WYSS & PARTNER

Investment Policy 2025

Anything is conceivable and many things are possible

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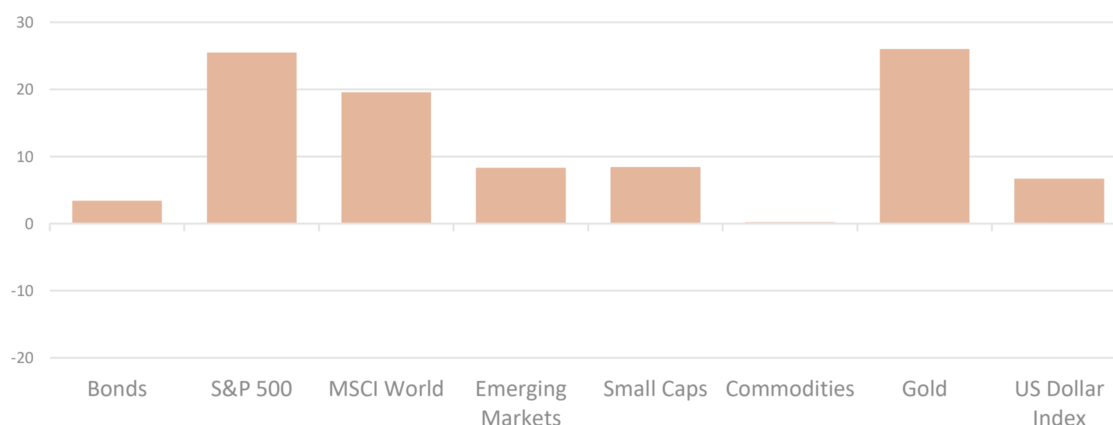
- Strong USA – weak Europe – wavering China
- Official interest rates continue to fall – Switzerland faces negative interest rates
- Soverign debt increase weighs on capital markets
- Trade war with unforeseen consequences – up to a global recession
- Equities: Exuberant optimism does not match the highly unstable environment

Review 2024: The year of interest rate turnarounds and punishment of governing parties

Chart 1: Performances in USD



Source: Bloomberg

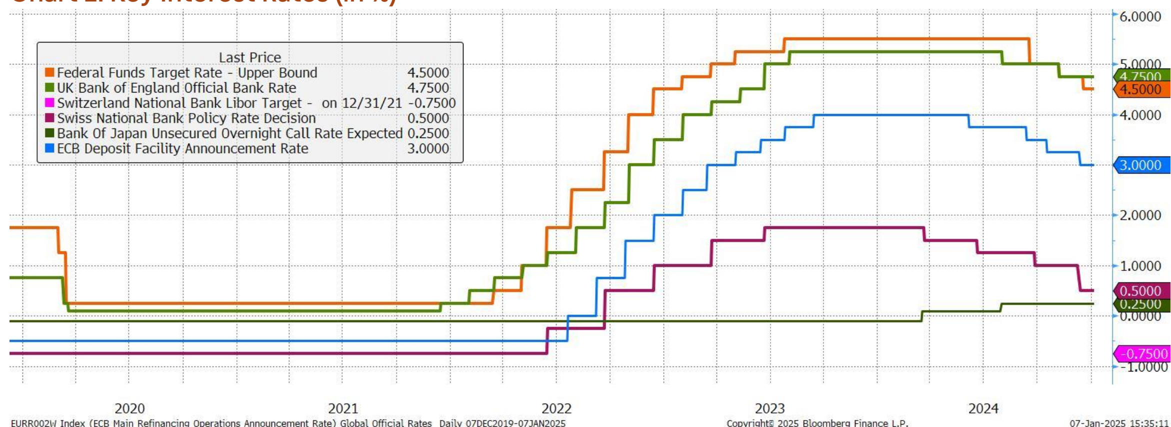
As expected, most industrialized countries saw a turnaround in interest rates in 2024. Rather surprisingly, the Swiss National Bank pressed ahead, cutting interest rates for the first time in the first quarter. The reduction in interest rates totaling 1.25% over the year was made possible by the successful fight against inflation. The European Central Bank followed with a delay, although the weakness of the economy suggested an earlier easing of monetary policy. The ECB's reluctance to take pre-emptive action was linked to the lack of progress on the inflation front. A similar situation was to be found in the USA,

