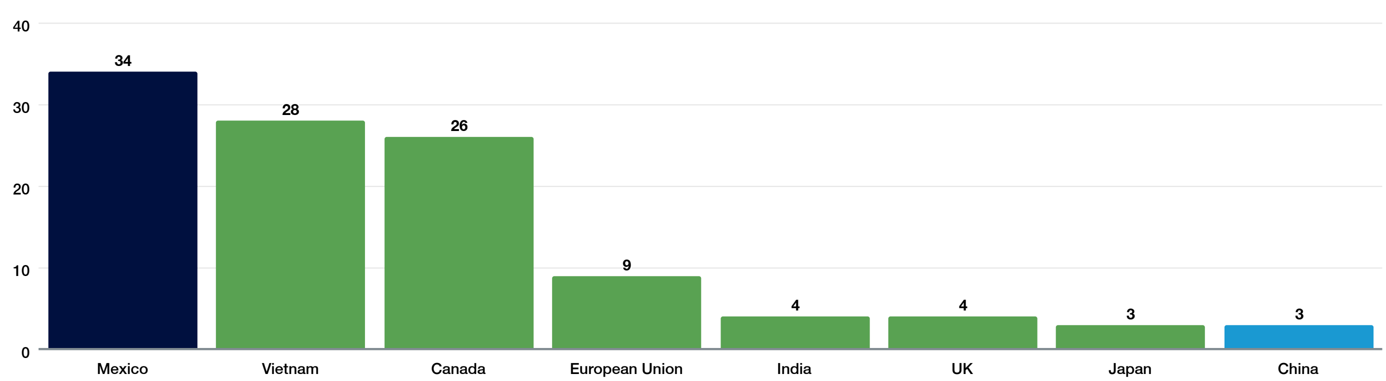
As China has Reduced Dependency on U.S. Trade

If broad tariffs are enacted, China will likely remain a prominent target, but the potential impact may be overstated. Over the years, China's trade policy has shifted toward regional partnerships, and global supply chain diversification has reduced its dependence on U.S. trade. Today, China's exports to the U.S. account for only 3% of its GDP—a smaller share than most of the U.S.'s other major trade partners.

