Systematic Global Equities

Q4 2024 Update: Change at the Top: Economic and Equity Market Implications

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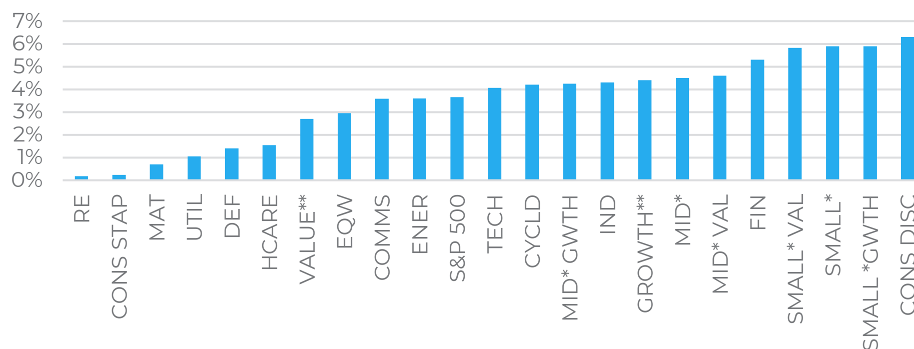
U.S. stock markets experienced positive performance in 2024, and that trend is expected to continue in 2025. However, 2025 also has the potential to experience increased market volatility and shifting trends due to policy changes from the incoming administration combined with uncertainty about inflation and global economic conditions. Policies on tariffs and changes to immigration limits could prove stagflationary while plans to deregulate and cut taxes may increase US investment, jobs, wages, and productivity. These changes will also have an impact on the Federal Reserve's actions. The overall effects on inflation and growth and ultimately global market performance are difficult to predict. An extensive discussion of expected policies from the new administration and their market implications across asset classes can be found in the piece The Precariat Are Still Mad! Part III – How Should Investors Play the Next 4 Years? It Depends! In this paper we focus on US equity markets.

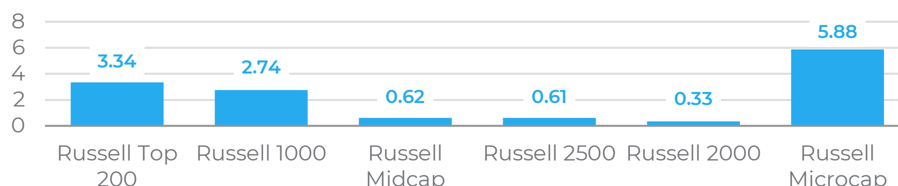
As we start 2025, a quick review of equity market performance and Fed policy in the fourth quarter of 2024 is worth mentioning to provide context for 2025 consensus market expectations. Equity markets saw risk appetites increase right after the November 2024 elections (**Chart 1**) and that was also reflected in the performance of the smallest names in the fourth quarter of 2024 (**Chart 2**).

Chart 1 | **Cheap, Risky, and Small Surged After the Election**
Sector and Style Performance, Nov 5th to Nov 8th



*Note: Small and mid refers to S&P 600 and 400 respectively
**Note: Value and growth refers to the S&P 500 styles unless mentioned otherwise
Source: Macrobond, ©BCAResearch 2025

