CHARLES STANLEY

RESEARCH

2025 Outlook

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MACRO COMMENTARY

By Patrick Farrell, Head of Research and Chief Investment Officer

What can we expect in 2025?

It is difficult to know where to start as we look at the outlook for 2025. The political and policy upheaval we can expect out of the US, the stimulus program out of China, economic stagnation in Europe, and the budget tightrope walk in the UK. How will these factors impact underlying demand for company sales, margin pressure, inflation pressure, central bank action, long-term bond yields and, ultimately, market outcomes?

We'll start with the US, as it will have notable impacts on all global markets. The intent and potential delivery of the key policy initiatives from the incoming Republican administration will have both short-term and long-term implications on the US and the broader global dynamic. Policy changes are likely to be prioritised over the next two years while the Republicans have the majority in the Senate and the House, which may change at the November 2026 mid-term elections.

Key US policy initiatives

Deregulation

Relaxing the capital requirements, particularly for the larger banks in the US, has already provided a significant boost to their share prices as it now allows the banks to lend excess capital or to repay it to shareholders. In any case, it provides larger lending institutions more options and greater potential profitability in the short term. However, it poses more risk in the longer term if they take on too much leverage and/or poorer credit quality of their underlying borrowers.

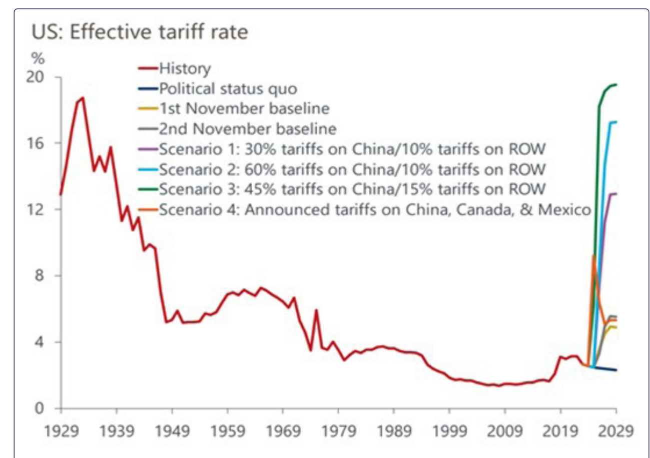
Ultimately, it will provide more accessible funds to corporates and individuals and make it easier to do business so will be a short-term market tailwind. To some extent, this benefit has already been reflected in US banks, with the S&P Banking Index up more than 11% in price terms since the election at the time of writing. Not only will financial companies benefit from the deregulation push, but also other industries will benefit from removing hurdles on key development areas such as autonomous vehicles.

Tariffs

This policy initiative is certainly getting the most headlines as it potentially takes the US back to the 1930s where tariffs were at similar levels to what has been outlined. This policy is favoured by Donald Trump as it threatens other countries to 'play ball' on other things.

For example, the 25% potential tariff on Mexico and Canada, which would plunge those economies into recession, aims to provide an incentive for those countries to do more to hinder the drug trade happening across their borders instead of leaving it to the US to battle. It prompted Canadian Prime Minister Justin Trudeau to hop on a plane and fly to Florida to have a chat with the president-elect.

Ultimately, tariffs will increase – and the US will use these as a weapon – but also a revenue source to continue the 2017 tax cuts for an extended time. The chart below from Oxford Economics looks at the effective US tariff rate under the different scenarios that have been highlighted. The current market expectation is for an effective rate of around 8% in the short term, but this could change quite dramatically.



Source: Oxford Economics

This will impact the US consumer in terms of the cost of the imported components that will largely focus on intermediate capital goods rather than final consumer goods, but the cost of US-produced products will still rise. As a result, this policy initiative is inflationary and the Federal Reserve will need to keep rates slightly

higher than neutral, at least in the short term, so it can see the broader impacts.

On a longer-term basis, the tariff policy is likely to isolate the US on the global stage and the clarity of the intent will resonate in the political corridors of adversaries across the world. We are likely to see even greater co-operation across emerging economies that will side with Chinese influence to diversify away from dependence on the US economy.

In other words, this policy initiative will hasten the bi-polar global dynamic by strengthening the resolve of the emerging-economy alliance, whilst weakening the Western alliance as the broader policy frameworks diverge, particularly between Europe and the US.

This is occurring on multiple fronts from climate change, banking regulation, defence, and trade. As a result, Asia will become a stronger economic hub even though it will suffer short-term headwinds from the US tariffs policy.

Immigration

The sudden deportation of illegal immigrants is likely to create a supply shock to the US labour force. The incoming immigrants have been absorbed into the US workforce over the last few years, which has eased some of the tight labour conditions and has allowed the unemployment rate to slowly creep higher to something more sustainable.

In the short term, this is likely to have one of the biggest influences on US inflation and growth prospects in 2025.

Even though these undocumented workers are likely to work in lower-income industries such as hospitality and agriculture, their removal will create a void and force those industries to find other, more expensive solutions. This will ultimately push costs onto the consumer again. The deterrent for future immigration is also going to create a squeeze on broader employment going forward, particularly if the domestic growth incentives continue to accelerate.

China's stimulus policies

In the next year, we are likely to see a significant shift in policy measures from the National People's Congress in China to provide stimulus to the economy. The difference this time around is that the focus will be on the domestic consumer. In the past, stimulatory programs have focused on expanding credit to build infrastructure and housing.

Following a severe property correction, the Chinese consumer is disenchanted, with falling house prices, weak equity prices, and deteriorating economic conditions. The central bank and Ministry of Finance have already enacted multiple easing measure during 2024, but these were quite targeted to provide support for improvements in the housing market and give help to specific industries that benefit the technology sector in the country.

The policy prospects announced more recently look to provide "more proactive" fiscal policy support and embrace a "moderately loose" monetary policy stance in 2025. This implies more interest rate cuts, action to stabilise property and stock markets, and a ramp up of "extraordinary counter-cyclical policy adjustments" to boost domestic growth. This suggests it is going to use a multitude of tools at its disposal to turn domestic confidence around. The impending US tariffs are only going to increase their resolve to insulate the Chinese economy.

From a market perspective, having a significant stimulus program in the world's second-largest economy is more important than the impending tariffs, which have rocked the domestic equity market in the short term. Chinese growth is good for the rest of the world, even if diplomatic relationships will be strained, as it will create a degree of demand from commodities to luxury goods.

However, more recent press articles, typically linked to reliable sources, have indicated that the focus for Chinese officials will move away from hitting specific growth targets, such as gross domestic product growth of 5%, and move to other targeted areas of growth to help the economy transition from an industrial output/export economy to a more self-sustaining domestic economy like the US.

Will Europe be left out in the cold?

Europe, more broadly, will be faced with a higher defence bill to support NATO and plans have already been drawn up. This will put pressure on already strained budget positions and put more pressure on the individual political arenas, as we are already seeing in France and Germany.

From a bottom-up perspective, industrial giants such as Volkswagen are struggling with labour disputes in Germany, as factories are destined to close as profitability is under immense pressure and German factories are too expensive to run. The prospects in

2025 for Europe are mixed as valuations for good quality companies are low, but the top-down economic prospects are muted. As a result, the European Central Bank will have to do much of the heavy lifting to stimulate the economy as fiscal policy goes in circles.

Where does that leave the UK?

The UK sits between the US and Europe in terms of policy and positioning. The relationship with the US was good in the first Trump presidency and, if tensions grow between Europe and US, then Prime Minister Keir Starmer will find himself caught in the middle. He has already been asked which side he will take. He replied by saying that it was not necessary to take sides – and the UK can work effectively with both regions. The budget has struggled to maintain the positive momentum on announcement, and more questions are coming through on the impact on different sectors, as well as the increase of National Insurance acting as a tax on employment.

The growth payoffs are not expected to provide a dividend on the spending initiatives for another few years. It is therefore likely that the UK's 2025 economic prospects fares better than Europe but not as good as the US. Equity market valuations in the UK look cheap even after adjusting for sector differences, and that is also reflected in the number of takeovers we are seeing and companies looking to make their primary listings elsewhere.