with the main difference being that the economy there was showing unbroken strength. The Fed only decided to cut interest rates by 0.5% for the first time in September, after signs of a cooling labor market surfaced. Japan was the only major central bank to take the opposite course and hike rates, which was a step towards normalization.
The elections for the European Parliament and national parliaments were largely a declaration of displeasure and resentment with the ruling parties and confirmed a trend towards a shift to the right. This resulted in a government crisis in France, and the German governing coalition paved the way for early parliamentary elections. The most astonishing elections in terms of process and outcome took place in the USA, where the Republicans achieved an undisputed victory and control both the White House and Congress.
The key interest rate cuts only had a positive effect on long-term interest rates in Switzerland, with the result that the total return on fixed-interest investments was unusually high at around 5%. By contrast, interest rates on 10-year government bonds rose in the USA, the eurozone, the UK and Japan over the course of the year. As risk premiums continued to fall, investments in fixed-interest investments still generated positive, but modest returns.

The interest rate shifts had the effect of strengthening the US dollar by around 7%, while the appreciation against the yen and AUD was even more pronounced. The major monetary steps taken in Switzerland succeeded in stabilizing the CHF/EUR ratio.
The gold price rose by 26% as a result of central bank purchases, while decoupling from its usual determinants. A stronger US dollar and rising US real interest rates usually have a negative effect on the gold price.

The hype surrounding artificial intelligence also boosted the stock markets in 2024, particularly the US market (S&P 500), which gained 25%. The ‘magnificient seven’, including Meta, Apple, Amazon, Alphabet and Nvidia, made an annual gain of 70%. The Swiss stock market SMI moved in modest spheres with a gain of 8%, which was largely due to Nestle's price loss of over 20%. The global index rose by around 20%, driven by the communication services and information technology sectors with a performance of 35% and 34%, respectively. The energy, consumer staples and property sectors remained below the 10% mark. The performance of shares in the healthcare sector was particularly disappointing, with a 1% decline. Shares in the materials sector lost 5% over the year. The universe of small capitalization stocks lagged behind the large index with a performance of 8%. Performance in emerging markets was mixed, averaging around 8%. Brazil and Mexico lost 30%, while Turkey and Taiwan each gained 17%.

Chart 2: Key Interest Rates (in %)



Source: Bloomberg

Outlook 2025

"All previous inventions have empowered humans... Artificial intelligence, on the other hand, is able to process information without human intervention, making humans superfluous in decision-making. AI is not a tool - AI is an actor... The real threat to humanity as a whole is the totalitarian potential of non-human intelligence. "*

Financial markets follow the thesis that AI is one of the greatest inventions in human history and will significantly increase the productivity of the economy, so that we will progress on the road to prosperity despite demographic handicaps. However, the gap between the blessing and the curse of this technology is immense. If we take Harari's concerns quoted above seriously, with all their possible consequences, then it is foreseeable that sooner or later a wave of regulation will limit the potential for productivity advances. But the question of whether the huge investments in artificial intelligence will be economically viable is yet to be unresolved. So far, only the 'tool suppliers' have benefited. In any case, there are plenty of reasons why the euphoria of the stock market on this topic could come to a halt.