Chart 2 | **4Q 2024 Performance**

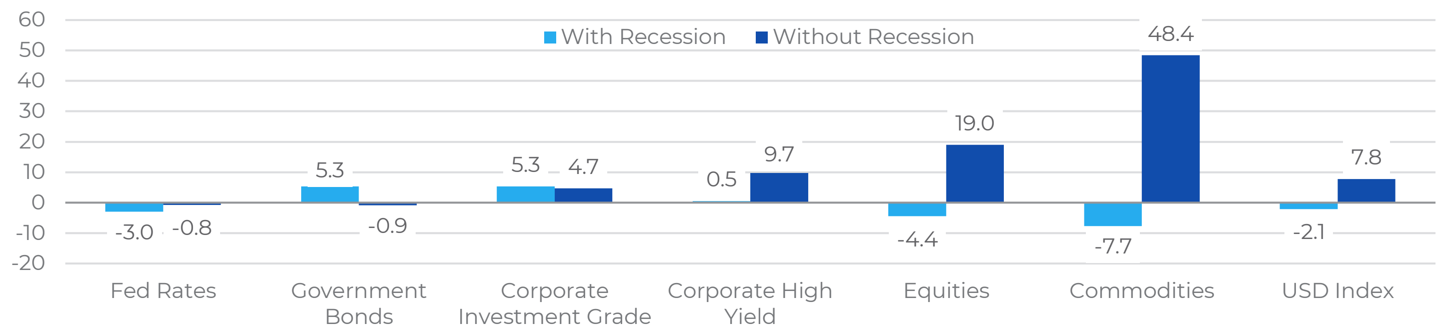


Source: FactSet

The Fed made their third and final rate cut of 2024 in mid-December to bring down the target range for the federal funds rate to 4.25% to 4.5%. The Fed also predicted that they will cut rates to 3.9% in 2025, suggesting that they will make just two rate cuts next year as inflation has not moderated enough and the economy remains strong. The initial forecast had been for four cuts for 2025. In other words, an easing cycle is in place, albeit at a slow and data-driven pace.

The US stock market has historically posted strong returns after the start of an easing cycle if the economy did not fall into a recession within the subsequent 12 months. Global equities, commodities, and credit have all seen positive performance in rate-cutting cycles when the US avoided a hard landing. Given that most of the economic data continues to hold up and the risks of a hard landing appear limited, risk assets are likely to trade well in 2025 (**Chart 3**).

Chart 3 | **Risk Assets Tend to Perform Well When the Fed Cuts Rates and the US Economy Avoids Recession**
Average global asset total returns since 1989 over 12 months after the Fed first cut rates,[1] As of 12/31/2024



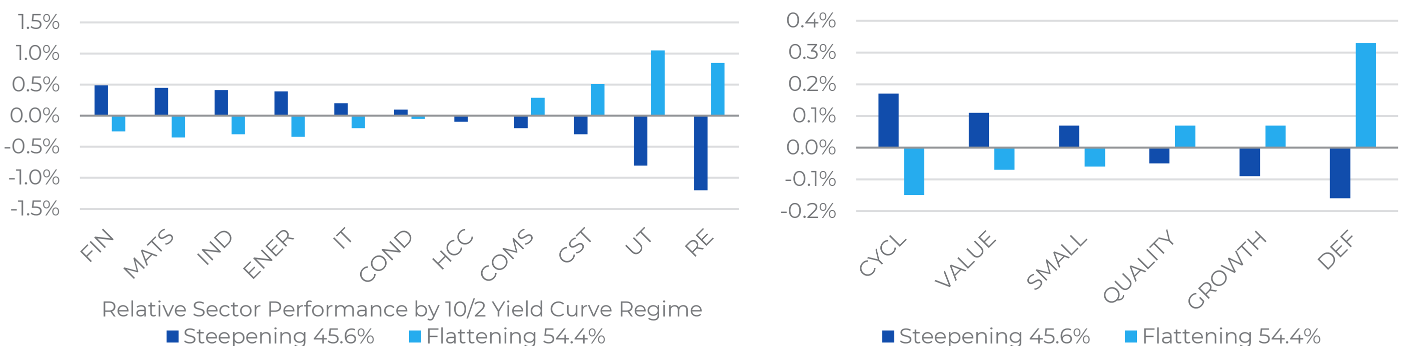
Sources: ICE, ICE BofA, MSCI, S&P GSCI, LSEG Datastream and Invesco Global Market Strategy Office, Invesco

The consensus outlook for 2025 assumes equity markets will maintain their upward march amidst a broadening out of markets with mid and small caps beginning to participate in performance along with value sectors like financials and industrials. The technology sector's dominance may wane in 2025 although it is still expected to generate positive returns.

