



STRATEGY UPDATE • JANUARY 2025

Charting a Course Through Rising Yields, Geopolitical Tensions, and Economic Divergence

KEY TAKEAWAYS

- Rising yields and fewer expected Fed rate cuts weighed on equities, while persistent inflation and geopolitical tensions added to market uncertainty.
- We maintain an equity overweight for medium- to long-term investors, supported by corporate earnings, innovation, and resilience across key US sectors.
- Equity opportunities extend beyond the “Magnificent 7”, as broader earnings growth and valuation differences support selective diversification.
- Europe faces a more challenging growth outlook, with potential US tariffs and limited fiscal support increasing reliance on further ECB rate cuts.

MARKET OUTLOOK:

Global equity markets experienced a significant downturn in the first half of December, driven by a mix of macroeconomic and geopolitical factors. A key contributor was the **rise in yields** as investors began pricing in fewer interest rate cuts for 2025, reflecting expectations of a more cautious Federal Reserve. This reassessment was fueled by economic data suggesting resilience in certain areas of the economy, leading to recalibrated market expectations. Additionally, an increase in corporate debt issuance added upward pressure to yields more broadly. Adding to this uncertainty was the Federal Reserve's December meeting. Investors sought clarity on the central bank's immediate monetary policy actions, particularly regarding its approach to interest rate adjustments in 2025. While the Fed confirmed two rate cuts are likely in 2025, its cautious tone and focus on data dependency left markets uncertain about the pace and extent of easing.

Inflation concerns also played a major role in the market's decline. Although recent data has shown some moderation, inflation remains elevated enough to sustain worries about its potential to weigh on economic growth and corporate earnings. This has kept markets wary of how the Fed might balance inflation control with supporting growth.

Geopolitical risks further compounded market anxiety. Ongoing tensions involving Russia and Ukraine, alongside geopolitical friction between the US and China, created additional uncertainty. These risks particularly weighed on sectors sensitive to global trade and energy markets.

While markets initially attempted to rebound in mid-December, they were then kept down by lingering concerns over monetary policy, growth prospects, and geopolitical uncertainty. Investors remain cautious about the Fed's approach to rate cuts, as fewer cuts than anticipated could prolong the higher-rate environment, putting pressure on equities and corporate earnings. Additionally, weaker economic data from Europe and mixed signals from Emerging Markets, including China, have added to the pessimism, reinforcing **concerns about global growth**. Furthermore, high valuations in certain equity sectors, especially technology, have made investors more sensitive to **potential earnings disappointments**. These factors combined to stall the recovery attempt, with markets struggling to find a clear catalyst for sustained upward momentum.

EQUITIES & EARNINGS

From a structural perspective, **many equity markets, particularly in the US, benefit from strong corporate earnings, innovation, and resilience across key sectors** such as technology, healthcare, and energy. Companies in these areas are well-positioned to capitalize on secular growth trends, including digital transformation, renewable energy adoption, and healthcare advancements. Additionally, **Emerging Markets, while currently facing headwinds, could provide attractive opportunities** as China's stimulus measures take effect and other regions stabilize. Furthermore, equities historically perform well during periods of moderate economic recovery, even when monetary easing is gradual. Valuations, while elevated in some sectors, remain reasonable in others, providing opportunities for selective allocation. Finally, equities offer a critical hedge against inflation over the long term. While inflation has moderated, it remains above pre-pandemic levels, and companies with pricing power can pass through costs, preserving margins and shareholder value. For investors seeking growth and protection against eroding purchasing power, equities remain an essential component of a balanced portfolio.

In the Eurozone, growth dynamics are expected to face challenges in the early part of 2025. Economic growth may disappoint, particularly if the region faces additional headwinds, such as potential US tariffs. As a result, inflationary pressures are likely to ease significantly, which could pave the way for the ECB to implement more rate cuts – possibly at a faster pace than previously expected. The lack of fiscal support in 2025 may place the responsibility for supporting Europe's economic growth squarely back on the ECB's shoulders. Given these dynamics, **investors should remain cautious about short-term prospects in the region** while keeping an eye on central bank policy and any fiscal interventions that may materialize.

For US equities, purchasing near all-time highs should not be considered a negative strategy. In fact, buying at these levels has historically been a better approach than waiting for a dip. While the S&P 500 may seem richly valued compared to its long-term average, there is significant valuation dispersion within the index. A large portion of the market's returns has been concentrated in a small number of tech-focused stocks, particularly those with high expectations around Artificial Intelligence (AI) and other disruptive technologies. In other words, while the index as a whole may appear expensive, many individual stocks within it are still trading at more reasonable valuations.