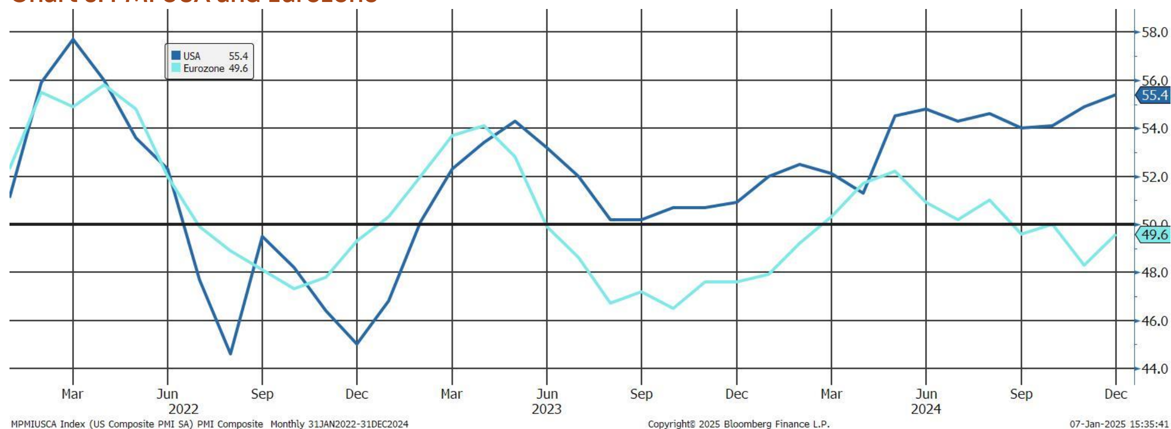
In addition to the question of investors' views and the government's intentions to regulate AI, the new government in the US will receive the full attention of the stock market. Trump's election program provides for taxes to be lowered, tariffs to be imposed, immigration to be restricted, regulations to be lifted and government spending to be cut. According to estimates, this will increase the budget deficit by an average of USD 1 trillion per year and push the US national debt further into the 100+ club, i.e. government debt will grow to well over 100 % of GDP. Other potential consequences of this program are an international trade war, re-kindled inflationary pressures and rising interest rates in the USA, a loss of prosperity and the danger of a global recession.

The prevailing opinion on the markets is that the trade policy will not be implemented in this way but will be used as a threat to achieve better negotiation results, which could cover completely different issues. Ideally, the entire package to improve the framework

* Yuval Harari, Nexus

conditions for the private sector will stimulate investment activity and generate growth that will bring the national budget back into balance, at least that is the government's view.