Style & Size

Value outperforms Growth when interest rates are rising or the yield curve is steepening, if that happens in anticipation of more economic growth (**Chart 4**). If the Fed continues its rate cutting campaign, lower rates should reduce the interest burden faced by smaller companies that are heavily financed with floating rate debt or that have nearer-term refinancing needs. In addition, the Trump administration's pro-growth, domestically oriented policies, tax cuts, and deregulation, is expected to benefit mid-smid-small cap companies. Protectionist policies should benefit domestic industries, while other countries' retaliatory policies may hurt US multinationals. Moreover, deregulation may also serve to broaden market performance.

Chart 4 | **Steepening Yield Curve Favors Small, Value, and Cyclicals**

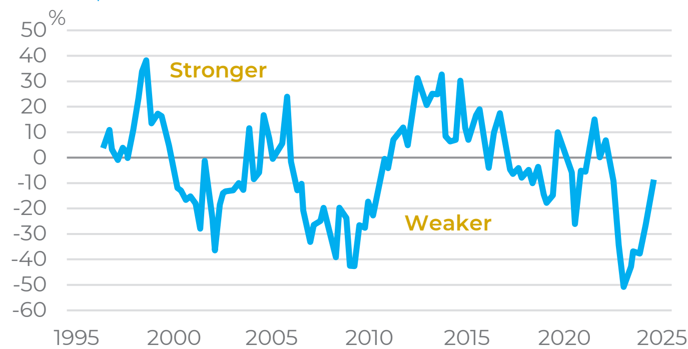


Source: ©BCAResearch 2025

Sectors

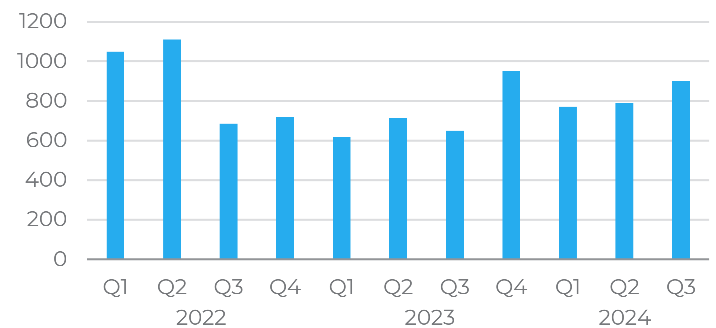
Financials: Consensus expects this sector to benefit from the policies of the new administration. Pro-growth policies and a steepening yield curve will benefit banks' net income margins. The demand for loans is turning the corner (**Chart 5**) and banks should profit from the Trump Administration's higher receptivity to mergers and acquisitions and a resurgence of capital market activity (**Chart 6**). In addition, Republicans favor rolling back some regulatory measures under the Dodd-Frank Act, offering relief to banks. They are also expected to curtail some pending Basel III proposals, which are designed to raise regulatory capital levels for regional and smaller banks. If the pro-growth policies of the Trump Administration are perceived as inflationary and result in interest rates remaining elevated, insurance companies would be beneficiaries of that trend.

Chart 5 | **Demand for Loans Is Improving**
US Banks Reporting Weakening Demand for Loans



Source: Federal Survey of Senior Loan Officers, ©BCAResearch 2025

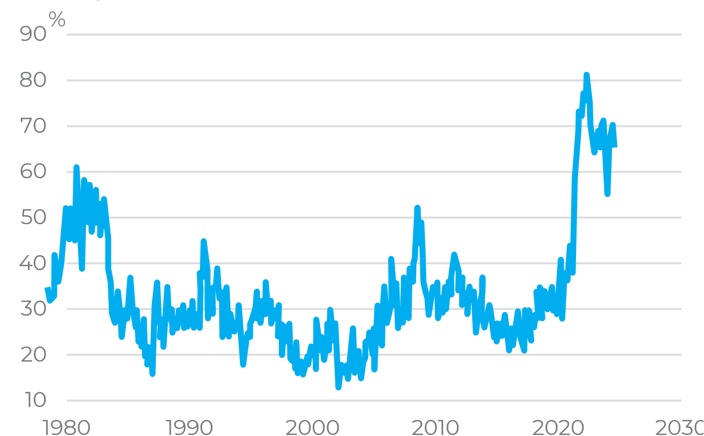
Chart 6 | **M&A Is Primed for a Rebound**
Global M&A, $Bn



