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Global Equities:

Market Outlook 2025

After last year’s stellar return for global equities, we are experiencing similar returns in only the first 10 months of 2024.

Given the current market sentiment, continued US rate cuts and the highly likely prospect of a ‘soft landing’ US economy in 2025, we continue to expect ongoing market strength.

Key drivers of global equity markets in 2024

After last year’s stellar 23% return for the MSCI World (in AUD), we are experiencing similar returns in only the first 10 months of 2024. October added another 3.8% return for the index, which brought the accumulated total to more than 21% year-to-date.

Global developed markets have followed earnings expectations up until the end of 2022 (when the market bottomed), but since then we have seen a strong rally without seeing consensus EPS expectations moving up.

FY24 consensus earnings (blue) and the index price (white) of MSCI World in the last 3 years

Source: Bloomberg

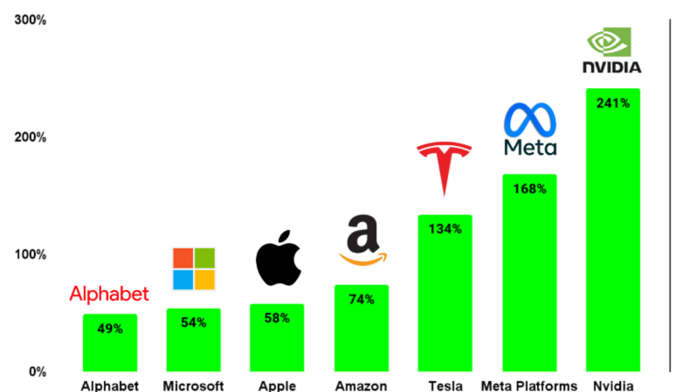
Not surprisingly, the forward P/E multiple of global markets has therefore significantly re-rated from a low of 14x at the end of 2022 to the current close to 20x level.

Market concentration levels are a factor, with the ‘Mega 7’ stocks becoming bigger in the index while trading on much higher multiples.

Another factor has been the declining inflation expectations where lower interest rates support higher multiples. However, this multiple expansion seems to be mainly driven by a general level of optimism.

Coming from the ‘sentiment lows’ of early 2023, where a recession was the base case for most investors, the outlook has certainly improved. It does however remain surprising that we have not (yet?) seen that translating into higher company earnings.

2023 “Magnificent Seven” Gains



Source: barchart.com

While the MSCI World index has seen multiple expansion, this has been mainly a US phenomenon. The chart on the following page shows the record 20-year multiple premium of the US over Europe. The earnings growth differentials and the fact that Europe does not have similar exposure to fast-growing sectors like IT, and hence less unbridled optimism, certainly explains part of this growing gap.

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Premium of the US over Europe

Source: Bloomberg

What will be the key drivers in 2025?

Having discussed the US election for months on end, the outcome was remarkably swift and decisive. The market subsequently reacted in a Pavlovian way and copied the playbook of the 2016 election outcome. This involved general optimism, based on a perceived lower tax, pro-growth, less regulation agenda that the Republican party has been selling. Sectors like Energy ('drill, baby drill'), Banks (less regulation) and Industrials (new investments outside of 'Green' technology) outperformed, as they did in 2016.

We do believe there is a material difference to 2016, due to the resounding 'Red sweep'. Trump will have the Presidency, the Senate and now The House.

On top of that, he has a very supportive Supreme Court that recently ruled to give almost complete immunity to any sitting president. One can also argue that the Republican Party has been transformed versus 2016, in that there is little to no diversity of opinion anymore.

In other words, there is a much higher likelihood that the Trump agenda will be implemented, which not only involves the abovementioned policies the market likes, but also several medium to longer term risks.

Key risks from the US election…

Tariffs:

Probably the most visible and quantifiable part of the Trump agenda, where especially China is targeted, but every trading partner will be faced with rising import duties. The obvious risk is the impact that tariffs have on inflation, as imported goods and materials increase in price which will be passed on to end consumers. The longer-term risk is the impact on global trade (and hence the economy) and the potential for retaliation, making things even worse.