Chart 3: PMI USA and Eurozone



Source: Bloomberg

Economic Outlook

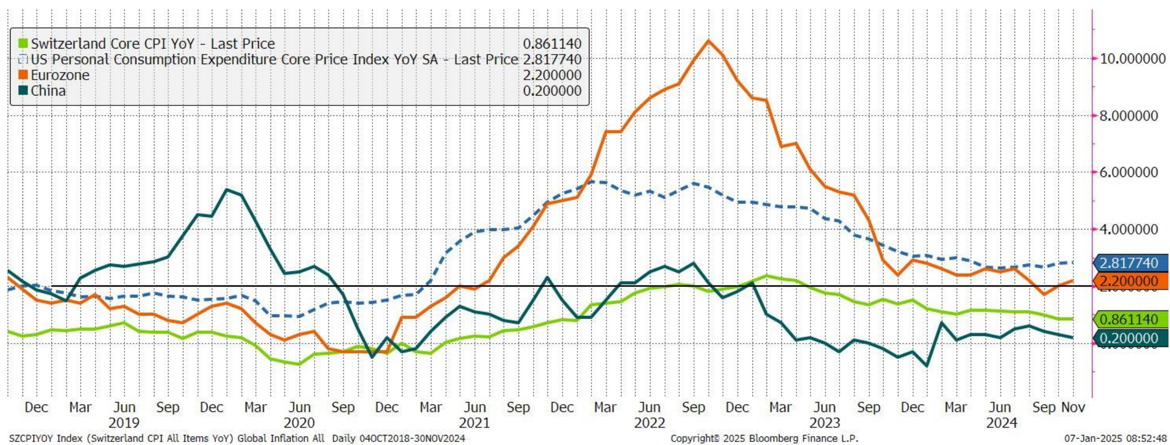
Excluding politics, the question arises as to the fundamental economic constitution of the most important economic blocs - the USA, Europe and China. The bold formulation that the USA is innovating, Europe is regulating, and China is imitating probably has some truth at its core.
According to the purchasing managers' index (PMI) surveys, growth momentum is likely to remain strong in the USA for the time being and slowdown in the eurozone. The reason for this is that global industrial weakness is stronger in Europe and the services sector is booming in the US to such an extent that it is more than compensating for the weakness in manufacturing.
However, the pace of growth in the USA is in our view not sustainable in the long term. The above-average growth in consumer spending will have to slow down, as Covid savings have been used up and credit conditions have deteriorated significantly. In addition, the labor market has returned to normal and could weaken further, exacerbated by a weak property sector, which will affect the propensity to spend. However, this is at least partly offset by the fact that net assets of private households have risen thanks to stock and property markets. The prevailing opinion is that the economic slowdown will be mild and that the US Federal Reserve will ultimately succeed in minimizing the collateral damage of monetary tightening, contrary to all historical experience. This scenario would be supported by increased investment activity that could follow from changes in the political landscape.
The economic weakness in Europe is due to the fact that domestic demand has been stagnating for years and export successes are flagging. A striking example of this is the European automotive industry, which is under enormous pressure from structural

changes in mobility and the changed competitive situation (China). Europe's strength lies in its industrial past and not in future technologies. This is at least the diagnosis of the Draghi expert report to the European Commission. The proposed solution is an investment program costing around 800 billion a year. Compared to the rescue of Europe after the Second World War with the Marshal Plan, this program would be around three times more expensive. Apart from whether this approach will be effective, the primary question is whether Europe is in a position to make political decisions of this magnitude at all. The two driving forces, Germany and France, are in a political crisis and will not be able to promote such a gigantic European project for the time being. It is therefore foreseeable that the economic situation in Europe will remain gloomy.

This bleak European outlook also affects the Swiss economy. However, Switzerland should not be faced with the challenge of providing fiscal policy support. Monetary policy surprised many observers in 2024 with its interest rate cuts, which increasingly took on the character of preventative measures. The Swiss National Bank has left little doubt that monetary easing will continue in 2025 if necessary.

China's economy has stabilized to some extent, but the fundamental problems remain. Growth to date has been based on exports and investment in infrastructure and production capacity. Retirement provision has largely been done through home ownership. The export engine is being weakened by the technological war with the USA and the threat of tariffs as well as competition from low-wage countries. The reorientation of export activities will only help to a limited extent. Expanding production capacity only makes sense if something can be sold. China's consumers have suffered heavy losses due to the collapse in property prices and are therefore less inclined to spend, resulting in deflationary pressures. And the savings rate in China is – for a variety of reasons – very high to begin with. To escape the growth or deflation trap, China will probably have no choice but to promote consumption in this constellation. It will become clear in 2025 to what extent the Communist Party will support the path to a consumer state.

Chart 4: Global Inflation rates



Source: Bloomberg

Monetary policy is or will be accommodating

Irrespective of whether the inflation targets are achieved, the central banks will align their interest rate policy with the requirements of the economy. The fall in interest rates in the USA in 2024 was in line with the fall in inflation, meaning that real interest rates remained at a high level. Even if core inflation remains above 2%, further interest rate cuts can be expected in 2025. The futures market expects one to two interest rate cuts of 25 basis points each for this year. Further monetary easing is more urgent for the eurozone for economic reasons, meaning that the extent of the interest rate cuts could be twice as large as in the USA. Switzerland will follow suit in order to prevent an excessive real appreciation of the Swiss franc. It cannot be ruled out that interest rates will fall into negative territory. The Chinese authorities are confronted with the risk of a deflationary price trend and will therefore ease monetary conditions further.

