Global Outlook

January 2025

Key word for 2025: uncertainty

2025 will be dominated by the Trump administration's policy agenda and its implications

Countries with below trend growth will see further interest rate cuts, but central banks will remain cautious

Focus shifts from monetary policy to trade and fiscal policies

BEVAN GRAHAM

Implications For Investors

US markets enter a risky phase as higher bond yields challenge rich valuations

Domestic equities' outlook improving, but we are not immune to global volatility

NZ dollar is near post-GFC lows and lacks a catalyst to recover soon

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Key word for 2025: uncertainty

January 2025 marks five years since the onset of the Covid pandemic, unleashing a wave of uncertainty and disruption to economic activity, markets and people's lives. The recovery has been slow and, in many respects remains ongoing, while in others the scars will inevitably prove more permanent.

Enter 2025 and the world is facing another set of uncertain challenges in the shape of the incoming President of the United States, Donald J. Trump. Mr. Trump was elected for his second term on a populist platform of raising tariffs, curbing immigration, tax cuts and deregulation.

The precise measures remain unknown at this stage but appear to us to collectively point to lower growth, higher inflation and higher interest rates in the United States. That brings wide-ranging implications for the rest of the world, most importantly for trade policy.

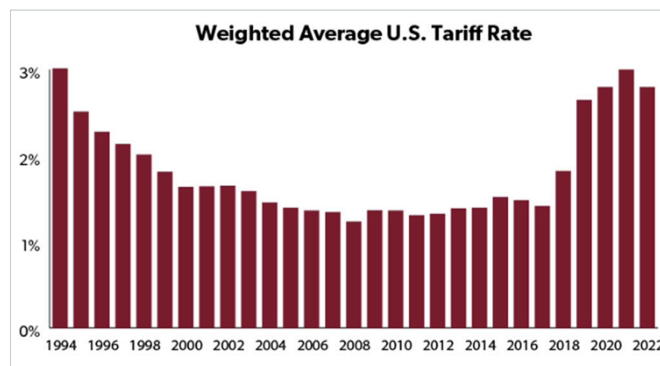
Will US exceptionalism continue?

The US economy ended 2024 in fine fettle. The ongoing resilience of the economy has been the biggest surprise of the past year, leading to the narrative of US exceptionalism, borne of moderating inflation in an environment of solid growth and a still relatively tight labour market.

The extent to which policy developments disrupt that narrative in 2025 will depend on exactly what of Mr. Trump's agenda gets implemented and, to a lesser extent, the sequencing of their implementation.

Tariffs will be unambiguously bad for US growth and inflation. Intended by the incoming administration to protect domestic industries and promote re-shoring particularly of manufacturing industries, they always backfire by increasing consumer prices, limiting choices, and stifling innovation and efficiency within protected industries, leading to long-term economic stagnation rather than fostering sustainable growth.

Regardless of this, the administration appears likely to move quite quickly on implementation. The question is the extent to which they follow through with the proposed 10% universal tariff, with 60% on imports from China, along with the more recent suggestions of 25% applying to Canada. It's possible that there are carve-outs for some countries or sectors, lowering the average increase, but that remains to be seen. But if imposed as has been suggested, the average US tariff will rise from around 3% to 17%.



Source: US National Taxpayers Union

Looser fiscal policy is good for growth but bad for inflation and interest rates. It's important to remember, however, that much of this easing is better described as a maintenance of the status quo. Trump's 2017 tax cuts are due to expire at the end of this year. If extended, as he proposes, that removes a potential growth-negative from the end of this year. He has hinted at additional tax cuts for the middle-class but has not provided specific details. He intends to cut the corporate tax rate to 20% with 15% applying to domestic profits.

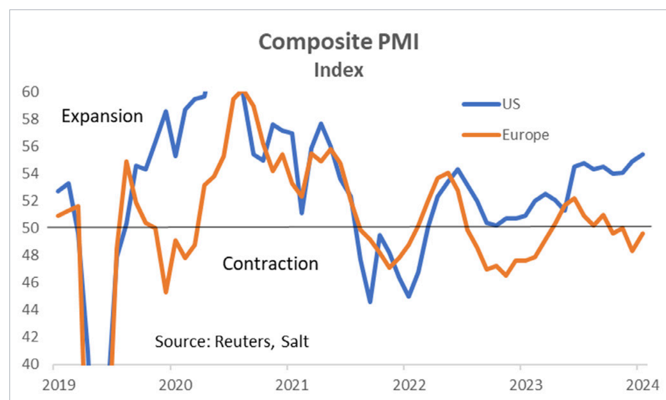
Immigration curbs and possible mass deportations will destroy a key component of the US exceptionalism story. The growth in labour supply has been a key reason the US has been able achieve significant disinflation in wages and CPI inflation while maintaining solid GDP growth. Limiting that supply of labour is a significant curb on the US's potential growth rate.

Deregulation will help the supply side of the US economy and will be positive for US growth on the assumption the measures implemented lead to greater investment and productivity.

Growth divergence

While policy changes present a clear and present danger to the US growth, the divergence in growth that opened between the US and Europe through the latter part of 2024 appears likely to persist in the near term. At the

same time, there are still concerns about the trajectory of the Chinese economy.



Regular readers will recall we take a dim view on Europe's growth prospects for mainly structural reasons. The exception (by European standards) has always been Germany. But even Germany's growth model appears fundamentally broken now. Since the start of the common currency, Germany's success has been borne of an artificially low exchange rate and low energy costs. But new challenges, particularly around energy supply, along with the likelihood of increased tariffs, is exposing deeper fundamental problems particularly with respect to productivity.

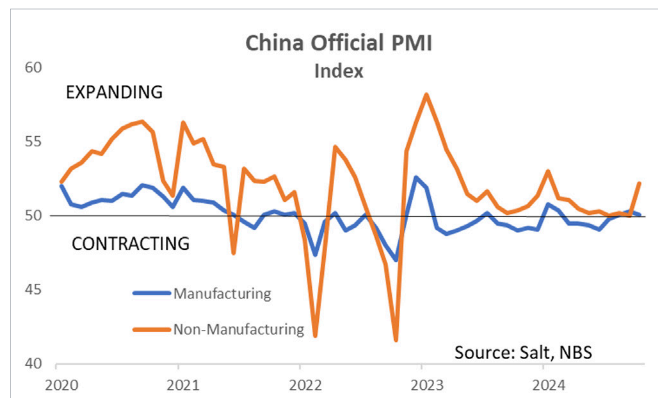
In 2024 the European Commission commissioned former European Central Bank President and Italian Prime Minister Mario "do whatever it takes" Draghi to write a report outlining the reforms required to ensure Europe is competitive in a shifting global landscape.

Implementation will prove challenging, for the very same reasons that the Lisbon Treaty has proved so ineffective. The 2009 Lisbon Treaty is the blueprint for a "United States of Europe", responsible for providing the union with the 'impetus necessary for its development' and for defining its 'general political directions and priorities', but Europe continues to suffer a lack of co-ordination on the big structural issues.

