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The Navigator

January 25

T2025. I'll be back!

By Edward Lim, CFA

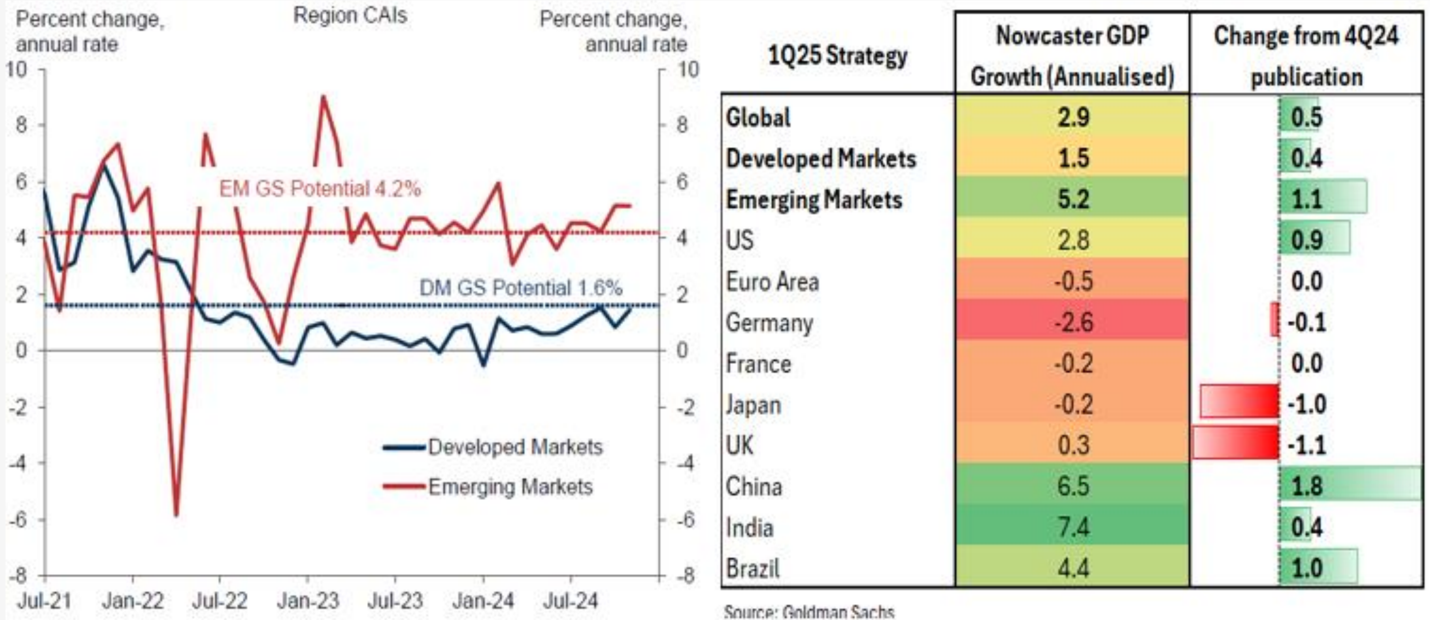
Nearly forty years after its debut, when asked by the British Film Institute about the origin of The Terminator, James Cameron recalled he had a vision that would spark one of cinema's most enduring sci-fi sagas. He described lying feverishly ill in a cheap pensione in Rome in 1981, haunted by the image of a chrome skeleton striding out of a wall of fire. What is less commonly known is that The Terminator was shot on a shoestring budget of just $6.4 million, so tight that the crew often could not afford proper permits or professional lighting. Instead, they staged guerrilla-style shoots, choosing spots where the streetlights matched the gritty mise-en-scene Cameron sought—yet these illicit efforts frequently attracted the attention of the police. At that time, Cameron himself was a virtual unknown, so strapped for cash he slept on a friend's couch and pawned his possessions to make ends meet. When production costs overran, he even surrendered his director's fee to ensure the film's completion. Stories like this reaffirm my belief that true greatness often springs from poverty, desperation, and an altered state of mind.

One can't help but draw similarities with the movie to the current geopolitical landscape spanning the return of Trump (model T2025) and his newfound friendship with the richest man on earth (Elon's Optimus and Neurallink). The onset of AI and its frightening progress towards singularity (Skynet), and the omni-presence of weapons of mass destruction (Judgement Day). But as a macro-economic strategist and not a futurist, and limited by imagination and intelligence, we will avoid hyperboles and instead focus on hard data and well-grounded economic theories as we navigate what will guaranteed be an eventful next four years.

We will keep to our time-tested framework ascertaining where we are in the growth, inflation, and central bank response of the investment clock and overlaying with "everything has a price" valuation lens. But for this addition, we will also focus on the two key issues of Trump's presidency that will have an impact on financial markets: tariffs and immigration.

Global growth ended the year on a strong footing with Nowcaster pointing to the global economy clipping at trend-like growth. But the narrative shared in last publication remains the same which is US exceptionalism presiding, but Europe and Japan weakening further. EM is helmed by China, Brazil and India which improved from the previous quarter. The disparity in growth trends does not present an imminent risk to capital markets but it does present vulnerability to Trump's tactic of using tariffs and his view on immigration.