Conclusions

We are in for a bumpy ride as the geopolitical 'tit-for-tat' scenario intensifies over 2025. The pro-US growth strategies will be inflationary, as it is hard to have stronger growth outcomes, restrict supply chains and reduce regulatory and fiscal restrictions and assume it won't be inflationary.

The Federal Reserve will be in a difficult position – both politically and economically – resulting in the month-by-month policy decisions reflecting what the data is saying and where the balance of risks lie both with inflation relative to target and with running full employment. Both factors will create confusion at the moment. I know there are lots of strategy meetings happening to work through the different scenarios as companies assess the potential impacts, both positive and negative.

As a result, from a company and therefore equity-market outlook perspective, we think that the growth prospects will be helpful for the broader market and hence see a greater breadth of returns rather than just in the mega-cap technology names. These are likely to still do well in that environment but are heavily susceptible to any negative shock, so we recommend caution.

For the rest of the world, we anticipate headwinds, but these markets will represent better buying opportunities at the right time as they will be more susceptible to upside surprises. We need to be fluid and flexible in this environment.

This volatility will also be reflected in the bond markets, particularly if Trump is too aggressive on the policy issues. A sharply higher bond yield could derail his growth plans, no matter what the Federal Reserve does, as higher market rates will translate to higher mortgage rates. Currencies will also be a major factor in 2025 returns, as more volatility with trade barriers and geopolitical tension will see greater speculation contrary to the relative calm we have seen over more recent times.

It is difficult to position portfolios for one scenario over another, so there will be a need to be more reactive in 2025 rather than proactive. A degree of preparedness in relation to portfolio positioning, so that moves can be made quickly, is warranted and can serve to mitigate some of the short-term risks, but also capture the opportunities in the short and longer terms.

The rest of Charles Stanley's 2025 Market Outlook will examine some of the major themes that look set to shape the investment landscape in the year ahead. We look at the expected rise in volatility and its potential causes, as well as prospects for bond markets on both sides of the Atlantic. As views diverge on the prospects for the 'Magnificent 7' group of mega-cap equities that have powered the bull market so far, we explore the range of options open to investors to get the exposure that they want. We look at prospects for major equity markets including the UK, US and Europe and detail the secular growth opportunities that are likely to emerge. The year also looks set to be dominated by the US's new president – Donald Trump – and we look at what changes lie ahead for responsible investing as this champion of the oil industry becomes the most powerful man in the world.

By Abbas Owainati, Head of Asset Allocation, and Tyler Bond, Quantitative Analyst

Is volatility set to rise in 2025?

Whilst 2024 has seen periods of volatility, calm has now been reinstated at year end. The most common measure of volatility (the VIX) has settled near record lows, eclipsing the period equity markets enjoyed after the global financial crisis through to the Covid-19 pandemic.

Volatility is one of the main measures of investment risk, and lower volatility can increase the appetite of investors for equities. This, in turn, can encourage businesses leaders to make more investments in their companies, which should ultimately boost earnings and economic output.

We are optimistic that 2025 will be a rewarding year. However, we don't expect the journey to be smooth. Here, we highlight the triggers that could cause periods of heightened volatility.

Looking at the numbers

The VIX is the most widely followed volatility index and is based on the implied 30-day volatility of the S&P 500. It does this by comparing the prices of put and call options and option pricing models.

- Call options are contracts that give the holder of the option the right to buy a specific asset at a fixed price.
- Put options are contracts that give the holder of the option the right to sell a specific asset at a fixed price.
- Option pricing models are the methods used by investors to calculate the value of an individual option.

The MOVE (Merrill Lynch Option Volatility Estimate) Index measures the expected volatility in the US Treasury bond market. This is done by calculating the implied yield volatility of Treasury options (see above) due to expire in the next month where the contracts are for various maturities. It provides insight into market sentiment and risk perception regarding future price fluctuations in US Treasury securities.

These two indices track volatility for US equity and bond markets and offer a good representation of overall market volatility.

Volatility, according to both measures, spiked in

mid-2024 before returning to normal levels. Looking at the last couple of years, bond volatility has been higher than equity volatility, as shown by the purple dots sitting above the 'line of best fit' in the chart above. This reflects the evolving assessment of central banks – and their resulting monetary policy response – to falling inflation after the pandemic. No doubt this trend for higher volatility in bond markets will continue into next year, but perhaps with equity volatility now a larger contributor to the mix.

Reasons for volatility ahead

As valuations stretch, and the US swallows a larger and larger share of global equity investments, it is difficult to see the US weighting in global indices continuing to grow. With near perfection priced into equity markets, the potential for market valuations to fall has increased. Furthermore, Donald Trump's desire to exert presidential influence over the independent Federal Reserve could lead to a public and vicious fight for power. Chairman Powell has indicated in no uncertain terms that he intends to remain for the rest of his term (which is due to end in 2026).

Tariffs have been proposed on all imports to the US by President-elect Trump. However, it is unclear whether these will go ahead. They may be a bargaining chip to arrive at some middle ground. The potential tariffs have hurt forward-looking consumer confidence, increasing the chance of a cascade of companies missing their earnings targets. Like any negotiation, we expect to see some retaliation from the rest of the world, elevating volatility until clarity and common sense prevails.

The disparity in economic growth of the US, Europe, and emerging markets could also be a catalyst for volatility.

- European inflation has fallen, at the cost of economic growth, and things do not look promising for 2025.
- On the other hand, US exceptionalism prevails with the economy continuing to grow at trend levels, further supported by 'Trumpenomics', which promises to deliver fewer regulations, more spending, and lower taxes.
- In Asia, cuts to Chinese lending rates have proven successful in the third quarter, but whether real output can continue to grow throughout 2025 remains to be seen.

Ongoing or potential conflicts around the world can create uncertainty and increase market volatility. For instance, geopolitical tensions in regions such as the Middle East and Eastern Europe could have far-reaching implications for global markets. Both regions continue to dominate energy supply and disruptions are likely, particularly given the fluid developments in recent weeks. The US support for Ukraine looks to be reaching its end, as Trump brings a new approach to Eastern European diplomacy; increasing the possible range of outcomes. The shifting geopolitical landscape towards to an emerging tripolar power struggle with a US-centric bloc, a Chinese-centric bloc, and 'the rest of the world' can also have a bearing on markets.

Whilst inflation has largely moderated recently, the new US administration's policies could increase inflation when coupled with a resilient underlying economy. In the UK, higher Employer National Insurance Contributions announced in the latest Budget could see these costs passed on to consumers, also marginally pushing inflation higher.

These will increase the complexity of any central bank response but could also create a divergence across major central banks, further fuelling volatility.

Portfolio response

Taken together, these catalysts for greater volatility strengthen the case for active management. While active management is usually thought of as a hunt for alpha – or outperformance against a benchmark – the other side of the coin is risk management.

Diversification can also be used to reduce the level of risk. In this case, diversification across asset classes from equities, to bonds, to commodities, can improve investment outcomes. With the traditionally negative correlation between bonds and equities, an allocation to fixed income is warranted.

Looking ahead, we have a moderate view on equities but will look to proactively manage portfolio exposures where performance risks emerge. Next year will bring its own set of challenges and, to be prepared for a reasonable spectrum of possibilities, scenario analysis is important. This preparation will allow investors to be nimble and agile with portfolio positioning.

By Oliver Faizallah, Head of Fixed Income Research, and George Martin, Fixed Income Analyst

Fixed income outlook 2025: the return of the term premium

We anticipate easing by central banks over the next year in the developed markets. However, some caution may be warranted when taking duration risk as we forecast a re-steepening of yield curves.

The normalisation of the yield curve in an abnormal world

A so-called 'normal' shape for the yield curve is where short-term yields are lower than long-term yields, causing it to slope upward. Bonds that have a longer maturity are more exposed to the uncertainty that interest rates or inflation could rise, and this risk is why investors usually demand a higher yield for longer-dated bonds.

The 'term premium' describes the extra return investors require for bearing the risk that comes with holding longer-dated bonds and can serve as a valuable concept to assess bond valuations.