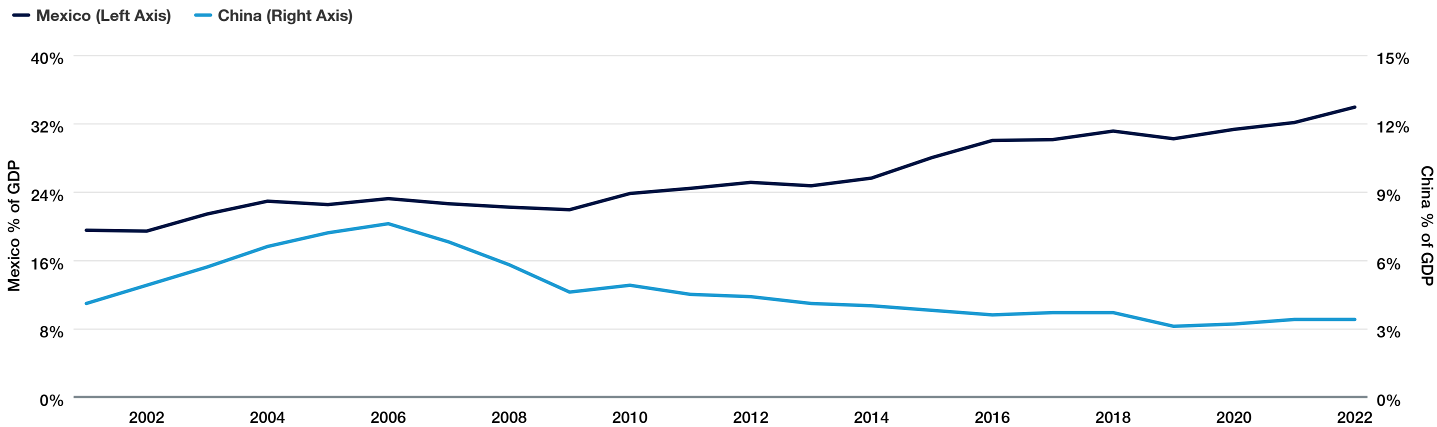
And Other Economies Are More Exposed

Economies like Mexico, Vietnam, and Canada are more vulnerable to U.S. tariffs or trade restrictions due to their heavy reliance on U.S. demand. For instance, more than one-third of Mexico's GDP is derived from exports to the U.S., a figure that has steadily increased over the past 15 years. While nearshoring has brought significant foreign direct investment into Mexico, it has also deepened the country's reliance on U.S. trade policies, making it more susceptible to tariff uncertainty.

Export Exposure to the U.S. (as a % of local GDP)



Mexico and China Historical Export Exposure to the U.S. (as a % of local GDP)



Source: World Bank as of 2022

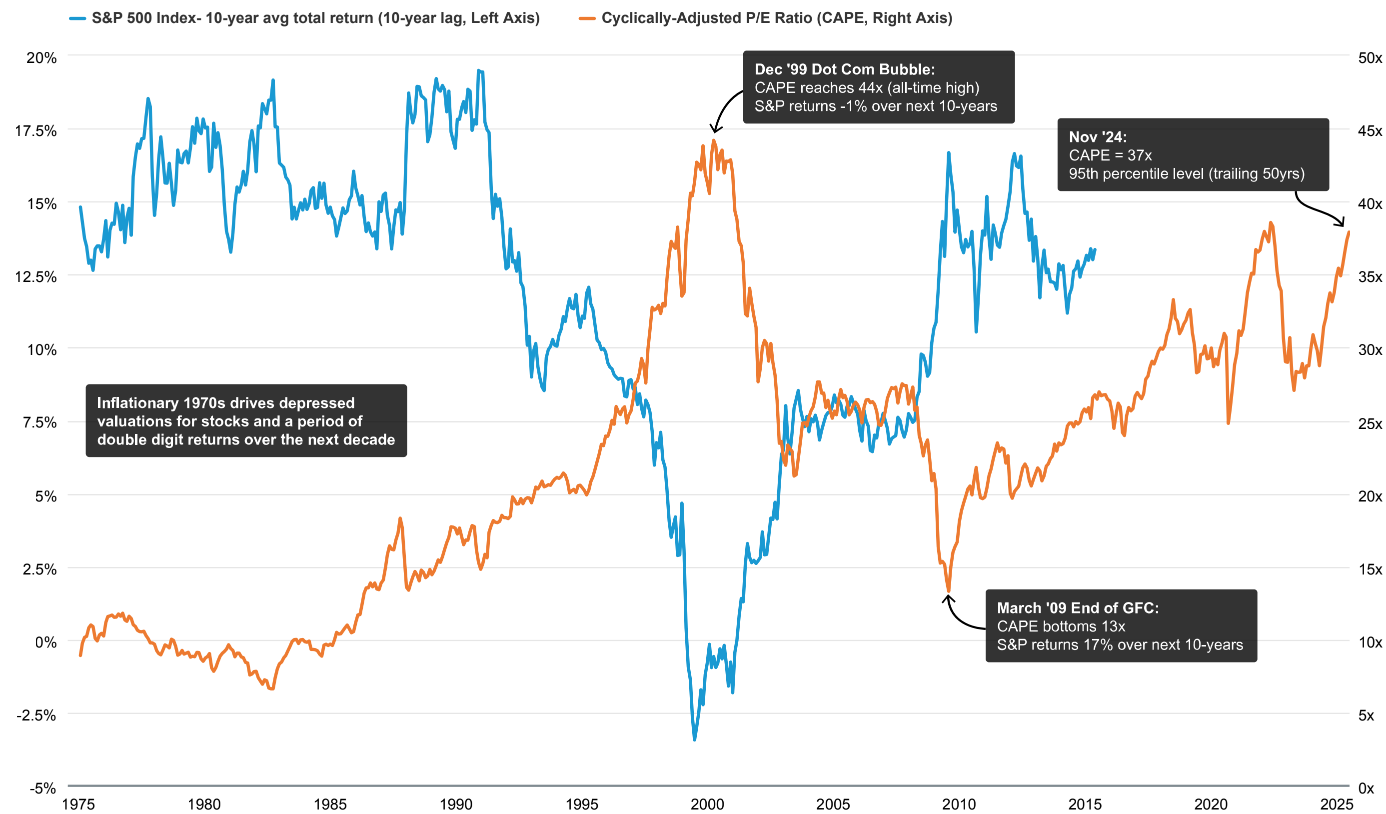
Elevated U.S. Valuations: Tempering Expectations for Future Returns

