Market Outlook

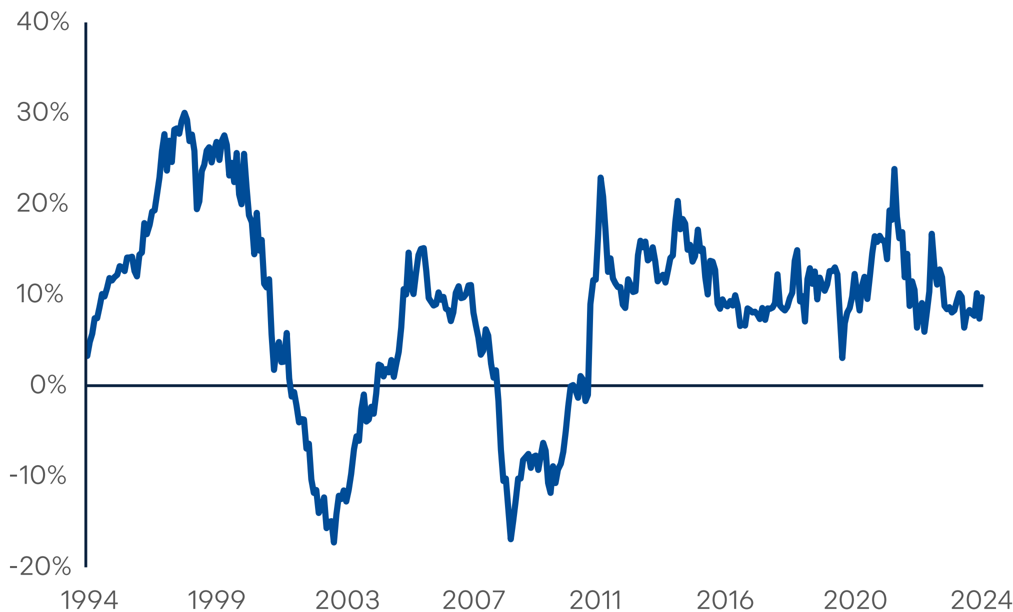
As we approach the midpoint of the 2020s, we think that one of the biggest questions on investors' minds is whether equity markets can continue to push higher after two strong years. Our view is that markets can continue to perform well in 2025, and we expect a number of key themes and sectors to continue to drive this performance, including:

1. Artificial Intelligence
2. Electrification
3. Reshoring
4. Consumer Strength
5. Obesity Drugs
6. Financials

Returns Do Not Look Stretched

One reason that we believe markets can continue to perform in 2025 is that the 3-year return for the market does not look stretched. As of the end of November 2024, the 3-year annualized return of the S&P 500 is 9.7%.[1] This is closer to the low end of the range that we have seen for the market in the years since the financial crisis, while the 3-year rolling return typically peaks above 20%.[1]