Through most of 2023 and well into 2024, the term premium between two-year and ten-year government bonds was deeply negative in the US, UK and Europe. Over the past year, we have seen yield curves 'un-invert', with ten-year yields exceeding two-year yields, mainly caused by short-end rates falling. Figure 1 highlights the recent return of a positive term premium.

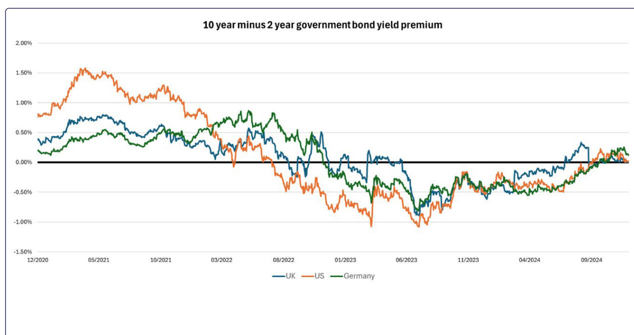
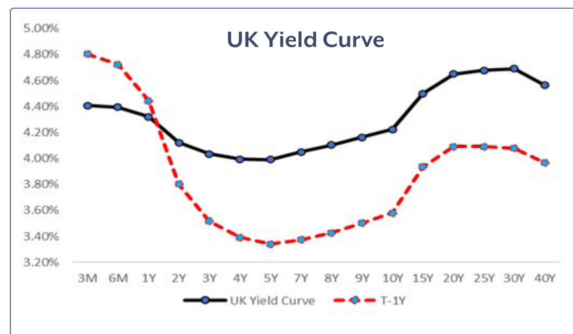
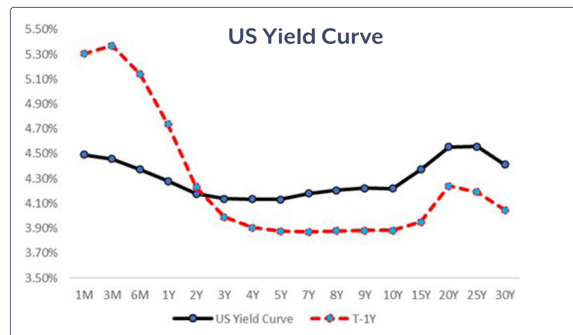


Figure 1. Source: Bloomberg, Charles Stanley

Across the developed world, short-end yields have fallen as central banks began cutting rates on the back of falling inflation. Long-end yields in the US and UK have drifted upwards because of increased political uncertainty, policies that will increase public spending, and concerns about an oversupply of government debt (***figure 2***).





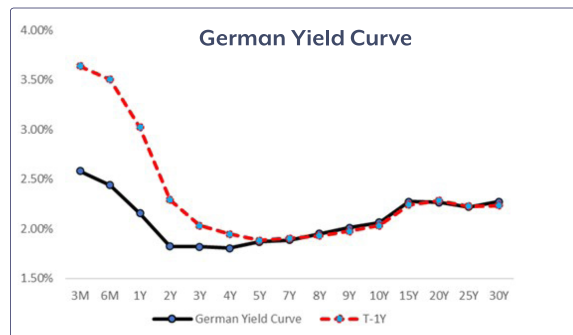


Figure 2. Source: Bloomberg, Charles Stanley

We expect short-end bond yields to continue falling in 2025, while longer-term bond yields may stay anchored at higher levels, resulting in the yield curve steepening further and pushing the 'term premium' higher.

Short-end yields to fall

We expect short-end yields to continue falling as central banks progress with their interest rate cutting cycles in 2025. Markets have recently reduced expectations of future rate cuts in the UK and US, while expectations of cuts in Europe have risen. However, the general view is that rates will continue to fall (***figure 3***).

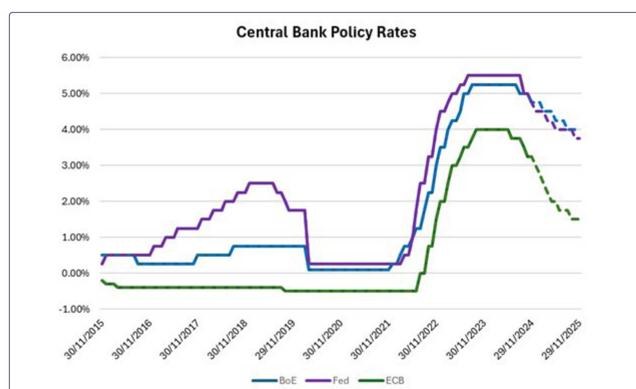


Figure 3. Source: Bloomberg, Charles Stanley

US

In the US, the key consideration for 2025 is how much the Federal Reserve (the Fed) will shift course in response to Trump's policies, many of which are widely regarded as potentially increasing inflation. In the near term, the market will pay close attention to:

i. the magnitude of tariffs, which may initially cause a direct increase to costs and therefore inflation, and;

ii.the impact of lower immigration, which may have indirect impacts on costs through higher wages associated with a tighter labour market.

We experienced a rapid increase in inflation across the developed world over 2022. However, the driver of inflation in the US differed from those in the UK and Europe. US price increases were more demand driven, reflecting the higher magnitude of post-pandemic government stimulus, rather than supply shocks and energy price rises which were experienced in the UK and Europe. Further expansion in US fiscal policy would be expected to keep driving that cause of inflation.

The Fed, which has reiterated its independence from fiscal policy, may choose to view the inflationary impacts of tariffs as a one-off, and continue focusing on supporting the US economy through rate cuts. However, we think the more prolonged impact of inflationary policies makes this route unlikely.

We think there is little doubt that the Fed will have to slow its easing of policy restrictions. They will remain flexible and reactive to changes in government policy, rather than pre-empting them, and we agree with market pricing of three to four 25-basis-point (bp) cuts over the next 12 months.

UK

In the UK, all eyes are on inflation and employment and, although we are yet to fully understand the impact of the recent Budget announcements, forecasts suggest it has inflationary characteristics.

Headline inflation has recently risen after falling below 2%, which was expected by the Bank of England and markets alike. But the bigger picture is one of inflation generally trending downwards. The fall in services inflation has been particularly slow – and remains the main risk to the view that the Bank of England (BoE) will continue cutting rates. Additionally, the Office for Budget Responsibility (OBR) expects headline inflation to be 50bp (or half a percent) higher at peak levels than previously thought, because of the Budget.

On a more positive note, planned fiscal stimulus isn't being passed directly to the consumer in the way we experienced during the pandemic and, as such, the actual impact on consumer demand (and therefore inflation) from the Budget is likely to be minimal.

Additionally, while services inflation appears worrying at first glance, looking at the detail, of the five components of 'all services' inflation, three are trending down.

Another policy from the Budget that will be monitored closely by markets is the rise in the national living wage. There is a risk that the cost to businesses of higher wages could be passed onto the end consumer. This is likely to have a more significant impact in services, where labour makes up nearly 70% of input costs. However, we believe it is more likely that the rise in living wage will result in job cuts and/or a fall in hiring, increasing unemployment.

Going forward, we expect the BoE to cut cautiously. We agree with market views that the policy rate will reach 4% by end-2025, allowing the short end of the UK gilt curve to continue drifting down.

Europe

Although Europe faces unknown risks relating to potentially growth dampening tariffs coming out of the US, it is domestic data that will be the dominant force on European Central Bank (ECB) policy.

Purchasing Manager Index (PMI) data in Europe – and particularly in Germany – make for bleak reading. It is interesting to note that in this cycle, peripheral Europe appears to be propping up the core, and ECB members will worry how long this can last.

In contrast to the largely demand-driven nature of US inflation, European inflation has been largely supply-driven; without cheap Russian gas (which was banned) energy prices have risen, hurting German manufacturing. All subcomponents of inflation in Europe are experiencing slower rises (disinflation) – and there is far less stickiness in core services inflation relative to the US.

We think this means the ECB can, and will, cut more than the Fed. Markets currently have priced in six cuts of 25bp each (or 0.25%) over the course of the next 12 months, which implies the policy rate will reach 1.50%. At Charles Stanley we expect five cuts over the next 12 months, with policy rates potentially reaching 1.75% by the end of 2025.