Nowcasting points to a strong but uneven pace of growth heading into 2025



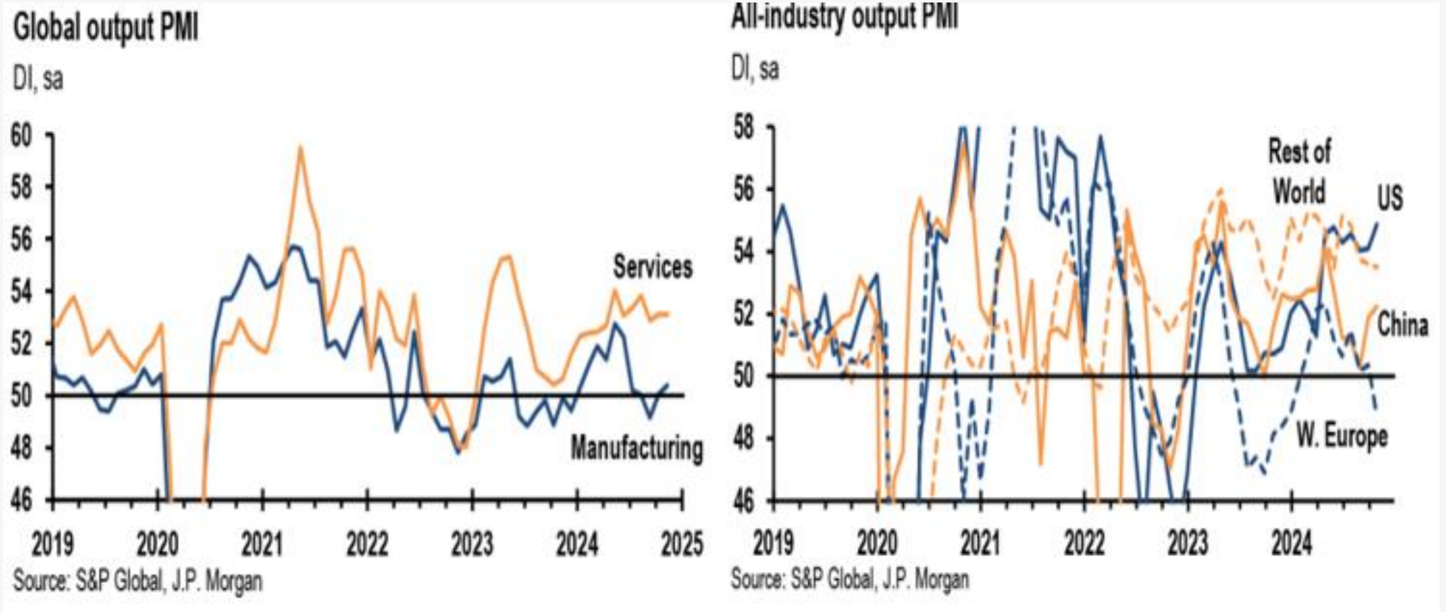
1Q25 Strategy	Nowcaster GDP Growth (Annualised)	Change from 4Q24 publication
Global	2.9	0.5
Developed Markets	1.5	0.4
Emerging Markets	5.2	1.1
US	2.8	0.9
Euro Area	-0.5	0.0
Germany	-2.6	-0.1
France	-0.2	0.0
Japan	-0.2	-1.0
UK	0.3	-1.1
China	6.5	1.8
India	7.4	0.4
Brazil	4.4	1.0

Source: Goldman Sachs

We have often relied on the PMI as a forecasting tool due to its universal application and acceptance, the consistent methodology used in its data collection, and its extensive historical record, which aids in regression analysis. However, in the post-COVID era, PMI indicators have frequently misjudged economic conditions, often predicting recessions that never materialized. Several factors explain why its reliability has diminished in recent times. First, the pandemic-induced supply chain disruptions, particularly during the first three years of COVID-19, may have undermined its effectiveness in signalling downturns in the manufacturing sector. Second, unprecedented monetary and fiscal policies introduced during this period could have obscured its predictive strength. Lastly, structural shifts—such as the growing prominence of the service sector in major economies and trade realignments following the retreat from globalization (marked by the 2018 tariff war)—may have further diluted its signalling capacity. Despite these challenges, we are not ready to abandon this method. We believe that many of these distorting factors are beginning to subside, restoring the PMI's forecasting utility.

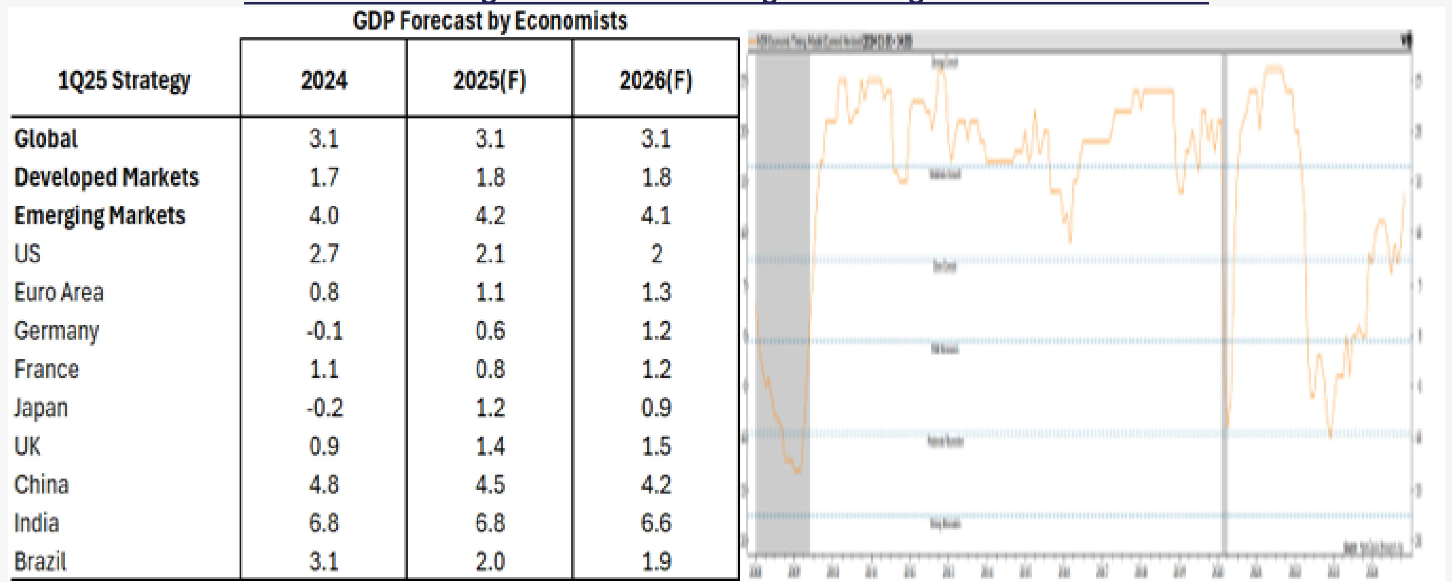
The latest PMI at 52.4 points to the global economy expanding at trend-like growth but the trend of resilient service sector but sluggish manufacturing sector prevails. Like the nowcasting model, PMI is also portending a divergent growth prospect with the US remaining strong, Western Europe deteriorating, and China trying to recover.

PMI is forecasting a robust but uneven growth environment



We also use forecasts by **economists to gauge GDP growth and their latest forecast for 2025 at 3.1%** paints the same picture as last year of the US helming global growth at a pace that is non-inflationary. EM as a group recovers even as China slows further, while Europe and Japan just eking out 1.0 to 1.2% growth. The Net Davis Economic Timing Model also corroborates the view of growth stability.