Lower taxes:

While lower taxes are loved by the market, they inevitably lead to lower government income, higher budget deficits and hence higher government debt.

Despite the political rhetoric, there is little to no evidence that tax cuts 'pay for themselves'.

Higher budget deficits mean more bonds issuance and hence higher interest rates. The impact on the longer-term strength of the USD is also likely to be negative.

Immigration:

A highly political hot potato, but in reality, the US is very dependent on its immigrant workforce. The quoted plans to deport 20-25m illegal immigrants seems not only very impractical to enforce but will ultimately have a negative impact on the ability to hire staff. Especially in an economy with near record low unemployment figures, which currently sits at 4.1%.

Environment:

Again, leaving aside the political and environmental arguments, the proposed policies around energy and the environment will have far reaching consequences. Winners will be the fossil fuel industry; losers will be the renewable energy sector. The impact on the Environmental Protection Authority as a regulator and current subsidy programs like the Inflation Reduction Act (IRA) are still unknown. The IRA is a significant piece of legislation passed in 2022 which emphasizes a broad range of issues including climate change.

Geopolitics:

Given the current state of the world, with large scale conflicts in the Ukraine and the Middle East, a steady hand from the world's biggest power will be needed. Trump's track record, especially dealing with the likes of Russia, China and North Korea, has been less than encouraging so far in this regard.

American households have amassed significant wealth since the onset of the COVID-19 pandemic, fueled by soaring stock prices, rising home values, and increased liquid assets.

A key driver of economic resilience has been the health of the US consumer whose spending at aggregate levels has been strong. Consumer spending is the biggest component of GDP, accounting for around two-thirds of this metric. As such the continued health of the US consumer is key to the economic outlook.

Readers can view an in-depth report on the overall health of the US consumer and the potential implications for inflation, interest rate settings and the US economic outlook at USA Spend-tacular: A report into the health of the US Consumer.

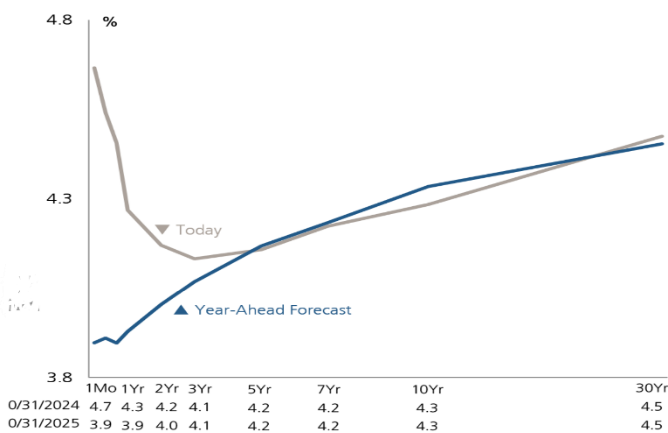
The equity market so far has taken the 'glass half full' approach with this change in administration. It is interesting however that the bond market has noted the risk of higher inflation from tariffs and potential higher supply of paper due to increasing deficits.

As a result, the US yield curve has shifted rapidly and materially in the last few months. Despite the very short end, where the two rate cuts of 75bp combined have impacted, the curve has moved up and is less inverse. The bond market is expecting to see a continuation of this trend in the next 12 months (see graph below), moving to a more traditional steepness in the curve.

The move in the USD has been less pronounced but has been up in general since the election. We have seen a more traditional 'flight to safety' on the first day after the election, where the USD jumped 1%+ against most other major currencies.

The longer term impact from isolationist policies and higher budget deficits points to future pressure on the USD, but we do not see this as a significant risk for our portfolio.

The expected move in the US Yield curve next year



Source: UBS

How to position the portfolio for 2025?