Source: Dealogic, ©BCAResearch 2025

Autos and Industrials: Demand for Autos is weak (**Chart 7**), and Industrials are under pressure because of a manufacturing recession (**Chart 8**). However, these sectors are expected to benefit from any protectionist policies that go into effect. Regardless, it is important to note that higher input costs resulting from the imposition of tariffs will offset the positive effects of protectionist policy on these sectors.

Chart 7 | **Demand for Cars Is Weak**
US Buying Conditions for Vehicles:*
Bad Time to Buy



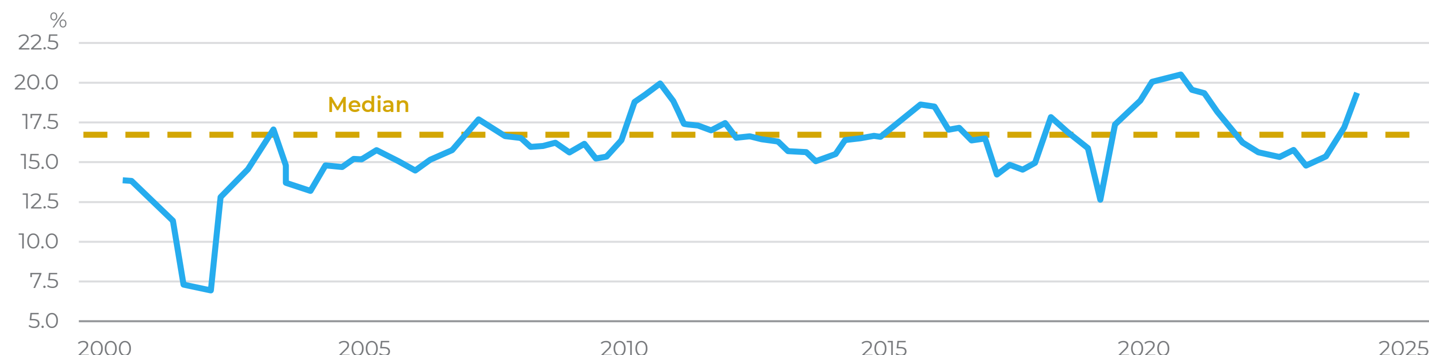
*Source: University of Michigan Surveys of Consumers, ©BCAResearch 2025

Chart 8 | **Industrials Under Pressure Because of Manufacturing Recession**
S&P Industrials EPS Growth NTM

Source: Refinitiv IBES, ©BCAResearch 2025

Utilities: Utilities are poised to benefit from the Republicans' deregulatory agenda that covers building out more power-generation capabilities to secure and advance the AI lead. Emergency powers can be invoked to waive environmental regulations to allow for the building of new nuclear and other electrical generation capacity to power the big data centers for advanced AI models. This will be very favorable for the sector whose margins are already soaring (**Chart 9**).

Chart 9 | **Deregulation Will Further Improve Profitability**
S&P Utilities: Operating Profit Margin