Long-end yields to remain elevated

With shorter-end yields expected to fall, we now look at reasons driving our view that longer-dated yields will remain higher. Those two combined will cause steeper yield curves in 2025.

We believe we will see a steepening in the US and UK yield curves, as yields at the longer end of the curve are unlikely to fall as much as the short end. In Europe, we expect to see a more parallel shift downwards in the yield curve.

US

Our view of a steeper yield curve reflects a growing budget deficit and an expected increase in US debt supply, a greater portion of which is likely to be longer-dated bonds issued.

On the deficit, given the republican clean sweep, the debt ceiling should be lifted in a less complicated fashion relative to previous episodes, and reducing the deficit is not a priority for the incoming US administration.

On the supply side, we expect this deficit to be funded with an ever-growing issuance of US treasuries, and it is expected that, over 2025, there will be a greater issuance of longer-dated coupon bonds relative to short dated 'bills'.

We expect a steeper yield curve by the end of 2025 compared to market expectations as represented by the 1-year forward yield curve (***figure 4***). This is mainly driven by a notable move down the yields of shorter-dated bonds.

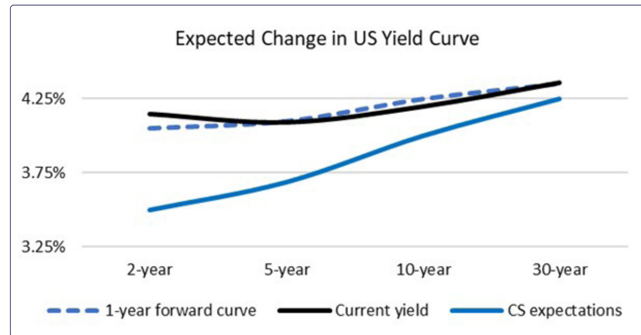


Figure 4. Source: Bloomberg, Charles Stanley

UK

The UK also has potential for a higher term premium, with long-end yields reflecting a market that may need to absorb a lot of extra gilt issuance. This is because of the much higher borrowing plans announced in the Budget, with a lot of that extra supply coming at the medium- and long-end, as in the US. In addition to this, markets may demand a yield premium on longer dated bonds because the government could fail to ignite worker productivity, which could exacerbate inefficiencies and create structurally higher long-term inflation.

Our 12-month forward expectations of the shape of the UK yield curve are broadly in-line with the market (***figure 5***).

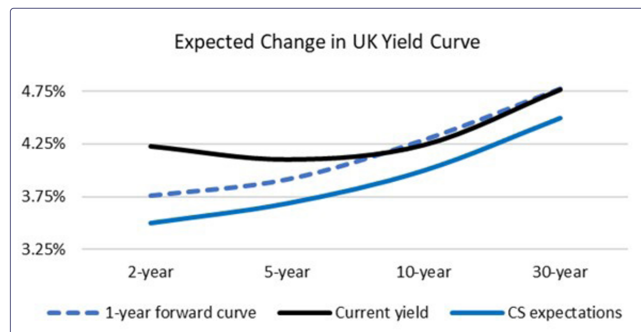
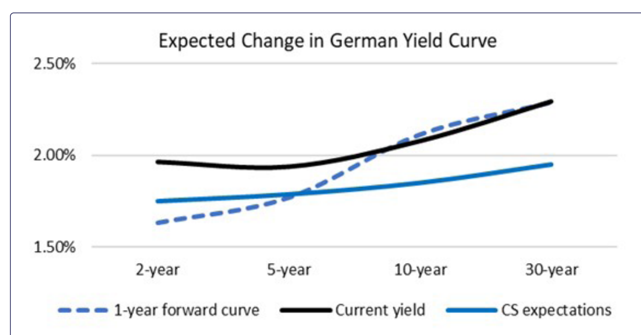


Figure 5. Source: Bloomberg, Charles Stanley

Europe

Consistent poor growth and growing recession fears are keeping hopes alive that the ECB may need to cut rates rapidly to support the economy. This may keep the yield curve subdued in Europe. Our expectations are for a more parallel shift downward in the German bund yield curve when compared to the market (***figure 6***).



By Lynn Hutchinson, Head of ETF and Index Solutions

US investments for 'Mag 7' bulls and bears

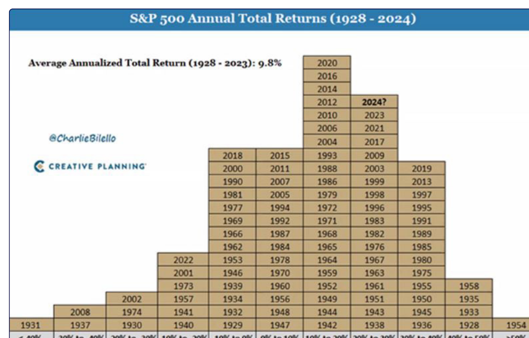
It has been an extremely difficult choice for an investor to have an "underweight" allocation to US equities over the past couple of years. Many have been "overweight" and benefitted as US indices led global gains. But some investors are wondering how long this can continue.

Providers of exchange-traded funds (ETFs) have capitalised on the popularity of US equities with global investors. They have further expanded their product range, and some have even lowered the cost of their products to entice more investors. There is an expectation of even more inflows over the course of 2025. On the other hand, some investors have been concerned about US valuations, so providers have also launched products that exclude US equities altogether from major benchmarks.

Whatever their view on the outlook for US equities, ETF providers have a product to fit investors' needs. So here we summarise the variety of low-cost options for investors with differing views on the outlook for the so-called 'Magnificent Seven'.

A series of record highs

The S&P 500 index continued to hit record highs in December 2024. As you can see in the following chart, the return in 2024 fits in the 20% to 30% bracket. However, as the index is up 29% at the time of writing it could very well sit in the next column by the end of 2024. This index is used globally by many investors as a benchmark to measure against their own portfolio returns on their US equity allocations.

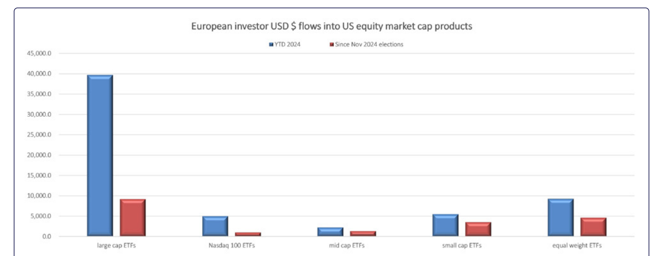


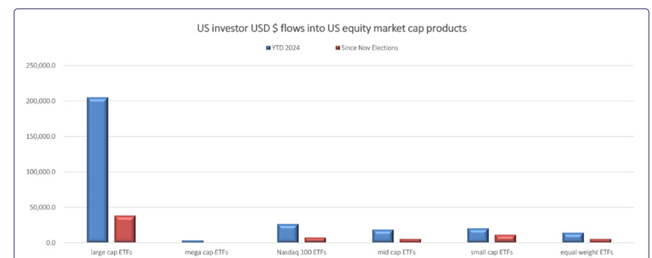
Source: Redburn Atlantic

In Europe, SPDR and Amundi lowered the ongoing charges figures (OCFs), which includes all charges, on their core US equity products to just 0.03%. A move that undercut all other providers. Other product providers lowered their OCFs on their MSCI World ETFs to as low as 0.11%. As a result of this cut in fees, these ETFs have seen billions of dollars of inflows in 2024.

Inflows

Over 2024, European investors have increased investment into US equities, with most flowing into ETFs that are weighted toward large market capitalisation companies, such as ETFs tracking the S&P 500. However, there has also been substantial flows into ETF products tracking other indices such as mid and small-caps and Nasdaq. Now product providers are giving investors a much wider choice, with "equal weight" options across the S&P 500, the Nasdaq, and world equity ETFs. Equal weight essentially means that each holding will have the same weight in a product regardless of its market capitalisation.





Data sources: Bloomberg and Charles Stanley

Exchange Traded Products (ETFs): some old and some new

So, European ETF providers now offer a wide range of US equity options. There are ETFs for US bears and bulls, for those wanting a little or large exposure to large-cap equities, or for those wanting broad market exposure. We will discuss these in more detail later, but let's first examine the backdrop against which these products have been launched.