Other forecasting tools collaborating a stable growth environment



GDP Forecast by Economists

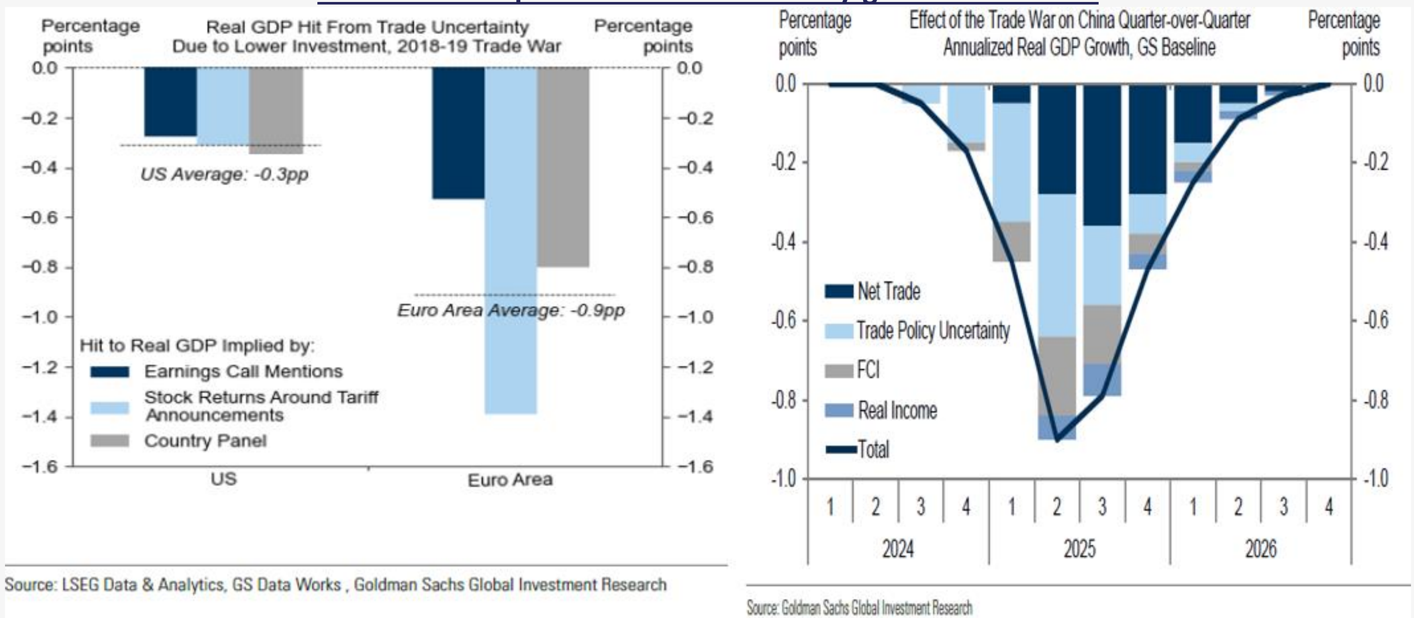
1Q25 Strategy	2024	2025(F)	2026(F)
Global	3.1	3.1	3.1
Developed Markets	1.7	1.8	1.8
Emerging Markets	4.0	4.2	4.1
US	2.7	2.1	2
Euro Area	0.8	1.1	1.3
Germany	-0.1	0.6	1.2
France	1.1	0.8	1.2
Japan	-0.2	1.2	0.9
UK	0.9	1.4	1.5
China	4.8	4.5	4.2
India	6.8	6.8	6.6
Brazil	3.1	2.0	1.9

Source: Bloomberg and NDR

But this Trump 2025, we should not be expecting same-as-usual. **This brings us to the first key issue; the most beautiful word in the world according to the incoming President, "Tariff".** Tariffs have both positive and negative impacts on growth. On the positive, tariffs protect domestic industries, increase domestic employment and investment, and over time can increase government revenue via the tax channels. On the other hand, tariffs can lead to higher costs for consumers, impacting growth through lower consumption, and lowering corporate earnings due to higher production costs, and can shield inefficient companies from competition. We do not know exactly what Trump will impose, and to who will he be imposing (case in point, his first salvo after election of including Canada in the list of countries that he will impose tariffs on was a surprise to the market), and we do not know how other countries will retaliate.

Nonetheless, we need to set out a base-case scenario. Based on what he has shared during the campaign trial, the base case is additional 10-20% tariff on all Chinese imports, a 60% increase for imports of Chinese autos, and a 10% increase for European autos. Complicating this analysis is that any enactment of tariff will also be likely accompanied by a modest fiscal easing including making his first term tax cuts permanent when it expires in 2025. The overall impact of these two counterforces is **global growth will slow down marginally but the impact will be most pronounced to China titling to just 4% in 2025, its worst pace outside of GFC and Covid. Japan and Europe will barely have any growth and ironically, US growth is lifted by a few ppt from current consensus forecast.**

First order impact: All will be hurt by global tariff war



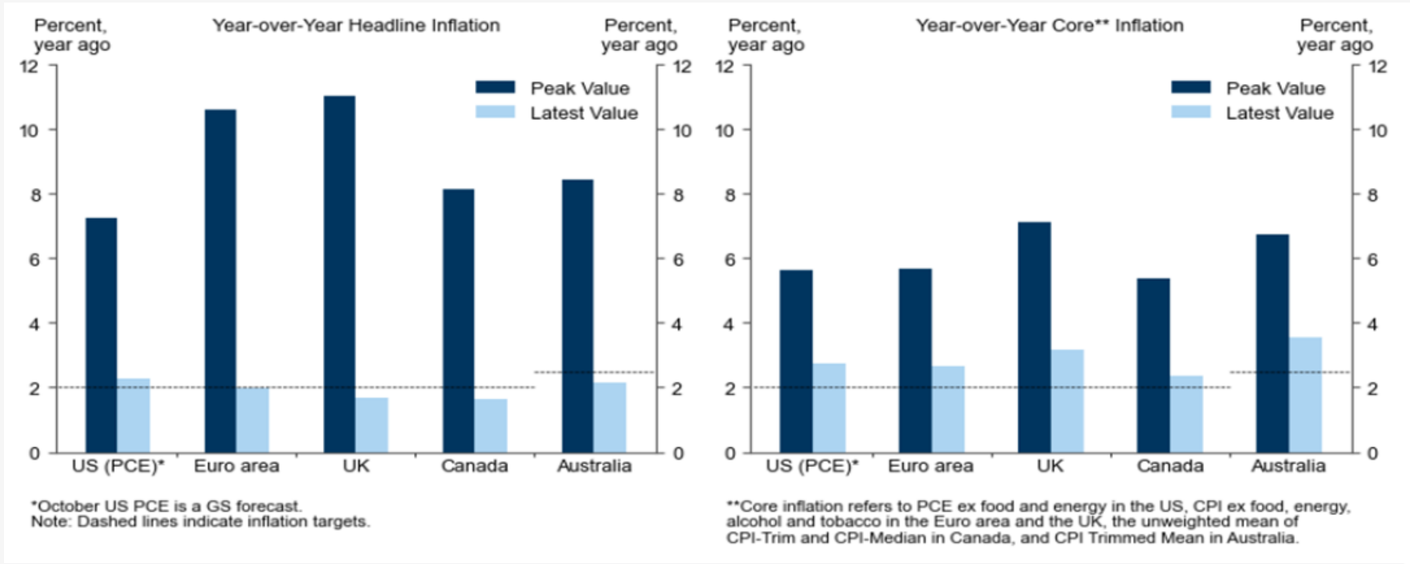
But fiscal easing could cushion impact: Still US benefits while RoW growth lowered