Key hurdles include overcoming fragmentation in national policies and resistance from member states protective of sovereignty. Coordinating industrial strategies across diverse economies requires political will and an alignment of priorities that is essentially non-existent. Financing these reforms, especially in green and digital transitions, adds pressure amid already tight fiscal constraints. Complex bureaucracy and regulatory inconsistencies within the EU also impede swift action. Furthermore, balancing global competition with domestic job preservation poses a dilemma, particularly in sectors vulnerable to external market forces.

We see nothing in the near- or medium-term that appears likely to change the European economic narrative from one of constraints borne of deep structural problems. The risk is that various European government's resort to fiscal largesse to mask the structural malaise which poses a problem for inflation.

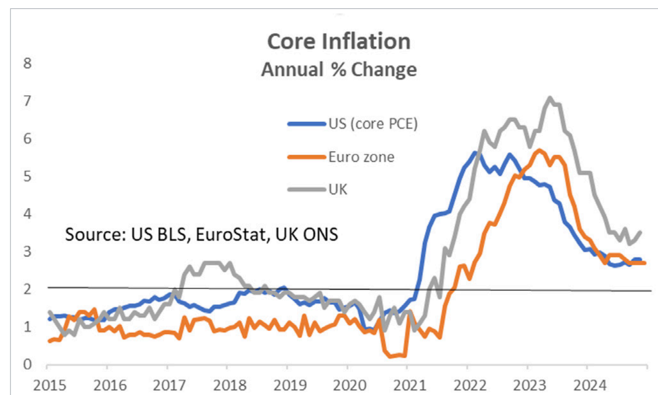
In China there are signs the recent stimulus measures are starting to have some impact. Latest Purchasing Manager Index (PMI) data for December saw the non-manufacturing index rise from 50.0 to 52.2, and while the manufacturing index came in weaker than expected at 50.1, there were glimmers of recovery under the hood. New orders improved, likely due to the consumer goods trade-in program and possibly export front-loading ahead of US tariff hikes.



More fiscal stimulus is still required, preferably aimed at boosting demand (consumption) rather than supply. The old model of supply-driven stimulus is over, at least for the next four years. Boosting production into an environment of weak domestic demand results in higher exports. That's a strategy that carries broader risk in an environment of increasing trade tensions and probable restrictions.

Sticky to the core means cautious central banks

Good progress has been made on returning core inflation rates to target through much of 2024, though progress stalled later in the year. Central bank's that started to cut rates cautiously, like the European Central Bank, have remained cautious despite deteriorating growth prospects. Others that started with a hiss and a roar, the US Federal Reserve for example, have recently become somewhat more circumspect.



Monetary policy is determined by where inflation is going,

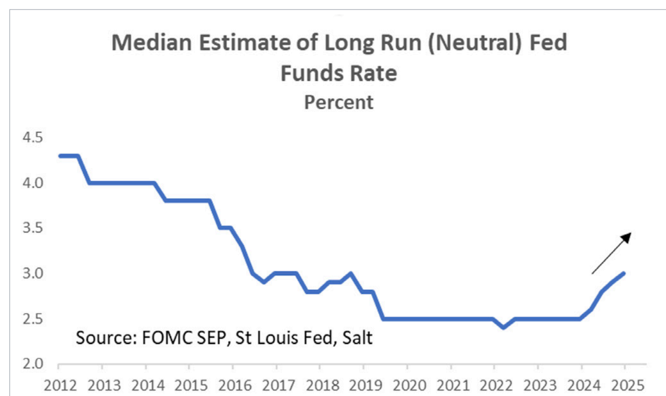
rather than where it's been. That means we are facing into more than the usual set of uncertainties. For a start, it is unwise to assume that lower growth automatically means easier monetary policy. Thinking about Europe again we know that recent activity data has been weak, but we also know it is mostly structural factors that ails European growth. In this case, low growth is therefore not necessarily as disinflationary as you might expect at first glance. And after all, central banks are mandated to achieve inflation targets, not growth targets.

Complicating matters for the US Federal Reserve (the Fed) is the fact that President-elect Trump's policy agenda is unambiguously inflationary for the United States. Higher tariffs would almost certainly be passed on in full to the end consumer – as a business, why wouldn't you when the higher costs are a result of government policy? Consumers will almost certainly seek to replace lost spending power through higher wage demands. Rebuilding supply chains will also inevitably lead to higher business costs and consumer prices. Also, the labour market will be tighter and wage pressure higher as immigration curbs bite, and fiscal policy will be easier, putting extra demand pressure on the economy.

The only good inflation news from tariffs comes from the prospect of various countries exports that were previously destined for America needing to find a new home at a likely lower price. Great for global inflation, less so for incomes in the exporting countries.

We also know that neutral nominal policy rates are now higher than they were. We have written on this extensively before. In short, the combination of de-globalisation, rising geo-political tensions, climate change, ageing populations, easier fiscal policy and rising public debt all suggest to us that the neutral rate is now higher than it was.

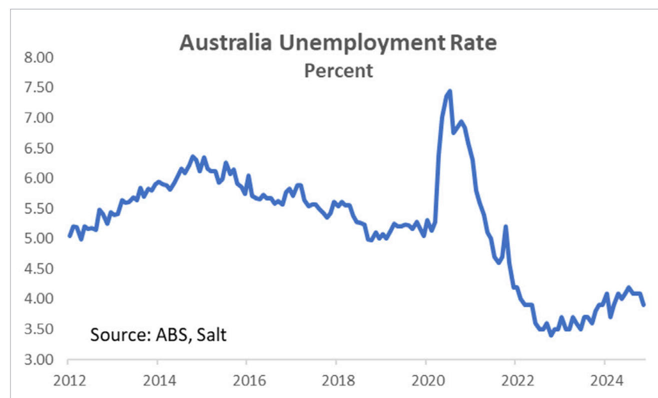
The bigger problem is that neutral rates are unobservable in real time, so central banks are running blind. At the Fed, the median estimate of the long-run (neutral) Fed Funds rate has crept up from a (briefly held) low of 2.4% in March 2022 to 3.0% in the last set of projections in December. That seems reasonable to us, but the accompanying "dot plot" shows a range of estimates from 2.4% to 3.9%!



The Fed last cut rates at the December meeting, as was expected. Projections showed a reduced number of cuts into the future with only two cuts signalled for 2025 rather than the four cuts expected previously. We think even that is ambitious. The combination of resilient activity, the tight labour market, recent stickiness of core inflation and the uncertainty around the Trump policy agenda means that the Fed is now on hold for the foreseeable future. A resumption of rate cuts, which we wouldn't see possible until March at the earliest, will require a renewed softening in the labour market or downside inflation surprises.

Rate cuts are still likely in countries where growth in activity is weakest, including the Euro zone, the UK and here in New Zealand, though caution is required for the reasons outlined above. Market pricing of the extent of rate cuts ahead will likely prove too optimistic, particularly in Europe. Indeed given structural and US-policy related risks to the inflation outlook, the more central bank cut interest rates from here, the more likely it is they will be back to tightening in 2026.

Across the Tasman Sea the Reserve Bank of Australia delivered a surprisingly dovish statement in December, appearing to open the door to a rate cut as early as February this year. However, that door appeared to shut as quickly as it opened following the release of labour market data showing the unemployment rate falling to 3.9%, its lowest level in 8 months.

