

QUARTERLY INVESTMENT UPDATE

AFTER CLIMBING A WALL OF WORRY, HOPES FOR US GROWTH SHOULD KEEP MARKETS GOING
Q1 2025

Although returns over the past year have been at times hard won, and often made in defiance of a doom and gloom narrative about the state of the world, most investors can look back on some reasonable gains.

Returns in 2024 exceeded our expectations

It certainly paid off in 2024 to ignore the 'noise' and focus on the 'signals'. We approached the year with a reasonable degree of optimism and it's fair to say that overall returns have outstripped our expectations. The risk is that some of those returns may have been borrowed from the future, but we wouldn't bet against further progress in 2025. We believe that the key factor for equity investors next year will be the health of the US economy. If it continues to grow, which we believe it will, then equities can continue to prosper.

Looking back on the 'year of elections'

Before it even started, 2024 was dubbed 'the year of elections', with more than half the world's population casting a vote. Several of these elections were being defined as a test for democracy. There was also a fear that a shift towards what might loosely be termed 'populism' could lead to the election of more extreme candidates, heralding socio-economic disruption. In this regard, the US vote for President was the defining election of 2024.

However, whatever one's opinion about the result, Donald Trump's decisive re-election helped clear the air and underpin a stock-market phenomenon that has become known as 'American exceptionalism'. American companies dominate global equity indices and US equities once again delivered the lion's share of returns to global investors. The UK's FTSE 100 Index has delivered a total return (including dividends) of 11% so far in 2024. That's a very good annual return. But it looks very disappointing compared to the 28% gain in America's S&P 500 (although over the last three years the total return of the FTSE 100 has kept pace with the US equity market, if you exclude the seven mega-cap tech stocks known as the Magnificent Seven).

"Well done...and this is what you could've won..."

Jim Bowen, the presenter of the TV show Bullseye (which somewhat implausibly combined darts with general knowledge), used to taunt less successful participants at the end of the programme with the words "And this is what you could've won". And the same could apply to market participants. The more technology-focused NASDAQ Composite Index was up over 30%

at the time of writing, while the Magnificent Seven as a group was up nearly 70%. And if you had put all of your eggs in the basket labelled Nvidia (the pre-eminent provider of processors to power the artificial intelligence revolution), you would've almost tripled your money (+172%). But that is not how we assemble portfolios, and the risks have to be spread across different asset classes and securities. As our co-chief investment officer Ed Smith notes in his video looking back on the lessons of 2024 (available on our [Insights page](#)), it's not only the most dazzling companies at the bleeding edge of exciting technological developments that delivered great returns over the past year. So have banks, financial services and media companies – very different sectors with different drivers.

UK equity gains may look parsimonious compared to the US, but it could've been worse. Political turmoil and a downturn in demand from Chinese consumers for France's luxury goods industry meant that the CAC40 Index's total return has been just 1%. Still, as the Telegraph's ever-reliable cartoonist Matt had one of his characters put it: "The worst thing about our government's blunders is that we can't properly enjoy France's problems!"

Labour's not working... yet?

And talking of our government, October saw the newly minted Labour leadership deliver its first Budget, which has won few friends in the business community. Neither has it gone down well with households. Warnings of the need to fill the alleged £22bn "black hole" in the country's finances bequeathed by the Conservatives had raised fears of tax increases, especially in relation to wealth and savings, which had reduced confidence. Perhaps because the Chancellor had managed expectations to such a low ebb, the relatively small rise in capital gains tax rates and the fact that pensions and ISAs were undisturbed provided some relief (although financial planners remain in high demand owing to changes to Inheritance Tax, in particular). But the real body blow was to businesses, especially to those in the retail, leisure and hospitality sectors. These labor-intensive industries were hit hardest by an increase in the rate of private employers' National Insurance Contributions and, more importantly, a reduction in the threshold for contributions being made – the latter bringing a lot more lower paid workers into the net. These businesses have warned that the extra cost will have to be absorbed through some combination of higher prices, reduced profits, lower wage increases or lower employment. Many companies have also indicated that they will cut back investment

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plans. None of this will be helpful to workers or the economy. The malaise that has taken over the UK since the election in July has been reflected in a precipitous drop in Citigroup's UK Economic Surprise Index, a measure of economic data releases against analysts' expectations, from +66 to -45. If there is any consolation, it tends not to fall much further than this, other than in extreme circumstances such as the global financial crisis or the covid pandemic. The reluctance of the Bank of England to continue to cut interest rates in the face of sticky service sector inflation is also something of a hindrance. Any signs that inflation is abating faster could give UK equities a boost, especially the more domestically focused small and midcap companies. We continue to see good value in the UK. And so, it seems, do corporate buyers if we consider the pickup in mergers and acquisitions (M&A) over the past year.