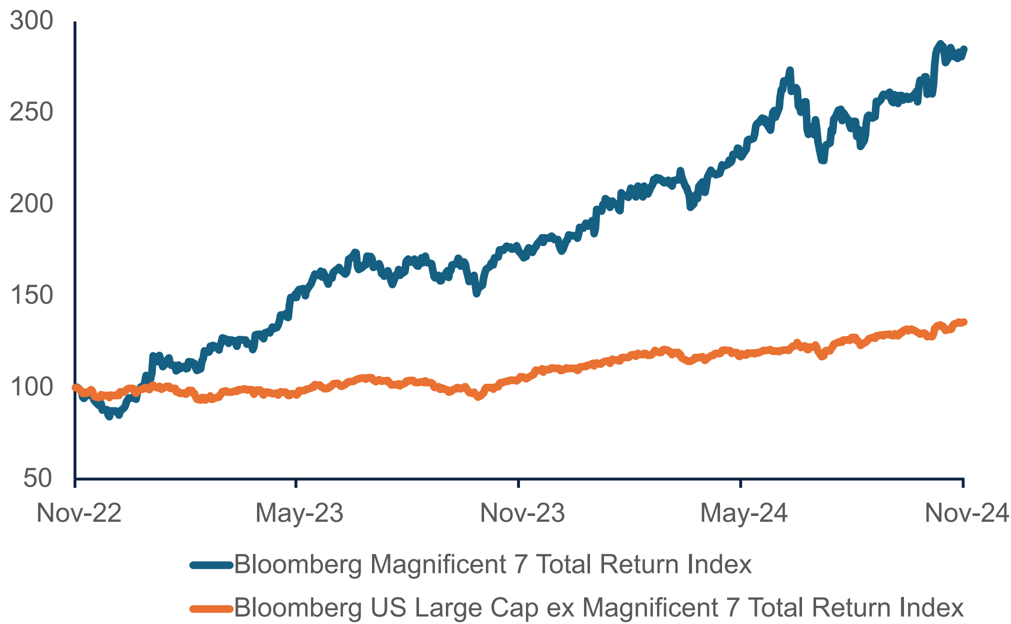
Rolling 3-Year S&P 500 Returns



Source: Bloomberg, December 11, 2024.

Furthermore, the consensus sell side forecast for 2025 is for the S&P 500 to get to 6,600, which would be a gain of 9.4% for the index level as of end of November 2024, while earnings growth is expected to be 12.2%.[1]

For 2025, we expect to continue to see a widening of breadth in the market. Returns over the past 3 years have been dominated by the "Magnificent 7" mega cap tech stocks, which have driven outperformance of market cap weighted indices versus equal weight indices.[1] We believe that this trend peaked in mid-2024, and we have recently seen outperformance from a broader group of stocks, including mid-caps, particularly on the back of the U.S. election results in November. While we are still bullish on the technology sector, broadening participation is positive for stock pickers and active management.



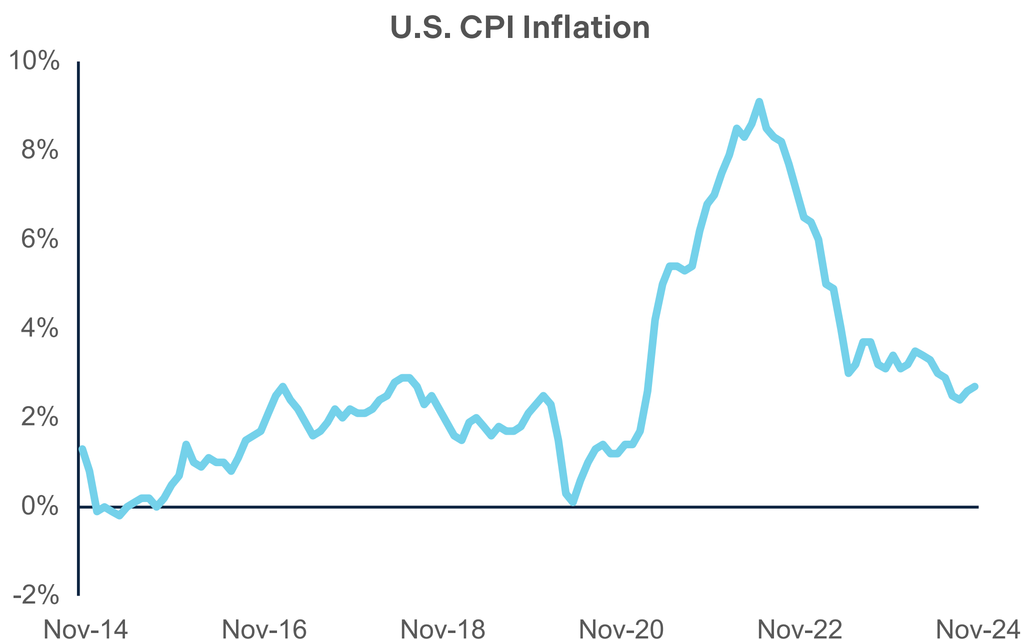
Source: Bloomberg, December 11, 2024. Rebased to 100 on November 30, 2022. Magnificent 7 Index includes Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta, Tesla.

Back to Normal

In terms of the economy, we believe that a soft landing has been achieved and that we remain on a path back to normal in terms of both inflation and interest rates. The U.S. 10-year yield has averaged 4.2% in 2024, and we believe it can continue to trade in a range that approximates nominal GDP growth, with consensus calling for 2.1% real GDP growth and 2.4% inflation in the U.S. in 2025.[1] We believe that the U.S. economy will continue to benefit from a strong consumer and continued growth in private sector capex, particularly around the themes of reshoring, electrification, and artificial intelligence.

