INVESTMENT STRATEGY

January 2025

EDMOND
DE ROTHSCHILD

IT'S FLAMENCO TIME!

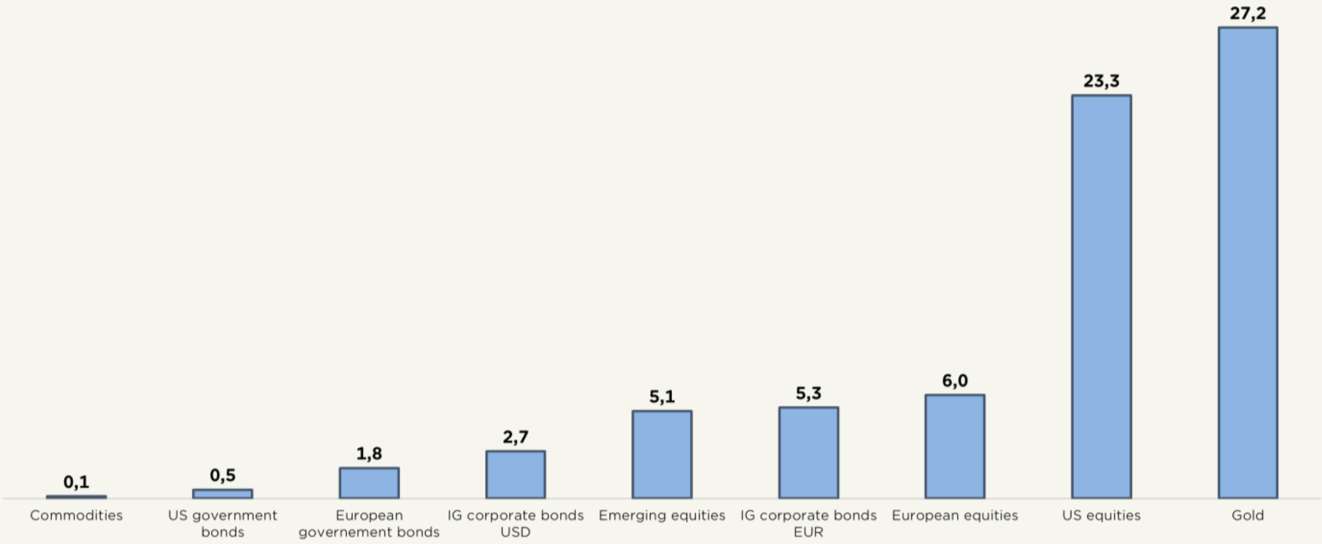
Waltzing is simple enough. Even the worst dancers (myself included) can pull it off in an honourable fashion. The music follows a linear, triple-time rhythm, the dance is elegant, everyone performs the same simple, repetitive and standardised steps and movements, and the whole endeavour is eminently accessible.

Investing in the markets in 2023 and 2024 was a waltz-like experience. At the risk of being overly simplistic, buying S&P 500 stocks and dollar-denominated vehicles was fairly straightforward, with satisfactory returns and few hiccups. Lulled by the steady increase in public spending and monetary liquidity, investors enjoyed an entirely agreeable period of prosperity.

Unfortunately, investing in 2025 will be more like dancing a flamenco than a waltz. And unlike the waltz, the flamenco calls for expertise and experience commensurate with the rhythmic change-ups involved. Given the political uncertainties in both Europe and the United States, the markets will be subject to the same abrupt changes in rhythm. The increase in public deficits remains the key factor, but the way these deficits will be financed will dictate the tempo of the stock markets this year. Mastery of the flamenco will be vital to negotiating a year that we still expect to be positive, but more complex.

Almost all asset classes trended positively in 2024. US equities and gold have proved particularly strong, with price increases of over 20%. But European and emerging assets are struggling to stay in step.

Performance of asset classes in 2024.
Apart from commodities, the prices of all assets increased, but US equities and gold stood out in particular.



Source: Bloomberg, Edmond de Rothschild Monaco.

These positive trends are all the more striking given the backdrop of war in the Near East and Ukraine, political instability in the core European countries of France and Germany, and a serious economic slowdown in China.

In another key development since the start of the decade, the United States' role in the economic and financial system has strengthened once again, with the country attracting ever more capital from around the world. The United States accounts for 26% of global GDP but a full 75% of global market capitalisation.

THE CONSEQUENCES OF POPULATION AGEING

The decisive factor in today's economic policies is population ageing in developed nations and China. With the downward trend in the economically active population, fewer people are contributing to the income of the overall population. At the same time, national healthcare, pension and defence commitments are rising year after year. To solve the riddle, governments have one of two, non-mutually exclusive choices: increase public debt or take in more migrants to boost the economically active population. But the latter option comes at a political cost. Playing the public debt card is often much more straightforward than advocating a proactive migration policy. Which means that we can expect an almost ineluctable increase in public debt in developed countries in the coming years, from what are already consequential levels. Public deficits have always existed, but the current decade stands out through the scale of increases in public expenditure. The United States, the world's largest economy, has had an average annual deficit of 8.7% of GDP since 2020. Admittedly, this period includes the exceptional stimulus measures introduced in response to COVID, but forecasts suggest that the trend is set to continue, with the generally optimistic forecasts of the US Budget Department pointing to annual deficit increases of well over 6% in the next ten years.