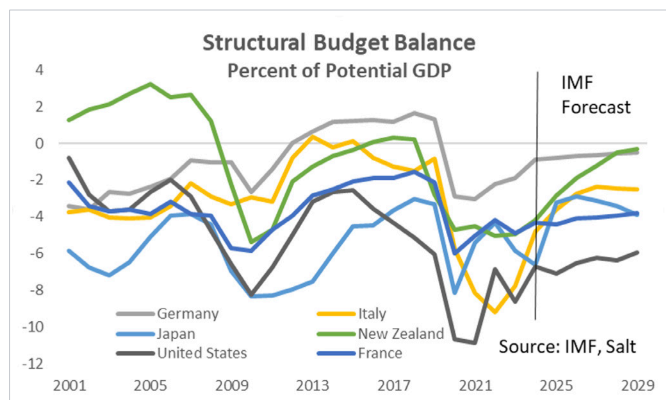


The rate cut exception remains Japan where the focus is on when the central bank will next raise interest rates. Our long-held belief is that Japan's deflation problem has been just as much, if not more than, due to wage setting behaviours as demographics. Indeed the 2023 shunto (spring wage negotiations) saw the strongest wage settlement in 30 years, underpinning a rise in core inflation that the Bank of Japan increasingly sees as sustainable. Furthermore, wages should remain under upward pressure amid the continued structural labour shortage stemming from Japan's aging demographics. Despite political challenges following the recent election, we expect the policy rate will be raised to 0.75% by the end of the year, up from 0.25% currently.

Focus shifts from monetary policy to trade and fiscal policy

As interest rates get closer to their terminal rates and trade policy uncertainties are resolved (for better or worse), we expect market focus to shift to fiscal policy.

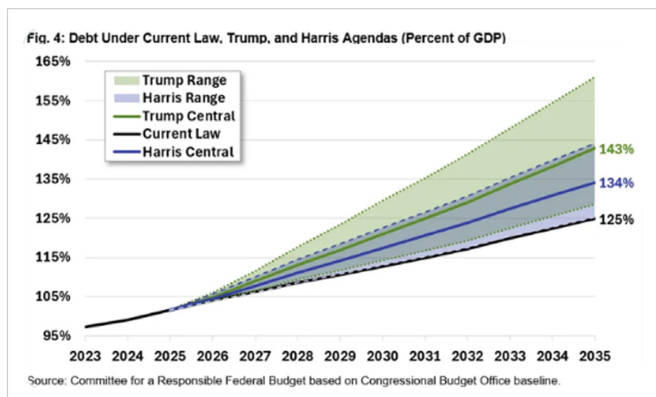
Developed market fiscal settings are increasingly messy and unsustainable, and there are no easy solutions. As we have written many times, there are a limited range of options when it comes to reducing structural budget deficits and unsustainable increases in public debt. The options are to achieve higher (per-capita) GDP growth, cut spending or raise more revenue. The first is challenging and the latter two are unpopular and thus politically challenging.



Conventional wisdom has it that the US is immune to the rules of fiscal sustainability by virtue of its reserve currency status. That appears, at least for now, to give the new US administration a blank cheque, though we attribute much of the recent rise in long-term US bond yields to fiscal policy angst. Furthermore, the US dollar will only be the world's reserve currency until the day it's not.

Latest US fiscal data for the September 2024 Fiscal Year showed a deficit of $1.8 trillion (-6.4% of GDP), the third highest on record after the Covid-fuelled deficits of 2020 and 2021. This result comes at a time when the economy is growing strongly, and the unemployment rate is still low.

Looking ahead, the Congressional Budget Office expects deficits to continue to rise, hitting $2.8 trillion by 2034 and for debt to rise from its current level near 100% of GDP to 122% over the same period. But that's on a "no policy change" basis which assumes the 2017 tax cuts expire next year. The Committee for a Responsible Federal Budget estimates that a full implementation of President-elect Trump's fiscal agenda would see the debt to GDP ratio rise to 143% of GDP by fiscal 2035.



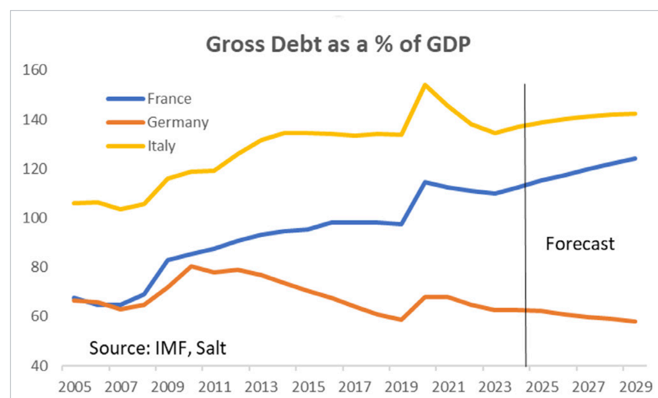
On the bright side, Trump has appointed (the un-elected) Elon Musk and Vivek Ramaswamy to head a new Department of Government Efficiency which has been charged with finding places to cut government spending. However, once accounting for big-ticket areas that are unlikely or unable to be cut such as Medicare, Medicaid, Social Security, Defence and interest payments, there isn't much left to trim.

Fiscal risks are greatest in Europe where various governments are struggling to reduce deficit levels to allowable EU limits, let alone return to surplus.

The biggest challenge right now is in France, where the Government is trying to push through a Budget that includes €60 billion in spending cuts and tax increases. As that process unfolds, France is now onto its third Prime Minister in four months, a situation borne of President Macron's surprise decision to hold legislative elections that resulted in an awkward coalition made of the full left- to far-right spectrum of French politics. No wonder it's tough to get an austere Budget through.

Elsewhere in Europe, Italy's fiscal position remains fragile, while Germany remains a beacon of fiscal prudence.

The ECB has recently raised fresh concerns over the Euro zone's vulnerability to high debt levels, sluggish growth and ongoing fiscal slippage. The bank warned that these factors, coupled with higher geo-political tensions and policy uncertainty, could reignite fears of another sovereign debt crisis, just as we saw in the early 2010's.



While much work has been done since then to shore up the viability of the common currency including the

establishment of the European Stability Mechanism alongside efforts to centralise banking supervision and resolution to protect the banking sector, the underlying problems of shared monetary policy but separate fiscal policies still pose risks.

Meanwhile, in the United Kingdom, the new Chancellor, Rachel Reeves, brought down her first Budget in October. She was only able to meet some of the new Government's election commitments by raising new revenue and raising borrowings. In fact, the extra borrowing was more front-loaded, and likely beyond what the market was braced for.

Bond markets are already demonstrating their discomfort with the fiscal outlook in the US, Europe (particularly France most recently) and the United Kingdom. In this environment, bond markets are susceptible to bouts of weakness on any talk of easier policy, or even any lack of political concern about, or willingness to resolve, unsustainable positions.

Oh Lord, it's hard to be centrist, when you're perfect in every way

The ongoing instability in France is leading to increasing speculation President Macron may resign early, forcing Presidential elections before those scheduled for 2027. Remember the current legislature is comprised of significant blocs of both the far left and Marine LePen's far right National Rally (formerly the National Front).