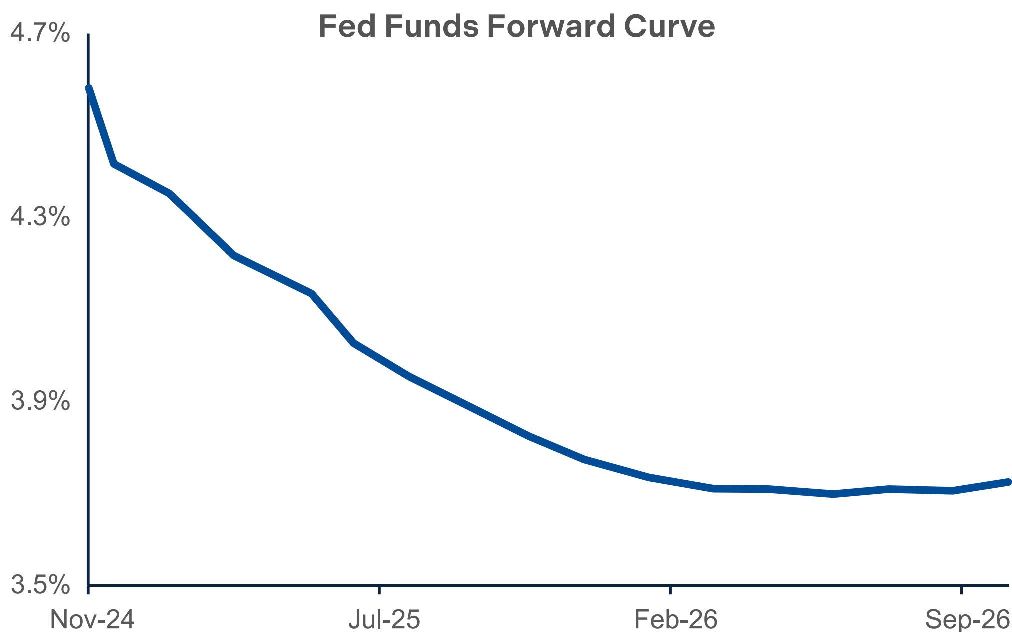
Source: Bloomberg, December 11, 2024.

The inflation picture continues to moderate with year-over-year inflation hitting 2.7% in the U.S. as of November 2024, while the market's forward-looking measure of inflation for the next two years is down to 2.5%.[1]



Source: Bloomberg, December 11, 2024.

Inflation remains slightly elevated relative to the Federal Reserve's (the "Fed") 2% target, so we expect the Fed to tread lightly with interest rate cuts in 2025. As of early December 2024, the market is pricing in 3 to 4 additional 25 bps cuts from the Fed, which would take the terminal rate to around 3.75% for this cycle.[1] Key risks to this forecast include the uncertain impact of Trump's policies, in particular the prospects for any new tariffs, which would likely be inflationary at the margin.



Source: Bloomberg, December 11, 2024.

Europe

We believe that the backdrop for European equities will be mixed in 2025. One major factor driving recent European underperformance versus rest of the world is the Trump administration's expected trade policies. However, we believe that the tariff threat will not be as bad as feared. The European corporate sector's exposure to the U.S. is about 26% on a revenue weighted basis; however, a significant portion of these revenues are from goods and services that are produced and consumed in the U.S. and wouldn't be subject to tariffs.[2] According to Morgan Stanley, only ~7% of European corporate revenues will be subject to any possible tariffs. Furthermore, some industries could be exempted from tariffs, either because of their strategic importance, such as defense and pharmaceuticals, or their high pricing power, such as aerospace. As such, we believe that the tariff panic on Europe could be less impactful than feared.

In our view, a bigger issue for Europe is its China exposure, where industries such as automotive, chemicals, luxury, mining, and semiconductors are vulnerable. China exposure will likely continue to drag on European corporate earnings growth on the back of weak demand and hawkish China-U.S. policy. Meanwhile, M&A volumes have picked from cycle lows, which should support equity valuations. In light of the above, we believe it will be a volatile market for European equities, and stock picking will become important with respect to alpha generation.

