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ANNUAL

THE
MECHAZILLA
MOMENT

GLOBAL
MARKET
OUTLOOK

SYNOPSIS

An enduring image from 2024 will be the capture of the SpaceX booster rocket by the Mechazilla robot arms on its return to Earth. This achievement served as a powerful metaphor for the year: *the improbable not only became possible but redefined expectations.*

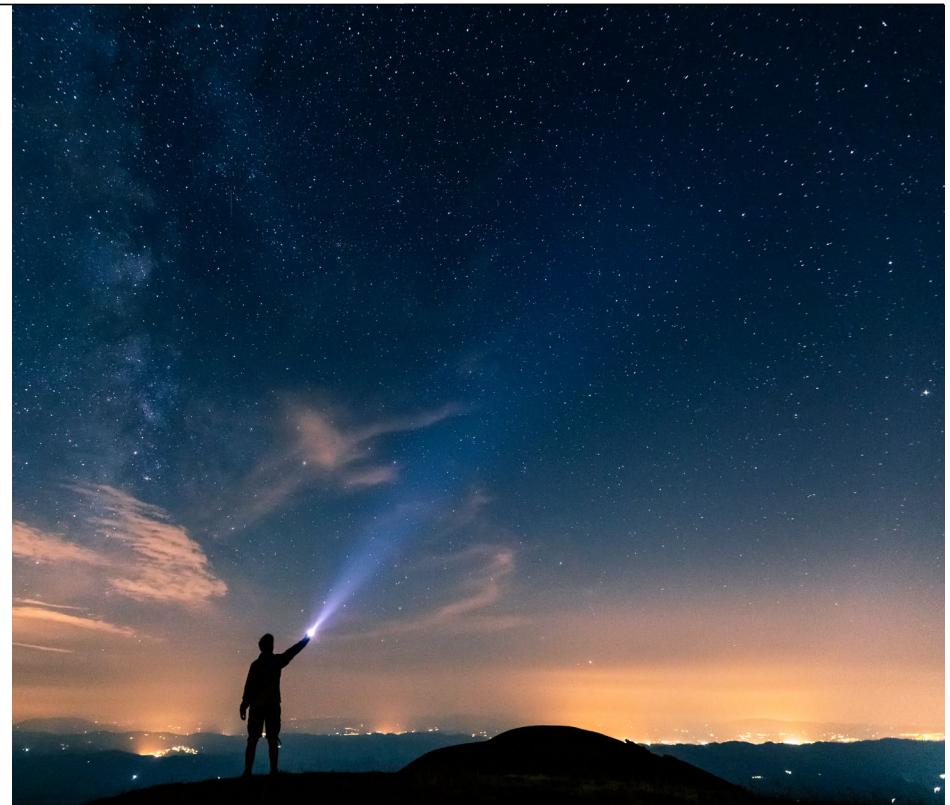
We expect 2025 to be another year of overcoming challenges and redefining limits against a backdrop of high U.S. equity market valuations, mega cap dominance, and uncertainty surrounding the policy agenda of U.S. President-elect Donald Trump. Our focus is on building resilient portfolios that can adapt to a wide range of scenarios.

KEY ECONOMIC THEMES FOR 2025

Looking into 2025, we anticipate a soft landing for the U.S. economy. Our assumption is that the new administration will ease its more aggressive stances on tariffs and immigration. With these dynamics in mind, here are our key economic views for 2025:

1. U.S. GROWTH AND POLICY TRADE-OFFS

The U.S. economy is expected to grow at a trend-like pace of 2.0% in 2025 in response to the lagged impact of tight Federal Reserve (Fed) monetary policy. The Trump administration's policies present a delicate balancing act. Tax reforms and deregulation are likely to stimulate growth, particularly in domestic and cyclical sectors. Tariffs and immigration restrictions, however, could trigger a stagflationary shock that might have the Fed contemplating a rate hike as the economy weakens.



2. GLOBAL HEADWINDS AND POLICY DIVERGENCES

Outside the U.S., growth will likely remain under pressure. Trade policy uncertainty and tariffs will weigh heavily on Europe. China will face headwinds from U.S. tariffs, a struggling property market, and deflation pressures. Japan remains an outlier, supported by a virtuous wage-price spiral that will anchor inflation expectations near 2%.

3. MARKET SENTIMENT AND VALUATIONS

Elevated equity valuations make the U.S. market vulnerable to negative surprises, and further dollar strength will challenge emerging markets. Sustained U.S. Treasury yields above 4.5% could challenge equities, diminishing the earnings yield advantage stocks have enjoyed over bonds since 2002.