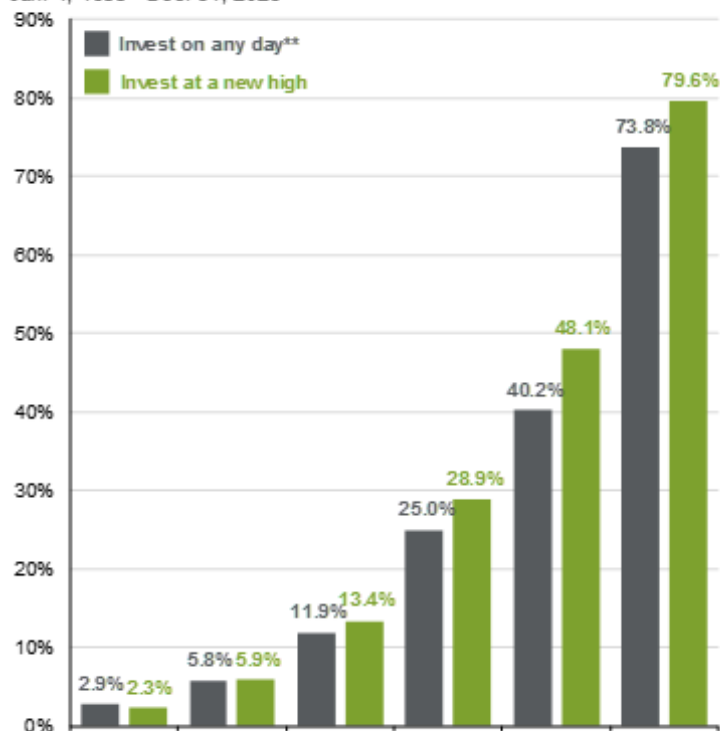
Profits are the main driver of equity returns, and during most of this rally, the "Magnificent 7" were the only companies generating meaningful earnings growth, which explains their outperformance relative to the broader index. However, with inflation easing, wage growth slowing, and interest rates expected to decline, the "S&P 493" is set to experience positive earnings growth for the first time since 2022. This shift signals a potential for broader market participation, as companies outside the tech sector begin to benefit from a more favorable economic environment, offering investors opportunities to diversify and capture steady profit growth across various industries.

OUTLOOK

Overall, the recent period highlights the challenges posed by a combination of rising yields, cautious monetary policy signals, and persistent geopolitical risks. Despite these headwinds, **maintaining an overweight allocation to equities remains compelling** for medium- to long-term investors. Equities continue to offer the potential for superior returns compared to fixed income, particularly in an environment where bond yields, though elevated, may stabilize as central banks approach the end of their tightening cycles. While volatility persists, driven by inflation uncertainties, economic growth concerns, and central bank policy, equities, especially in sectors driven by technological innovation in the US, continue to present solid growth opportunities. Meanwhile, in the Eurozone, the outlook for 2025 appears more cautious, with growth challenges potentially placing additional pressure on the ECB to support the economy.

Average cumulative S&P 500 total returns

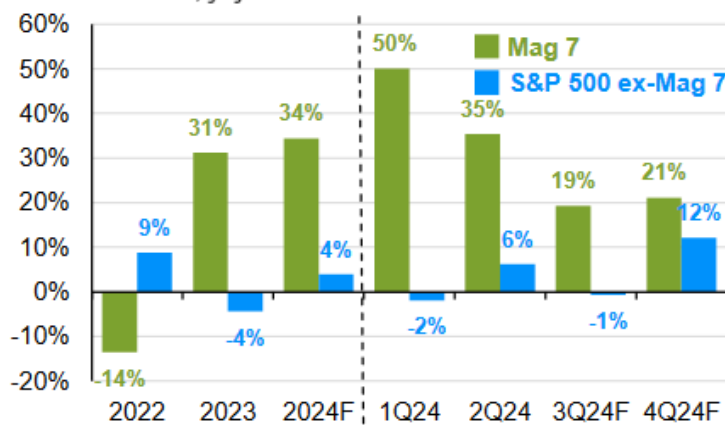
Jan. 1, 1988 - Dec. 31, 2023



SOURCE: JP MORGAN

Earnings growth

Pro-forma EPS, y/y



As always, maintaining a selective allocation and focusing on sectors with strong growth prospects will be key to navigating the upcoming period.

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