Assumptions on tariff	US GDP Impact	China GDP Impact	Europe GDP Impact	Japan Impact	Global GDP Impact
Tariffs on China (up to 60%) and auto tariffs increase for Europe and China. Modest fiscal easing via tax cuts	2025: 0.4 ppt ↑ with fiscal easing and tax cuts	2025: ↓ 0.5ppt; Could be cushion by large stimulus	2025: ↓ 0.2%; trade uncertainty hurts	2025: ↓0.3% It's auto export vulnerabilities.	Global at 2.7% in 2025, ↓0.4%

Source: Goldman Sachs and JP Morgan

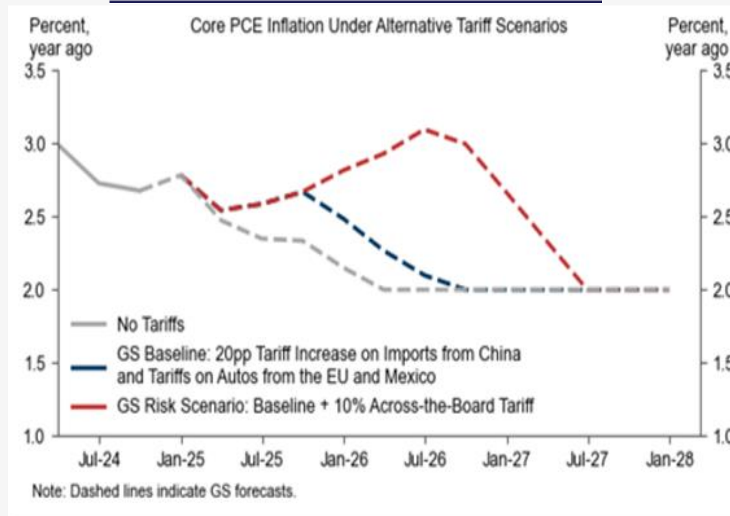
This leads to our next axis. **How will tariff impact inflation and how will central bankers respond to this?** Credit to the central bankers who have tightened monetary policy in the last 2 years despite being under intense domestic pressure. The latest data shows inflation in nearly all key regions is within their targets.

Latest inflation prints are within sight of central banks' target

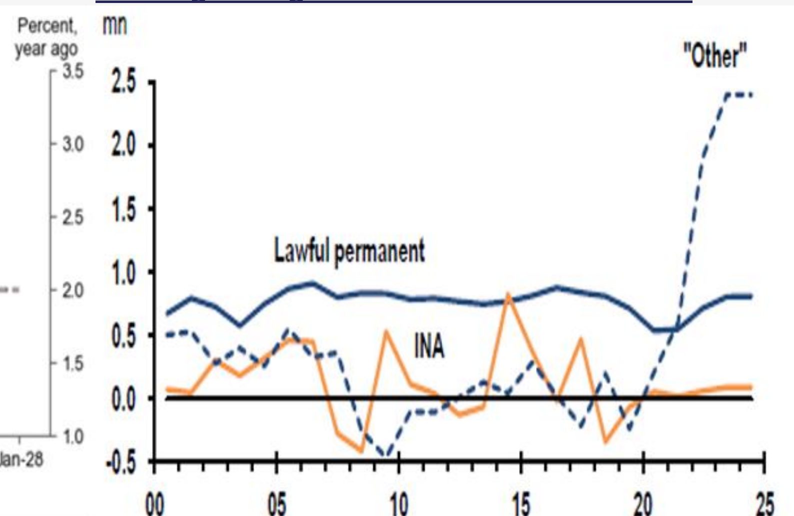


Tariff will have the most material impact on the US because all the other regions are net exporters unlike the US. The impact on inflation will again depend on the extent of tariffs imposed. In our base-case scenario, there is an immaterial spike in inflation towards the 2H25 and the path to 2% Core PCE will be delayed by 2 quarters from end 2025 to mid-2026. However, in the worst-case scenario of our base case plus 10% across the board tariff of all imported goods, inflation will reverse higher to 3% from 2H25 onwards and the path to 2% is pushed out till 2027. If that happens, it will present a significant quagmire for the Fed.

US Inflation could rise with tariffs



Curbing immigration could raise inflation



Trump's agenda to deport undocumented immigrants could have inflationary implications. When examining wage pressures across both high skilled and low skilled labour during and after the pandemic, it is the low skilled wages that had a more pronounced rise in the early part of the pandemic. But in the latter part, they fell more quickly as th e influx of unskilled workforce flooded into the US market. We have consistently maintained that inflation is likely to decline with two of its three primary drivers—wages and commodity prices—reverse course, as we have written in The Last Mile. Our confidence in the moderation of wage growth comes from a combination of slowing jobs creation and labour supply increasing. This gap between jobs and workers availability has already normalised to pre -pandemic level.

If there is a drastic reverse of this pool of labour, wage inflation could rise again. A deportation of 1mn immigrants a year would decrease the labour force by 0.5% and if he conducts his campaign pledge of deporting 15 to 20 million undocumented immigrants that would lead to a 5 to 7.5% reduction in the workforce. A tighter labour market translates to higher wage inflation.