The so called 'Magnificent Seven' comprises Apple, Microsoft, Amazon, Alphabet, Meta Platforms, Nvidia, and Tesla, and they have played a crucial role in driving US market growth. These large-cap names now comprise 33% of the S&P 500 ETFs and some investors are increasingly concerned about the ability of these tech-focused names to continue to beat market expectations.

When investors talk about these equities the focus is almost always on their extreme market capitalisation and thus their dominance in indices. While not all these seven companies are pure 'technology' businesses, they are seen as using advancements in technology and have a significant global presence and customer base. They also have superior revenue growth, are profitable, and have a significant management focus on cost reduction. They have large amounts of cash on their balance sheets to benefit from higher interest rates, sufficient to reinvest to generate future profits. Many have benefitted significantly from the current progress in artificial intelligence (AI).

The combined weight of the technology sector in an overall product can be high, a situation that may ultimately leave an investor overexposed should there be a change of sentiment surrounding the sector.

The overall weight of US equities in global indices is also a concern.

American equities currently account for 74% of the MSCI World, a developed-countries index-tracking ETF. Due to this skew towards US mega-cap technology names in major indices, product providers have launched equal-weight products that limit the influence of these mega-cap companies on returns and have even launched a "developed world" equity ETF that excludes US equities altogether. They have also launched products for investors with the opposite view – which gain an even higher exposure to these US mega caps.

Here are some of the different ETF products that are available to global investors:

- **S&P 500** – Tracks the 500 largest US-listed equities by market capitalisation. An ETF product tracking this index has a high exposure to technology, with a weighted allocation of 32%. Its top 10 holdings account for 25% of the overall product. The 'Magnificent Seven' now account for 33% of the overall ETF. It is a very low-cost product – European investors can access a UCITS ETF for an OCF of just 0.03%.
- **S&P 500 Equal Weight** – Like the S&P 500 ETF above, an ETF tracking this index tracks the 500 largest US-listed equities companies by market capitalisation. However, all the equities are weighted equally, so have an approximate weight of 0.2% each (the index generally holds just over 500 names and is currently 503-companies strong). Due to the equal weighting of the ETF, some sectors have a much lower allocation than the S&P 500 market capitalisation index, with technology making up just 14%. Industrials has an allocation of 16% compared with 8% in the S&P 500 ETF above. This product tends to be more expensive than the S&P 500 ETF, with an OCF of 0.20%.
- **S&P 500 Top 20** – There is a newly-launched ETF tracking this index. The ETF was launched for investors that believe the US mega caps are going to push even higher and outperform the S&P 500, so is aimed at investors seeking an extremely bullish (positive) position. It covers just 20 equities, so the top 10 holdings account for 78% of the total exposure. There is currently a huge 48% allocation to the technology sector. The 'Magnificent Seven' holdings account for 71% of the ETF. The ETF also has an OCF of 0.20%.
- **MSCI USA Mega Cap** – A new ETF tracking this index which defines mega-cap stocks as companies with a market capitalisation over €185bn. It was launched for investors who believe the mega caps are going to push even higher and outperform the S&P 500. The ETF tracks 37 US equities. The top 10 holdings account for 65% of the overall ETF, so this ETF is less concentrated than the S&P 500 Top 20 ETF referenced above. The sector exposure has a huge 46% allocation to technology. The 'Magnificent Seven' holdings account for 59% of the overall ETF. The OCF is 0.15%.

- **MSCI USA ex-Mega Cap** – Another new launch, this ETF excludes US mega caps and currently tracks 551 equities. As would be expected, it has a small overall weighting of just 8% to the top 10 holdings, with the biggest sector allocation being industrials, at 18%. It has no allocation at all to the 'Magnificent Seven'. It is aimed at investors who are bearish on the mega cap names but want to be invested in the remaining equities of the US large-cap market. It has an OCF of 0.15%.
- **Nasdaq 100** – Considered by some investors to have a large-cap technology focus, although as you can see from the table below it also covers other sectors. The top 10 equities account for 52% – with the 'Magnificent Seven' holdings making up 45% exposure. An ETF tracking this index can have an OCF as low as 0.20%.
- **Nasdaq 100 Equal Weight** – Another new ETF launch this year, it tracks the 101 equities in the Nasdaq 100 index but equal weights each holding to approximately 1% apiece. This gives an investor a lower technology sector weight of 40% compared to 50% for the market-cap weighted ETF. Its top 10 holdings have a significantly lower weighting, at approximately 13% currently (until the next ETF rebalance when it will fall back to 10%). The biggest difference relates to the 'Magnificent Seven', which currently account for just 8% of the overall ETF. The OCF for an ETF tracking this index is 0.20%.
- **S&P Mid Cap 400** – An ETF tracking this index has been around for some years now. It tracks the next 400 largest equities after the S&P 500. The top 10 holdings come to 7% with 0% allocation to the 'Magnificent Seven'. Its top-weighted sectors are industrials and financials. The OCF is 0.30%,
- **Russell 2000 Small Cap** – An ETF which tracks this index has also been available for some years now. It currently tracks approximately 1,800 small-cap equities and its top-weighted sectors are industrials and financials. The top 10 holdings represent just 4% of the ETF and there is no allocation to the 'Magnificent Seven'. The OCF is 0.30%,

	Amundi MSCI USA	SPDR S&P 500	Xtrackers S&P 500 Equal Weight	iShares S&P 500 Top 20	Amundi MSCI USA Mega Cap	Amundi MSCI USA Ex Mega Cap	Invesco Nasdaq 100	Invesco Nasdaq 100 Equal Weight	SPDR S&P 400 Mid Cap	SPDR Russell 2000 Small Cap
	Large Cap US Equities								Mid Cap US Equities	Small Cap US Equities
OCF (Cost per annum of the ETF) %	0.03	0.03	0.20	0.20	0.15	0.15	0.30	0.20	0.30	0.30
No of Equities in the ETF	590	503	503	20	39	551	101	101	401	1,787
Top 10 holdings weight in the ETF	34%	25%	3%	78%	65%	8%	52%	13%	7%	4%
SECTORS										
Communications	9	9	4	13	13	4	16	10	1	2
Consumer Discretionary	11	11	10	15	13	9	15	13	14	12
Consumer Staples	5	6	7	4	6	5	6	6	5	3
Energy	3	3	4	2	3	4	1	2	4	5
Financials	13	14	15	11	10	17	1	1	18	18
Health Care	10	10	11	8	8	13	5	10	9	16
Industrials	9	8	16	-	-	18	5	12	23	20
Information Technology	32	32	14	48	46	17	50	40	10	11
Materials	2	2	5	-	1	4	1	1	6	4
Real Estate	2	2	6	-	-	5	-	-	7	6
Utilities	2	2	6	-	-	5	1	4	3	3

The table on the next page highlights the individual and combined weight of the 'Magnificent Seven' equities in a number of ETFs. This table will help you determine the exposure across index-tracking investments and can be used to work out total exposure in a portfolio by the addition of direct equity or active fund holdings exposures.

