Rothschild & Co
Asset Management

Review & Outlook 2025

Editorial

“Profit margins are currently at their peak and are expected to grow further…”

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The year 2024 was marked by "American exceptionalism," in contrast with the rest of the world both economically and in financial markets.

From an economic standpoint, the United States recorded a growth rate of approximately 2.8%[1]. This was driven by sustained consumption, a wealth effect stemming from the sharp rise in equities and real estate since 2019, as well as measures promoting investment. Notably, productivity exceeded past trends and surpassed that of most developed countries. Finally, optimism regarding Donald Trump's pro-business policies on corporate results, coupled with a moderate reaction in interest rates despite inflation concerns, allowed the U.S. market to achieve successive record highs.

This situation contrasts with a stagnating European economy, hindered in part by a struggling German industry. Germany faced persistently higher energy costs than in the United States, a key market in China suffering from weak growth, and a structural loss of market share in that region. Spain stands out, benefiting from the deployment of funds under the European NextGenerationEU plan and robust tourism, while France remains mired in political gridlock. A similar contrast is observed with emerging markets, particularly the former BRIC countries, which suffered economically from near-deflation in China and inflationary pressures in India and Brazil.

In this environment, financial markets are less appealing than they were at the beginning of 2024. In the bond space, yields for top-rated corporate bonds dropped by 40 basis points (bps) compared to the end of 2023, and even by 130 bps compared to October 2023, settling at approximately 3.2%[2]. For equity markets, especially in the United States, where the economy is operating above potential, profit margins are currently at their peak and are expected to grow further. U.S. equities rose by more than 20% for two consecutive years, with earnings transitioning from a 3% decline in 2023 to a 10% increase in 2024[2]. In a context where long-term rates rose by 60 bps, the risk premium is now nonexistent.

Moreover, investors have heavily favored U.S. equities, which attracted approximately 80% of inflows[3]. In Europe, while performance was more modest, markets advanced more than earnings, which saw only modest growth in a stagnant economic environment. This phenomenon was particularly pronounced in Germany. China, meanwhile, presents extremely modest valuations, which could only improve through substantial fiscal measures and resolution of the real estate crisis.

In such a context, prudence and responsiveness emerge as the watchwords for 2025.

(1) IMF, December 2024.
(2) Source: Bloomberg, 12/31/2024.
(3) Bank of America, décember 2024.

Macro

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In 2024, global growth has remained stable and world trade has been recovering, while price pressures continued to ebb. Investors project that this resilience will continue in 2025, with inflation further converging towards central banks' targets. However, this outlook masks significant differences across sectors and countries, and is surrounded by important uncertainties.

Downside risks in the US…

The global economy has proved resilient in the last year. Disinflation has enabled monetary policy easing in most major economies, thus supporting household spending. Still, 2024 has been the biggest election year in human history, and incumbent parties worldwide have been doing very poorly amid four years of successive crises – a global pandemic, a large-scale war in Europe for the first time in decades, and the most significant surge in inflation since the 1970s. In that regard, a Harris win in the US would have been an astonishing exception to the rule. In fact, last year's electoral results showed that inflation has an impact on everyone, whereas unemployment is a much more delineated prejudice, and voters are sensitive to price levels which remain much higher compared to pre-pandemic levels.

The irony is that the US experienced the fastest GDP growth in all G7 countries in the past two years, and this exceptionalism would persist this year according to the latest OECD economic projections. Yet, while the recent pattern of unexpected US resilience could continue, risks are nonetheless skewed to the downside.

On the positive side, productivity growth, potentially fuelled by new advances in artificial intelligence, may surprise to the upside. However, at the top of Donald Trump's agenda, three items are likely to be inflationary – raising trade tariffs, curbing immigration and prolonging expiring tax cuts – and their implementation could not only make it difficult for the Fed to ease, but also hurt the export sector if the US trading partners were to retaliate. Furthermore, as immigration normalises and labour demand cools, consumption growth will likely slow, especially as there is less scope for consumers to further draw down savings. Investment growth could also ease as households and businesses that were locked in low rates during the pandemic must now refinance at higher rates. What's more, the very large budget deficit and rising debt ratio during the actual period of strong growth increase fiscal risks. Indeed, the higher and more volatile inflation outlook, combined with a sharp rise in government debt, could increase the term premium investors require to buy Treasuries. In turn, higher interest rates would weigh on economic growth both domestically and abroad, since the US bond market has ripple effects well outside of its boundaries.