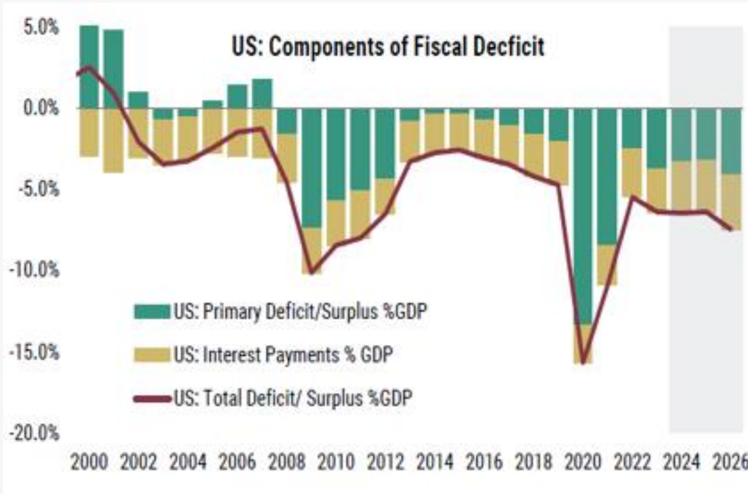
Even though tariffs and reversing immigration flows can impact inflation and at margins are bad for growth, a Trump presidency in 2025 could bring countervailing forces that may bode well for economy. Deregulation has the potential to invigorate corporate animal spirits fostering increased investment and M&A. Moreover, if the "DOGE" initiative implemented as outlined, the U.S. could stand out as the only Western economy with a concrete plan to reduce government deficits and curb its debt growth. Additionally, should Trump pursue his "drill, baby, drill" energy agenda, the U.S.—already self-sufficient in oil—could strengthen its position as a major oil exporter. This could lead to a significant reduction in pump prices, which is still 15% higher than pre-pandemic levels. Lower energy costs would bolster consumer wealth and provide a meaningful boost to economic activity. It is too early to judge the Trump 2025. He could be the saviour US, and the world are clamouring for even as they do not recognise that yet.

Asset Allocation Strategy

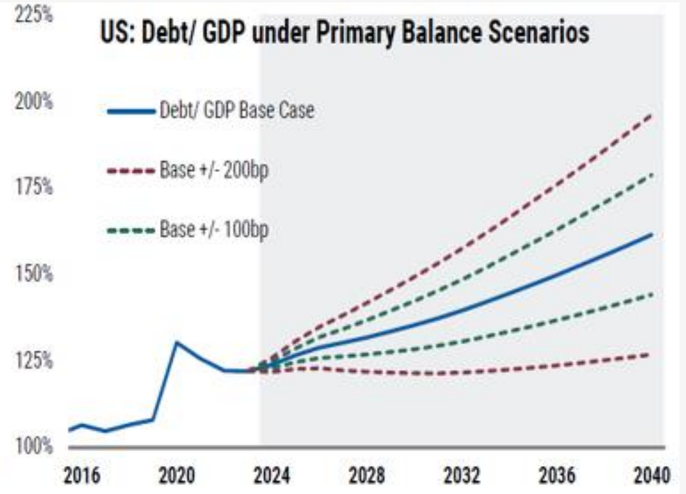
While our current baseline is trend-like growth, against a benign inflation allowing central banks to ease further, we recognized there is a high level of uncertainty to these assumptions, both on the up and downside.

Fixed Income: Downgrading to Underweight. The first order effect of our downside risk scenario of higher inflation stemming from tariff and immigration is it will affect treasuries more than equities. Furthermore, bond buyers are already casting aspersion to the sanctity of the USD hegemony given that US Debt/GDP is already at 123% and is running a primary deficit of 4%. If no policies are enacted to rein in spending and/or raise revenues (DOGE to the rescue?), its Debt/GDP will rise to 130% and its primary deficit will double to 8% by 2030. Put it in another way, the US is now adding $1trn of debt to its existing $36trn every 100 days. When you combine the inflationary effect of tariffs and immigration outflow, and interest rate was to rise by 2% from current level, it will dramatically increase its Debt/GDP to 150% by 2030. This is again negative for Treasuries.

US fiscal deficit to worsen if nothing is done

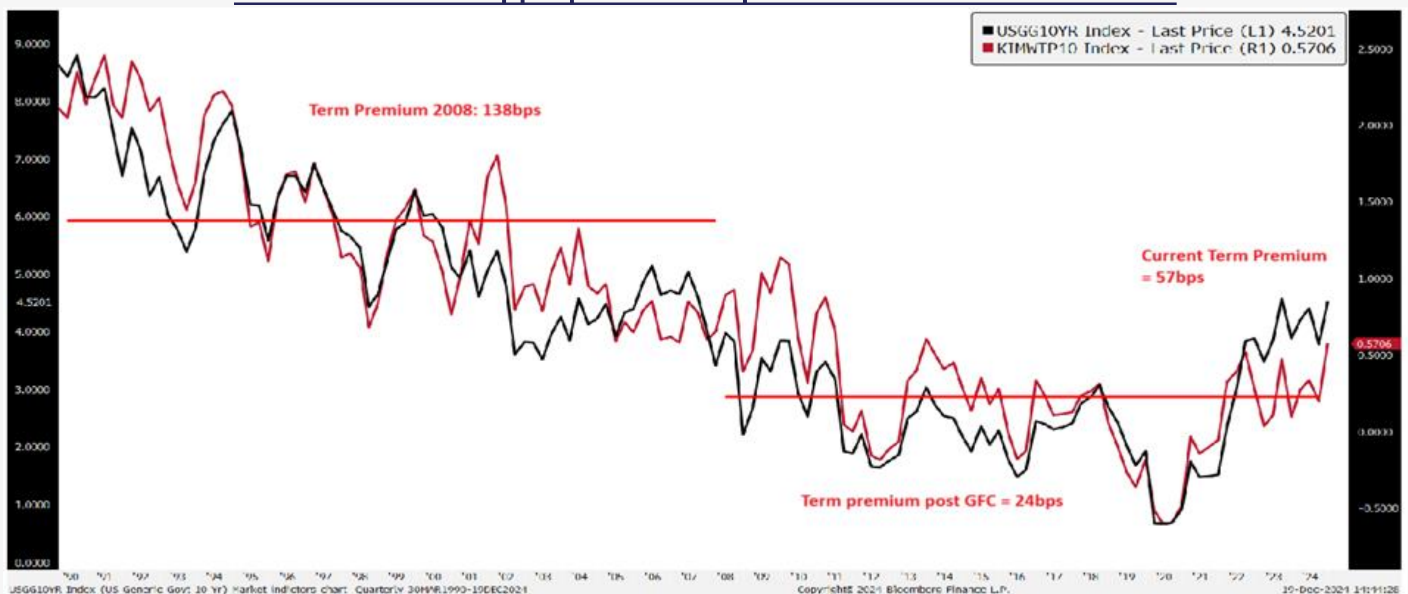


Debt/GDP is susceptible to interest rate



The bond vigilantes will start to call time on US status as the reserve currency of the world and we have written in detail in Now I know when I must retire. **This brings up the issue what should be the term premium for US government bonds in the long run – which is a risk that is more pertinent to bonds than equities.** Post GFC, US term premium has averaged 24bps. However, it has since risen to 57bps as the market begins to scrutinize its debt sustainability. And if we were to look at US Treasuries term premium from 1990-2008, it used to trade at 138bps in a period when the US economic growth trailed rest of the world especially with the emergence of China. We know from various studies from the World Bank and IMF that high level of indebtedness slows growth in the long run. If so, should the US Treasuries term premium trade closer to 138bps? We don't quite have an answer to that yet, but we know according a higher term premium equates to a higher yield for US Treasuries.

