Mt Fort Advisers
- Investment Strategy Update -

December 16th, 2024

Dear All,

We are delighted to publish our latest investment strategy update encompassing our views for the first half of 2025 with the valuable insight of our independent macro strategist, Prof. Michel Girardin. You can access the detailed report using the following **link**.

"The days follow one another and look alike." Or so it seems for the past two years in the financial markets, which have enjoyed **exceptional returns** overall. The MSCI All Country World Index, a broad proxy for equity markets, appreciated a cumulative +47% over the past two years. However, when including the dismal year of 2022, the three-year cumulative performance drops to +21%, or an average annualised return of +6.5%, notably lower than the +8.2% historical average for the past 30 years.
The second half of 2024, while appearing calm on the surface, featured a **significant correction**: a -10% decline from peak to trough between mid-July and early August, triggered by profit-taking in large-cap stocks. The "Magnificent Seven" technology giants fell -16.4% at their lowest. Nevertheless, markets remained **resilient**, recovering strongly. Can we witness a third consecutive year of returns above 20%? Such instances are rare, with the last two occurring during the Post-War Boom in the 1950s and the Dot-Com Boom from 1995 to 1999.

Concentration and Growth: The "Magnificent Seven" Effect
The robust performance of equities has been **concentrated** among a select group of growth stocks, propelled by the promise of artificial intelligence (AI). The "Magnificent Seven," which now comprises 48% of the remaining 493 companies in the S&P 500, soared +145% over the past two years, compared to the broader S&P 500's more modest +57%. NVIDIA stands out as a prime example, surging over +800% during this period to become the world's second-largest company, with a market capitalization exceeding $3.3 trillion. Remarkably, NVIDIA added almost $3 trillion in value within two years.

Valuations: Are We in a Bubble?
While some speculate about a potential bubble, many growth stocks are underpinned by **robust earnings growth**. For instance, NVIDIA's price-to-earnings (PE) ratio in November 2022 was 34x with EPS growth of +19%; by September 2024, it traded at 33x PE with EPS growth of +55%. At its peak, NVIDIA reached almost 60x PE. These elevated valuations remain sustainable as long as earnings continue to grow at a strong pace. Many growth companies generate strong cash flows, operate with minimal debt, and demonstrate consistent profitability. Any disappointing news about reduced growth however would be **sanctioned** very sharply.
More broadly, it is an understatement to indicate that the equity markets have been **front-running** the effective corporate performance. Since its 2022 lows, the S&P 500 appreciated by 69%, while operating earnings increased by a modest 32%.

Macro Trends and Monetary Policy
Financial markets in the second half of 2024 were buoyed by **easing monetary policies**. The Federal Reserve **pivoted** in September with a larger-than-expected -50bps interest rate cut, followed by an additional -25bps cut in November. As of writing, markets anticipate another -25bps cut during the December 18th FOMC meeting. The Swiss National Bank (SNB) led the way, initiating a rate cut in March 2024, reducing its benchmark rate to 1.5%. Major central banks, including the ECB and Bank of Canada, followed suit, except for the Reserve Bank of Australia, which maintained its rates, and the Bank of Japan, which raised rates by 10bps in March and 25bps in July.

The Trump Effect and Market Dynamics
The U.S. presidential election concluded with a decisive victory for Donald Trump, alongside a Republican sweep of both the Senate and the House. This political landscape provided a **tailwind** for financial markets rallying to the end of 2024. It is interesting to note that key asset classes such as equities and gold are trading at all-time highs, while corporate bond spreads tightened to cyclical lows (with U.S. investment-grade spreads around 80bps), making **all asset classes expensive** in relative terms. The Trump victory boosted another more marginal asset: Bitcoin, which soared +130% in 2024, crossing $100,000. Despite its growth, cryptocurrencies remain a small asset class, with a capitalisation of $3.4 trillion compared to global equities exceeding $100 trillion.
Not all markets fared well though in 2024. Mexico, Brazil, South Korea, and France were among the worst performers, with French equities down -6% year-to-date. The performance gap between U.S. and European equity markets continues to widen. Since 2000, U.S. real GDP has grown by +70%, compared to the Euro area's +35%. One US dollar invested in the S&P 500 in 2000 would yield $4 today, compared to one Euro remaining the same €1 if invested in the EuroStoxx50!