Market volatility is a feature, not a bug

As we round up our look back on 2024, it is worth recalling the sharp fall in equity markets in early August, because this episode has lessons for us as investors that we can take into the new year.

The catalyst was a combination of weak US economic data (something of an aberration, as it turned out) plus an unexpectedly aggressive rate increase and withdrawal of monetary stimulus by the Bank of Japan. This triggered a reversal of a phenomenon known as the 'yen carry trade', in which investors borrow yen at very low interest rates to invest in higher returning assets in other currencies. This ranged from more currency-based yield-enhancing strategies to leveraged bets on go-go growth shares. The biggest reversals were seen in trades involving the Mexican peso and US mega-cap technology companies, especially the Magnificent Seven (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla). This group collectively dropped by 18% during that period. The sell-off was amplified across the markets as rising volatility forced other investors to reduce their exposure to equities and other risk assets.

Why is it important to bring this up again? Financial markets are increasingly vulnerable to such episodes, where seemingly inconsequential catalysts can have outsized effects far beyond what can be described as any shift in the 'fundamentals'. The key thing when they do happen is to evaluate whether they are the beginning of something much worse or a brief squall that will quickly blow out, as happened in August. But as investors it's important that we recognise that such events seem to be an integral feature of the wealth accumulation process and not a bug, so we can be prepared emotionally to ride them out.

The year ahead – a rare 'average' outcome?

With 2024 neatly wrapped, what is the outlook for 2025? Analysts' estimates for global equity returns range around 5-10%, while bond prices are expected to be little changed. But these predictions come with the caveat that, for example, US equities have achieved such middling returns in the 5-10% range only eight times in the last hundred years despite the long-term

average being around 8%. We are very wary of setting price targets for equity indices, given the complex interaction of the variables that drive them and the surprises that can result. The past year was a case in point, when around half of the appreciation in the S&P 500 Index was driven by rising valuations, with much of that down to ebullient animal spirits. In fact, excluding the seven tech giants, US profit growth in 2024 is on track to be just 3%.

US growth is the key, and we're positive

As we noted at the start, we believe the health of the US economy will be the key factor for equity investors. If it continues to grow, which we believe it will, then equities can continue to prosper. However, we would also expect to see some broadening of leadership away from the technology giants and we continue to see higher quality small companies offering good relative value.

Whether other regions can catch up with the US remains questionable, although a yawning valuation gap has opened between much more expensive US equities and most of the rest of the world. Neither the UK nor Europe appears capable of stimulating strong growth, although sentiment towards both is low and any sign that either government stimulus or central bank rate cuts are gaining traction could attract investment flows.

China, the world's second largest economy, remains mired in a balance sheet recession, where businesses and households are focused on paying down their debts and there's no appetite for borrowing or investing. We await evidence that recently announced stimulus measures are having any effect. The ongoing improvements in Japan's corporate governance are attractive. We have a generally positive view on Japanese equities, but this is tempered by uncertainty around monetary policy, with the BoJ negotiating a tricky exit from a long period of zero interest rates.

Of course, there is one wild card in this game, and that is the policy of incoming US President Trump. The market has initially responded positively, sniffing out an investor-friendly regime of lower corporate taxes, an extension of reduced personal taxes and looser regulation, at least in aggregate. His nomination of a seasoned hedge fund manager, Scott Bessent, as Treasury Secretary has gained nods of approval. Still, Healthcare bosses are more fearful of Robert F. Kennedy Jr. should he become the Health Secretary as currently planned. The banking industry is already looking forward to an increase in fee-generating M&A and initial public offerings.