Key Themes For 2025

As we look out to 2025, we believe that the investment landscape will be dominated by key themes and that maintaining exposure to these themes will be critical to driving investment performance. Below is a summary of some of the key themes/sectors that we think will be important for 2025.

Artificial Intelligence

The Artificial Intelligence ("AI") revolution has been one of the dominant investment themes of the past two years. For 2025, we believe that we are entering another inning in the AI revolution given the pace of technological advancements as well as the development of AI applications and machine learning algorithms. At the same time, AI "hyperscalers" – companies that are building out the largest AI data centres – continue to invest at a rapid pace with capex among the top 4 companies expected to exceed $300B in 2025, according to Morgan Stanley.[3]

Hyperscaler Capex Estimates ($B)	2023	2024	2025
Amazon.com, Inc.	$52.7	$75.0	$96.4
Alphabet Inc.	$32.3	$51.3	$62.6
Meta Platforms Inc.	$28.1	$40.0	$52.3
Microsoft Corp.	$41.2	$74.1	$89.9
Total Hyperscaler Capex	**$154.3**	**$240.4**	**$301.2**

Source: Morgan Stanley, November 4, 2024.

Today's AI systems are becoming more sophisticated and one step closer to competing with human intelligence. Generative AI is poised to be a $1.3 trillion market by 2032 as it boosts sales for the tech industry's hardware, software, services, ads and gaming segments at a compound annual rate of roughly 43%, according to Bloomberg.[4] Mega cap tech companies have a significant number of AI patents, offer machine learning-as-a-service, and can leverage their large userbase in driving AI adoption. Large enterprise software companies have begun to offer intelligent decision-making capabilities in their software as well as intelligent automation. Leading chip manufacturers and related semiconductor companies provide the silicon building blocks that make AI possible.

Artificial intelligence has the propensity to disrupt the global economy over the longer term and drive the next leg of growth. AI could contribute up to $15.7 trillion to the global economy in 2030, more than the current output of China and India combined, according to a report by PwC.[5] We believe that AI transformation is three pronged:

1. Automation – creation of a new virtual workforce
2. Augmentation – AI can augment human labour
3. Diffusion – AI innovations could drive transformational changes in the economy (new industries, business models)

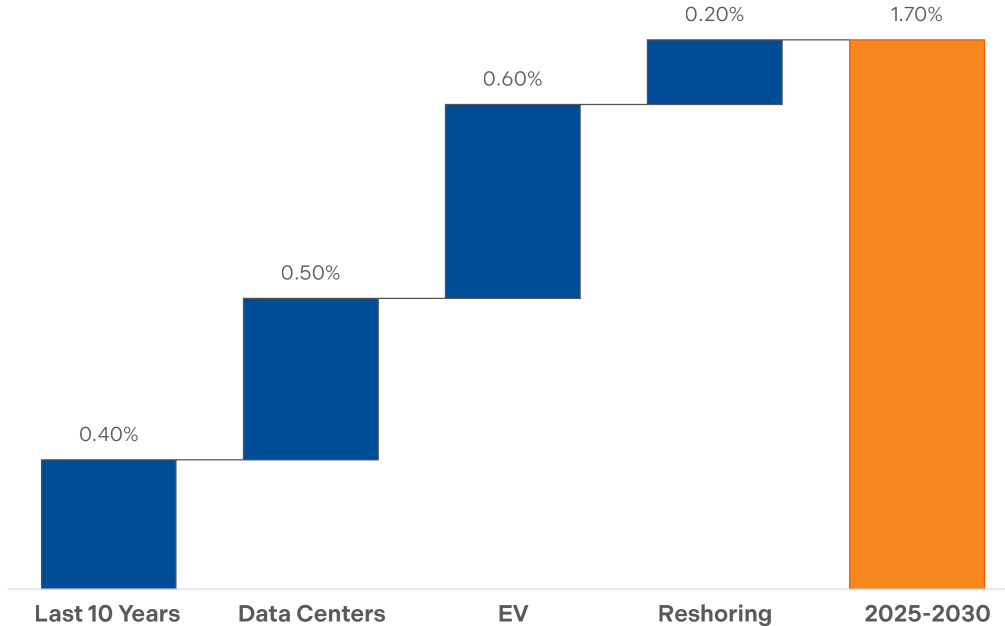
With the proliferation of AI, many are concerned about machines taking over human jobs. We believe that AI will in the near term co-exist with humans in the workforce, augmenting functionality, improving productivity and realigning the labour force towards more highly skilled jobs.