France isn't the only political hotspot right now. Germany is heading for fresh elections this year following the collapse of Olaf Schulz's "traffic light coalition". This coalition fell apart after significant disagreements over fiscal policy and broader disagreements on economic and climate change policies. The far-right Alternative for Germany (AfD) is gaining support amid economic frustrations.

Prime Minister Trudeau of Canada has only recently resigned in the last few days due to declining popularity as cost-of-living pressures, healthcare, housing affordability, climate change and Canada's relationship with the USA under a Trump administration dominate the political discourse, all areas in which Mr Trudeau's government is struggling to find answers.

In Asia, South Korea's President Yoon Suk Yeol's came under sufficient pressure to declare martial law, leading to his impeachment and political chaos. And in Japan, recent elections saw the Liberal Democratic party lose its parliamentary majority for the first time since 1999.

At risk of over-generalising, it appears to be increasingly challenging for centrist political parties to hold on to power in the face of increased populist-led political polarisation. This is becoming particularly acute for government's attempting to rein in runaway spending put in place during the pandemic at the same time as growth is slowing, populations are aging, infrastructure deficits are being exposed, and debt servicing costs are rising.

In the US, Donald Trump's second term as US President has fundamentally changed the foundations of US politics. In 2016, Trump clearly wasn't a Democrat, but neither was he really a Republican. He was probably best described as an independent who managed to secure the Republican nomination. In 2025, there appears less dissent within the Republican Party to his victory. Perhaps that's because his second term reflects an inability of the political elite/liberal orthodoxy, either Democrat of Republican, to present a compelling alternative vision or believable plan for greater prosperity amongst low- and middle-income America. Fast-forward to 2028 and it's hard to see the Republicans selecting anybody other than another authoritarian, anti-China nationalist candidate for the Presidency. The bigger question is how the Democrats will respond.

We don't have any answers to the increasing challenges facing politicians, other than to note that markets will be a forceful gauge of the stupidity or otherwise of policy positions. Just ask Liz Truss.

Geo-political challenges

The geo-political landscape was volatile in 2024 as Russia's war in Ukraine continued and conflict escalated in the Middle East.

In Europe, the ongoing repercussions of the war in Ukraine strain NATO's unity, while the European Union grapples with energy insecurity and economic recovery. Russia's persistence in asserting its influence, coupled with its strategic partnerships with China and Iran, poses a continued challenge to Western-led international order.

Donald Trump's return to the White House is the key development that will shape the geo-political landscape in 2025. In terms of the conflicts currently playing out, Trump's return possible increases the chances of a US-brokered ceasefire in Ukraine, but possible increases the risk of conflict with Iran.

The perhaps more intriguing aspect of 2025 will be the ongoing, indeed even deepening rivalry between the two superpowers, the United States and China, rooted in economic competition, ideological differences, and strategic ambitions.

Economically, the U.S. accuses China of unfair trade practices and intellectual property theft, while China criticises American efforts to decouple supply chains as protectionist.

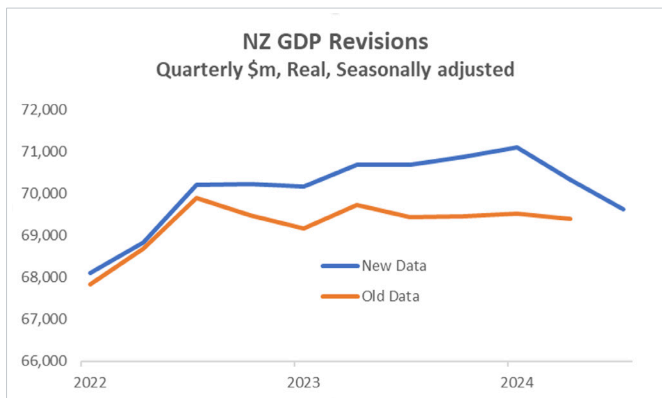
Militarily, the U.S. has increased its presence in the Indo-Pacific to counter China's assertiveness in the South China Sea and Taiwan Strait. Technologically, the race for dominance in AI, semiconductors, and 5G has become a proxy for broader strategic competition.

Ideologically, Washington promotes democracy and human rights, while Beijing advocates its model of authoritarian governance. These tensions extend to alliances, with the U.S. strengthening ties with partners like Japan and Australia, while China deepens its influence in Asia, Africa, and beyond. The rivalry reflects a struggle for global leadership in a rapidly changing international order.

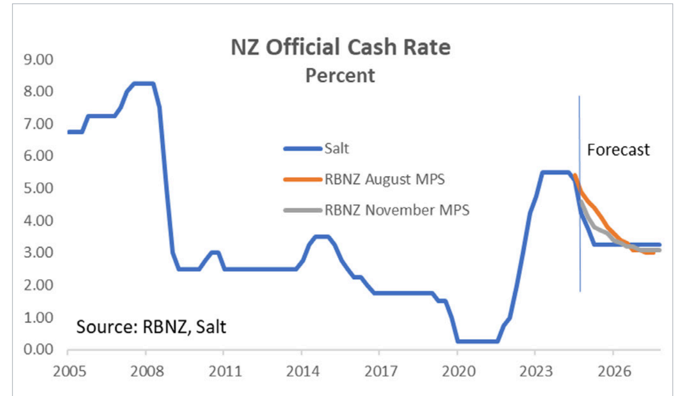
We argued before the US election that the biggest risk of Trump 2.0 was his complete disrespect of and disregard for global institutions. Yet it these very institutions that small countries like New Zealand rely on for our security and economic interests.

New Zealand in 2025

New Zealand GDP data released just prior to Christmas for the September quarter incorporated significant revisions to history, changing the trajectory of economic growth over the past two years. Those revisions lifted the level of activity over the last two years. But June quarter data was revised down, and the September quarter came in significantly weaker than market expectations. Essentially the picture is now of a recession that has come later and been deeper. However, after all that, the level of GDP in the new data is higher in September this year than the old data had it at June. This profile better fits our belief that the worst part of the recession would be in the middle of 2024, in fact it is now the only recession in the data as previous technical recessions have been revised away.



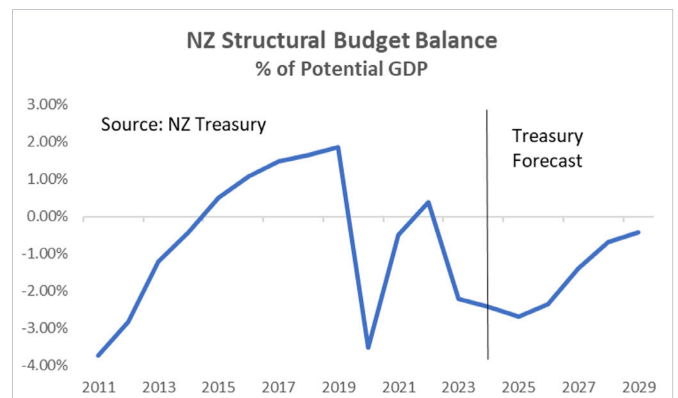
This new GDP picture validates the RBNZ's move to start cutting rates in August and firms up the likelihood of a 50bp cut in February while we have added an extra 25bp cut into our forecasts. That means a terminal rate of 3.25% vs. the RBNZ's 3.1% in the November Monetary Policy Statement. That's not because of the new level of GDP – the problem is the new strongly negative growth trajectory of the last 6 months which suggests another negative quarter is possible in the December quarter.