Following an 18% pullback in 2022, the S&P 500 has surged nearly 60% over the past two calendar years, ending 2024 near an all-time high. Strong earnings growth in U.S. equities has played a role, but much of the recent rally has been fueled by optimism surrounding artificial intelligence, leading to significant multiple expansion. For instance, the Cyclically Adjusted Price-to-Earnings (CAPE) ratio – a measure that compares the current price of the S&P 500 Index to its inflation-adjusted average earnings over the past decade – currently sits at 37 times earnings, surpassing peaks seen during the Great Depression and approaching levels historically only seen during the tech bubble of the late 1990s.

While valuation ratios like the CAPE have limited utility in predicting short-term market movements, they can be highly instructive over longer horizons. Historically, periods of elevated CAPE ratios have often been followed by more modest returns over the subsequent decade (see figure below).

As of December 2024, the CAPE ratio's current level ranks in the 95th percentile over the past 50 years and in the 97th percentile when extending the analysis back to 1930. This underscores the importance of managing expectations. While we are not forecasting the near-term direction of U.S. equities, elevated valuation metrics suggest that the exceptional returns of recent years are unlikely to persist. Investors should prepare for a more tempered return environment over the next decade.

As CAPE Is High, Investors Should Prepare for a More Moderate Return Environment



Source: Shiller Data and Morningstar Direct
Past performance does not guarantee future results.

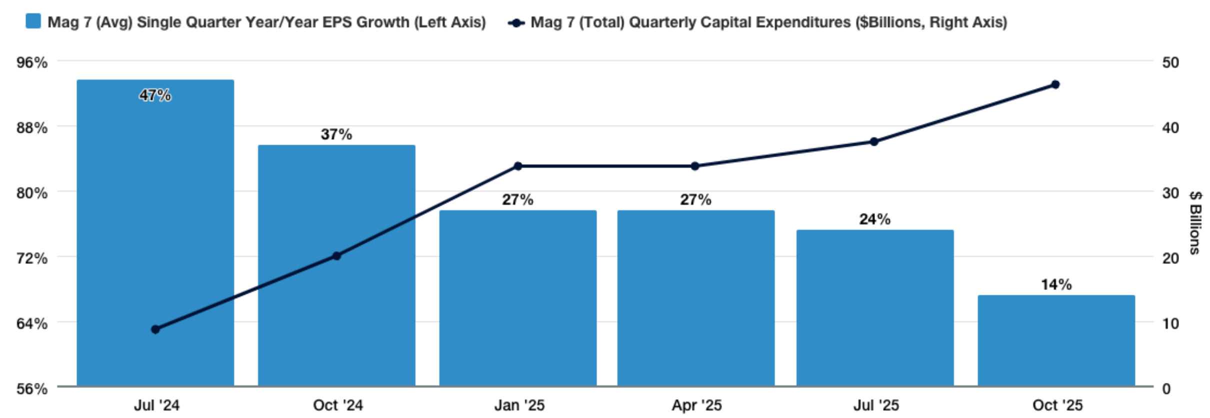
AI Spending Boom: A Challenge to the Mag 7's Earnings Momentum

The rapid advancements in artificial intelligence (AI) have propelled the "Mag 7" to remarkable growth over the past two years. However, the path forward is likely to be more measured, as the immense capital required to support AI-driven innovations begins to compress earnings growth. Aggregate capital expenditures by the Mag 7 are forecast to rise from a quarterly run rate of $60 billion in mid-2024 to over $90 billion by Q3 2025. This dramatic increase in spending is expected to weigh on profitability, with single-quarter year-over-year EPS growth projected to slow from 47% in Q2 2024 to just 14% by Q3 2025.