Even so, there is greater uncertainty in Trump's policy, notably the threat of increased import tariffs. As we explain in further detail in our [post-election update](#), rather than being the deficit-reducing solution that Trump deems them to be, we see tariffs as disruptive and inflationary, and that is before we account for any retaliatory action. The optimistic line is that they are a negotiating tool to extract better terms from trading partners, or even to influence their domestic policy.

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There is also the issue of immigration. An estimated 10 million people have entered the US during the last four years, expanding the labour pool and contributing to demand. Should that flow be reversed, there is a risk of labour shortages developing, which might lead to higher inflation through the wages channel.

A policy initiative which could have a more positive outcome is the formation of the Department of Government Efficiency, a body to be headed up by the mercurial entrepreneur Elon Musk. If Mr Musk is able to apply technology to enhance productivity, so much the better, but we are taking nothing for granted.

Overall, our view on equities remains positive.

Government bonds can continue to provide insurance

What about bonds, the other main component of balanced portfolios? Following two years of negative total returns for Bloomberg's Global Aggregate Index, an unprecedented third year of losses is set to be avoided, but not by much. Government bonds have struggled in the UK and US as growth turned out to be more resilient and inflation somewhat stickier than expected. Burgeoning government borrowing has also added to concerns of oversupply. Even so, during the equity markets' August swoon, government bonds did prove their worth as diversifiers by moving in the opposite direction. This was because investors were worried about growth slowing down, as opposed to 2022 when the concerns were squarely centred on rising inflation, and bonds and equities fell in tandem.

A generally accepted rule of thumb for 10-year bond yields is that they don't stray far from the economy's nominal growth rate (real growth plus inflation). US Treasuries and UK gilts are fairly close to both the current and projected nominal growth rates of their respective home economies, leaving no greater prospective return than the yield on offer. However, in the absence of expectations that inflation is going to increase markedly in the foreseeable future (with some caveats around the uncertain effect of tariffs and immigration policy in the US), bonds could once again offer some insurance against an economic downturn.

Interest rates – be careful what you wish for

Market pricing implies further reductions in interest rates through 2025, although it is sobering to look back at what was being discounted at the beginning of 2024. Back then US rates were expected to end the year at 3.75% and UK rates at 3.5%, far below the 4.5% and 4.75% rates where they've ended up. Even so, that has not stood in the way of a decent year for equity investors, because growth has been stronger than forecast. We always counsel investors to be careful what they wish for when it comes to lower interest rates. If they are a function of benign inflation and steady growth, that tends to turn out well; but if rate cuts are a response to lower growth, then that's bad news for corporate profits. In any event, markets are currently pricing in rates of 3.75% and 4% by the end of 2025 in the US and UK respectively, which we think is reasonable.

Geopolitical risk becomes 'business as usual'

Beyond the realms of government and central bank policy, we must also keep a keen eye on geopolitical developments. China's reaction to tariffs and its attitude towards Taiwan will be crucial, as will the next steps in its desire to stimulate its domestic economy. Meanwhile, we will have to wait and see whether Trump's promise to end hostilities in Ukraine on "day one" of his presidency hold water and what any ceasefire agreement might look like. Although the conflict in the Middle East hasn't produced any major disruption to crude oil supplies, which tends to be viewed as the biggest risk to the global economy from conflict in that region, it is still evolving. Hedging against geopolitical risk remains one of the harder challenges faced by global investors. With tensions on the rise, we've recently updated our geopolitical risk report, [Peace of Mind in a Dangerous World](#) report, where we discuss what the major risks are and how we would respond if any of them were to come to fruition.

Still climbing the wall of worry

As we head into the new year, there seems to be little celebration of the fact that typical balanced portfolios have delivered decent returns, and well above what would have been achieved by holding cash, even with interest rates being as high as they are. The world feels unstable and bad news is amplified by (especially social) media; and yet good companies continue to be able to generate growth and to compound their returns. It would have been very tempting on several occasions in the last few years to abandon equity investments, and yet here we sit with global equities at all-time highs.

The past 12 months have provided plenty of object lessons in sticking to our investment-process guns and not being deflected by the sometimes-overwhelming noise around us. It is inevitable that we'll be jostled by more bumps in the road ahead, but we must always bear in mind that market volatility is the price that we pay for superior long-term returns.

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