Even with the low growth environment, the RBNZ needs to remain cautious. Lower interest rates will soon expose our structural weaknesses. Once the recovery has reabsorbed the spare capacity opened up by the recession, the constraints of lower growth in working age population and poor productivity growth will be revealed.

Fiscal policy will also be closely watched in New Zealand in 2025. While it is true that our fiscal settings must be the envy of the developed world, the Half-Year Fiscal and Economic Update released in December underlined the structural nature of New Zealand's fiscal deficit and the challenge ahead for the Government in balancing the achievement of necessary fiscal consolidation at the same times as meeting increasing fiscal challenges.

In the update, the return to surplus was pushed out while debt was revised higher. NZ Debt Management lifted their bond issuance guidance over the forecast horizon by $20 billion. That was more than twice our expectations.



The Government faces a massive challenge in achieving necessary fiscal consolidation at the same time as meeting the challenges of a significant infrastructure deficit, an ageing population, climate change commitments, rising demand for quality public services, alongside an ongoing commitment to current pension entitlements.

The squaring of the circle is becoming increasingly difficult and is becoming a significant topic of conversation. The options to close our structural deficit are just the same as anywhere else: grow the economy faster, raise more revenue or cut spending. With our relatively low debt levels, some are advocating allowing a higher debt ceiling.

We continue to believe there are ample opportunities to cut spending before any other options are considered. However, the current strategy of just shaving the top off departmental budgets will prove insufficient. The government needs to make some hard about what we can and can't afford. We are not the wealthy country we like to think we are.

We will take a closer look at the NZ economy in our upcoming NZ Chartbook publication.

Bevan Graham

Implications for Investors

Investors who maintained a positive bias through the last year were well-rewarded with strong portfolio results, as equities continued to deliver significantly elevated returns compared with their long-run averages. The story for bonds has been rather weaker, although after significant volatility persisting throughout 2024, both NZ and global fixed interest indices managed positive single-digit annual returns.

Markets traversed a broad range of risks in the Fourth Quarter, and the month of December saw a pause in the recent US-led strength in global equities, as bond interest rates moved sharply upward. Nevertheless, investors have interpreted the imminent second Trump presidential term as supportive for the US economy and for growth asset classes. The reality, when it dawns after the inauguration on January 20th, may prove to be less of an unqualified boon, but for now, most commentators are accentuating the positives and calling for continued robust expansion in the US economy and in corporate profits.

The trumpets sound for Trumpism

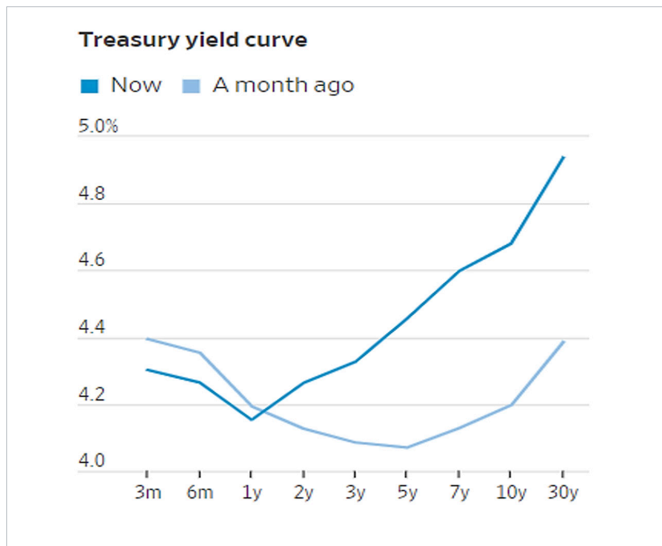
It is not easy to disaggregate the substantive economic reforms likely to be enacted in the US in the next few years from the wide-ranging promises the Republican candidate made in his successful election campaign. The "clean sweep" achieved, with the Presidency and both houses of Congress under G.O.P. control, suggests that the road is clear for some very business-friendly policy shifts in the US. Some fairly "crazy kites" were flown during the campaign, but how many of them will land is presently unknowable.

The sharp swing in the US political narrative away from the Biden administration's focus on industry-specific targeted stimulus spending toward the likely Republican prioritisation of deregulation and promoting (selective) US business interests introduces a high degree of uncertainty, and investors need to be alert to both new opportunities and to the risks of disappointments. The American economy is a complex entity, which - while it is dominated by private consumer choices and a free-enterprise mindset with flexible capital markets – also relies substantially on the activities of State sector agents. Whether the latter can be substantially culled (as has been flagged) without negatively-disruptive impacts is an open question, fraught with potential unintended consequences.

Put simply, there is a lot of economic activity in the US that relies on some form of government transfers or investments, even where some recipients of state largesse do not necessarily see it that way. One thinks of the numerous private downstream beneficiaries of massive military, social security or health spending. Key US professions also rely on interpreting (or contesting) the thicket of Federal regulations as their bread- and-butter work. Thus, government efficiency drives, once initiated, will run up against substantial vested interests. Awareness in key US political players, of a contractionary economic impact if there is a swift and radical transition away from the status quo, has been hinted at. However, for now, the incoming US leadership appears unconcerned. This is without considering any negative impact on activity from new trade restrictions or tariffs, as discussed earlier in this Report.

How long can the golden weather continue?

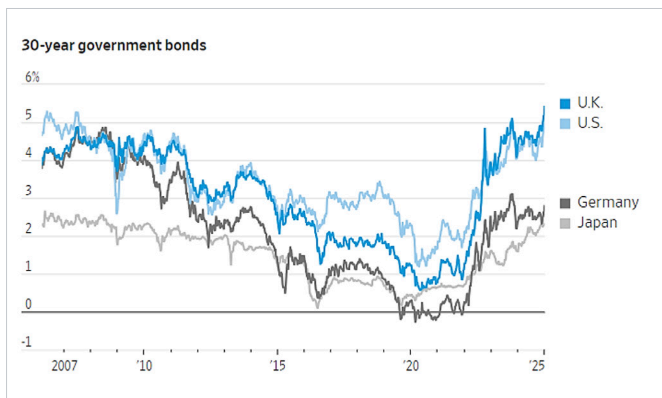
So far, optimism in markets has been founded in the slowing inflation patterns observed in major economies, allowing central banks to progress to monetary policy easings, and on decent corporate profits. After an extended period of bullish returns, the key question looking ahead is whether markets are now a touch too optimistic on the "goldilocks forever" scenario, given still-present risks from unresolved macroeconomic and political factors. Policy interest rates, though gently declining, remain restrictive. Forward-looking rates markets have however re-calibrated to now factor in a less aggressive degree of policy dovishness in the US, which the Federal Reserve has validated. This has hurt returns from government debt securities in the final quarter of last year (when the US Treasury Bond Index lost -2.5%) and into January. US 10-Year Bond yields have risen by 1.0 percentage point since their mid-September lows, as data remains positive and sovereign debt investors uneasily contemplate high Treasury issuance ahead, alongside Republican fiscal stimulus via tax cut extensions.



