Market Outlook 2025

The major event of 2024, the presidential election, is now over, and President-elect Donald Trump is assumed to enter office come January 2025. This helps us make much more informed decisions as the uncertainty of policy and regulation have subsided. While this does not affect major themes like AI, cybersecurity, Japan, etc., the intensity of regulation and competition does stifle significant progress and business developments, even while undergoing generational changes. To provide additional clarity, we will explore the key themes shaping the investment landscape in 2025.

Let's dive deeper into what we see waiting for us in 2025:

TRUMP 2.0

While on the road during their campaign stops, both candidates made promises to energize their supporters, but implementation will be limited to congressional approval and the real market acceptability of the proposals. Trump is pragmatic when it comes to monitoring the markets to see how well his policies and appointments are accepted. He has campaigned for tariffs, deregulation, tax cuts, and the "Drill Baby Drill" policy to keep energy costs low and make the USA a dominant player. Here is a sectoral analysis of the potential impacts of Trump's economic policies:

Energy Sector

The traditional energy sector is poised for growth under Trump's policies:

- Deregulation efforts are expected to boost oil and gas companies.
- The administration plans to repeal fuel economy regulations for both light- and heavy- duty vehicles.
- Requirements for electrification under Biden's emissions regulations are likely to be eliminated.

These changes could lead to increased production and profitability in the fossil fuel industry. However, renewable energy may face challenges:

- Funding for electric vehicle charging infrastructure and technologies like wind and solar energy may be reduced.
- The National Electric Vehicle Infrastructure Program (NEVI) and the Charging and Fueling Infrastructure Program (CFI) could be altered or repealed.

Financial Sector

Banks and financial institutions are expected to benefit from Trump's deregulatory agenda:

- **Yield Curve Steepening:** Republican economic policies often lead to a steeper yield curve, enhancing banks' net interest margins.
- **Deal-Making Opportunities:** With fewer regulatory hurdles, mergers and acquisitions could gain momentum. Notably, bank mergers declined by 44% under the previous administration.

While these developments create growth opportunities, systemic risks from reduced oversight must be carefully monitored. Additionally, as fintech innovation accelerates, balancing growth and risk management becomes increasingly vital.

Industrial and Manufacturing Sector

The industrial sector is set to gain momentum in 2025:

- **Economic Growth:** S&P Global Ratings projects U.S. GDP growth of 2.0% in 2025, supported by robust equipment investments forecasted to rise by 4.2%.
- **Tax Cuts:** Proposals to reduce the corporate tax rate from 21% to 15% for U.S.-based manufacturers could provide a significant boost to profitability.
- **Tariffs:** Increased tariffs aim to encourage local onshoring and bolster domestic supply chains.

However, higher tariffs on imports could raise input costs for some industries, necessitating strategic adjustments to maintain competitiveness.

Trade and Global Impact

Trump's trade policies could reshape global economic dynamics:

- **Import Tariffs:** A proposed 10% tariff on all imports could add $1,700 annually to the typical middle-class household budget.
- **Inflation Risks:** Tariffs of up to 60% on Chinese goods may boost inflation by 1 percentage point, pushing it to 3.4% annually.

While these measures aim to strengthen domestic industries, their broader economic impacts, including potential retaliatory actions from trading partners, must be considered

Small Caps

Small-cap companies and regional banks could experience a favorable environment under the new administration:

- **Market Share Gains:** Tariffs on imports could reduce competition, enhancing domestic small-cap companies' pricing power.
- **Tax Benefits:** Corporate tax cuts disproportionately benefit small caps, which typically pay closer to the full corporate tax rate.
- **Undervalued Opportunities:** Small caps are trading at 14x forward P/E, a 30% discount to large caps, with Russell 2000 earnings projected to grow by 20% through 2026.
- **Rate Cuts:** Small-cap companies, often with higher variable-rate debt, stand to gain from the Federal Reserve's continued easing cycle in 2025.

These factors present a compelling case for small caps, though investors must remain vigilant about potential volatility in local economies and sector-specific risks.

AI & Cybersecurity: An Interconnected Revolution

Artificial intelligence (AI) and cybersecurity are two of the most transformative themes of our time, deeply intertwined as advancements in one directly influence challenges and opportunities in the other. In 2025, these fields will shape how businesses innovate, operate, and protect themselves in an increasingly digital world.

The AI Arms Race

The AI arms race among major tech companies shows no signs of slowing as they continue to outspend one another year over year. Revenue growth and efficiency gains are becoming evident, and early movers may gain first-mover advantages akin to YouTube or Facebook during the early days of the internet.

