



STRATEGY UPDATE • FEBRUARY 2025

Diverging trends, AI disruptions, & Central Bank policies amid global uncertainty

KEY TAKEAWAYS

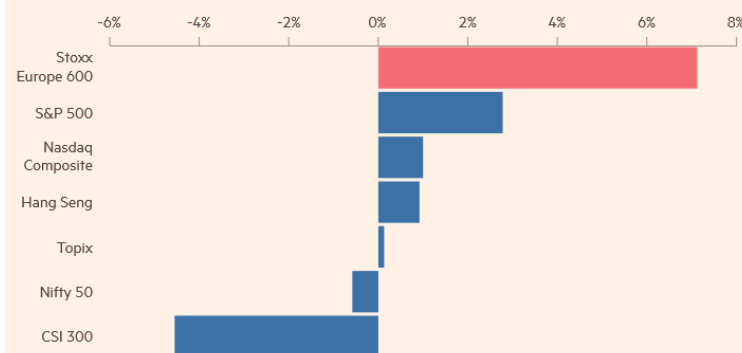
- European equities outperformed US markets, though structural growth constraints and geopolitical risks cast doubt on sustained European leadership.
- DeepSeek challenged US technology dominance, triggering AI volatility while reinforcing the need for diversification across technology and related investment themes.
- Inflation remains the key risk, with diverging central bank policies and uncertainty over US tariffs and fiscal measures shaping market expectations.
- We remain constructive on equities, complemented by defensive exposures and hedge funds to strengthen portfolio resilience.

MARKET OUTLOOK:

Despite some hiccups, equity markets concluded the month on a strong note, with **European equities outperforming their US counterparts**. This divergence raises an important question: is this shift in relative strength a temporary fluctuation or the beginning of a more sustained trend? European markets benefited from resilient economic data, improving corporate earnings, and a more measured stance from the European Central Bank compared to the Federal Reserve. Whether this

European stocks have outpaced major global peers this year

Year-to-date change (in local currencies)



FINANCIAL TIMES

Source: LSEG • Correct as of January 30 2025

momentum can persist is uncertain as it will depend on a combination of macroeconomic conditions, policy decisions, and broader market sentiment. However, in the long run, we believe Europe is likely to underperform the US due to structural factors such as lower long-term growth prospects, political uncertainty, and its proximity to the Russia-Ukraine conflict, which continues to pose economic and geopolitical risks.

TECHNOLOGY & MARKET SENTIMENT

Adding to market uncertainties, the first weeks of Donald Trump's presidency saw the US market navigate tariff concerns without immediate disruption. However, the landscape quickly shifted with the **DeepSeek announcement**. The revelation that a Chinese AI start-up has achieved a major technological breakthrough at significantly lower costs disrupted the prevailing consensus around US technology dominance. This news triggered a sell-off in AI-related stocks, with major players such as NVIDIA experiencing sharp declines. The broader market is now questioning whether this event will challenge the supremacy of US tech firms or merely represent a temporary shock. Despite this volatility, we remain confident in the long-term growth prospects of the AI and broader technology sector. The accelerating pace of innovation and continued investment in AI infrastructure reinforce our constructive stance, even in the face of short-term fluctuations. The DeepSeek breakthrough has also sparked debate over the sustainability of the **AI arms race between the US and China**. Market participants are reassessing the substantial capital expenditure required for data centers and energy consumption, raising concerns about the long-term profitability of AI investments. Meanwhile, questions remain about the ability of major cloud service providers to optimize their systems to mitigate these costs. While AI stocks have faced headwinds, this technological evolution has paradoxically broadened investment themes, benefiting more diversified strategies.

CENTRAL BANK POLICY

Beyond the AI sector, market participants continue to focus on **central bank policies**. The ECB recently cut interest rates, signaling a shift towards a more accommodative monetary policy. This move aims to support economic growth and counteract stagnation, but it also raises concerns about the sustainability of inflation control and the impact on currency valuation. Lower rates could provide a temporary boost to European equities and encourage borrowing, yet they may also weaken the euro and reduce the attractiveness of European assets relative to US investments. **The trajectory of inflation remains a key factor** in shaping expectations for interest rate movements. While initial optimism about rate cuts fueled risk appetite, recent data has prompted a reassessment, with markets now pricing in a **more cautious approach from the Fed**. The ECB, in contrast, appears to be taking a less aggressive stance. This policy divergence partially explains the outperformance of European equities and underscores the importance of closely monitoring inflationary trends in the coming months.

TRADE & GEOPOLITICS

The political landscape remains another key factor influencing market sentiment. With the new Trump administration, tariffs are expected to be implemented, adding complexity to global trade relations. The budget deficit remains high, advocating for higher interest rates, yet Trump has expressed his intention to **reduce the deficit through economic growth**. His strategy relies on fostering business-friendly policies and maintaining strong relationships with large corporations, which in turn could accelerate economic expansion. The administration's key pillars include **fiscal expansion**, partially offset by tariff revenues, and **attempts to control inflation** by limiting government spending, though sustaining low inflation in a high-growth environment remains a challenge. The uncertainty surrounding US economic policies, particularly in relation to tariffs and global trade relationships, continues to weigh on investor

confidence. The recent market reaction also reflects concerns over the potential implications of US fiscal policy shifts, particularly in light of the Trump administration's 'Stargate' AI initiative. Meanwhile, China's rapid advancements in AI, backed by a growing pool of engineers and substantial government support, are adding competitive pressure on Western tech firms. This evolving dynamic has led to increased volatility in AI-related equities, reinforcing the need for strategic portfolio diversification.

PORTFOLIO OUTLOOK

Looking ahead, we remain constructive on equities, particularly in areas supported by structural growth drivers such as technology and AI. The 'Magnificent 7' have delivered earnings and are expected to gradually revert to the mean, while other companies are likely to take the lead and drive the S&P 500 to new highs. Europe could also experience reindustrialization and a return to growth, provided it adapts and strengthens cooperation with the

US. Despite current uncertainty, Germany remains the primary driver of the region's medium-term economic trajectory. On the fixed income side, yields remain compressed, making government bonds more attractive than investment-grade alternatives. **The main risk we continue to monitor is inflation**, which could persist as a result of economic expansion and fiscal policies. Our diversified portfolio approach, which also includes defensive exposures such as Swiss equities, value stocks, and high-dividend plays, has proven resilient in the current market environment. Additionally, **we see hedge funds as an attractive component within a diversified portfolio**. With low correlations to traditional assets and the possibility of "higher-for-longer" interest rates, hedge funds benefit from elevated base rates, providing a favorable tailwind. While not our base case, a market selloff due to a recession or inflation resurgence could reinforce their value. The evolving macroeconomic landscape, corporate earnings trends, and geopolitical developments will all play a crucial role in shaping market direction.

AI optimism supercharged Wall Street in recent years

— Magnificent 7 market capitalization



Source: LSEG
Created by Thomson Reuters
AI optimism supercharged Wall Street in recent years

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