	'Magnificent 7 Weights' in each of these ETFs									
	Amundi MSCI USA	SPDR S&P 500	Xtrackers S&P 500 Equal Weight	iShares S&P 500 Top 20	Amundi MSCI USA Mega Cap	Amundi MSCI USA Ex Mega Cap UCITS ETF	Invesco Nasdaq 100	Invesco Nasdaq 100 Equal Weight	SPDR S&P 400 Mid Cap	SPDR Russell 2000 Small Cap
	Large Cap US Equities								Mid Cap US Equities	Small Cap US Equities
Alphabet A & C	3.6	3.6	0.2	7.9	6.8	-	4.7	1.0	-	-
Amazon	3.9	4.0	0.2	8.6	7.3	-	5.5	1.1	-	-
Apple	6.9	7.2	0.2	15.6	13.2	-	8.8	1.0	-	-
Meta	2.5	2.6	0.2	5.6	4.8	-	5.0	1.0	-	-
Microsoft	5.8	6.4	0.2	13.7	11.0	-	7.8	1.0	-	-
Nvidia	6.7	7.0	0.2	15.0	12.7	-	8.5	1.2	-	-
Tesla	1.9	2.0	0.3	4.2	3.7	-	4.2	1.5	-	-
TOTAL	31	33	2	71	59	-	45	8	-	-

Data sources: Product provider websites and Charles Stanley & Co

Global Equities:

- **MSCI World** – A developed country index that tracks the world's largest equities by market capitalisation. It currently has a huge 74% allocation to US equities. It can have a high concentration across some sectors, with technology now having a weighted allocation of 26%. Its top 10 holdings account for 25% of the overall product. The 'Magnificent Seven' holdings now account for 23% of the overall ETF tracking this index. Low-cost product and European investors can access UCITS ETFs for an OCF as low as 0.11%.
- **MSCI World Equal Weight** – A new ETF launch which tracks this index, the ETF enables investors to spread risk – not just at the company level but also at a sector and geographic level. The investor ends up with an allocation to US equities of around 42%, compared with 74% in the MSCI World. This allows a higher weighting to other developed countries such as Japan, the UK, etc. Its top 10 holdings are just 2% of the overall ETF –with the 'Magnificent Seven' holdings making up just 0.5%. The OCF is a bit higher at 0.20%.
- **MSCI World ex-USA** – This is another launch for 2024 to help investors diversify away from holding too much allocation to US equities in their portfolios, while getting exposure to other developed country allocations in one product. Its top 10 holdings have an 11% weighting with no exposure at all to the 'Magnificent Seven' equities. The sector weights shift around a little compared to the standard MSCI World ETF, with the current highest allocation to financials but a very low exposure to technology. An ETF tracking this index has an OCF of 0.15%

	SPDR MSCI World	Invesco MSCI World Equal Weight	Xtrackers MSCI World ex USA
	Developed World Equities		
OCF (Cost per annum of the ETF) %	0.12	0.20	0.15
No of Equities in the ETF	1,384	1,384	817
Top 10 holdings weight in the ETF	25%	2%	11%
SECTORS			
Communications	8	5	4
Consumer Discretionary	11	10	10
Consumer Staples	6	7	8
Energy	4	4	5
Financials	16	17	22
Health Care	11	9	12
Industrials	11	18	17
Information Technology	26	11	9
Materials	3	7	7
Real Estate	2	5	2
Utilities	3	5	3

	'Magnificent 7 Weights' in each of these ETFs		
	SPDR MSCI World	Invesco MSCI World Equal Weight	Xtrackers MSCI World ex USA
	Developed World Equities		
Alphabet A & C	2.6	0.1	-
Amazon	2.9	0.1	-
Apple	5.1	0.1	-
Meta	1.8	0.1	-
Microsoft	4.3	0.1	-
Nvidia	4.9	0.1	-
Tesla	1.5	0.1	-
TOTAL	23	0.5	-

	Top Weighted Countries in each of these ETFs		
	SPDR MSCI World	Invesco MSCI World Equal Weight	Xtrackers MSCI World ex USA
	Developed World Equities		
US	74	42	-
Japan	5	14	20
UK	3	6	12
Canada	3	6	12
France	3	4	9
Switzerland	2	3	9
Germany	2	4	8
Australia	2	4	7
TOTAL	94	82	77

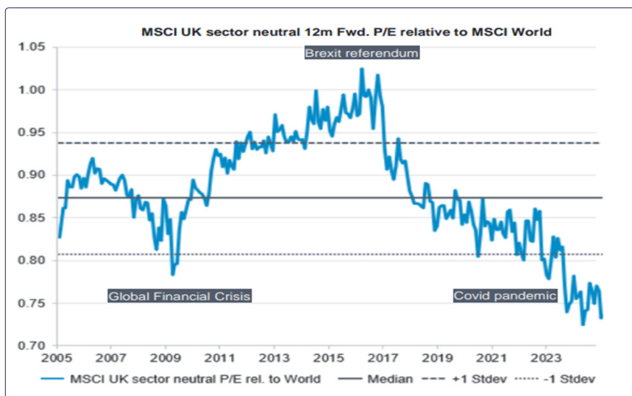
Data sources: Product provider websites and Charles Stanley & Co

COLLECTIVES RESEARCH

By Ross Brookes, Head of Collectives

UK equities: undervaluation is a double-edged sword

All areas of the UK market are cheap. The FTSE 100, FTSE 250 and FTSE Small-Cap index are all trading at large discounts to their long-term forward price/earnings averages. UK equities are also at low valuations compared with major global peers such as the US, Europe (ex-UK), Japan, and the rest of Asia. The sectoral bias towards cyclical industries and a lack of world-leading technology companies is often cited as the reason for this. But even taking this into account, the UK still appears cheap compared to the MSCI World Index.



Source: JP Morgan Equity Strategy, Datastream, Fidelity Special Values presentation

The US equity market is sucking in capital from investors, at the expense of our domestic market. UK funds have experienced 41 consecutive months of outflows at the time of writing. This ongoing technical headwind results in mutual funds having to sell investments to meet the demands of investors wanting to cash out. This in turn drives share prices lower, leading to more underperformance and more outflows. Or so some market commentators would suggest. They describe a 'doom loop' that is very hard to break out of.

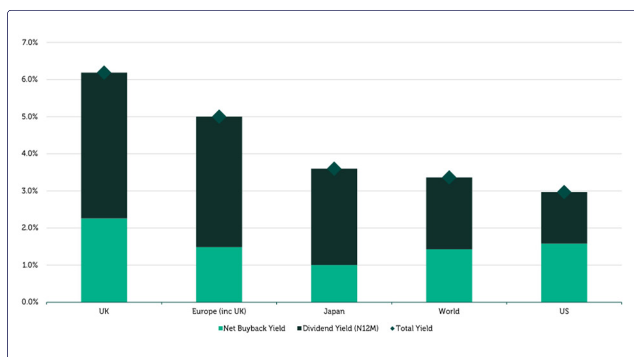
The UK market's apparent inability to fairly value its companies is very much a double-edged sword. On the one hand, if companies are fundamentally undervalued relative to their future prospects, they tend to make rather good investments, and good active managers should be able to identify these opportunities and reap the rewards.

The issue is that the process of unlocking this value is often through takeovers, which results in a shrinking equity market. We note there have been 262 takeovers in the UK market in the five years to the end of June 2024. This has been at an average premium of 44% to the 30-day volume-weighted average price, and at an average multiple of 14.5x EV/EBITDA. Corporates and private-equity investors have been willing to step in and take a longer-term view on the value and quality on offer.

The sheer amount of interest from buyers suggests there is a valuation disconnect. The problem is that the active managers we follow need enough high quality and diverse companies from which to build portfolios. We don't just mean today, but in three to five years' time and beyond.

With all this takeover interest and the initial public offering (IPO) market dormant for the reasons listed above, we're seeing this pool get smaller and smaller. The shrinkage is most stark in the small-cap market. The FTSE Small Cap index has shrunk by about 60 companies (or 21%) over the past five years. The FTSE Fledgling and AIM markets have shown a similar reduction in the number of trading companies. The FTSE 250's number of constituents doesn't change, but now includes lots of investment trusts, not true UK PLCs. Active managers tend to be overweight in these smaller names, but their choice is becoming increasingly restricted.

Takeovers are headline grabbing but investors tend to overlook the effect on share buybacks. The economics of a buy back are compelling if a company is really trading below its intrinsic value and isn't relying on borrowing. But, while it grows the per-share value of a company, a buyback tends to shrink the overall value as it is, ultimately, a return of capital. We've seen a huge pick up in the number of companies conducting meaningful levels of share buybacks in recent years. Combining buyback yields and dividend yields gives us a total shareholder yield, a measure of the total capital being returned to investors. This looks very attractive for UK equities at present.



Source: Temple Bar Investment Trust

So there lies the double-edged sword. Undervaluation is an opportunity in the short-to-medium term, but the means of realising this value could be a threat to the long-term health of the UK equity market and those that invest exclusively in it. This is why the IPO market is so important.