Source: Wall Street Journal, Tullett Prebon

Standard sovereign bonds still not favoured

From an investment strategy viewpoint in diversified funds, it has thus been demonstrably too early to move aggressively overweight in international bonds, and in our own funds we have remained at near- neutral tactical weightings in this asset class. We believe that the optimal point to go overweight bonds will likely arrive by mid-2025, once inflation disruptions fade out and the US economy enters a slow-down. Our own portfolio also remains strongly biased to short duration assets, which assists given global yields have jumped most sharply in the 5-year to 30-year maturities (a "bear steepening," in market parlance.)



Source: Wall Street Journal, Tullett Prebon

Higher interest rates make the Tech narrative vulnerable

Our view is that interest rate-sensitive equity assets are not all alike, and that the prudent investor's approach should clearly differentiate between them, depending on the investment horizon.

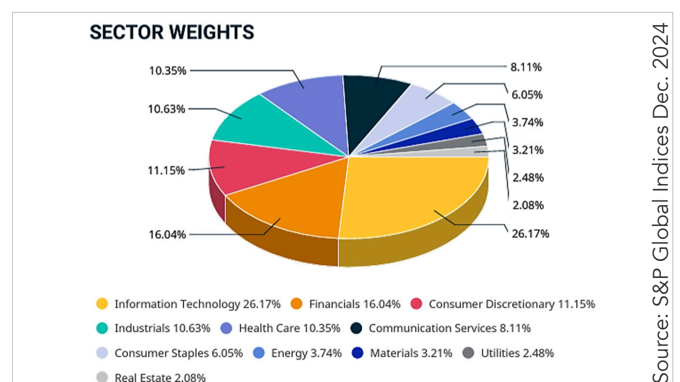
One set of equities at risk from a resumed uptrend in bond yields are the shares clustered in Information Technology, whose valuations are already elevated and whose future cashflows (discounted by an interest rate assumption) are vulnerable. A great deal of money has been invested in cutting-edge data processing technologies with unclear return-on-investment metrics reflecting the novel nature of technologies like Artificial Intelligence (AI.) Such securities present a near-term risk, to the extent that their stellar 2024 performance has been responsible for most of the year's gain in the key US benchmark equity index (S&P 500.) If there were to be a "deep re-think" of the AI profit narrative alongside persistently higher risk-free bond interest rates, this could deflate the extreme valuations that persist in the "Tech Darling" market segments. If the multiples investors are willing to pay for future earnings were to contract, the overall market would suffer proportionately, because of the high market capitalisation those sectors have achieved in the last two years.

Our Sustainable Global Shares fund investment partner, Morgan Stanley Investment Management, noted in December that "investors are having to contend with an increasingly narrow market environment. While the MSCI World Index is designed to be globally representative, capturing large- and mid-cap stocks across 23 developed markets, its market-cap weighted methodology has led it to become increasingly distorted, with the dominance of US tech giants propelling the US to 70% of the overall index.

Index distortion impacts valuation. The 10 largest companies in the index, which account for 25% of MSCI World's total market capitalisation and are nearly all tech or tech-adjacent, trade at an average 34x next 12 months (NTM) earnings. If you compare this to the broader MSCI World Index which trades at a near historical high of 19x NTM earnings, the equal weight index at 15.4x, and the ex-U.S. segment at just 14x, it becomes glaringly obvious that size and geography matter."

As shown below, pure IT industry stocks reached a 26% share of the global benchmark index at the end of 2024, and a 33% share of the S&P 500 Index. 30 years ago, before the commercialisation of the Internet, Tech-related companies made up just 10% of the S&P 500 market cap, whereas today, the IT sector plus "tech-adjacent" firms make up fully 40% of the US benchmark.

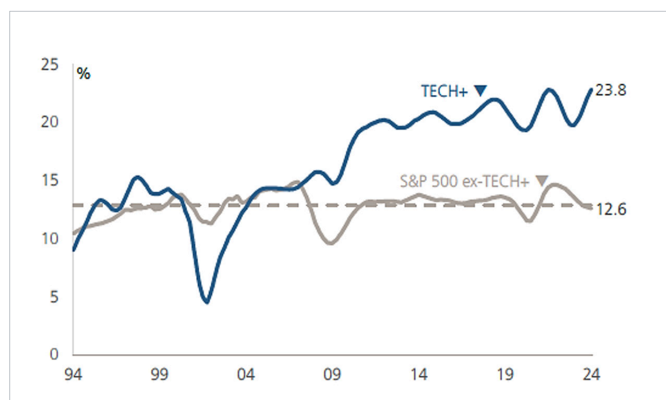
MSCI World Index by sector



Source: S&P Global Indices Dec. 2024

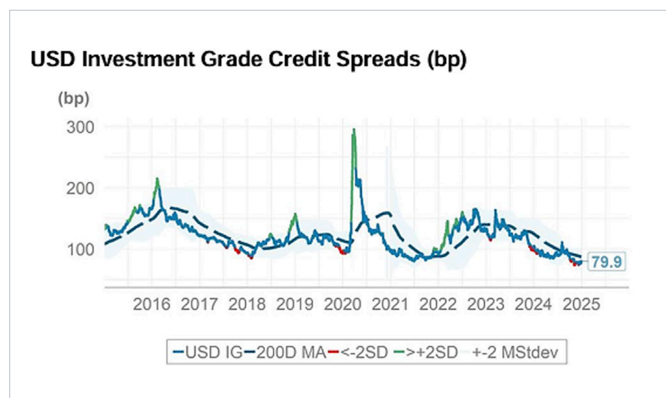
To be fair, there are some fundamental justifications for extended US Info Tech company valuations, which should not be dismissed out of hand:

- **Superior top-line revenue and margin growth.** According to recent UBS research, the last 30 years has seen US Tech+ Sales Growth (CAGR) average 10.5% p.a. versus 5.7% p.a. for non-Tech firms.
- **Superior EBIT Margins** for Tech+ have developed and are currently almost double the margins prevailing in the US non-Tech industries, at 23.8% versus 12.6%.



Source: S&P, Refinitiv, FactSet, UBS Dec. 2024

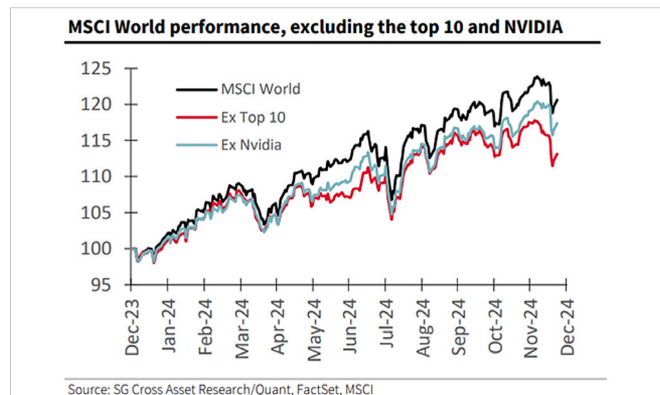
- **Improved Cash Flows.** S&P 500 companies have become less capital intensive. As a result, both Tech+ and non-Tech companies have become far more cash flow generative. Higher free cash flow companies return more to shareholders and should naturally trade at higher P/E ratios.
- **Lower Discount Rates.** In recent times, the cost of capital has been at times as much as 20% lower than its historical average (proxied by a combination of bond yields and credit spreads.)