KEY PORTFOLIO THEMES FOR 2025

As we navigate 2025, the interplay between the shifting policy landscapes and evolving market conditions calls for thoughtful portfolio construction. Building on the macroeconomic backdrop—defined by resilience in U.S. growth, potential disruptions from trade and immigration policies, emerging opportunities in AI (artificial intelligence)-driven productivity, and growth in private markets—three strategic themes guide our approach:

1. BALANCING U.S. GROWTH AMID POLICY SHIFTS

The U.S. economy is resilient as it enters 2025, but the road ahead will be shaped by shifting policy dynamics.

Asset class implications:

- **Equity**

We are focused on U.S. small caps, where post-election dynamics, improving earnings, and attractive valuations may create compelling opportunities. We also see growth managers targeting high-growth cyclicals like software, while value managers identify M&A (mergers and acquisitions) potential in financials and healthcare. Core managers are balancing cyclical exposure and managing risks in rate-sensitive sectors.

In addition, we expect increased market volatility from U.S. foreign policy actions to create opportunities for active managers to find quality companies temporarily impacted by headline risks.

- **Fixed income**

We see a steepening yield curve offering opportunities in short-term bonds, as short-term rates are expected to decline faster than long-term yields. Credit markets may have limited upside due to tight spreads, particularly in U.S. high-yield and investment-grade bonds. This creates an opportunity to expand fixed income exposure into areas with more attractive risk/return trade-offs, such as emerging-market U.S. dollar bonds and private credit.

- **Currencies**

The U.S. dollar is expected to face upward pressure from tariffs, the strength of the U.S. economy, and a less dovish Fed compared to other central banks. However, its valuation remains high, and emerging-market currencies have already been under pressure. Given this, we are keeping currency bets in portfolios limited for 2025, while staying alert to any opportunities and risks that may arise throughout the year.

2. PRIVATE MARKETS: THE NEW GROWTH ENGINE

Private markets continue to play an increasingly vital role in the evolving landscape of capital flows, as the shift away from public markets accelerates with fewer IPOs (initial public offerings) and later-stage listings.

Market implications:

- **Private equity**

We are focused on private equity opportunities in European middle-market consolidation, along with continued growth in Japan and the Persian Gulf states. Managers with sector-specific expertise are outperforming generalists, and we believe that portfolios can benefit from this trend.

- **AI and tech**

We believe private market ventures in AI, particularly those focused on scaling innovative technologies across industries, will continue to be key drivers of long-term growth. We are actively looking for investments in AI-driven companies that are poised to enhance productivity and reshape industries.

- **Private credit**

We see private credit as a resilient asset class, particularly in the current higher-rate environment. With asset-based lending and European direct lending providing attractive relative value, we are broadening our fixed income exposures into these areas to capture higher yields and better diversification.

- **Infrastructure**

We are favorable to infrastructure as a long-term growth anchor and a hedge against inflation. The asset class has proven resilient during recent market volatility and benefits from long-term trends such as the energy transition, renewable energy, and digitalization. Increasing demand for sustainable and digital infrastructure continues to drive significant capital inflows. Additionally, hybrid models combining private and public market exposure are unlocking new growth potential.

- **Venture capital**

We see significant opportunities in AI-driven venture capital (VC), particularly in early-stage companies with the potential to reshape industries. As the VC market stabilizes, we are concentrating on firms with strong fundamentals, a track record of innovation, and a capacity to scale effectively.

3. THE BROADENING OUT OF MARKET LEADERSHIP

While mega cap AI stocks have driven market returns in recent years, leadership is shifting to companies using AI to create real-world efficiencies. The new U.S. administration's focus on deregulation and tariff-based policies may provide an added boost to smaller, domestically oriented companies, which are less exposed to international trade disruptions than mega caps with significant foreign revenue, such as Apple. We see this shift reducing market concentration and opening the door for alpha opportunities.

Market implications:

- **Equity**

Active equity managers have been challenged by the recent severe market concentration. Our research indicates that even a flattening out of these trends—which could be driven by policy shifts, or changing sentiment around earnings growth and valuations for mega caps—can be quite supportive for active manager outperformance. We and our active managers are focused on sectors where AI adoption is accelerating, such as industrials, healthcare, and consumer goods. We believe companies leveraging AI for productivity improvements are well-positioned to gain a lasting competitive edge and generate strong returns. Skilled active managers can seek out these companies, especially those in less-covered segments of the market.

- **Real assets**

We see attractive investment opportunities in real estate and infrastructure, particularly in areas benefiting from stabilizing long-term interest rates and favorable relative valuations compared to other growth assets. AI applications in real estate, such as data centers and healthcare facilities, are emerging as key growth areas. Additionally, infrastructure investments are gaining momentum from energy utilities and pipeline exposures, especially with the U.S. administration's focus on expanding LNG (liquefied natural gas) production.



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