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CIO PERSPECTIVES

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January insights for the year ahead

Our US economic outlook remains constructive, although this scenario comes with its share of uncertainties and risks. We are slightly revising our growth and inflation forecasts upwards for 2025 and 2026, reflecting the consideration of a pragmatic approach by the new US administration in terms of economic policies. This evolution in our growth and inflation assumptions leads us to anticipate a more cautious approach from the Federal Reserve (Fed), with the policy rate expected to reach 4% by the end of 2025 and 3.5% by the end of 2026.

The scenario of strong growth and the moderately inflationary impact of Donald Trump's policies already appears to be significantly priced into the rates markets, and we continue to favour the short end of the US yield curve (up to 5 years) while having a more neutral view on longer maturities. On the equity side, after two years of performance driven by the dominance of the technology sector and artificial intelligence (AI), we expect continued performance in US equity markets. However, 2025 could see more emphasis on the broadening theme, both within the US and in Emerging markets. Meanwhile, Europe could present an attractive investment case for contrarians, although effective catalysts are currently lacking for us to adopt a positive view.

US Outlook for 2025: Growth, inflation and policy

The US economy continues to perform well, supported by strong consumer spending and productivity growth, with GDP advancing by 3.1% (Quarter-on-Quarter, annualised) in Q3 2024. The Atlanta Fed's real-time estimate for Q4 2024 currently stands at 2.7%. Along with a stream of positive activity data, there has also been an improvement in employment prints after several months of noisy data, with job creation averaging 170'000 over the past three months. Additionally, disinflation seems to have paused in recent months, with Core CPI stabilising at 3.3% since the summer. Meanwhile, as the inauguration of Donald Trump as the 47th President of the United States (on 20 January 2025) approaches, the market continues to assess the various potential impacts of the new administration's policies. With notably some concerns that the combination of overly accommodative fiscal measures and the imposition of tariffs on imports could undermine the disinflation process and the Fed's interest rate cuts.

In this context, the US economy appears to be on track to continue outperforming in 2025, with a consumer supported by healthy financial balance sheets and real wage gains, and productivity growth contrasting with the stagnation seen in Europe. Of course, Trump's upcoming inauguration brings its own set of uncertainties to our scenario. Imposing universal tariffs, annexing Greenland, Canada, or the Panama Canal – there has been no shortage of sensational headlines in recent weeks. Trump's campaign emphasised tariffs, reducing drastically immigration, cutting taxes, and deregulation, a combination that could prove decidedly inflationary.

Nevertheless, despite numerous uncertainties about the measures the new administration will take and their timing, we anticipate they will remain pragmatic to avoid disrupting the soft landing. And for good reasons; for example, a measure such as implementing universal tariffs has the potential to significantly put upward pressure on inflation, adversely affecting growth dynamics. Similarly, a large-scale fiscal stimulus could counteract the disinflation process hoped for by the Fed, with the future administration's room for manoeuvre being heavily limited by deficits of 6.5% and a debt-to-GDP ratio of 123.1%.

Thus, in our central scenario, we expect a slight increase in tariffs, particularly targeting China (around 20%), a reduction in net immigration to pre-pandemic levels (below 1 million compared to 3.3 million in 2023), an extension of the Tax Cuts and Jobs Act (TCJA) on the fiscal front, pro-business measures supporting business confidence, investment, and possibly an increase in energy production that could exert slight downward pressure on energy prices. This combination leads us to revise our growth forecasts for 2025 upwards to 2.3% (+20 basis points (bps)), 2.1% for 2026 (+10 bps), and for headline inflation to 2.4% for 2025 (+20 bps) and 2026 (+20 bps). Despite the slight upward revision of our inflation forecast for 2025 and 2026, we still expect disinflation to continue, particularly through services, with the labour market rebalancing expected to curb service inflation rigidity. This central scenario is constructive for US economic prospects but comes with its share of risks.

In this regard, continued rigidity in core inflation observed in recent months could challenge the Fed's rate cut cycle and hurt economic activity through tighter financial conditions. An overly aggressive approach by Trump on tariffs or fiscal policy or a less-than-expected deceleration in the services component (such as shelter) could justify such dynamics. However, despite the upward revision of our inflation forecast for 2025 and 2026, we still expect disinflation to continue, particularly through services, with the labour market rebalancing expected to curb service inflation rigidity. While the recent focus of the Fed and markets has shifted from the labour market to inflation, a slowdown in job creation could pose a downside risk to our growth outlook. This might bring the "Fed Put" back into play to preserve a healthy labour market. Despite recent strength in payrolls, the job market remains challenging for job seekers due to low hiring levels, even though layoff rates are currently low. Finally, a positive alternative scenario for the US economy would be for the new administration to remain very measured on inflationary and growth-penalising policies, such as tariff increases and immigration reductions, while favouring more pro-growth policies based on deregulation and fiscal stimulus.

Federal Reserve: When the facts change, we change our minds

Market pricing for the expected path of the US Fed Funds rate has been a rollercoaster ride over the past year. We saw one extreme in April 2024 where the market was pricing in just one rate cut of 25 bps for the whole year. Then we saw the other extreme this past September - after a string of disappointing labour market numbers the market positioned for a sharp rate cutting cycle (4.5 cuts additional cuts priced for the few months remaining in 2024, even after the 50 bps rate cut in September).