The chart below demonstrates this divergence: as capital expenditures accelerate, EPS growth decelerates, signaling a trade-off between seizing long-term AI opportunities and sustaining short-term profitability. The steady decline in EPS growth raises questions about the sustainability of recent high returns. If revenue gains fail to keep pace with rising capital expenditures, investor expectations for immediate returns could place additional pressure on these companies.

Despite these challenges, the Mag 7 will likely maintain leadership positions within their industries. However, the anticipated moderation in EPS growth suggests a shift toward more moderate returns, emphasizing the importance of balancing innovation with shareholder value.

Mag 7 Expenditures Will Pressure Earnings



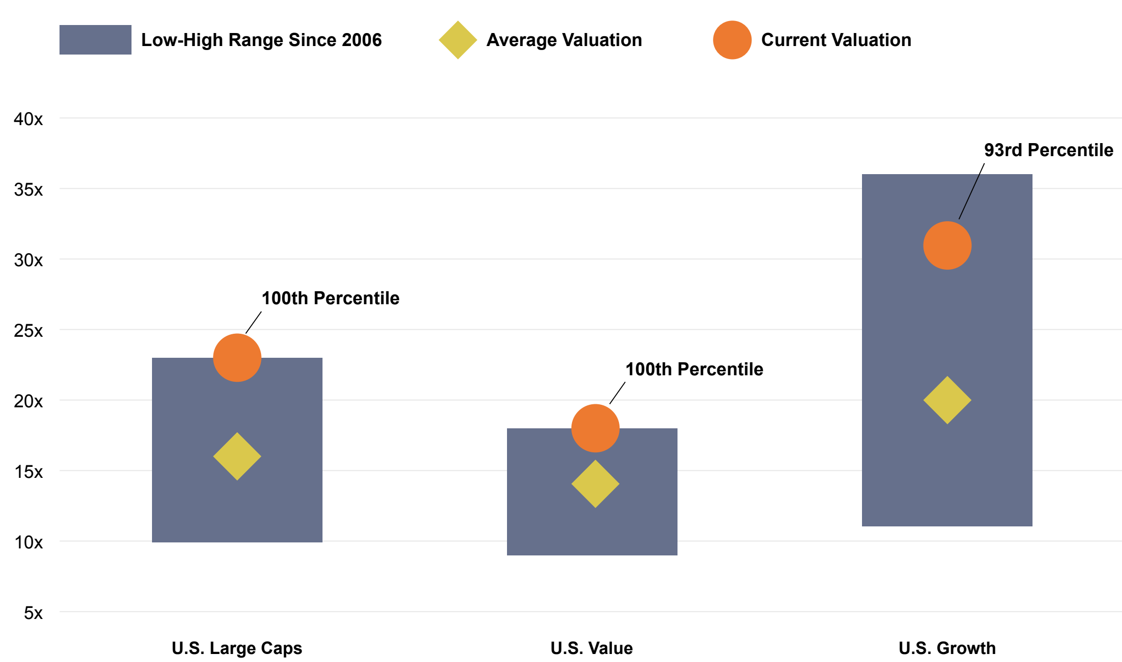
Source: Bloomberg

Value Isn't Cheap: It's Not Just U.S. 'Big Tech' That's Priced for Perfection

While U.S. growth stocks, particularly in Big Tech, have garnered much attention for their elevated valuations, U.S. value stocks are also reaching uncharted territory. Over the past two decades (the longest period for which data is available), U.S. value stocks now sit at the 100th percentile of their historical valuation range on a forward price-to-earnings basis. In simpler terms, they have never been more expensive.

This development challenges the traditional view of value stocks as a haven for conservative investors seeking lower valuations. Today, the valuation stretch is no longer confined to high-growth sectors; it has broadened across the style spectrum, raising concerns about the sustainability of current market pricing. In this environment, assuming value stocks inherently offer a margin of safety could be a misstep.