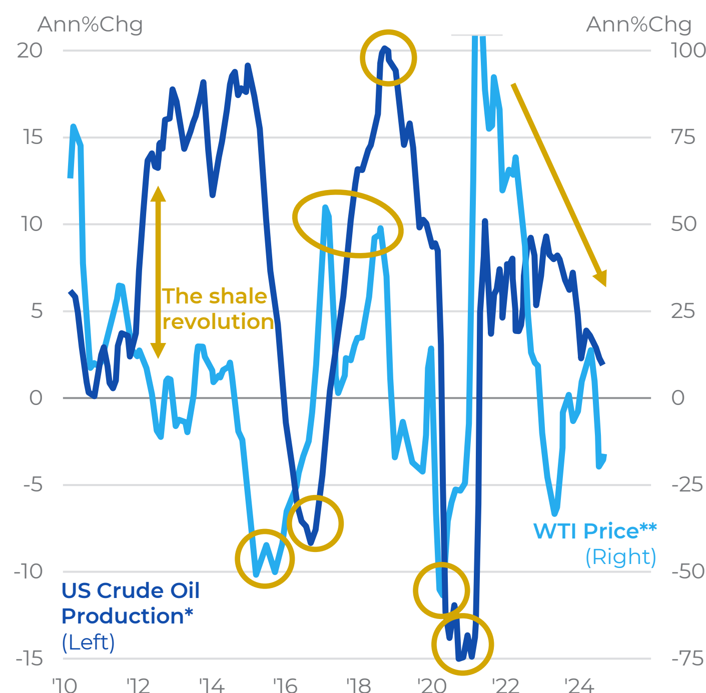


Source: Refinitiv IBES, ©BCαResearch 2025

Technology, Semiconductors, and AI: The Trump Administration is expected to be favorable for AI. Big Tech will benefit from the incoming administration's lighter touch on antitrust enforcement, which may spur acquisitions in the AI space. However, protectionist policies like imposing new controls on chip exports to China, could become a headwind for the entire industry. Regardless, the AI trade may enter a new phase in the coming months after passing through two previous phases - "Phase 1" focused solely on Nvidia (NVDA), whose advanced chips made it the key enabler of the AI boom; "Phase 2" included companies that were essential for the buildout of AI infrastructure. "Phase 3" is expected to see investors turn their attention to companies monetizing AI. Software and services companies across the capitalization spectrum could be the primary beneficiaries of the next phase of AI's evolution.

Energy: Energy production should be poised to grow under regulatory easing and policies that will support US energy independence. However, an increase in drilling will lead to lower energy prices, which will be detrimental to sector profits given the backdrop of weak global demand (**Chart 10**). Energy producers may therefore decide to maintain capital discipline and not increase production despite a favorable regulatory environment.

Chart 10 | **US Oil Production Will Be Driven by Prices and the Supply/Demand Balance, Not Likely Deregulation**

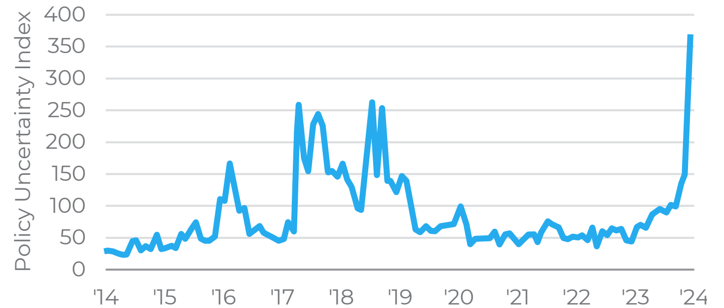


*Source: EIA
*Series truncated at -0.5% and 20%
**Series truncated at 100%
Source: ©BCαResearch 2025

What Can Go Wrong?

While the consensus view for 2025 assumes a macro environment conducive for domestic equity markets, there are a range of potential risks that could act as headwinds and heighten financial market volatility. Several key policy risks could disrupt markets. Trump's "America First" foreign policy, characterized by tariffs, trade wars, and skepticism toward international agreements, could escalate tensions with major trading partners such as China, the EU, Canada, and Mexico. Although campaign promises are unlikely to be fully implemented, tariffs are expected to be used as a negotiating tactic and in all probability will rise to some degree. The rush to fulfill campaign promises in the early days of the administration could heighten global trade uncertainty and market volatility as investors reassess the impact of such policies on global growth, inflation, and corporate earnings (**Chart 11**).