- **Amazon**: AWS saved 4,500 developer-years of work in 2024, generating $260 million in annualized efficiency gains through enhanced security and reduced infrastructure costs. Additionally, 79% of auto-generated code reviews were implemented without further modifications. Amazon is projected to invest $96.4 billion in GPUs and server expansion for its cloud and AI services.
- **Microsoft**: Azure AI reported a 60% year-over-year growth in customers, reflecting strong adoption and efficiency improvements in cloud services through AI.
- **Meta (Facebook)**: AI-powered features contributed to an 8%-10% increase in watch time for Facebook Reels, directly translating into increased ad revenues as users spend more time on the platform.

Not only do capital expenditures continue to rise, but the efficiency gains extend from services to manufacturing. For example, the invention of air conditioning enabled Coca-Cola's dominance as a beverage company, while automobiles revolutionized suburban living and tourism. Similarly, the AI revolution is expected to drive immense but distant opportunities, with early leaders in cloud services and semiconductor industries playing pivotal roles.

The Role of Cybersecurity in an AI-Driven World

While AI opens unprecedented opportunities, it simultaneously amplifies risks. The adoption of cloud infrastructure across banking, workplaces, and even food delivery has increased vulnerabilities to cyber fraud and threats. Cybercriminals now leverage AI tools to scale operations, launching sophisticated attacks at unprecedented scales.

- **Global Cyber Attacks**: Check Point Research reported a 30% increase in global cyberattacks in Q2 2024 compared to the same period in 2023.
- **Ransomware Growth**: Ransomware incidents rose by 81% in 2024, with AI cited as a key enabler for scaling these threats.
- **Advanced Threats**: AI models now enable the creation of highly realistic deepfakes and 3D environments from minimal data, amplifying risks in data security and impersonation.

The increasing reliance on cloud infrastructure, whether for banking applications or supply chain logistics—makes cybersecurity investments critical. Companies that combine robust cybersecurity with AI innovations are positioned for exponential growth.

AI and Cybersecurity: A Symbiotic Relationship

The interplay between AI and cybersecurity is both synergistic and adversarial. While AI enhances efficiency and innovation, it also demands equally advanced security measures to mitigate emerging risks. For instance, businesses adopting AI technologies must simultaneously safeguard against AI-driven cyberattacks.

Future Perspective

AI and cybersecurity will define the next era of technological progress. Investors should focus on companies excelling in innovation and security, as these firms are likely to dominate the rapidly evolving landscape. The dual challenge and opportunity presented by these fields make them critical areas for long-term investment strategies.

Japan: A Unique Investment Opportunity

After years of prolonged stagnation and deflation, Japan has experienced inflation above 2% for the first time for 24 consecutive months and is expected to maintain this trend in 2025. There are several unique changes to Japan that make it much more attractive than other investment destinations:

Economic Fundamentals

While Germany is expected to have a second year of negative GDP, Japan, on the other hand, will experience real GDP growth of 0.5%, driven by domestic consumption and strategic government spending.

Corporate Governance

The Tokyo Stock Exchange (TSE) took significant steps to enhance corporate governance practices by implementing stricter listing criteria, particularly for companies in the Prime Market. This involved urging firms trading below book value to disclose plans for capital efficiency improvement, with a warning that failure to meet these standards by March 2025 would initiate a one-year improvement period, followed by six months under supervision before potential delisting. This is a significant shift, improving governance, transparency, and accountability.

Attractive Investment Climate

The Japanese government has implemented policies to create a favorable environment for foreign direct investment (FDI):

- A target has been set to double inward FDI stocks to 80 trillion yen by 2030, reaching 12% of GDP.
- The Ministry of Foreign Affairs has established contact points for Direct Investment toward Japan in 126 diplomatic missions overseas.
- The Japan External Trade Organization (JETRO) offers support to foreign investors, including consultation on administrative procedures and arranging meetings with regulatory agencies.

Japan has also started an IRA-equivalent program, NISA, increased investment limits, and provided permanent tax benefits for domestic investors, encouraging them to invest locally.

Vibrant Investment Opportunities

Not only are Japanese companies trading at half the valuation of U.S. companies on an EV/EBIT basis, but they are also innovative and essential in the new industrial revolution:

- **Semiconductors:** Dominance in manufacturing equipment and materials with companies like Tokyo Electron and Renesas.
- **Robotics:** Pioneers in industrial and service robotics, exemplified by Fanuc and Yaskawa Electric.

- **Precision Machinery:** Leaders in high-precision tools and optics, with firms like Okamoto and Nikon.
- **Advanced Materials:** Innovators in materials like carbon fiber, led by companies such as Toray Industries.

These factors position Japan as a unique and resilient market with significant potential for growth.