What should the appropriate term premium of US Treasuries be?



Source: Bloomberg

In our previous Navigator, we have highlighted the difference in performances between a shallow vs aggressive easing cycle using empirical data since 1970. In a shallow cycle aka recession is averted, US10 yield tend to rise 88bps 12 months after the first cut and the probability of US10 yield rising is 75%. In an aggressive cycle, yields fall most of the time (80%) and compressed by 130bps. **Given our view that the US economy should grow at trend in 2025, further collaborated by December's FOMC rhetoric that conveys shallower cuts as implied by the Fed dots, the most likely path is for US 10 yield to rise in 2025.** We have exited our long-dated US Treasuries completely and will be more judicious trading our new US10 yield range of 4.0% to 4.75%. Key is to keep the overall duration of the fixed income portfolio short for 2025.

In a shallow cycle, corporate credit spreads can narrow by 16bps and often credit spreads do compress (75% of the time). **This supports our view to retain our investment in credit while eschewing Treasuries.** The yields on investment grade corporate credit is above 5% and Emerging Markets 6.7% do provide sufficient carry to counter the risk of rising yield. With the duration of our overall fixed income portion at only 3.7 years, we believe our fixed income portfolio is quite insensitive to the risk of rising US yields. Case in point, our Global Investment-Grade Portfolio is up 3.4% despite the US 10 yield rising 70bps year-to-date due to the buffer of a high coupon and holding a relatively short duration, while our EM credit manager is up 7.7% even though Dollar index strengthened by 6.7% this year. Furthermore, with yields at these attractive levels, holding corporate credit does provide a hedge to inflation and is also higher yielding than prevailing fixed deposit rates.

In a shallow Fed easing cycle, 10 yield rises while credit spread compress

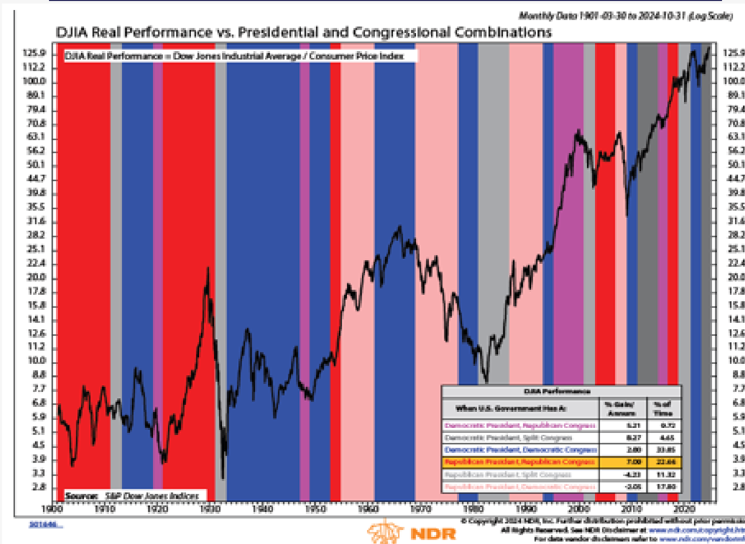
	12 months returns after first cut in Shallow cut cycles	12 months returns after first cut in Aggressive cut cycles
Change in US10 (Average)	87.8	(130.0)
% Spread Compressed	25%	80%
Max Compression	(181.0)	(401.0)
Change in Credit Spread (Average)	(15.5) - Narrow	41.8
% Credit Widen	25%	80%
Max Credit Spread Widen	(79.0) - Narrow	90.0

Source: Bloomberg

Alternatives: We advocate for a prominent inclusion of hedge funds in investment portfolios in the current landscape that is marked by uncertain economic policies and complex central bank strategies amidst ongoing global tensions. Our fund of hedge funds has consistently achieved its primary objectives: delivering respectable returns —with an annualized return of 11.0%, while maintaining low volatility at only 3.5%. It has experienced a minimal drawdown of -1.6% (which was the first month of its inception in Oct 2023) only and a swift recovery by the third month. Additionally, the fund demonstrates a low correlation with traditional asset classes, recording correlations and betas of 0.56 and 0.13 with equities, and 0.17 and 0.10 with bonds, respectively. We encourage you to consult your wealth manager to explore how this investment solution can complement your portfolio.

Equities: Neutral with an eye to neutralize our underweight in the US when valuation is more attractive. It is important to highlight a Republican Sweep tends to be bullish for equities. While it does not happen often (23% since 1900), five out of the seven terms, the US equities market ended higher. It is the 2nd best return outcome of 7% annualized return while a Democrat President working with a split Congress returned 8.3%pa. It is also important to note that a less aggressive Fed easing cycles also portend to better return outcome with 100% of the time returns are positive at an average return of 21%. The S&P has so far risen only 7.5% since the Fed first eased in Sep 2024.

Red wave is the 2nd best outcome for equities



Always +ve returns in a shallow cycle

	12 mths returns after first cut in Shallow cycle	12mths returns after first cut in Aggressive cycle
SPX Return Average	20.9	(1.4)
% Returns Positive	100%	60%
Maximum Loss	NA	-23.91

Source: Bloomberg and NDR

But does high valuation and substantial returns of the previous year mean the forward year of equities return will be poor or worse negative? The good news is there is little to suggest that following year returns will be much lower or negative after coming off the back of a strong performance in the prior year. Using data since 1929, Goldman Sachs illustrate if the previous year's return is more than 20% (the S&P returned more than 20% in 2023 and 2024), the median return for the following year is 13%. The return dispersion is also skewed positively with 10th percentile in low single digit negative returns while the 90th percentile is skewed above +20%. However, **if the starting point of valuation is expensive, the median return for next year can be negative though the dispersion is evenly skewed with +/- 15% at the 25th and 75% percentiles.** By all counts, US and Global equities valuations are expensive but these two findings underscore our view to stay neutral rather than tilting bearish.