Source: Morgan Stanley Investment Management Jan. 2025

However, these rationales for the resilience of Tech+ company valuations, while perfectly valid in explaining the recent decade's market phenomena, are not necessarily permanent. Corporate credit spreads have been at record lows for some time and can blow out rapidly if economic worries mount. The reduced cost of capital due to lower bond yields is vulnerable in the medium-term to poor fiscal outcomes leading to severe deficits and ballooning bond issuance, and the impending Trump Presidency increases prospects for somewhat higher US yields, accordingly.

Tech has certainly been the engine room of returns last year, and many managers concerned about valuations have lagged benchmarks as a small set of "Superstar stocks" contributed most of index returns.



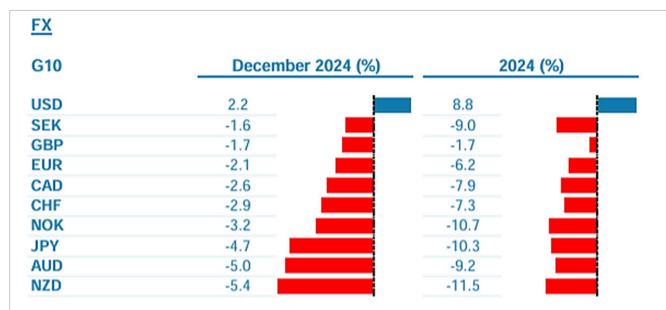
Although Morgan Stanley's strategists note that markets tend not to worry about high multiples so long as strong earnings growth persists, any knock or fading in earnings growth may spell trouble, particularly for a distorted index which seems to be priced for perfection. The year ahead will provide more clarity on US corporate profits' trajectory, and the tax cut ideas raised by Donald Trump could, if enacted, provide quite a boost to earnings from 2026 onward. At present, analysts' US earnings revisions for 2025 are neutral, rather than clearly positive or negative, awaiting further key information.

Interplay of interest rates, currencies and equity returns

The effect on the broader global equity markets of an upshift in long bond interest rates occurring alongside the Central Bank easings (which have been targeted at pushing down shorter-term yields) has been mixed so far. The US dollar has continued to strengthen, which assists other nations exporting to the US – at least, until tariffs come along to offset some of that trade demand. Unhedged global shares portfolios have therefore benefited mightily, as most world currencies depreciated against the US dollar.

The New Zealand dollar was among 2024's weakest, undershot only by certain Emerging Market currencies, against the US currency. The kiwi has also depreciated meaningfully against the Pound, Euro and Swiss franc in 2024. Because many of the world's largest companies have shares denominated in those base currencies, NZ dollar returns have been flattered. Introducing a degree of dynamically hedging International Equities returns is being considered for the year ahead, within our Sustainable Growth fund.

Flightless Kiwi dollar boosted unhedged returns



FX

G10	December 2024 (%)	2024 (%)
USD	2.2	8.8
SEK	-1.6	-9.0
GBP	-1.7	-1.7
EUR	-2.1	-6.2
CAD	-2.6	-7.9
CHF	-2.9	-7.3
NOK	-3.2	-10.7
JPY	-4.7	-10.3
AUD	-5.0	-9.2
NZD	-5.4	-11.5

Source: Morgan Stanley Investment Management

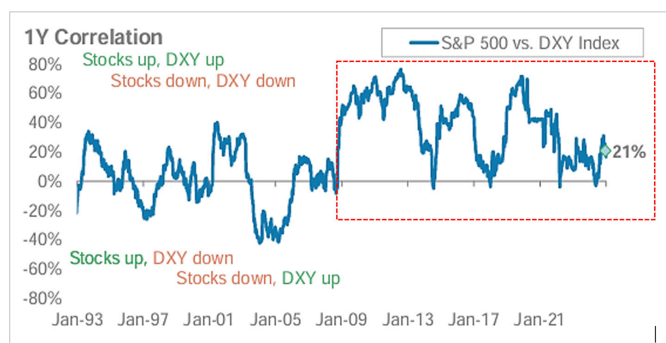
This meant the already-robust +19.2% return from MSCI World Equities (in USD) logged in 2024 translated into an annual return from the Index above +34%, expressed in NZ dollar terms. This scale of positive reinforcement, whereby a strong offshore market rally has returns bolstered by our home currency's sharp depreciation, is a pleasant portfolio returns sweetener. All the same, such phases only occur sporadically and tend to develop when there are marked divergences in economic health between countries and regions. De-synchronised global dynamics are extreme at present, and they may not endure through the next three years quite as strongly as they have dominated the period since Covid-19.

Resilient US currency defies doom-sayers

Viewed over the last three decades, it is mainly since the Global Financial Crisis that a strong US dollar (measured by the DXY Index) and strong US equity market performance have been positively correlated.

The major secular bull equity market in the 1990s saw much less of a clear relationship than that which has been observed since 2009. In contrast to common economic expectations and crypto market truisms, neither Quantitative Easing nor massive deficit spending have debased the US dollar as yet. The confidence in USD has aided the US equity market, as superior growth outcomes and active interventions to stave off recessions drew global funds into the US, which have been invested in bonds, equities and alternative asset classes. A virtuous circle developed making US assets the most attractive (and hurting Europe and Emerging Markets).

USD strength broadly mirrors share market direction



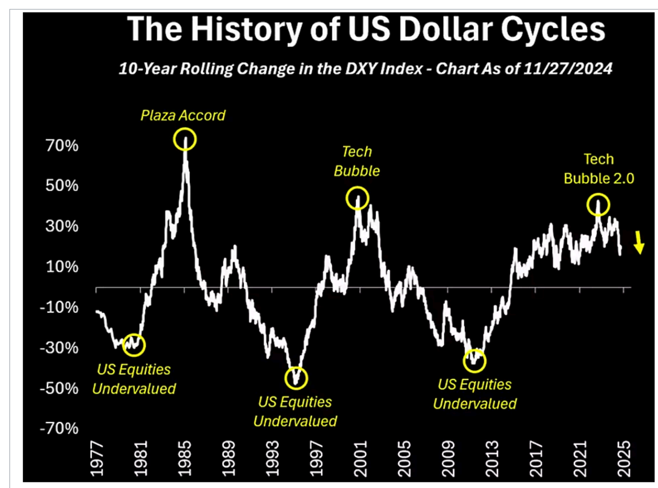
Source: Morgan Stanley Investment Management, Dec. 2024

In this regard, it bears mentioning that Donald Trump is on record as favouring a lower USD exchange rate, to assist the rebirth of domestic manufacturing by supporting the competitiveness of US exports and thus helping to reduce the US trade deficit. Trump has few concerns about how to encourage a realignment in Forex relationships, having mentioned several disruptive ideas during the election campaign. Of course, virtually any of the ways in which the new administration might do this – imposing capital controls on foreigners' purchases of US assets or interfering with the Federal Reserve's independence – would seriously undermine US financial credibility.

For a President who has in the past used the health of the US equity market as a barometer of his policy efficacy, a falling USD is probably best avoided as it may be associated with reduced vigour in the domestic share market. Recent gains in commodities, actions by the Bank of Japan, and tense trade dynamics between the US and China could all work against and neutralise US dollar-supportive Republican policies.