Chart 5: USD Credit spreads

Source: Bloomberg

Bond markets offer limited return potential

Rising inflation expectations have driven the development of the US yield curve, with the result that yields on government bonds with a term of three years or more have risen. Whether fears of higher inflation in the longer term will increase even further depends on how large of a budget deficit the US government will turn run under Trump. Conceivably, this process could continue and further push up interest rates. In addition, the Federal Reserve is not available for financing; on the contrary, the process of balance sheet reduction (quantitative tightening) is underway. If the path of unbridled debt policy is embarked upon, interest rates are likely to react violently, forcing politicians to make a correction. This corrective of the US bond market would eventually set a limit to the rise in interest rates.

In a more favorable case, we expect interest rates to move sideways, with only short maturities benefiting from falling key interest rates. Yield premiums for private borrowers with good credit ratings are likely to remain at the longer-term average, meaning that yields of towards 5% can be expected under normal circumstances. Yields for lower-quality borrowers and borrowers from emerging markets are naturally higher, but the

gap has narrowed significantly. The risk of major price corrections must be kept in mind here, which will occur in particular in the event of poorer economic data.
Interest rates in the Swiss franc are below 1% for all maturities. Even if a further fall in interest rates - possibly into negative territory - cannot be ruled out, the earnings potential for investors in fixed-interest securities is extremely modest. Shares with high dividends can be considered as a possible way out. However, it should be borne in mind that the volatility of the portfolio can increase significantly.

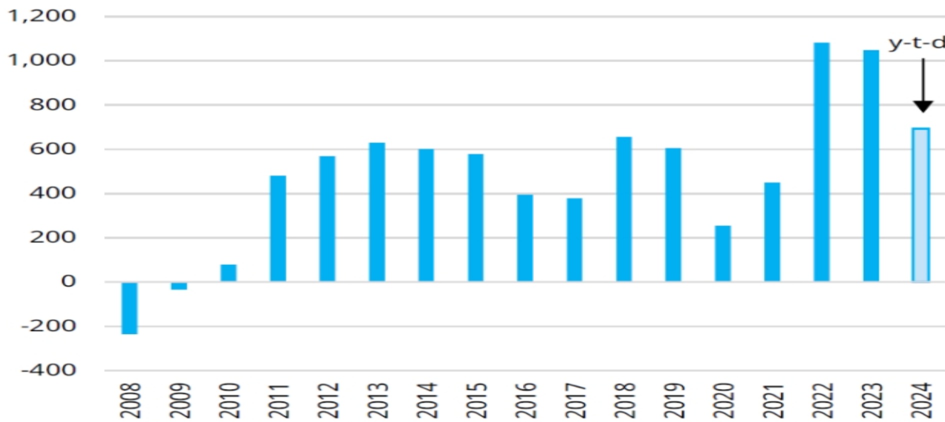
Interest rate trends argue in favor of continued USD strength

The US currency is overvalued against most currencies and should weaken in terms of purchasing power. In relation to the yen, this overvaluation of around 50% is particularly pronounced. However, the interest rate differential is likely to be more decisive and develop in favor of the USD, not least in relation to the euro. The relationship with the yen is likely to be significantly influenced by the interest rate for 10-year US government bonds and is therefore more likely to remain stable than follow the long-awaited devaluation path.
As interest rates in the eurozone are likely to fall more sharply than in Switzerland, the Swiss franc is expected to strengthen. If the real appreciation is too strong, the central bank is likely to intervene in the foreign exchange market in order to maintain the competitiveness of the Swiss export economy. The reintroduction of negative interest rates is also conceivable as an alternative or supplement in a worst-case scenario.