We are mindful that many aspects of our industry are cyclical – and we certainly wouldn't want to be the one to predict the terminal decline of UK equities. But the trend of companies choosing to list in the US in pursuit of premium valuations is a concerning one and it is little surprise the government has been so focused on this issue. Perhaps we will need to wait for this unprecedented period of US exceptionalism to abate before normality is restored.

At least it looks like we'll be well paid waiting for that to happen.

EQUITY RESEARCH

By Amish Patel, Head of Equity Research

A year of volatility – and rigorous analysis

As we look ahead to 2025, we maintain a cautiously optimistic outlook for equity markets, despite the likelihood that values will be highly unpredictable (volatility). Several pivotal factors will shape market dynamics, including economic growth rates, monetary-policy adjustments, geopolitical developments, and sector-specific trends.

Given the uncertainties ahead, stock selection will play a crucial role in client portfolios.

American exceptionalism expected to persist

This year has proven to be a strong one for global equities, with the US market standing out, being propelled by the performance of the so-called 'Magnificent Seven'. This select group of technology giants has been responsible for more than 50% of the S&P 500's returns, at a time when US equity market concentration is at record levels.

As we look ahead to 2025, optimism remains high that the US market will continue its upward trajectory, driven by expectations of broader-based performance and strong earnings growth. While we maintain a positive view on US equities, the increasingly complex investment environment requires a nimble approach and tempered return expectations.

The recent Republican election victory is set to reinforce the narrative of American exceptionalism. Donald Trump's win could be beneficial for markets, signalling a shift towards expansionary domestic policies. Forecasts point to a 14% rise in US corporate earnings in 2025, outpacing most other regions in terms of growth, return on equity, and net debt levels.

This election outcome has sparked optimism among investors who foresee a business-friendly environment conducive to growth and innovation in the coming years. However, risks from tariffs and trade tensions with China and Mexico could affect specific sectors. Nonetheless, any resulting reflation may enhance earnings and mitigate concerns about high corporate valuations.

The narrative of US exceptionalism may face challenges and forthcoming policy changes might lead to increased volatility, but sentiment suggests the current opportunities outweigh the risks. The main headwind facing stocks is valuation; the S&P 500 is trading at a price-to-earnings ratio (P/E) of 22x, which is high by historical standards and higher than when Mr Trump first took office in 2017. While this does not rule out the possibility of stock-market gains, it underscores how earnings growth will need to be the primary driver of future price increases.

Still cautious on European equities for now

The outlook for European equities presents a mixed picture. Despite high household savings rates, robust wage growth, and low unemployment, the European economy faces challenges such as weak consumption, poor domestic demand, and low fixed investment that have led to a downward revision in earnings guidance. Additionally, China's economic struggles pose a significant headwind, particularly for Germany – a major trading partner with Beijing. And political uncertainty in Berlin further compounds these issues.

However, there are opportunities within the European market. While Eurozone equities have lagged due to disappointing growth and earnings, low valuations and positioning could lead to a rebound. With corporate earnings expected to grow by 11% in 2025 and the region trading on a P/E multiple of 14x (below the five-year average) certain sectors appear attractive. Global sectors like Energy, Health Care, and Industrials, which are less exposed to domestic-consumer weakness, offer potential. Also, the UK economy, with its smaller manufacturing footprint, is less vulnerable to rising tariffs and trade uncertainties, presenting a positive risk-reward profile .

Other positive indicators for European equities include bottoming inventories and significant real-wage growth, which could boost consumer spending. Europe's sensitivity to interest rates suggests that gross domestic product (GDP) could respond

positively as monetary policy loosens. The upcoming German elections might also offer potential for a relaxation in government spending, providing a more favourable environment for stock picking with a focus on valuation.

Overall, while we remain cautious, the outlook for European equities in 2025 holds promise for stock pickers willing to navigate the complexities of the market.

Japanese corporate profits to continue to blossom

In 2024, Japan Inc. is making strides to overcome decades of deflation, with a shift towards value creation and shareholder returns. Japanese equities are expected to perform well in 2025, supported by improving sentiment and economic fundamentals.

Japan's economic recovery is accelerating, enhancing consumption and capital spending. The labour market is revitalised, with annual wage gains of more than 5%, rising numbers of people in work, and record-low unemployment. This environment is stimulating consumer spending, crucial for sustained growth.

Favourable currency dynamics are also benefiting exporters and boosting corporate confidence. Projections indicate that capital investments could reach historic levels by 2025, driven by strong international demand and favourable currency conditions.

Corporate governance reforms are also gaining momentum, with many companies committing to transparency and accountability, alongside plans for increased shareholder returns in the form of dividends and share buybacks. Fund flows into Japanese equities are likely to rise as domestic pension funds and households invest more ahead of an expected increase in inflation.

Overall, these developments position Japanese equities for continued growth and increased investor interest in the coming years.

Secular-growth opportunities in 2025

Looking back at the start of the year, we highlighted long-term themes such as artificial intelligence (AI) and obesity as areas that could perform well. In 2025, we believe investors should continue to focus on these themes but, as these technologies advance and mature, the opportunity set will evolve, making stock selection increasingly important.

The GenAI sector is poised for substantial growth, with the AI chip market projected to reach nearly $92bn. Major tech firms are geared up to invest more than $200bn in AI infrastructure, driven by the need for enhanced data-processing capabilities that support AI applications integral to business operations. However, concerns about the sustainability of returns from these investments persist, as making money from AI technologies may take longer than first thought. Investors must navigate this landscape cautiously, balancing the potential for high returns against risks of overvaluation and market saturation in certain segments.

In healthcare, advancements in treatments for chronic conditions like obesity and diabetes present promising long-term investment opportunities. The market for obesity drugs is expanding rapidly despite supply constraints and with many leading firms now working on newer, more-innovative approaches that use the hormone Amylin in combination with, and instead of, the current glycogen-like-peptides (GLP-1s). Additionally, the integration of AI into healthcare is creating new avenues for personalised medicine. Regulatory challenges, particularly around drug pricing in the US, could impact certain stocks, making it essential for investors to focus on companies that can effectively navigate these changes.

The return of animal spirits

While the trends mentioned above are a continuation of those seen in 2023 and 2024, the coming year may see a resurgence in corporate activity, particularly in mergers and acquisitions (M&A) and initial public offerings (IPOs), which have been subdued in recent years.

Since 2022, corporate decision makers have faced challenges such as double-digit inflation, global trade disruptions, military conflicts, and political uncertainty, leading to decreased M&A and IPO activity globally. Although M&A picked up in 2024 from a decade low in 2023, it remains below historical levels. With political uncertainty easing and a pro-growth administration in the US, corporate leaders are likely to explore expansion opportunities through acquisitions. A return to trend in M&A activity could broaden equity-

market returns beyond the dominance of major tech firms to include small- and medium-sized businesses that have lagged.

Similarly, while the IPO market improved in 2024, it still falls short of the last decade's activity levels. Many companies are choosing to remain private longer than before, but several high-profile IPOs may emerge as private-market investors seek opportunities amid a strong US equity market. This environment suggests potential for increased corporate activity as companies adapt to changing market conditions and capitalise on new opportunities.

Overall, the combination of improved political stability and a favourable economic climate may lead to a more vibrant corporate landscape in 2025, fostering growth through strategic expansions and public listings.

2025: A stock-picker's year

Equity markets are poised to present a blend of risks and opportunities, as in any year. While lower interest rates, strong earnings, and a surge in innovation create a supportive environment for equities, geopolitical uncertainties and shifts in the labour market could heighten the risk of a downturn. US markets are expected to continue outperforming their European counterparts, but investors will need to remain vigilant regarding the sustainability of market returns, particularly in the US.

A less-synchronised interest-rate cycle may emerge globally as a result of new US policies and the knock-on effects on currency markets. This makes for a stock-picker's market, where it is more essential than ever to understand the interplay between currency changes, global supply-chain redesign, and the impact of new tariffs on business models.

With current valuations being elevated, it will be crucial for investors to pinpoint the best opportunities as the economic landscape shifts. Our approach centres on rigorous fundamental analysis while maintaining valuation discipline. We remain focused on finding companies that meet our quality criteria, as we believe that a portfolio comprised of such high-quality firms will deliver outperformance over the long term.