We are entering a period of global change, which justifies pointing out that history shows the cyclical nature of the US dollar often aligns with broad secular shifts in global asset markets. Historical episodes illustrate this, with the dollar's trends serving as both a reflection and catalyst for evolving economic and financial landscapes. To summarise the evidence, long US dollar uptrends often align with periods of US equity outperformance, particularly in growth-oriented sectors supported by technological advancements. These phases are marked by elevated valuations and concentrated capital flows into US markets. Conversely, dollar downturns frequently favour gold, undervalued international equities, and commodities, with Emerging Markets and value-oriented strategies regaining prominence. Current developments hint at a maturing USD cycle, but the precise inflection point may not arrive this year.

US dollar moves in long waves against 6-major currency basket (DXY)



Source: Bloomberg, Crescat Capital

Future profit strength depends on much going "right"

The top risk to US equities we identified back in mid-October is "an indication that the US economy is re-accelerating and removing the need for larger rate cuts." Investors have deferred the pricing of the next Federal Reserve rate reduction to July (previously, June) and now only expect probably 1 cut this year.

Index gains over the two months since the US election have been interrupted and reversed as a result. North American equity markets after a New Year slip, are back to their mid-November level – though parts of the Tech sector are still slightly ahead. The durability of such gains depends on the "best future case scenario" being realised, which should become clear in the next few months. We believe there will likely be bumps in the road ahead, even as the US economy cools, with activity remaining sufficiently strong to keep unwanted inflation pressures percolating. Trump's ideas and Fed policy may soon come into friction.

Prospective indicators of a definitive end to the secular bull market are not yet present, which argues against any substantial shift to greater defensiveness until we know more about the US political direction once Trump takes office. As shown below, the MSCI World equity index (blue) is very close to the level at which we instituted the risk reduction, while the US S&P 500 (purple) has gained only very slightly. The source of positive portfolio returns from global equities in the last 3 months of 2024 has largely been due to the depreciating NZD over that period, rather than to sustained strength in global equities per se, as measured in their local currencies.

Source: MSCI, MarketWatch 8 Jan 2025

Negative US market Equity Risk Premium counsels caution

Finally, with long bond yields moving back up, the US market is displaying a negative Equity Risk Premium (calculated on both earnings and dividend yields) which implies that there will be little compensation for embracing share market risk compared to putatively "risk-free" assets like Treasury bonds. Another way of looking at this historically rare development is that investors are now willing to "pay" to take on equity market risk, rather than to "be paid" to do so. Other things being equal, that suggests euphoria and does ring some alarm bells about investors' capacity to endure any period of flat or bearish equity market returns with fortitude. Investment discipline is presently locked in an epochal tussle with a one- directional trader mentality (favouring perpetual dip-buying) and easy retail access to options markets.

A negative Equity Risk Premium could imply that the earnings yield of stocks has become less important to some, when compared with stocks' capacity to appreciate sharply in a short time when assisted by dominant narratives about the future. Time will tell.

Source: Morgan Stanley Investment Management, Jan. 2025

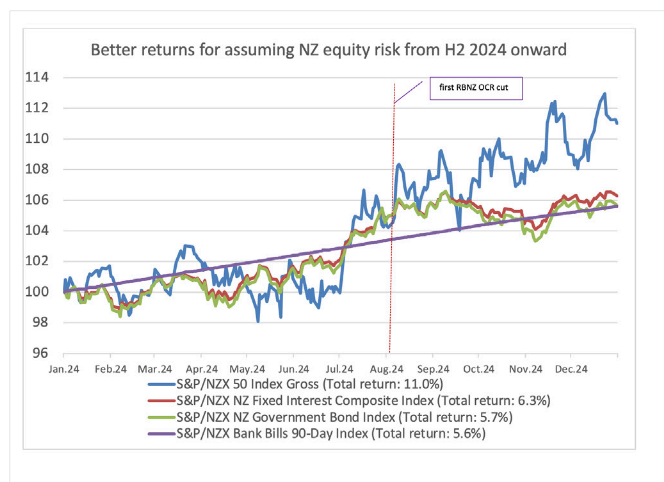
New Zealand equities responding to RBNZ easing path

Whilst the New Zealand economy is still in the throes of the very difficult domestic trading environment, we believe that a progressive easing path initiated by the Reserve Bank of New Zealand and the defensive nature of the industries that are heavily represented on the NZ exchange means that we can anticipate a continuation of our NZ equity holdings contributing improving returns to the total returns of both the Salt Sustainable Growth and Income Funds.

There are many unresolved macroeconomic and industrial uncertainties affecting the domestic share market. Nevertheless, the investment managers domiciled in New Zealand (particularly KiwiSaver managers) can be substantial marginal buyers of domestic shares, and the commencement of the latest Official Cash Rate easing cycle on August 14th provided the rationale for beginning re-building domestic share allocations within multi-sector portfolios.

This has been supported by a sense that the NZ corporate earnings downgrade cycle is at an advanced stage, and that mid-2025 could begin to see positive surprises in guidance. Thus, while the economy is not yet out of the woods, the domestic asset markets are experiencing a sentiment shift towards looking for an improving narrative in the course of 2025. However, headline risks remain as enterprises are still being liquidated and the Government has not yet identified a "circuit breaker" for the rather downbeat domestic economic narrative, leading to substantial emigration flows across the Tasman and suppressing private demand.

NZ equities outperforming Cash, while Bond returns are in line



Source: S&P Global Indices, data to 7 January 2025

Strategy conclusions

We expect 2025 to be choppy, as some positive tailwinds fade for Growth assets, but conditions should improve for select Income types. In our Sustainable Income Fund, we continue to diversify via superior yield sources into the global bond markets and will begin incrementally moving from neutral, to a small overweight position in global fixed income securities. In our Sustainable Growth Fund, we will look for opportunities to lower the International Equity exposure a little further, as we believe there is presently too much market trust in "Trump and Tech effects" and that scope for disappointment is elevated.

Our current investment market views are:

- US corporate earnings need to validate the optimistic assumptions reflected in equity prices after the 2024 rally. Analysts now expect 12% YoY Earnings growth for Q4 2024 and 15% for 2025.
- Equities (as a whole) should see average annual returns close to their long-term norms in the next 3 years with interim weaker periods; after recent gains this implies a correction might be near. Selected equity sectors and markets still have scope for resilience and show desirable investment features. There are all-weather stocks and defensive sectors that have lagged in recent years. Consumer Staples stocks and Health Care stand out.
- Within the broader market sectors, thematic and valuation support in Utilities and Consumer Staples, Healthcare, and Software as a Service (SaaS) enjoy pricing power which assists them to ride out sentiment storms and hedge against economic slowdown.
- Listed real assets still offer superior, defensible yields, in a fraught macroeconomic and geopolitical phase, which increasingly stand out as cash interest rates slide.
- We see much better compensation for duration risk in bonds. However, yield levels will remain volatile. Within fixed income, thematic support is ready to be a prime differentiator, as sovereign and corporate bonds face major refinancing risks.
- We acknowledge sustainable, labelled and "green" bonds as a valuable theme and this market will survive US political hostility to ESG.

Greg Fleming

IMPORTANT INFORMATION

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