… and Europe

Economic growth in Europe has been mediocre in 2024, as GDP probably expanded less than 1 per cent in the UK and the Eurozone[1]. Looking ahead, recent indicators suggest ongoing weakness with the PMI business confidence index[2] hovering around the neutral 50-threshold at the end of 2024, thus flagging downside risks to investors' sanguine forecasts.

Regionally, Germany and France are both facing a challenging political environment, which in turn could affect businesses' strategic decisions, hinder investment and dampen household consumption. Although the war in Ukraine has triggered additional military spending and the Next Generation EU programme is supporting public investments, fiscal consolidation in some countries given the still high deficits could weigh on economic activity. Meanwhile, the Eurozone's December manufacturing PMI (at 45.1)[2] signalled another month of deteriorating conditions, stretching the current sequence of under the 50-threshold to two-and-a-half years. The new orders sub-index dropped even more than in the previous two months, crushing any hopes for a quick recovery, especially considering the accelerated decline in the order backlogs sub-index. More broadly, Europe is also bracing for new tariffs and less security support from the incoming Trump administration.

However, the main tailwinds are the labour market and the easing of financial conditions. The unemployment rate stood at a record low of 6.3 per cent in November[3]. Combined with strong growth in negotiated nominal wages, up 5.4 per cent y/y in the third quarter from 3.5 per cent in the second quarter[3], it should support consumption. This is especially true as the savings rate remains significantly higher compared with the pre-pandemic norm. In addition, the ECB easing is being transmitted to the banking sector as the demand for loans from businesses and households increased according to the ECB's latest Bank Lending Survey.

(1) Source : Bloomberg, january 2025.
(2) Purchasing Managers' Index, an indicator reflecting the confidence of purchasing managers in a sector of activity. Above 50, it indicates an expansion in activity; below 50, a contraction.
(3) Source : Eurostat, december 2024.

China's murky outlook

Since the end of September, China's growth has shown some tentative signs of steadying due to the recent policy push. For instance, the decline in house prices across major cities slowed in November for the first time since early 2024. However, retail sales growth unexpectedly weakened and inflation decelerated in November to a mere 0.2 per cent from 0.3 per cent[(4)], a sign that the domestic economy remains fragile.

Investors expect a softer pace of economic activity with GDP growing 4.5 per cent and 4.2 per cent in 2025 and 2026, respectively, from 4.8 per cent in 2024[(1)]. However, there is a wide range of possibilities due to significant uncertainties. US tariffs are likely to be increased to the full amount of what was pledged during the presidential campaign (i.e. 60 per cent), but the timing and purpose will matter, and a gradual approach and multi-rounds of negotiations would help in absorbing the shock. The government is expected to unleash more measures, but the extent of the support will likely be adjusted depending on the degree of the external drag.

(4) Source : National Bureau of Statistics of China, december 2024.

Market views

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What to Remember from 2024?

International Equity

Yoann Ignatiew : In 2024, the global economy demonstrated remarkable resilience. The gradual decline in inflation enabled central banks to initiate a cycle of monetary easing, growth remained steady, and companies recorded significant profit increases. Global equity markets closed the year with strong gains, with the MSCI All Country World Index up by 15.7%[1]. However, regional disparities emerged: the United States outperformed with a 23.3%[1] rise in the S&P 500, while China, despite a challenging context, saw the Hang Seng gain 17.7%[1]. The Eurozone, hindered by geopolitical tensions and political instability, ended more modestly at +8.3%[1].