Given the current market sentiment, continued rate cuts and the highly likely prospect of a 'soft landing' economy in 2025, we continue to expect ongoing market strength.

We do believe that there will be room for the market performance to broaden out further, as the expected growth rates in the Mega 7 and the rest of the market are slowly converging (see chart).

When that broadening happens, we expect to see more focus returning to the fundamentals of 'the rest', which we expect to be positive for bottom-up stock pickers.

Converging growth levels

Source: Jeffries

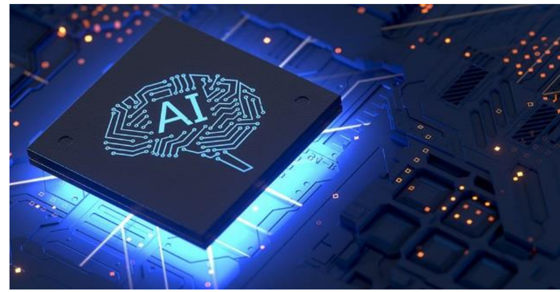
However, we remain selective in our holdings of the big 7 tech companies, and see our holdings of Alphabet, Microsoft and Nvidia as having superior earnings growth prospects at more reasonable valuations than the overall group.

Furthermore, we have exposure to a range of high-quality stocks that we believe are attractively valued and will benefit from a broadening in performance. These tend to be lower risk, steady growers providing core products and services. Examples include Visa in payments; Informa in journals and events; Becton Dickinson in health care equipment; Marsh McLennan in insurance broking; and CME in exchanges.

These holdings are accompanied by positions in stocks that have exposure to several of the biggest themes and growth opportunities in the coming years. These positions typically provide higher expected growth outcomes but with only modestly higher valuations.

Examples of the themes and stocks we have exposure to in the portfolio include:

- **The GenAI revolution:** The real excitement is yet to come in our view when we move from the infrastructure build-out phase to the monetisation phase. Longer-term opportunities will centre around increased productivity and cost savings from GenAI. We have material exposure through Nvidia, Alphabet, Microsoft, Salesforce, Adobe, Synopsys and ASML.
- **Obesity/GLP-1s:** Novo Nordisk gives direct exposure to the massive obesity opportunity as only 0.25% of the obese population use GLP-1s today!
- **The US industrial renaissance:** Crumbling US infrastructure has led to a trifecta of acts injecting >USD$2tn of spend which is only just starting to flow. United Rentals, Ashtead, Advanced Drainage Systems and Clean Harbors are well placed to benefit from this spending.
- **Energy transition:** Companies with dominant positions protected by IP/regulation operating in markets that are undergoing rapid transition - e.g. Enphase and Legrand.



Conclusion

The current market sentiment, an expected continuation of US rate cuts and the highly likely prospect of a 'soft landing' US economy in 2025, bode well for ongoing market strength.

We remain focused on finding companies that meet our quality principles. We believe that owning a portfolio of companies that can demonstrate these key quality criteria will deliver outperformance over the long term.

This information has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Ethical Global Equities Fund.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au

The information in this document was published on 2 December 2024 by Warakirri Asset Management Limited ABN 33 057 529 370 (Warakirri) AFSL 246782 and issued by Northcape Capital ABN 53 106 390 247 AFSL 281767 (Northcape) representing the Northcape's view on a number of economic and market topics as at the date of this report. Any economic and market forecasts presented herein is for informational purposes as at the date of this report. There can be no assurance the forecast can be achieved. Furthermore, the information in this publication should only be used as general information and should not be taken as personal financial, economic, legal, accounting, or tax advice or recommendation as it does not take into account an individual's objectives, personal financial situation or needs. You should form your own opinion on the information, and whether the information is suitable for your (or your clients) individual needs and aims as an investor. While the information in this publication has been prepared with all reasonable care, Warakirri and Northcape do not accept any responsibility or liability for any errors, omissions or misstatements however caused.