Debt and Sustainability
A growing concern is the **ballooning cost of servicing public debt**. In the U.S., debt servicing reached nearly $1 trillion in 2024, contributing to a budget deficit of $1.8 trillion (6.4% of GDP). U.S. public debt now exceeds $36 trillion, while global debt has climbed to $323 trillion from $100 trillion in 2000. The sustainability of these levels in a higher interest rate environment warrants close attention.

The Outlook for 2025 - the Path of U.S. Monetary Policy and Its Implications
The trajectory of U.S. monetary policy remains a pivotal factor and will depend heavily on economic data, particularly **inflation** and **labour** market trends. The latest inflation

report, published on December 11th, revealed a sticky core CPI inflation rate of 2.7%. This is driven by robust service prices, underpinned by wage growth, and a slower-than-expected decline in shelter costs. Achieving the "**last mile**" to bring inflation down to the Federal Reserve's 2% target is proving to be the most challenging phase. **Trump's policies** ("Trumponomics" II), discussed further below, could exert additional **upward pressure on prices**, as reflected in swap market anticipations. The Federal Reserve may be forced to adapt by accepting a higher baseline inflation target closer to 2.5% in the future. Such a shift would imply a higher nominal neutral interest rate (nominal R*) around 3.5% to 4.5% in the U.S.. The U.S. **labour** market remains robust, with the unemployment rate increasing by only +0.4% year-over-year, well below the +1% threshold that typically signals a recession. Positive nonfarm payroll data further reinforce this outlook. However, potential tighter immigration policies under Trump's administration could constrict labour supply, placing upward pressure on wages and further complicating inflation control efforts.
Under current conditions, markets anticipate a -25bps rate cut by the Federal Reserve at its December 18th FOMC meeting. However, the updated **dot plot** is likely to indicate a more **gradual pace** of rate reductions through 2025, contingent on inflation and labour data. Prolonged higher rates could threaten debt sustainability, amplify the U.S. deficit, and provoke reactions from bond vigilantes, potentially destabilising equity markets.

The Impact of Trumponomics II

Trumponomics II could profoundly influence the U.S. economy and financial markets, though the specifics of its implementation remain uncertain. The key pillars of Trump's policy agenda include:

1. **Tax Cuts:** Alpine Macro estimates that tax reductions could lower PE ratios to 19.2x, assuming all other factors remain constant.
2. **Deregulation:** Easing regulatory burdens to boost corporate efficiency.
3. **Increased Trade Tariffs:** Potentially impacting global trade flows and costs.
4. **Tighter Immigration Policies:** Likely to constrain labour supply and increase wage pressures.
5. **Increased Government Spending:** Focused on defence and infrastructure, which could further stimulate economic activity.

Most of these policies have **inflationary** tendencies, but their ultimate impact will depend on the scope and timing of implementation. Trump's prior presidency demonstrated his focus on financial markets as a measure of his success, which may temper the scale of disruptive policies.

China: A Pivotal Factor for 2025

China might be a critical driver of global economic developments in 2025. We remain hopeful for more assertive monetary and fiscal **stimulus measures** from the Chinese government and the People's Bank of China (PBoC) to address the current deflationary spiral triggered by the property sector collapse. The nation is grappling with a profound confidence crisis, which necessitates decisive actions to stimulate consumption (currently less than 40% of GDP, compared to approximately 70% in the U.S.) and reduce excessive savings. We anticipate further reductions in interest rates and more aggressive supply-side interventions. Chinese equities are trading at **attractive valuations**, with price-to-earnings (PE) ratios below 9x, presenting potential opportunities for long-term investors. However, **geopolitical risks**, particularly the situation in the **Taiwan Strait**, continue to pose significant challenges. These tensions

are often viewed as an existential threat, rendering Chinese assets “uninvestable” for many investors.