The slowdown in inflation allowed the ECB and the Fed to cut their benchmark rates by 100 basis points, settling at 3% and 4.25%[2], respectively. These adjustments reflect distinct economic dynamics, with inflation near 2% in the Eurozone but still above 3% for its core component in the United States[4]. The year 2024 was also marked by major political events. In the United States, Donald Trump's victory was greeted with optimism by the markets. In China, measures aimed at stabilizing the real estate sector and boosting domestic demand initially had positive effects, though momentum faded in the fourth quarter. In Europe, elections further accentuated political fragmentation.

European Equity

Anthony Bailly : In European markets, 2024 was notably marked by the political instability of the Eurozone's two largest economies. Votes of no confidence led to the appointment of a new government in France and the prospect of early elections on February 23 in Germany. This political uncertainty, coupled with the scale of France's deficit, weighed heavily on the CAC 40, which ended in negative territory at -0.7%[3]. This was not the case in Germany, where the DAX rebounded by 18.6%, driven by strong performances from certain stocks (SAP, Rheinmetall, Siemens Energy) and hopes of budgetary easing. The strong performances of southern European markets, with the IBEX up 20% and the FTSE MIB up 18.9%, helped the EuroStoxx post an 8.7%[1] increase. Sector-wise, China's economic difficulties weighed on the commodities, luxury, and automotive sectors, all ending in negative territory. Conversely, tensions over rates—supported by resilient inflation—propelled banking and insurance sectors to the top of the performance rankings.

(1) Bloomberg, 12/31/2024. Performance expressed in local currencies, dividends reinvested.
(2) ECB, Fed, December 2024.
(3) Bloomberg, 12/31/2024. Euro performance calculated with dividends reinvested.
(4) Source : Eurostat, U.S. Bureau of Labor Statistics, décembre 2024.

Another notable feature was the divergence with the United States. American exceptionalism was evident throughout the year, allowing for significantly stronger economic growth and corporate earnings compared to Europe. This attracted significant inflows, with U.S. equity markets capturing $480 billion[1], a trend that intensified following Donald Trump's election. Conversely, outflows from European equities continued, amounting to $65 billion. The region's weighting in global allocations has never been lower. This dynamic is also reflected in valuations: European equity markets are trading near historical averages (P/E[5] of 13.2x), while U.S. markets, with a P/E of 22.2x, are at historical highs[1]. The valuation gap between European and U.S. markets, now exceeding 40%, has never been wider.

Fixed Income

Emmanuel Petit : The pivot by central banks, marked by the start of a rate-cutting cycle, was the key event for fixed-income markets in 2024. This adjustment occurred in a context where inflation, although declining, remains far from the 2% target. Despite their differences, the monetary policies of the Fed and the ECB converged in the same direction. Anticipation of these moves by investors allowed markets to respond positively throughout the year. However, uncertainty increased during the final quarter.

Notably, Donald Trump's election introduced divergence in expectations on either side of the Atlantic. This resulted in rising long-term rates in the United States, driven by promises of economic stimulus, while short-term rates in Europe declined amid fears of weakened growth. Despite these differing causes, the effects were similar, with moderate steepening of yield curves in both regions.

Overall, central banks managed to maintain a relative balance in 2024. However, very distinct economic dynamics on either side of the Atlantic appear to be shaping up for 2025. The year ends with significant political instability in Europe. While the election results in the United States are clear, the potential impact of measures from the Trump administration could exacerbate these divergences.

(5) Price Earning Ratio

What is Your Central Scenario for 2025?

International Equity

Y. I. : We approach 2025 with a decidedly cautious stance, refraining from significantly re-exposing ourselves to risk in the current context. The repercussions of last year's global election cycle, coupled with Donald Trump's second term in the United States, amplify uncertainties surrounding inflation, growth, and trade. Investors must also navigate an environment marked by new geopolitical realities, evolving supply chains, and the rapid rise of artificial intelligence. Within this context, we remain convinced that opportunities persist. In the United States, the equity market remains attractive due to robust economic growth, strong earnings, and significant innovation. While inflows remain concentrated on the "Magnificent 7"(6), other opportunities exist, notably in banking stocks, which should benefit from promised deregulation. Corporate earnings expectations, with projected growth around 15%(7), warrant close monitoring. Any disappointment could lead to significant sell-offs.