In the end, we achieved the 100 bps in rate cuts that we had been calling for, bringing us down to a target rate of 4.5% from 5.5%. Throughout the noise, we remained steadfast in our view for the equivalent of four rate cuts of 25 bps, anchored on our US macroeconomic scenario. Now, looking ahead to the end of 2025, our view has been that the Fed would continue the same pace of rate cuts i.e. four more rate cuts, eventually landing at our estimation of the 3.5% neutral rate. That said, to paraphrase the famous expression often attributed to John Maynard Keynes, "when the facts change, we change our mind".

We had been flagging the risk of less cuts in the US, and now with the upgrades to our 2025 US economic growth scenario, recent rhetoric coming out of the Fed, and, crucially, our upward revision to inflation (incorporating a reasonable base case for the policies of the new Trump administration), it's time to update our view. We therefore now believe that the Fed will be in no rush to keep cutting rates and are **changing our forecast from four rate cuts for 2025 to two** (which would leave the Fed Funds rate at 4% by year-end). This means that the Fed will keep policy a bit more restrictive for longer to combat stickier inflation and will not get back to our 3.5% neutral rate until 2026. For reference, the latest Fed summary of economic projections also signals two 25 bps rate cuts for 2024 (revised down from four in December alongside a more hawkish tone), while the market is currently pricing around one and a half cuts).

What does this mean for our view on US duration more broadly? Given that longer-term yields can be decomposed into the expected path of short-term rates in the future plus a risk premium to justify committing capital at a fixed longer-term rate (known as the term-premium), naturally our revised view on the Fed implies higher longer-term yields as well. That said, with the US 10-year Treasury yield now close to 4.7% (100 bps higher than mid-September), we would argue that this revised macro scenario is already largely in the price. We would highlight 10-year real rates at 2.3%, not far off the highest levels we have seen since 2009, as offering a compelling valuation anchor. We are therefore comfortable keeping our positive view on the short end of the US curve (up to 5 years) and neutral on the intermediate part of the curve (5-10 years).

The year of broadening horizons

US dominance and AI, particularly the "Magnificent 7", were key themes in our Global Outlook last year and will remain relevant in 2025. The S&P 500 saw strong performances in 2023 and 2024, but over a three-year period, the annualised return is about 10%, aligning with long-term performance. Half of this performance was driven by the "Magnificent 7" tech stocks, indicating a concentrated, tech-driven rally. While the S&P 500 is richly valued and another 20% performance next year seems unlikely, favourable macro growth prospects and earnings expectations, supported by a pro-business administration, make us constructive on US equities for different reasons. Furthermore, the "Magnificent 7's" strong performance is largely driven by fundamentals like earnings growth, and they still have the highest earnings expectations for 2025, with ongoing AI *momentum*. US profitable small caps are also an opportunity for investor to broaden out in 2025, responding positively to growth and declining interest rates. Their earnings-per-share (EPS) are trending higher, with substantial catch-up potential, with the recovering Mergers & Acquisitions (M&A) cycle serving as an additional catalyst. We are already seeing increased flows into this segment.

When discussing broadening our investment strategies, we also refer to geographical diversification. Despite some scepticism from international investors, we maintain a positive outlook on Asian equities. Surveying overseas commentators reveals a generally negative sentiment, particularly regarding China's governmental support. However, this long-awaited policy-maker support is warmly welcomed by onshore commentators and investors. This highlights a clear distinction between onshore and offshore opinions, potentially leading to a long-term economic growth arbitrage opportunity. China's stimulus package, estimated at around RMB 10 trillion, is designed to boost economic growth by aiding struggling industries, stabilising the property market, and increasing consumer confidence. This could help China achieve its economic growth target, we have upgraded our 2025 GDP growth outlook to 4.7% and project 2026 growth at 4.5%. The stimulus package includes measures to stabilise financial markets and encourage capital market activity, which should lead to improved investor sentiment and increased investment in the equity market. We believe Chinese equities have bottomed out, and valuations remain attractive for medium-to-long-term investment. There are opportunities for a government-led economic push, like advanced technology and State-owned Enterprises (SOEs).

In contrast, Europe lagged significantly in 2024, with a multitude of bad news already factored into the market. The performance gap between European and American stocks is one of the worst since the inception of the Stoxx 600 index. European Monetary Union (EMU) exposure will be a key question for 2025. However, for now this performance gap is for us justified from a fundamental perspective and is likely to persist due to growth and productivity disparities. GDP growth is expected below 1% in 2025 and the differential in US vs. EMU earnings prospects is notable (9.8% vs. 1.8% respectively in 2024 and 14.5% vs. 7.4% in 2025 according to Reuters). Sentiment differences also play a role, with the US benefiting from a seemingly pro-business environment, whereas Europe faces high political and geopolitical uncertainties complicating reform. While there are valid reasons for this pessimism, the markets have already priced in a lot of the bad news, so a technical rebound is possible. However, we believe this rebound may lack sustainability without new catalysts, such as a cease-fire in Ukraine or a pro-debt-brake reform from the German government following the February Federal election. This does not mean we should neglect the European market. It is crucial to differentiate between macroeconomic conditions and market performance.

Market performance is heavily influenced by sector-specific factors (e.g., the DAX is impacted by tech stocks). Therefore, equity markets should not be approached solely from a geographical standpoint but also by sector and investment style (e.g., European real estate benefiting from rate cuts and significant discounts).

In this transforming world, we take the opportunity, on behalf of Indosuez investment teams across the globe, to wish you and your loved ones a prosperous and joyous 2025! May this year be filled with new opportunities, growth, and continued success. Thank you for your trust and partnership. We look forward to navigating the exciting economic landscape together.

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