Electrification

Looking beyond traditional tech firms, power producers, utilities, natural gas producers, and industrial companies are poised to benefit from the AI revolution. AI is an extremely power intensive operation. One ChatGPT query takes almost 10x the amount of energy of a typical Google search and uses almost as much as keeping a 5-watt LED bulb on for an hour, while loading an AI image can take as much power as charging a smartphone.[6] Availability of power is currently one of the key bottlenecks in data center growth. Estimates suggest that data centers could reach 7.5% of total U.S. power consumption by 2030 vs 2.5% in 2022.[7]
One of the reasons we need so much power for these data centers is because servers generate a lot of hot air which needs to be cooled. The next gen AI chips require advanced cooling technology that traditional HVAC (air cooling) cannot handle. Liquid cooling is a far more efficient way to cool datacenters in excess of 30kW.[8] Currently the liquid cooling market is small but is seeing 25%+ compound annual growth rate, which is higher than the data center infrastructure market itself.[8]

After being nearly flat for two decades, electricity demand is expected to grow by 1.7% p.a. to 2030 potentially at a 2.5% CAGR out to 2050, according to Bernstein.[9] This massive growth in electricity demand poses challenges for power grids and emphasizes the need for energy-efficient technologies and increased investment in power generation and distribution infrastructure. This creates investment opportunities in sectors related to power generation and distribution. This includes utilities, renewable power producers, grid equipment companies and HVAC producers.

Expected Growth in Electricity Demand (2025-2030)



Source: Berstein Research, November 4, 2024.

Reshoring

The reshoring trend, which involves companies bringing manufacturing and production back to the United States, has gained significant momentum in recent years. This shift is driven by various factors, including supply chain vulnerabilities exposed during the COVID-19 pandemic, geopolitical tensions, and a growing emphasis on national security and economic resilience. Government support has played a crucial role, with legislation like the CHIPS Act and the Infrastructure Investment and Jobs Act allocating substantial funding to encourage domestic manufacturing, particularly in critical industries such as semiconductors and infrastructure.

There are several companies that benefit from these trends. These include firms in Infrastructure Construction, Machinery, Electrical Equipment and Factory Automation amongst others, as well as ancillary industries such as transportation, real estate and energy.

Consumer Strength

We believe that the consumer will continue searching for value in 2025, similar to what we have seen in 2024. This is largely due to moderating but still elevated inflation and declining household savings rates post-COVID. On the bright side, further rate cuts by global central banks should bode well for household budgets and thus boost consumer spending. Middle-income and high-income cohorts will likely keep driving overall retail sales. Furthermore, while demand for services remains intact, demand for goods is reaccelerating with early signs showing a strong holiday season.

Despite these tailwinds, the consumer sector faces challenges from political uncertainties and economic headwinds. Any incremental tariffs imposed by the Trump administration will weigh on companies with goods imports from China. This will likely be compounded by reduced pricing power in the sector as we believe that most companies will struggle to adjust pricing with inflation continuing to trend lower. Strong volume growth while maintaining margins will be the key to differentiating winners from losers in 2025.

Heading into the new year, we remain selective within the consumer space and slightly prefer discretionary over staples, as discretionary generally benefits more from lower interest rates and deregulation, and also shows lower sensitivity to a strong U.S. dollar. Meanwhile, we are cautious on names that are tariff sensitive as well as those that are too exposed to China. Despite compelling valuations, staples are likely to lag the market as the leadership continues to shift away from defensives.