In Europe, despite challenges related to energy, political instability, and low productivity, opportunities exist in sectors such as healthcare, industries, and luxury goods, driven by globally competitive companies. It's difficult to consider emerging markets as a homogeneous bloc, given their diverse economic characteristics. Nonetheless, growth has shown remarkable resilience overall, and inflation has receded significantly from the peaks of 2022. In China, despite substantial stimulus measures, the government struggles to boost domestic demand. November's monetary easing announcements disappointed, but the government retains room to increase deficits. Trump's re-election and the threat of new tariffs could heighten pressure, forcing Beijing to prioritize domestic consumption amid a more challenging export environment. We remain committed to exposure in local consumption in China and, more broadly, across Asia and Latin America. In conclusion, our scenario envisions an uncertain environment where geopolitical, inflationary, and growth-related challenges coexist with opportunities, particularly in specific sectors and resilient regional markets.

(6) Microsoft, Nvidia, Tesla, Meta, Apple, Alphabet & Amazon.
(7) Source: Consensus december 2024.

European Equity

A. B.: Expectations for Europe are very low this year, with fragile economic growth projected at around 1% and earnings per share growth estimated at 7-8% according to consensus[7]. Deteriorated PMI[8] indicators reflect a high level of uncertainty among economic agents. The lack of a rebound in China, concerns about upcoming tariffs, and Trump's inflationary policies add to Europe's political difficulties.

However, some elements could counterbalance these concerns. Trump's entry into the White House could yield positive effects not yet priced in. Firstly, his stated desire to quickly resolve the Russia-Ukraine conflict could reduce the risk premium weighing on European markets since the conflict began. President Zelensky remains dependent on U.S. funding, potentially forcing a compromise.

Secondly, increased military spending within NATO member states could push Germany to relax its budgetary constraints. Additionally, once U.S. tariff hikes are announced, China may calibrate a fiscal stimulus plan likely oriented toward domestic consumption, indirectly benefiting Europe. Finally, while inflation is already more resilient in the U.S. than in Europe, Trump's inflationary agenda suggests the Fed may maintain a hawkish[9] tone as indicated in its December meeting. Conversely, Europe's ongoing inflation decline offers the ECB more room for maneuver. Continued rate cuts could support credit, revitalize economic activity, and ultimately benefit equity markets.

Fixed Income

E. P.: We expect a divergence in economic and monetary policy trajectories between the Atlantic regions in 2025. Central banks appear to stay the course, with yield curves continuing to steepen and increased risks on long-term rates. Based on market expectations of four rate cuts, Europe's trend aligns with the U.S. dynamic. The ECB's terminal rate could exceed 2%, though it may need to adopt a more aggressive pace, with growth remaining its primary concern amid persistent political uncertainties and the protectionist tendencies of the new U.S. president.

In the U.S., further rate cuts by the Fed seem unlikely given inflationary risks tied to the incoming administration's program. The central bank has managed to approach its inflation target without triggering a recession, achieving the near-ideal "Immaculate Disinflation[10]" scenario. The neutral rate likely now stands higher than previously anticipated. Labor market developments and the impact of Trump's promised measures will need close monitoring. It's not inconceivable that the Fed may raise rates again in 2025.

(7) Source: Consensus december 2024.
(8) Purchasing Managers' Index, an indicator reflecting the confidence of purchasing managers in a sector of activity. Above 50, it indicates an expansion in activity; below 50, a contraction.
(9) In favor of a more restrictive monetary policy to combat inflation.
(10) Scenario in which inflation slows but unemployment does not rise.

The year should continue 2024's trend of gradual yield curve steepening. Agility will be key as opportunities may arise from events and decisions with contradictory effects across regions. Credit market performance will hinge on the alignment of monetary policies with the macroeconomic environment in each zone. In this context, the Fed's flexibility contrasts with the ECB's apparent rigidity. However, given current fundamentals, the asset class retains a certain appeal. We remain attentive to cyclicality in our positions and overall credit quality. While valuations in some segments may seem high, we consider them justified given the fundamentals as long as the macroeconomic environment does not deteriorate.