THREE-STEP WALTZ: FINANCING DEFICITS WITH MONEY YET TO EXIST FAVOURS THE VALUATION OF RARE ASSETS.

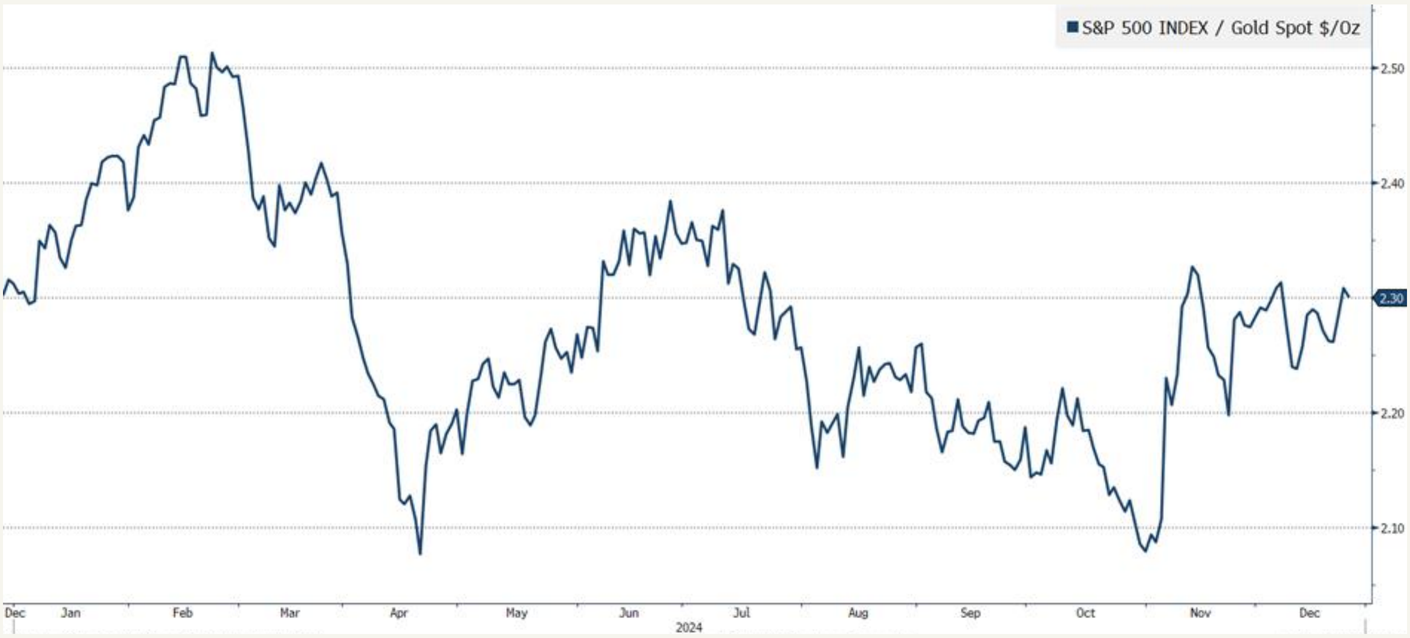
It is hard to dissociate the increase in public debt from the increase in money circulating in the economy. Creating money to subscribe to new government bonds remains a go-to option. Politically speaking, it is much easier than raising taxes or forcing the private sector to sell other assets, because the side effects are far less visible.

But doing so makes it harder to convert this money into goods and services or financial assets. Monetary inflation, then, is not a mere rise in prices; it diminishes the capacity of the money in circulation to be converted into goods and services. Naturally, inflation serves to boost the valuation of any assets that stand as a bulwark against the loss of this monetary capacity, specifically rare and durable assets. Gold is the quintessential asset in this respect. On the financial markets, this is reflected primarily in the increase in the price of gold and that of the stocks of top-flight businesses producing unique goods and services.

It should be noted here that we are talking about monetary inflation rather than real inflation. This is a vital distinction, because if the quantity of newly created money remains in the financial sphere, only the valuation of the financial assets will increase without that of the goods and services of the real economy being affected.

This situation was fully illustrated in 2024. In the United States, while the public deficit increased by 6.5%, US equities increased by 25%, with a particularly strong performance by tech stocks. But if equities had been valued using gold rather than the dollar, their price would hardly have changed! This is monetary inflation. Valued in euros or dollars, high-quality equities and gold are thriving in today's environment and proving a godsend for their owners.