Current Valuations Are Historically High



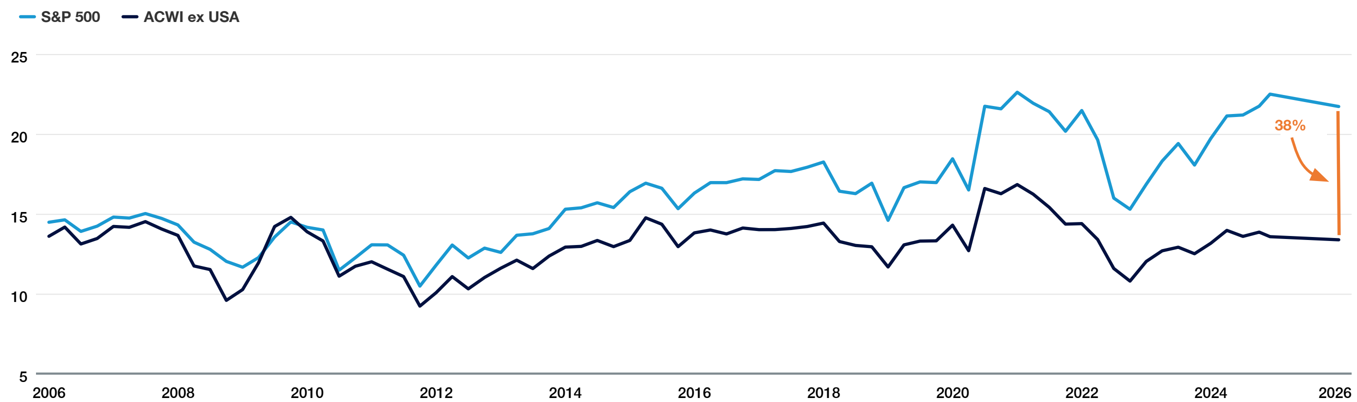
Source: Bloomberg

Non-U.S. Equities: Historic Valuation Gaps Highlight Opportunities Abroad

U.S. equities are trading at elevated levels compared to their own history and relative to the rest of the world. On a 12-month forward earnings basis, the valuation gap between the S&P 500 and the MSCI ACWI ex-US is historically wide. U.S. equities now trade at a 40% premium to their international counterparts—nearly three times the longer-term historical premium.

While we are not making a macro call on specific regions, the international landscape offers compelling opportunities for stock pickers. These valuation gaps present potential for relative value and diversification benefits, particularly for investors willing to look beyond U.S. borders for opportunities.

U.S. Valuation Premium Is Historically Wide



Source: Bloomberg

Fixed Income: Yield Opportunities Amid Tight Spreads

As we kick off the new year, fixed income markets present a mixed picture. Spreads across sectors are at their tightest levels since the global financial crisis (GFC), with investment-grade corporate spreads not this narrow since 1997. However, yields remain in the highest decile of cheapness post-GFC. This dichotomy is likely self-reinforcing as investors, drawn to elevated yields, accept lower spread compensation.

Yields and Spreads Are at a Dichotomy

Index	Spread (bps)	Rank (0=expensive, 100=cheapest)	Yield (%)	Rank (0=expensive, 100=cheapest)
Bloomberg US Aggregate Index	34	4	4.91	95
Bloomberg US Universal Index	58	1	5.13	93
Bloomberg Global Aggregate Index	35	7	3.68	92
Bloomberg US IG Corporate Index	80	0	5.33	88
Bloomberg Global High Yield Index	329	1	7.49	64

Past performance does not guarantee future results.
Source: Bloomberg as of 30 September 2024.