Interest Rates & Federal Reserve

The Federal Reserve has been on a rate-cutting cycle since July 2024. It has done a remarkable job of maintaining GDP growth above normal levels (2.8%), low unemployment (4.2%), and stock markets at all-time highs, all while avoiding a recession. Credit is due to the Federal Reserve's ability to align its actions with market expectations, even as the market initially anticipated eight rate cuts (2%) compared to the Fed's projection of four cuts for 2024.

However, navigating 2025 brings challenges:

Forward Guidance Challenges

- The Federal Reserve uses "forward guidance" as a tool to influence market expectations, adjusting them without directly changing rates. This has its limitations when inflation remains above target.
- The Fed's target of 2% core CPI, which peaked at 6.6%, is still hovering around 3.3%, far from their mandate.
- Cutting rates too aggressively could reignite inflation, keeping it permanently above 3.5%, while insufficient cuts might slow economic growth.

Fixed Income Market Risks

- Despite 100bps in rate cuts, the US 10-year Treasury yield has not declined, instead moving upward as the year progresses due to tariff threats.
- The 10-year Treasury is critical for determining borrowing costs for the government, businesses, and housing mortgages.
- With Fed funds down but no relief from long-term rates, the economic outlook remains uncertain.

The unpredictability of next year's fixed income market underscores the potential risks from higher inflation, escalating tariffs, and reduced participation by China in US Treasury auctions. Balancing rate cuts without destabilizing inflation or economic growth will be the Fed's primary challenge.

Key Risk Factors We Are Monitoring Closely

Markets are adjusting after the election results, repricing the economic policies on the horizon. As we head into 2025, here are the key risk factors we are closely monitoring, which could create major headwinds for investors:

1. **Persistent Inflation and Monetary Policy**
   - The U.S. Core Personal Consumption Expenditures (PCE) Price Index remained steady at 2.8% in November 2024, slightly below forecasts of 2.9%.
   - Persistent inflation suggests that the Federal Reserve may maintain elevated interest rates into 2025, impacting borrowing costs and investment decisions.
   - After a 25bps cut in December, the Federal Reserve signaled only two cuts for 2025, 50% fewer than its earlier projections.
2. **Corporate Debt Refinancing Challenges**
   - U.S. speculative-grade firms have reduced their 2025 debt maturing by over $180 billion (down from $2 trillion), shifting much of it to 2028.
   - Despite this mitigation, refinancing costs in a high-interest-rate environment remain a significant challenge.
3. **Rising Unemployment Levels**
   - The U.S. unemployment rate is projected to rise from 4.2% in Q4 2024 to 4.5% by mid-2025, signaling a slowing economy.
   - A fatigued consumer base, burdened by higher debt levels and tighter financial conditions, could exacerbate weaker economic growth and reduced consumer spending.
   - While higher unemployment suggests weaker earnings, it increases the likelihood of Federal Reserve rate cuts.
4. **Equity Market Valuations**
   - The S&P 500's forward P/E ratio stood at approximately 21.6 as of December 2024, significantly above historical averages.
   - Elevated valuation levels suggest vulnerability to market corrections if corporate earnings do not meet expectations.
5. **Household Debt Levels**
   - Total U.S. household debt reached $17.94 trillion, with credit card balances increasing by $147 billion.
   - Rising debt levels may constrain consumer spending, a key driver of economic growth.

6. **Political and Fiscal Policy Risks**
    - Trump's push for tax cuts and deregulation may face gridlock in Congress, limiting their effectiveness.
    - Fiscal deficits exceeding 5% of GDP could weigh on Treasury markets, pushing yields even higher.
7. **Negotiation Uncertainty**
    - While President Trump's strong-handed approach often emphasizes "The Art of the Deal," it may backfire, creating uncertainty in corporate earnings and lending environments.
    - Sudden policy changes or overnight announcements could drastically shift sector and industry dynamics.
8. **Retaliatory Tariffs**
    - Lower regulations and taxes may initially buoy market optimism, but sectors like Big Tech and semiconductors, which make up 40% of the S&P 500's value, could face retaliatory tariffs from the EU or China.
    - Such tariffs could significantly impact market valuations, given these companies' premium pricing and capital-light business models.

Closing Thoughts

We remain optimistic for 2025 given the regulatory, tax, and trade environment. The private capital expenditure driven by AI, along with increased efficiency, positions the U.S. to extend its lead in technology, defense, and healthcare in the coming years. Rewards outweigh the risks in the long term for investing in the dynamic U.S. economy—a preferred destination for entrepreneurs and global capital due to its innovative ecosystem, funding, and relatively lighter regulatory burden.

At the same time, we remain vigilant, prepared to adjust our strategies against potential risks and market shocks that could arise at a moment's notice.