Trend in the S&P 500 index valued in gold. In dollar terms, US equities gained 25%, but in gold terms, they remained at the same level as at the beginning of the year. The increase in money in circulation largely explains the increase in stock market prices.



Source: Bloomberg, Edmond de Rothschild Monaco.

DEBT IS RISING LINEARLY, LIQUIDITY ERRATICALLY

Consequently, public debt is rising, and so is liquidity. This configuration strengthens the close relationship between liquidity and the valuation of top-quality financial assets.

Public debt is rising at a linear, and now predictable, pace of 6% to 7% a year. But the pace of monetary creation is entirely different, In 2023 and 2024, liquidity reserves were plentiful (via the reverse repo market) and the deficit could be financed without investors having to sell other assets. But this will not be the case in 2025. The excess liquidity having served to drive equities and gold has now dried up. And it is precisely this change in pace in monetary creation that suggests that 2025 will not be a simple continuation of 2024.

Liquidity will be created in an erratic fashion and will lead to episodes of greater volatility than in 2024.

But make no mistake: top-quality equities and gold will rise over the long term so long as public deficits are funded primarily by an increase in monetary creation.

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The excellent performance in the last two years of US assets in general and US equities in particular has been driven by three factors: the highly promising investment theme of artificial intelligence; abundant monetary liquidity; and the prospects of rate cuts by the US central bank. But these three factors look set to falter in 2025.

1- While AI remains by far the most promising activity in terms of company revenue and income, the market valuation of the sector has rarely been as high as today. And we know that these heady price levels are above all a reflection of a particularly generous environment of monetary liquidity. This is no longer true in 2025.

2- In terms of liquidity, the reverse repo market, which served to fill gaps in public financing needs without having to draw on household and business savings, has dried up. With no new liquidities, any increase in the value of assets will prove complicated and volatility is expected to make a comeback.

3- Inflation looks to be starting up again in the United States, preventing the Fed from continuing the rate-cutting cycle expected by the market. Only two cuts are expected now in 2025. This means that dollar-denominated money-market rates should remain above 4% for most of the year. Here again, calling rate cuts into question also calls into question the pace of the increase in the valuation of financial assets.

Ultimately, while we think that “monetary anti-inflation” assets will continue to thrive in the coming years, 2025 looks set to be less favourable for US equities than the 20% annual increases to which we have grown accustomed in the last two years. And while AI still holds the most attractive growth prospects, the sector’s high valuations are limiting any price growth potential in the short term. Given the less favourable monetary environment and the future US president’s potential fiscal reform for businesses, we think the leadership of the equity market could shift over the course of the year in favour of businesses with smaller capitalisations.

This view is underpinned by a further phenomenon. The contrast between the strong economic momentum of the United States and the slowdown in Europe and China left few doubts as to the preferred geographical region in 2023 and 2024. US assets, including the dollar, are the world’s most attractive and, for now, US equities remain our preferred investment vehicle.

But it is highly unlikely that the situation will not change in Europe and Asia. Economic slowdowns and increased political risks generally spur public authorities to take action. It is more than likely that European and Asian government will implement measures of monetary stimulus (in the shape of rate cuts and increased liquidity) or fiscal stimulus (increased public deficits) in 2025. Which would make it a good time to reallocate capital to these regions, whose valuations are much more attractive than those in the USA.

In bonds, we expect yield curves to steepen, with long yields recovering and short yields weakening. This situation calls for a conservative approach on duration, which is why we are favouring short- and medium-term debt maturities in euros and dollars.

A key aspect in bond risk is that when a country takes on debt, it transfers liquidities to the private sector. Under these conditions, and with more money in circulation, the general risk level for corporate bonds diminishes. This is not expected to change in 2025. The phenomenon can be seen clearly in the remuneration premiums provided by corporate bonds relative to government bonds with the same maturity. The lower the perception of risk, the lower the premiums. In this respect, they are much less attractive than they were two years ago. In the United States in particular, credit spreads are trending at historically tight levels. However, we consider that the yields offered (over 3.5% in euros and 5.0% in dollars) are higher than those of inflation and thus sufficiently attractive to purchase. By favouring short maturities, we are benefiting from an attractive return on investment while limiting the risks of substantial variations in prices.

And now to gold, the price of which is increasing constantly. Gold continues to trend upwards, hand in hand with the increase in public deficits and, above all, monetary liquidity. As with high-quality equities, we expect another positive year in 2025. But once again, today's extreme uncertainties over how public deficits will be financed leave the door open to more erratic fluctuations. Gold and equities are highly liquid financial assets that are sold primarily to address urgent cash-flow needs. These hiccups, almost non-existent in the last two years, are exactly what we expect in the coming year. Our strategy is aimed at buying weakness.

In the middle of a flamenco dance, feeling the "compàs" means adapting deftly to the abrupt change in rhythm. This will be the keyword in 2025.

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Chief Investment Officer