Drivers of Tight Spreads and Elevated Yields

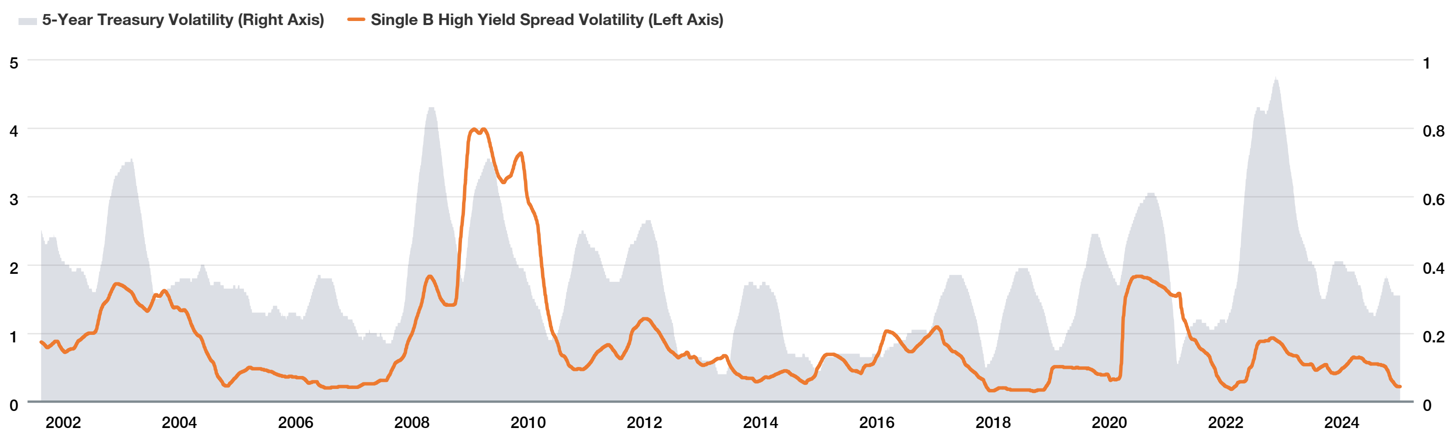
- **Macro Factors:** Investors remain optimistic about the U.S. economy's growth trajectory, buoyed by the latest GDP data (3.1% quarter-over-quarter annualized), resilient nonfarm payroll growth, and continued strength in manufacturing. These factors have supported risk appetite.

2025 OBSERVATIONS IN GLOBAL MARKETS

- **Fundamental Factors:** Corporate and consumer balance sheets remain strong. High-yield default rates, at just 1.1% (per JP Morgan), are well below the historical average of 3.4%. Consumer debt, relative to GDP, is at its healthiest level since the GFC.
- **Technical Factors:** Fixed income markets have experienced robust inflows during 2024, with mutual fund inflows reaching a decade high of $425 billion. Additionally, net negative issuance in the high-yield corporate space in prior years has left the sector modestly smaller, contributing to a favorable supply-demand dynamic.

Despite these supportive conditions, historical patterns suggest caution. While there is little indication that a recession is imminent – if so, investors would price this risk into credit spreads immediately. We observe that the current environment resembles past environments where complacency was preceded by an unforeseen shock.