Europe: Recovery Potential Amid Geopolitical Resolutions

Europe’s recovery in 2025 will likely hinge on developments in China and a potential resolution to the Russo-Ukrainian conflict. A de-escalation of trade tensions with the U.S. could further support the region’s economic outlook. The European Central Bank (ECB) is expected to maintain a dovish monetary policy stance, which would provide a supportive backdrop for equities. We might see **tactical opportunities** to build positions in select European markets, particularly in France and Italy, where valuations and potential policy shifts may create favourable conditions for investors, although the timing might still be premature.

Asset Allocation Strategy

Our base case for asset allocation is to maintain a **neutral equity exposure** aligned with the desired strategic allocation, while **tactically hedging** part of this exposure using bear put spreads. This approach reflects the possibility of a market correction, given **frothy** equity market conditions. According to Prof. Girardin's indicator (world equity returns minus world bond returns), we are not yet in "greed territory" (<30%, currently at 25%), but the margin for safety is slim. Elevated market concentration, high valuations, overbought technical indicators, and bullish sentiment all suggest a **potential air pocket** in equity markets. Nevertheless, these factors do not alter our broader, **positive long-term view**. We remain positioned to add on risk during market weakness, assuming no significant changes in macroeconomic conditions. Further details on our granular exposures across geographic zones, sectors, and factors are available in our barometer section.

We maintain a **neutral** exposure to **fixed income**, distributed across mid-term treasuries, investment-grade bonds, and high-yield bonds. While credit spreads remain tight with limited yield pickup, the direction of long-term interest rates is uncertain. We assume the Federal Reserve will continue its dovish monetary policy stance, albeit at a moderate pace, which should render cash deposits less attractive compared to bonds. **Gold** remains well-positioned as a hedge, bolstered by expectations that several central banks, including the influential PBoC, will continue to increase their reserves. The **USD** is expected to maintain its strength, although the Euro could benefit from positive catalysts such as a stronger Chinese rebound and a resolution to the Ukrainian conflict. Meanwhile, the JPY, which is sharply undervalued, has potential for appreciation; however, we find it challenging to identify appropriate assets to express a long position effectively.

Geopolitical Landscape

We cannot conclude this summary without addressing the geopolitical events currently unfolding. The Middle East appears to be entering a calmer phase, marked by the dismissal of Bashar al-Assad’s regime in Syria and the establishment of ceasefires in Lebanon and Gaza. These developments raise the possibility of a more politically driven resolution in the region, contingent on Trump’s intentions and involvement. Similarly, a potential resolution to the Russo-Ukrainian conflict could emerge, potentially brokered by Mr. Trump. However, even as these areas show signs of stabilisation, attention may shift toward **growing tensions in Asia**, particularly in the Taiwan Strait. This geopolitical hotspot continues to loom as a significant risk, akin to a sword of Damocles for investors with exposure to Chinese assets.

Staying Prepared Amid Uncertainty
With numerous key variables at play and a significant leadership change in the U.S., financial market outcomes for 2025 could vary considerably. It is imperative to remain nimble and open-minded while maintaining disciplined execution of our investment mandates. We strongly encourage investors to regularly review their investment objectives and ensure their portfolios align with their risk appetite and liquidity requirements. Adjustments should reflect changes in personal circumstances and evolving perceptions of the global environment.

For a deeper dive into our strategies and insights from Prof. Girardin, please access our full investment strategy update **link**.

We look forward to discussing these insights further and hearing your valuable thoughts.

In the meantime, the whole Mt Fort Advisers Team wishes you its warmest Season's Greetings in this festive period.

Thank you for your continued trust and support,

Your Research Team

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