Strong past year's returns (<20%) does not mean next year's returns will be weak

But high starting valuation challenges next year return paths

In the last two years, we have argued high valuation has been the bugbear and yet equities have massively outperformed all assets classes, even private equities and global real estate during this period. **The two key conditions for equities to generate positive returns even if it is expensive is for earnings to grow and more importantly is for earnings forecast to be revised upwards – our delta of change argument.**

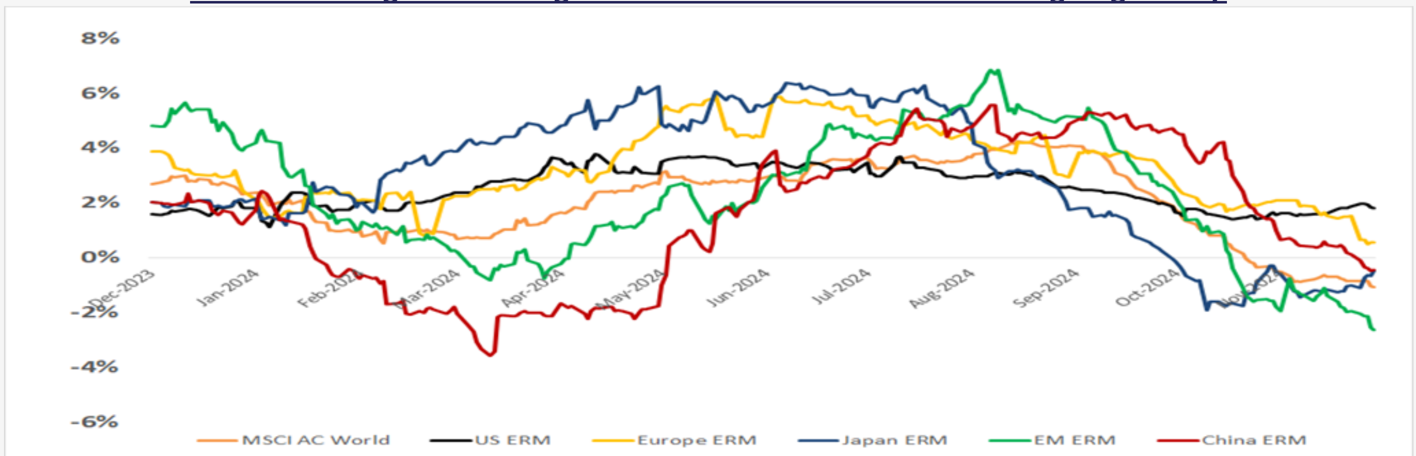
As illustrated in the table below, **US markets remain relatively expensive compared to the rest of the world.** The S&P 500 and NASDAQ are currently trading above their +1 standard deviation levels from the past ten years, likewise for the MSCI World Index. However, **consensus forecasts suggest growth in 2025 will be faster than 2024**, with projected gains of 10% for MSCI World, 12% for the S&P 500, and an impressive 21% for NASDAQ. Notably, US markets are expected to outpace the growth of many key regions, apart from India and broader Emerging Market (EM) equities.

Valuations are expensive but 2025 EPS forecasts look strong

	PE 2025	PE 2026	Std Dev (10 years)	EPS Growth 2025(F)	EPS Growth 2026(F)	ERM (3 mths)
MSCI World	18.4	16.5	1.3	10.0%	11.9%	-0.75%
S&P500	24.9	21.7	1.9	12.2%	11.9%	2.08%
NASDAQ	30.1	24.7	1.4	21.4%	21.8%	6.91%
Euro 50	13.5	12.4	-0.8	5.8%	8.9%	0.41%
FTSE UK	11.4	10.6	-0.9	3.5%	7.2%	1.99%
Topix	14.8	13.6	-0.1	3.2%	9.2%	-0.69%
MSCI EM	11.9	10.5	-0.1	13.6%	13.2%	-2.06%
MSCI China	10.0	9.0	-0.7	8.8%	11.8%	0.09%
MSCI India	22.0	19.8	1.1	15.4%	11.0%	0.67%
Source: Bloomberg						

However, **earnings revision momentum (ERM) has shifted dramatically lower in the last 2 months.** ERM for MSCI World Equities and EM Equities are now negative. European equities ERM while still in positive revision, the momentum has turned negative. Japan equities remain in negative territory but are seeing incipient signs of moving back to positive. Only the ERM of US equities remains positive and momentum is stable.

Delta of change in Earning Revision Momentum is increasing negatively



Source: Bloomberg

History informs us to be especially cognizant that at high valuation, if earnings upgrades persist, returns can still be positive. But should downgrade in earnings occur, the return profiles is skewed to the downside.

History tells if ERM turns negative and at high valuation, forward returns suffer

MSCI ACWI Forward Return by Starting PE and Forward Earnings (past 20 years)							
		With Upgrades in Earnings			With Downgrades in Earnings		
Starting PE	# obs	3-mo	6-mo	12-mo	3-mo	6-mo	12-mo
Less than 13x	51	6 %	13 %	26 %	(1)%	(0)%	4 %
13x to 14x	32	4 %	9 %	19 %	3 %	3 %	3 %
14x to 15x	64	4 %	6 %	11 %	1 %	2 %	2 %
15x to 16x	46	4 %	9 %	15 %	0 %	1 %	6 %
Greater than 16x	48	3 %	5 %	10 %	(1)%	2 %	(2)%
Aggregate	**241**	**4 %**	**7 %**	**14 %**	**0 %**	**1 %**	**3 %**

Source: MSCI, FactSet, IBES, Goldman Sachs Global Investment Research

It is this reason the composition of our equities remains defensive. **We are underweight US equities because of its relative high valuation even though it has a better macro setup than other regions.** Within the US, much of our exposures are in relatively lower beta investments such as our long/short equities hedge fund, a growth-at-reasonable-valuation active ETF, utilities, healthcare, and consumer staples ETFs. Outside of them, our other key equity holding is in our in-house global equity portfolio that is US, tech and growth centric. The portfolio has navigated this AI boom well generating a cumulative return of 55% in the last two years compared to 45% for MSCI World Equites.

We have software sector as another attractive growth opportunity and will be looking for better entry points to re-enter the trade. Post election, we have seen CTOs surveys indicating they are willing to spend more on software and cybersecurity to harness AI as well as to counter increasing AI-driven cybersecurity attacks. The software ETF is expected to generate 2 years CAGR EPS growth higher than the broader market at 16.3%. After several years of generating inferior ROEs compared to S&P due to over generous compensation scheme and over-investment in human resources, we are witnessing greater discipline in these two areas and expect its ROE to trend back to its pre-covid level at 16-17% narrowing its ROE gap between S&P.

As for the Mag7, 2024 is another year of its stupendous outperformance. These seven stocks are now 33% of the S&P500 and contributed half of the index return; lower than 2023 where they contributed 65% of the return. **We believe their outperformance will continue in 2025 albeit at lower clip than the last 2 years.** First, their net income growth at 17.7% will continue to outpace the S&P 500 growth of 12.2% and 10.7% if we exclude the Mag7. Second, they will be even larger part of the index's cumulative net income rising from 24% in 2024 to 26% in 2025. Third, their contribution to the growth will still be material contribution 33% of 2025 index net income growth but lower than 2024 39%. As a group, they are not significantly expensive trading at 28x forward PE versus the overall market of 22x but delivering 5.5ppt higher net income growth, generate margins double that of the index's margins, and ROE 1.6x higher as well.