Rate Volatility Significantly Higher than Spread Volatility



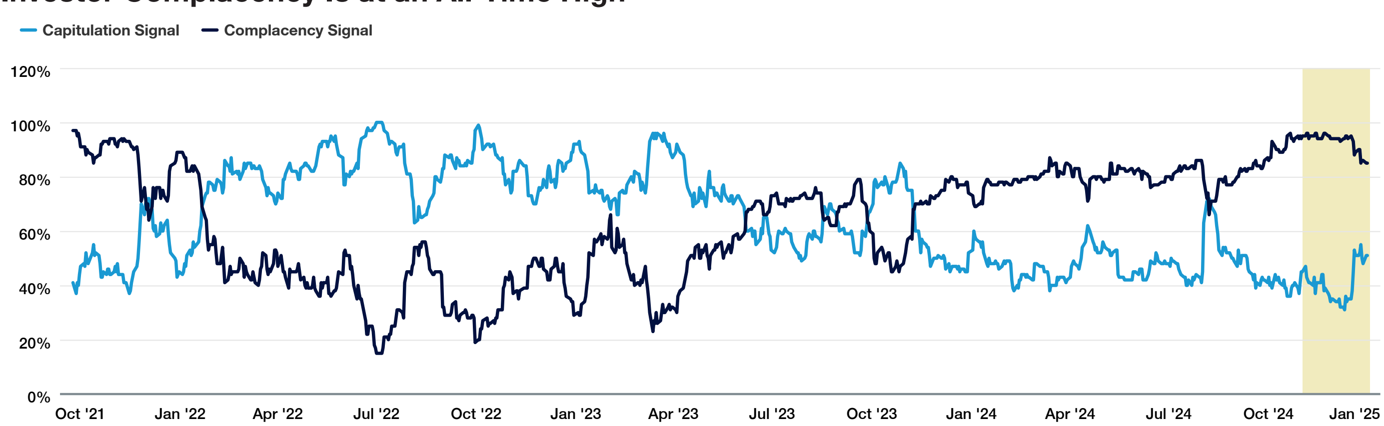
Source: Bloomberg

Historical Lessons in Volatility and Complacency

A look back in history at the difference between rate and spread volatility (chart above) reveals that the current environment resembles other periods of complacency, such as 2005–2007 and 2018–2020, both of which preceded significant shocks to the global economy. During these times, tight spreads, combined with declining volatility, masked underlying risks that later emerged with substantial market dislocations.

In a similar vein, Barclays' "Complacency Signal"—which tracks several market-based factors including high-yield realized volatility, high-yield and bank loan fund inflows, and the price of high-yield tail hedges—indicates that markets are at their highest level of complacency since September 2021. This signal underscores a growing risk that investors may not be adequately pricing the potential for disruption, particularly in credit-sensitive areas.

Investor Complacency Is at an All-Time High



Source: Barclays

Soft Landing: Historical Challenges and Modern Risks

The current pricing of risky assets reflects a market that has declared victory over recession. The Federal Reserve's current communication suggests the risks to inflation and employment are roughly equal, which is a favorable place for the central bank to be. Rates that appear to be above neutral give the Fed the leverage it needs to keep inflation in check while having the ammunition to deliver cuts in the event that nonfarm payrolls trend lower.

However, history suggests that avoiding a recession after a rate-hiking cycle is the exception rather than the rule. Over the past 50 years, achieving a "soft landing" has typically required three conditions:

1. **No Shocks:** Past shocks, such as oil price spikes, war, and the COVID-19 pandemic, have often derailed economic stability.
2. **No Financial Bubbles:** Financial excesses, such as the dot-com bubble in 2001 and the housing bubble in 2008, have historically led to recessions.
3. **Good Politics:** A combination of responsible fiscal policies and independent monetary policy is critical.

Achieving a Soft Landing Is… Hard

HIKING CYCLES		GDP IMPACT		
FED CHAIR	END OF HIKING CYCLE	DID RECESSION OCCUR?	REAL GDP	LESSON
Burns	July 1974	YES	-2.7%	Inflationary Politics | Shock
Burns/Miller/Volcker	April 1980	YES	-2.2%	Inflationary Politics
Volcker	January 1981	YES	-2.1%	Inflationary Politics
Volcker	August 1984	NO	Positive	No Shock | No Financial Bubble | Good Politics
Greenspan	April 1989	YES	-1.4%	Shock
Greenspan	April 1995	NO	Positive	No Shock | No Financial Bubble | Good Politics
Greenspan	July 2000	YES	-0.1%	Financial Bubble
Greenspan/Bernanke	June 2006	YES	-3.8%	Financial Bubble
Yellen/Powell	December 2018	YES	-10.1%	Shock

Soucre: Bloomberg and Thornburg as of 30 September, 2024.

The mid-1980s and mid-1990s were rare periods when all three conditions aligned, enabling soft landings. Today, the risk of shocks remains unpredictable, but political/fiscal dynamics present a notable headwind. Addressing significant budget deficits could constrain growth, reducing the government's contribution to economic expansion.

Final Thought

This outlook is designed to equip financial professionals with the insights needed to navigate a challenging and evolving investment landscape. For additional perspectives and analysis, please get in touch with our team to see how we can best support you in 2025.

Important Information

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