Commodities - Gold doesn’t fade

The price trend for cyclical commodities will be subdued, primarily due to the fragile economic situation in China, the most important importer of many commodities. On the oil market, the tendency towards overproduction will be accentuated by the energy policy in the USA and a presumed expansion of production in Saudi Arabia.
Falling inflation rates and a firm US dollar argue against a continued upward trend in the gold price. In addition to lower short-term interest rates, central bank purchases are likely to remain the most important driver of gold prices in 2025. In the wake of Western sanctions against Russia, many monetary authorities have reconsidered their foreign exchange reserve policy. In order to emancipate themselves from the US dollar world, they have diversified into gold; this process could continue for some time and provide good support for the gold price

Chart 6: Gold purchases of Central banks and official agencies (in tons)

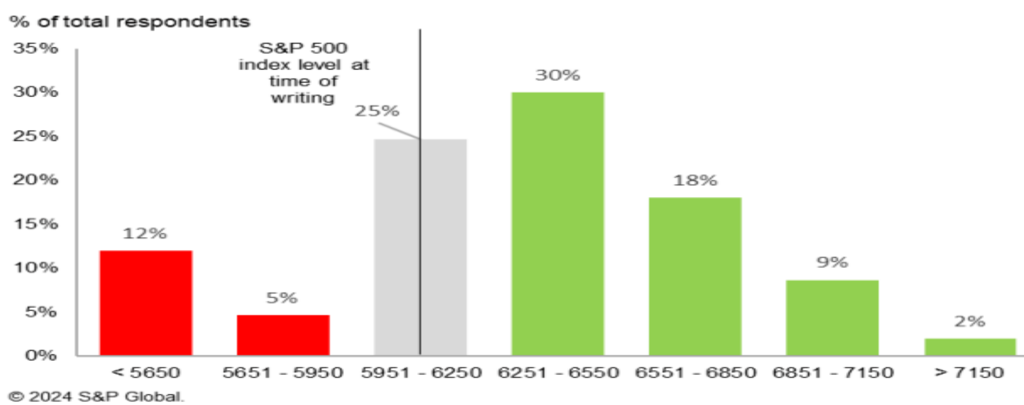


Source: TheMarket/NZZ

Equity markets - will there be a break?

According to a survey conducted by S&P Global in December, optimism prevails among professional portfolio managers regarding the development of the US equity market in 2025. This is obviously based on low interest rates, a soft landing of the US economy and thus further earnings growth in the US of around 10%. Apart from the usual technical corrections, a continuation of the rally would then be expected. The assessment of the European equity markets is quite similar. The major difference lies in the fact that the valuation of the US market is excessively high: the risk premium - the difference between the earnings yield on the equity market and the yield on the bond market - is at a level last seen 20 years ago. The valuation comparison between the USA and the rest of the world is devastating. However, it would be presumptuous to deduce from this that there will now be a reversal in investment flows. The current bull market is being driven by shares in the technology sector, which account for a significant share of the US equity market at around 40%.