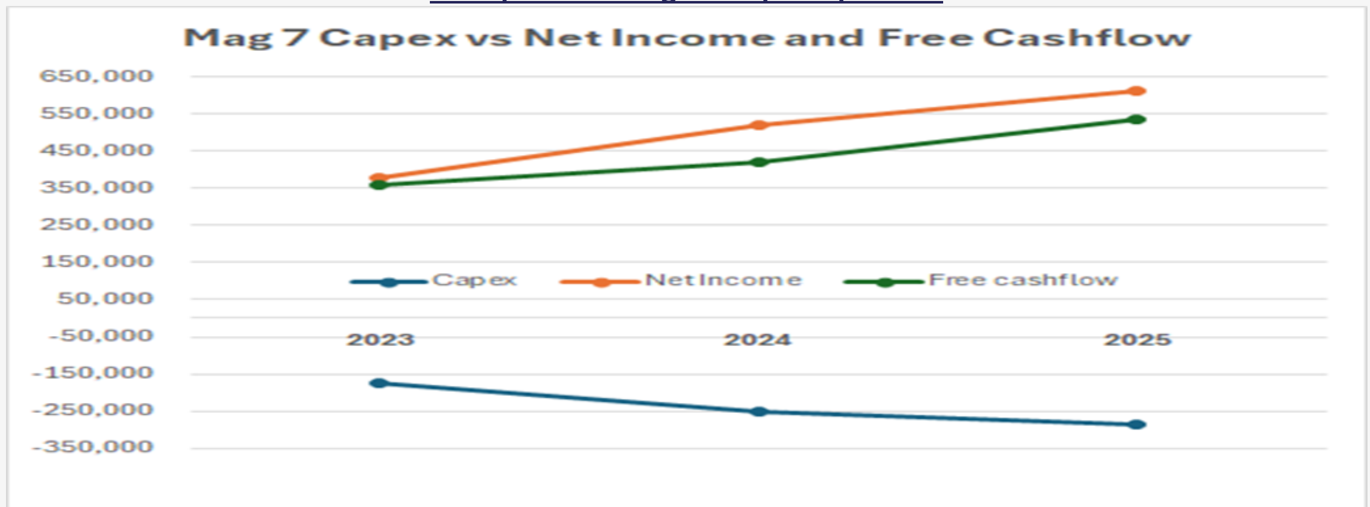
Mag7 remains significant contributor to index on all counts

	2025 Net Income Growth	% of Total 2024	% of Total 2025	Contribution to 2024 Growth	Contribution to 2025 Growth	Net Margin	ROE
Magnificent 7	17.70%	24%	26%	39%	33%	25.6%	28.5%
S&P 500 ex Mag7	11.40%	76%	74%			12.8%	17.8%
S&P 500	12.80%						

Source: Bloomberg

Lastly, we believe the pace of AI capex peaked in 2024 even as the quantum remains large. Despite spending hundreds of billions from 2023-2025, they are expected to still increase their free cashflow by 27% in 2025 (17% in 2024) to the tune of $534bn translating to a free cash flow yield of 3.8%!

AI capex still large but pace peaked

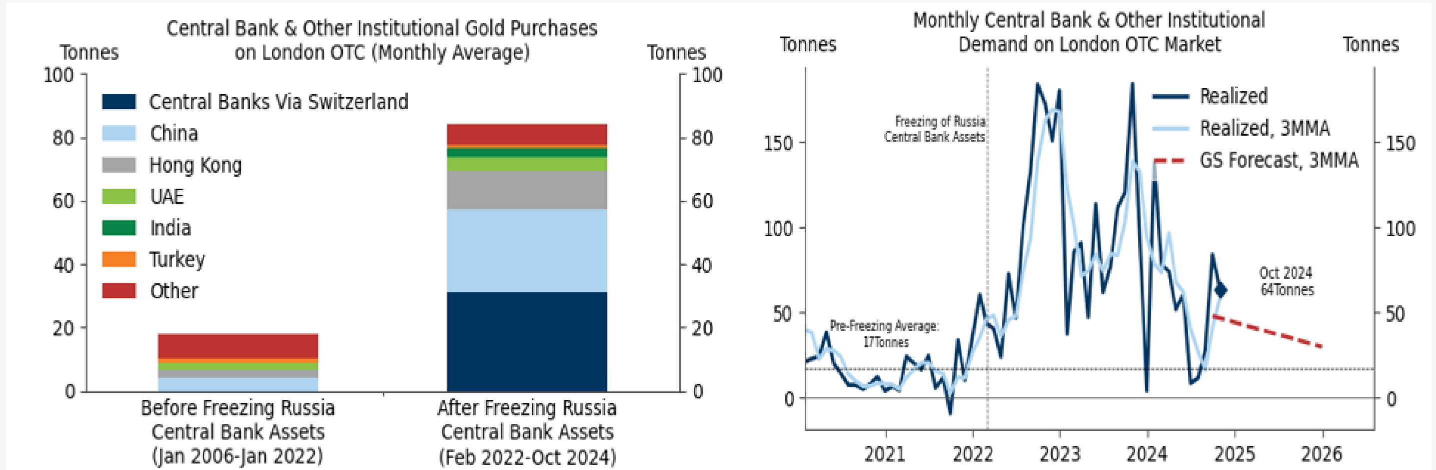


Source: Bloomberg

We have not made any changes to rest of the world with a slight overweight in Japan focusing on banks and improving shareholders' governance trades, an underweight Europe, and staying out of short-term trading in China (have a read in last quarter publication for more details).

Commodities: We have been bullish on Gold since late 2023, How difficult is it to sink a US aircraft carrier. Even though our long-term thesis of gold as a hedge to the USD losing its hegemony status does not change, in the shorter-run, we believe Gold will range bound between $2550 - $2750. The confluence of higher yields, stronger USD, and increasing price sensitivity of central bank purchases is hampering gold from establishing a new trading support above $2800. Retaining Gold but need to be patient with entry level.

CBs bought 4x since freezing out Russia **But delta of change has slowed**



Source: Goldman Sachs

Cash/FX: Cash remains higher than normal as we mark to market economic developments in Trump's first 100 days. We expect USD to strengthen moderately as well.

Featured Picture/Quote:

"Few still talk about the apocalypse, and they usually have a completely mythological conception of it. Strangely, they do not see that the violence we ourselves are in the process of amassing and that is looming over our own heads is entirely sufficient to trigger the worst." Rene Girard

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Risk Disclosure

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