Chart 11 | **Trade Policy Uncertainty Spiked Sharply to Highest Level in a Decade**



Source: Caldara, Dario, Matteo Iacoviello, Patrick Molligo, Andrea Prestipino, and Andrea Raffo, "The Economic Effects of Trade Policy Uncertainty," manuscript presented at the 91st meeting of the Carnegie-Rochester-NYU Conference on Public Policy, April 2019. Data as of 06-Dec-2024.

Aggressive government spending, combined with more tax cuts could exacerbate the already wide fiscal deficit, putting pressure on bond markets and raising borrowing costs for the US government. This could dampen investor sentiment and fuel market volatility. Additionally, with the labor market already tight, further fiscal stimulus may overheat the economy, leading to a resurgence of inflationary pressures. The Fed could then be forced to reverse course and hike interest rates to control inflation, negatively impacting equity markets. Under this scenario, the yield curve would continue to steepen due to the expectation of increasing budget deficits. Rising bond yields pose the biggest threat to US equities and have the potential to derail market expectations (**Chart 12**).

Chart 12 | **In the US, Rising Corporate Bond Yields Are the Key Risk to Share Prices**

*Source: Bloomberg Indices
**Source: MSCI Inc.

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A renewed focus on restricting both legal and illegal immigration could lead to labor shortages in critical industries such as agriculture, construction, and technology. On the campaign trail President-elect Trump promised the largest mass deportation of undocumented migrants in US history. While an immigration crackdown may boost domestic wages in the

short term, it could also hinder long-term productivity growth by disrupting the flow of highly skilled workers to the US from other countries. Companies and industries heavily dependent on immigrant labor may be subject to abrupt policy shifts, potentially increasing economic and financial volatility.

Given that President Trump was elected to curb inflation and spur economic growth, both voters and bond yields may impose restraint on fiscal policy and tariff impositions, forcing a pivot towards laissez-faire. However, the range of unknowns remains wide and there is an environment of caution and concern across policy areas. Investors face uncertainty due to shifting policy frameworks and unpredictable outcomes in fiscal, trade, regulatory, and immigration policies.

While pro-growth measures may support equity markets, the risks from rising tariffs, potential trade wars, and fiscal policy overreach necessitate a cautious yet diversified investment strategy to navigate the twists and turns of 2025.

The possibility of increasing volatility prompts us to monitor policy developments closely and adopt a cautious approach to portfolio construction by maintaining well diversified portfolios with tracking errors on the lower end of target ranges. Our fundamental principles of investing with a focus on earnings growth and reasonable valuations continue to remain in place. Our stock selection models are dynamic and nature and can adjust to changing market trends. The first hundred days of the new administration will be critical in understanding policy impacts on equity markets – sectors, Industries, capitalization, and style and in estimating the probability that consensus views are correct.

[1] Notes: Past performance is no guarantee of future results. Data as of October 31, 2024. The chart shows the total return on global assets in the 12 months after the first Fed rate cut in easing cycles since 1989. Data does not exist for all assets for every easing cycle, with the global high yield and investment grade returns for the 1989 and 2005 easing cycles represented by US returns. "Gov Bonds" = government bonds; "Corp IG" = investment grade; "Corp HY" = high yield. See below for definitions, methodology and disclaimers. Sources: ICE, ICE BofA, MSCI, S&P GSCI, LSEG Datastream and Invesco Global Market Strategy Office, Invesco

Global assets in Fed easing cycles analysis. We use the following benchmarks for each asset class (with date of first easing cycle for which data is available): Equities = MSCI World (June 1989); Government bonds = ICE BofA Global Government Index (June 1989); Corporate investment grade = ICE BofA Global Corporate Index (January 2001 and replaced by the ICE BofA US Corporate Index for the June 1989 and July 1995 easing cycles); Corporate high yield = ICE BofA Global High Yield Index (January 2001 and replaced by the ICE BofA US High Yield Index for the June 1989 and July 1995 easing cycles); USD index = DXY US Dollar Index (June 1989); Commodities = S&P GSCI Commodity Total Return Index (June 1989).

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