Obesity Drugs

The market opportunity for anti-obesity drugs is shaping up to become one of the largest pharmaceutic therapeutic categories. Recent innovations have produced medications that mimic incretin hormones (gut hormones that aid in digestion and blood glucose control). These medications are classified as incretin mimetics and include glucagon-like peptide-1 (GLP-1) and glucose-dependent insulinotropic polypeptide (GIP) which are approved for people with Type 2 diabetes and for chronic weight management in certain people. Incretin mimetics have demonstrated to achieve weight loss in the mid 20% range, approaching weight loss similar to what can be achieved with bariatric surgery.[10] The global market for chronic weight management is projected to reach $100 billion in 2030 up from $6 billion in 2023 according to Goldman Sachs.[11] The anti-obesity drug market is anticipated to be somewhat of a duopoly between Novo Nordisk's semaglutide (Ozempic-diabetes, Wegovy- chronic weight management) and Eli Lilly’s tirzepatide/Mounjaro (GLP-1/GIP dual-agonist).

We believe there is ample opportunity for other healthcare companies in the anti-obesity revolution. There are over 54 next generation anti-obesity medications in clinical trials or with positive phase 3 data according to Bloomberg.[12] These next generation weight-loss drugs seek product differentiation across a variety of factors including efficacy, side effect profile, combination potential, maintenance potential, route of administration, quality of weight loss (fat mass vs. lean mass). Beyond the drug companies, the anti-obesity theme is a tailwind for contract drug manufacturers, distributors, and tool manufacturers. As the anti-obesity revolution matures, we believe there could be disruption in the cadence in of hospital and medtech volumes, as a healthier population reduces the prevalence of obesity-related conditions. Looking beyond healthcare, the anti-obesity revolution could alter the dynamics of consumer demand for food, beverage, sports and leisure activities.

Financials

Following the Republican sweep in the U.S. election, the banking sector is poised to benefit from several favorable factors heading into 2025. Trump’s administration is expected to continue its strong push for deregulation, consistent with his first term, with new appointments to key regulatory agencies including the Securities and Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Consumer Financial Protection Bureau (CFPB). These personnel changes are anticipated to be more industry-friendly, leading to reduced oversight and regulation of banks. De-regulation efforts could include making changes to the Basel III Endgame re-proposal, potentially releasing US$86 billion in excess capital, as estimated by Morgan Stanley, and accelerating shareholder returns through increased share buybacks and dividend growth.[13] We also believe the recent FDIC merger guidance issued in September 2024, which broadened the scope of transactions subject to FDIC approval, may be rescinded or modified, facilitating an end to the logjam of pent-up consolidation in the banking industry and creating a more favorable M&A environment, with estimates suggesting up to US$700 billion (Raymond James Nov 12, 2024) in bank M&A deals.[14] Accelerating capital markets revenue will be a major growth driver for large cap U.S. banks in 2025, with capital markets players benefiting the most.

As the Fed continues to lower rates in 2025, deposit costs for banks are expected to drop further, and loan growth, which was sluggish in 2024, is anticipated to accelerate. At the same time, the yield curve is expected to steepen further, driving net interest margin improvements for banks. Overall, these factors—deregulation, increased capital markets activity and an improving interest rate landscape—will all serve as strong tailwinds for the banking sector in 2025.

[1]Source: Bloomberg, December 11, 2024.

[2]Source: Morgan Stanley, November 17, 2024.

[3]Source: Morgan Stanley, November 4, 2024.

[4]Source: Bloomberg, March 8, 2024. Generative AI races toward $1.3 trillion in revenue by 2032.

[5]PwC's Global Artificial Intelligence Study: Sizing the Prize, 2017.

[6]CNBC, July 28, 2024. How The Massive Power Draw Of Generative AI Is Overtaxing Our Grid.

[7]BCG, September 13, 2023. The Impact of GenAI on Electricity: How GenAI is Fueling the Data Center Boom in the U.S.

[8]RBC Capital Markets, June 21, 2023.

[9]Bernstein Research, November 4, 2024.

[10]Gou Y, Schwartz MW. How should we think about the unprecedented weight loss efficacy of incretin-mimetic drugs? J Clin Invest. 2023 Oct 2;133(19):e174597. doi: 10.1172/JCI174597. PMID: 37781919; PMCID: PMC10541183.

[11]Goldman Sachs, October 16, 2023.

[12]Bloomberg, March 5, 2023.

[13]Morgan Stanley, November 7, 2024.

[14]Raymond James, November 12, 2024.

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