By Paris Jordan, Head of Responsible Investing, and Lewis James-Lawrence, Responsible Investment Analyst

Look through Trump-inspired political noise

There has not been a shortage of responsible investment news throughout 2024. In the past year alone, wildfires have triggered agricultural price rises, droughts have hit supply chains, and heat stress has impacted productivity. And all have had a knock-on impact to companies and investments.

We've witnessed sustainability regulations progressing across the UK and Europe, while a backlash has been growing within the US. As 2024 will be the first year that global average temperatures have broken through 1.5°C above the pre-industrial era, this also suggests that physical risks are coming quicker than expected.

Risk remains increasingly relevant

When considering the broad sustainability themes that will be in focus in 2025, we expect a greater focus on risk. We've witnessed multiple climate risk models highlight the growing unpriced impact of climate change (physical risk) and risks associated with the transition to net zero. In 2024, we have also witnessed economic climate risk models forecast greater hits to future global gross domestic product (GDP) as climate targets aren't met.

As both governments and companies increasingly become more impacted by natural events, supply-chain disruption and mass migration, the impact on investment portfolios should not be underestimated. Therefore, considering this risk on investment portfolios is likely to become more important as time passes. Pleasingly, as climate risk reporting, specifically the Task Force on Climate-Related Financial Disclosures (TCFD), becomes more embedded within organisations, the management of these risks is likely to improve.

Political progress and political tension

Considering the potential risks and impacts that are increasingly being revealed, responsible investment is now something that cannot be ignored by political leaders, even if the response is to actively reject it by some.

In the UK, both the government and regulators have been making strides to embrace it, and a major step forward in the investment world was the introduction of sustainability labels for UK funds and the implementation of an anti-greenwashing rule. This should help UK investors understand what types of sustainable funds they are investing in and provide greater transparency to build confidence and support in this investment area. This progress is expected to continue into 2025.

On the other hand, the most obvious threat to responsible investing is the change in leadership within the US. Phrases such as “Green New Scam” and “drill, baby, drill” have made headline news and the effect of this rhetoric is likely to be somewhat negative, although the chances are that much of this is just noise. However, what we do expect under the Trump administration is that investment messaging is likely to change.

For example, research approaches that take Environmental, Social and Governance (ESG) factors into consideration are likely to endure extensive criticism and scrutiny. We have already witnessed a range of climate/ESG anti-trust allegations from Republican congressmen in recent years and we expect this to grow, given the new government's composition. Alongside this, the new co-lead for the newly created Department of Government Efficiency, Vivek Ramaswamy, is a staunch anti-ESG activist. It is therefore highly unlikely it will receive federal encouragement.

The knock-on effect is that investors are likely to witness greater ‘greenhushing’ of ESG research and perhaps even a rollback on subsequent positive sustainability initiatives and investment, so they are not caught in the crossfire.

While there are many other non-US investors who will still favour investing sustainably, and require ESG research/risk assessments, we do expect the sentiment within the US to have a consequent effect to global sustainability efforts and investment. Over time, it's plausible to expect a global division in sustainable marketplaces as other nations extensively take the lead on sustainability efforts to reduce growing risks and meet client demand.

We also expect to see further division in the US marketplace with bigger asset management firms who are, where willing, better able to defend themselves against any regulatory or litigation-based pressures coming from the new government departments. Smaller firms are less likely to be willing to take the time defending any progressive initiatives they have and are likely to step back from arrangements.

However, in terms of investment opportunities, there are still many long-term, sustainable opportunities which are here to stay and can be captured by investors.

The biggest long-term sustainable theme is energy transition

We continue to acknowledge that in 2015, through the Paris Agreement, most of the global economy agreed to focus on the year 2050 for global carbon emissions to be neutralised – 'net zero'. By hitting this goal, the aim was to limit the average global temperature rise to below 2°C. This target hasn't dissipated and, while it may be creating political tension, it remains firmly on the global agenda.

One of the major focal points for reducing global carbon emissions has been our energy system which accounts for 73% of total global carbon emissions. The transition away from the high-carbon-emitting sources of energy towards cleaner renewable sources is a monumental task. It is worth recapping how this topic translates in terms of numbers and future expectations.

- The International Energy Agency forecasts annual clean energy investment of $4.3 trillion before 2030 for net-zero alignment. Compare this to current stated policies of $2.3 trillion investment per year.
- Global forecasts to meet net-zero alignment are 11,000 GW in renewable capacity by 2030. Compare this to the current installed capacity of 3,600 GW (2022); an increase of three times is required.
- Renewable energy is forecast to be close to 90% of total global electricity generation by 2050.

This is not a new story. Clean energy and most sustainable investments have been a particularly hot topic from 2018 through to late 2021. The global low-interest-rate environment created a strong backdrop for growth investing, whilst a relatively calm geopolitical period had soothed markets.

The transition disconnection trifecta

Since then, we have had a backdrop that has made for a much cloudier short-term picture taking the allure out of this space – and hence performance has been woeful.

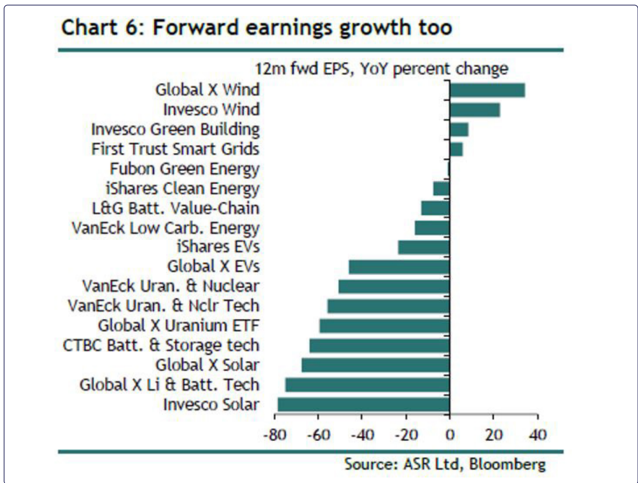
Firstly, interest rates have risen to considerably higher levels than experienced for nearly two decades. This caused investors to switch to shorter-term investments as offering better cash flows than those offering longer-term returns. This sent the share prices of companies in this space crashing.

Secondly, the growth rates for some of these businesses have slowed as the global economy found its feet after the Covid-19 pandemic. Higher interest rates have also disturbed the investment profile of some of the higher risk, speculative investment themes.

Thirdly, and most recently, we have the political backdrop. A changing of the guard in the White House is likely to increase the already polarising views on climate change and fuel the anti-ESG and "drill, baby, drill" rhetoric.

In our view, this has created a disconnect between the long-term growth projected for much of the energy transition industry versus the short-term adjustment and performance weakness we have seen.

We have even seen some sharp downward revisions for sales and earnings forecasts with implied reductions in earnings per share for some thematic exchange-traded funds (ETFs) ranging from 20% to as much as 80% (*Source: Absolute Strategy Research*).



This latest post-Trump election sell off, has now created what we think is a compelling value opportunity to invest in a long-term positive theme with very strong support. For example, here are valuations for some of the more popular companies held by these funds:

Security	Five-year historic average valuation (1FY PE)	Current Valuation (1FY PE)
Enphase Energy	53x	32x
Orsted	33x	17x
First Solar Inc	37x	15x
SSE	14x	10.5x
Vestas Wind	1.7x Price to Sales	0.8x P/S

Final conclusion

Donald Trump's election has certainly added disruption risk to the short-term progress. However, this does not mean the whole world gives up on trying to limit global warming and climate change. If anything, his turbocharging of the oil and gas industry will only create further dependencies on energy from a single source.

If we have learnt nothing from Covid and the Russia-Ukraine conflict we should encourage being even less dependent on external nations for our energy. This further drives the need for energy independence through renewable sources. Joe Biden's very popular Inflation Reduction Act is also hugely beneficial for Republican states, so the chances that this is fully removed is perhaps an overreaction.

Nothing in this document should be construed as personal advice based on your circumstances. No news or research item is a personal recommendation to deal.

The value of investments can fall as well as rise. Investors may get back less than invested.

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