What headwinds and headwinds can you identify?

International Equity

Y. I. : In 2025, several key factors could influence markets, including the divergence in monetary policies between the Fed and the ECB. The Fed may maintain high rates to contain inflation spurred by Trump's expansionary policies, while the ECB might adopt a more accommodative stance to support sluggish growth in Europe. The first 100 days of the new U.S. president will be crucial: his tax cuts and promised deregulations could stimulate short-term growth, but heightened protectionism risks stifling the economy and exacerbating inflation. A strong dollar could weigh on U.S. exports and challenge emerging economies with dollar-denominated debt. Simultaneously, the artificial intelligence craze, which is concentrating stock market inflows, warrants caution. A significant correction could occur if investors are disappointed in companies' ability to turn this technology into concrete results. Moreover, the development of AI poses energy challenges due to its high consumption. In Asia, China must refocus growth on domestic demand to offset a more challenging international trade environment. Globally, rising public debts remain a major challenge, with the U.S. budget deficit at 6.3% of GDP in 2024 and global debt reaching 93% of GDP[11].

European Equity

A. B.: European market underperformance largely stems from uncertainties around fragile economic growth, rising tariffs, and political instability in Europe—all factors widely recognized by investors. This raises the question of whether this underperformance is set to continue, given the historically high valuation gap between European and U.S. markets and Europe's economic strengths. Real

(11) Source : IMF, 15/10/2024.

wages continue to grow amid a healthy labor market, while excess savings only await a return of confidence to be unleashed. Conversely, with a P/E of 22.2 and projected EPS[12]rowth of 15%, the U.S. market appears vulnerable to economic weakness or normalization of AI-related growth rates[1].

European markets also offer numerous opportunities, including investing in undervalued European champions with strong international exposure and sectors likely to benefit from plausible catalysts. These include construction, which would benefit from an end to the Ukraine conflict; real estate, which would welcome a more accommodative ECB policy; and industrial sectors (commodities, chemicals, industrial goods, automotive) poised to gain from German and/or Chinese stimulus plans.

More broadly, sectors currently priced for a slowdown could rebound if sentiment improves. In this regard, the "Value"[13] style could regain favor after slight underperformance in 2024. Finally, differentiation factors also offer promise. Europe is leading the ecological transition, home to major players in this field. Expected rate cuts should reignite investments in this theme. Europe's head start in clean energy could become an asset as AI-driven energy demand rises.

Fixed Income

E. P.: Political dynamics remain the primary concern among headwinds. Early elections in Germany and a fragile governmental context in France weigh on the sluggish growth of the Eurozone's two main engines. Trump's proposed measures—tax cuts, anti-immigration policies, and tariff increases—threaten to deepen Europe's struggles while bolstering the U.S. economy. These measures also carry inflationary risks that should not be overlooked.

The Fed may find itself torn between inflation and employment concerns. The labor market is beginning to send mixed signals, and Trump's intent to reduce immigration could exacerbate tensions and boost wage inflation. A return of inflation could force the Fed to raise rates, destabilizing credit markets.

Nevertheless, some factors remain supportive. The economic environment continues to favor the asset class. Although absolute returns are lower than in past years, they are relatively more attractive than those of monetary assets. This should sustain inflows. Furthermore, amid today's uncertainties, the asset class has shown remarkable resilience. Central banks' ability to make necessary adjustments and approach their inflation targets has ensured relative market stability. It is hoped they will continue along this path.

(12) earnings per share.
(13) We speak of value strategy when the investor is looking for companies undervalued by the market at a given moment, that is, whose market valuation is lower than it should be with regard to the results and the value of the assets. of the company. Value investors select securities with low price to book ratios or high dividend yields.

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Published by Rothschild & Co Asset Management, a portfolio management company with capital of €1,818,181.89, located at 29 Avenue de Messine – 75008 Paris, AMF license No. GP 17000014, Paris Trade and Companies Register No. 824 540 173.

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