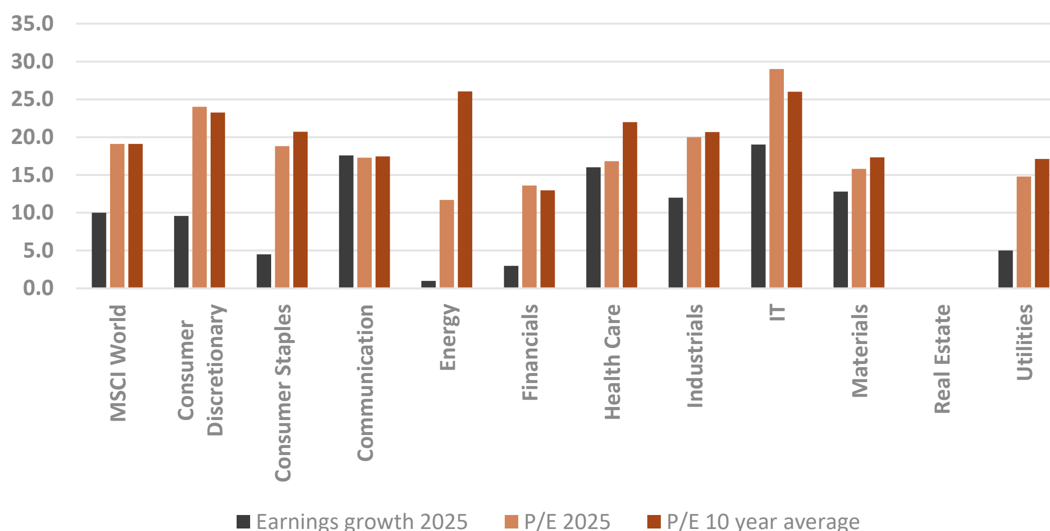
Chart 7: S&P 500 Forecasts



Source: S&P Global, Investment Manager Survey

In Europe, this share is less than 10%. The strongest earnings growth of around 20% is expected globally in this sector as well. It can therefore be assumed that the IT sector will remain an investor-favorite despite its aggressive valuation. Consumer stocks, on the other hand, appear less attractive and are quite expensive despite the subdued earnings outlook, especially for consumer staples. The healthcare sector promises above-average earnings growth at a below-average valuation.

Chart 8: Earnings expectations 2025 and the valuation of global sectors



Source: Bloomberg

It is doubtful whether a change of government in Germany will be able to boost the European stock market. In light of the structural challenges, we assume that European equities will remain in the shadow of the USA. Smaller capitalized companies are being pushed out of investors' focus by the success of the big players. Even if lower interest rates can help this market segment, a turnaround in investment preferences will probably first be necessary to give these shares a fresh boost.

This generally positive picture could be spoiled by several concerns:

The euphoria killers

- The euphoria surrounding IT shares and the investment theme of 'artificial intelligence' could sober up, as expectations are immensely high. Disappointing information from individual key companies regarding profit development, order intake or investment intentions are conceivable triggers. If doubts arise about the monetization of AI investments, a massive correction of the market will occur, which is an adjustment to new realities and will therefore be drastic for the companies affected.
- The Trump administration is pushing through the tax cuts and is hesitant to introduce tariffs. The bond market reacts sourly to the prospect of rising government debt and interest rates rise noticeably. At the same time, the stock market

suffers. The government is forced to find sources of revenue to calm the markets. If tariffs are increased after all, there will be a variety of reactions. The unpredictability of a trade war will certainly not calm the markets.

- The geopolitical situation is tense and the battle for regional and global leadership is in full swing. The predictability of political and military conflicts in a multipolar world is very limited. Therefore, at least temporary distortions in the financial markets are always possible for political reasons. However, positive impulses are also conceivable, for example in the event of a ceasefire in Ukraine and a search for a solution at the negotiating table.

Conclusion

The economic and political framework conditions are highly unstable. The new US administration's experiment with a supply-oriented economic policy is full of uncertainty. The threat of trade war is creating a variety of responses and at the core remains the possibility of a global economic crisis. It is therefore difficult and risky to prioritize a specific scenario. It is more important than ever for investors to be prepared for many variants in 2025.

Financial markets reflect an optimistic picture at the turn of the year, even if this is not the case in some areas. It is possible that this positive momentum will continue for some time. We would take advantage of this opportunity but keep an eye on diversification and in particular avoid focusing solely on AI. It is also advisable to check your own risk appetite and, of course, your capacity, as there are possible development scenarios that could result in a longer period of subdued returns. Bonds and gold should help to stabilize the portfolio. In the fixed-income sector, attention must be paid to the quality of debtors, as the credit risk is not always compensated for. The Swiss franc and US dollar are likely to retain their role as safe-haven currencies. The Japanese yen will appreciate if the US economy stumbles and could therefore be used as a hedge against a US recession.

Wangs, January 2025