

MACROECONOMIC AND INVESTMENT OUTLOOK

# 2025 outlook: too fast too high too strong?

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# 2025 outlook: too fast too high too strong?

In 2024, risky assets continued their upward trend, driven by:

- ▶ Ongoing disinflation on both sides of the Atlantic, fuelling the current cycle of interest rate cuts;
- ▶ A macroeconomic environment that proved resilient overall, particularly in the United States;
- ▶ Positive fundamentals, although progressively normalizing;
- ▶ Monetary and fiscal stimulus measures deployed worldwide.

**Markets are therefore anticipating a “goldilocks” scenario, and recent performances leave little room for error.** However, this scenario could be challenged by a number of factors.

## Key factors to watch out for in 2025



**Although the main performance drivers remain in place** (monetary and fiscal stimulus, ongoing disinflation, macroeconomic resilience and earnings growth deemed attractive), **some uncertainties persist in markets marked with high valuations.**



### ECONOMIC GROWTH FACES GRADUAL NORMALIZATION

**Economic data point to a gradual deceleration**, although recent results have generally been better than expected. While manufacturing activity continues to face challenges across the globe, the services sector remains robust overall. At the same time, faced with persistent inflation and a gradually slowing labor market, **consumers are increasingly turning to less expensive products** (the «trading down» phenomenon). As a result, in the US, many consumer goods companies have revised their sales forecasts downwards<sup>1</sup>.



### IN CHINA, GROWTH IN STRUCTURAL DECLINE

Stimulus measures recently adopted by the Chinese authorities are designed to pull China out of its economic and deflationary slump and avoid the «Japanization» of the economy. Nevertheless, **long-term uncertainties remain:**

- **Structural problems**, such as a deep crisis of confidence, economic imbalances, excessive leverage and an unresolved real estate bubble, **still pose major challenges.**
- **It is not certain whether monetary measures focusing on liquidity injections or fiscal measures**, which are not sufficiently detailed at present, **will fully remedy the situation.**



### IMPACT OF A CHANGE IN THE INTEREST RATE REGIME

**Rising interest rates could continue to lead to greater asset dispersion.** On the corporate side, excessive leverage is a sign of stress. For example, a CCC issuer is now financing at nearly three times its current coupon level, i.e. 14% instead of 5%. This represents an increase of almost 10 points, likely to have significant repercussions on issuers' capital structures<sup>2</sup>.

**On the government side**, and given the high levels of budget deficits, **the economic policies adopted in response to excessive government indebtedness will play a crucial role in determining the cost of public debt.**

<sup>1</sup> Bloomberg, data as of 15/11/2024

<sup>2</sup> Bloomberg, data as of 15/11/2024



## TRUMP 2.0: PRO-BUSINESS BUT MARKED BY CONTRADICTIONS

The Trump administration's proposed fiscal measures would be the most economically disruptive. These include, among other things, the continuation of tax exemptions enacted in 2017 beyond 2025 and potential further reductions in corporate tax rates aimed to stimulate growth. Although this new tax regime seems particularly promising for US companies in cyclical sectors, it is also perceived by investors as a factor that could further increase the already massive US budget deficit.

Furthermore, tariffs represent a potential threat to household purchasing power, as they may lead to increased consumer prices. We can also reasonably imagine that, should the announced tariffs be applied, major repercussions for certain companies, notably Chinese and, to a lesser extent, European, could be expected. Nevertheless, given the time required to implement such a policy, market visibility in this respect remains limited.



**Market fundamentals remain positive overall. (...) Nevertheless, valuations of risky assets remain high, contributing to market volatility and a lack of support during periods of stress.**

**Market fundamentals remain positive overall:** the macroeconomic environment remains resilient, particularly in the US, the disinflation cycle appears to be ongoing, monetary and fiscal stimulus is being deployed worldwide, and the Trump administration's fiscal measures accompanied by deregulation could provide further support for risky assets. **Nevertheless, valuations of risky assets remain high, contributing to market volatility and a lack of support during periods of stress.** Simultaneously, the economy and consumer spending are normalizing, and tariffs and huge budget deficits could weigh on markets, potentially triggering new spikes in volatility.

## Is credit still attractive?



Although credit risk premiums have tightened on both sides of the Atlantic<sup>3</sup>, bonds have become an essential asset in any allocation. For the first time in over ten years (excluding Covid)<sup>4</sup>, investors can lock in a yield deemed attractive, whether in Investment Grade or High Yield: credit has become a yield product, not a spread product.

In the high yield segment in particular, we believe that issuers' fundamentals are still in good shape: default rates remain contained<sup>5</sup> and net margins in Europe<sup>6</sup> maintain comfortable levels. Technical factors have also contributed to the tightening of risk premiums in European HY since the beginning of the year. Indeed, we have seen significant and continuous capital flows into the asset class over the past two years<sup>7</sup> at a time when the size of the European high yield market is shrinking<sup>8</sup> (from around 500 billion euros in 2021 to 375 billion today).

**In this sense, building a portfolio exposed to quality issuers with reasonable levels of leverage and yields of 4% to 7%<sup>9</sup> is now a core strategy.**

There's no need to venture into overly complex issuers facing for example refinancing difficulties to find profitability, since even high-quality issuers can now offer attractive yields. This core exposure can be complemented by satellite strategies, aimed to further optimize portfolio yields while taking advantage of significant market dislocations. These include:

- Lower-rated bonds, particularly CCC.
- Subordinated financial bonds.



**Credit has become a yield product, not a spread product.**

<sup>3</sup> Bloomberg, data as of 15/11/2024

<sup>4</sup> Bloomberg, data as of 15/11/2024

<sup>5</sup> Moody's, Goldman Sachs Global Investment Research, data as of 06/30/2024

<sup>6</sup> FactSet, Goldman Sachs Global Investment Research, data as of 08/31/2024

<sup>7</sup> JP Morgan, Bloomberg, data as of 15/11/2024

<sup>8</sup> Bloomberg, data as of 18/10/2024

<sup>9</sup> Bloomberg, data as of 15/11/2024

### LOWER-RATED BONDS, PARTICULARLY CCC

Indeed, the recent outperformance of the BB segment has made this segment less attractive (BB risk premium ratios are close to lows compared to high yield)<sup>10</sup>. Consequently, stepping away from the BB universe by selecting issuers deemed of high quality but with lower ratings, notably CCC, can generate additional yield. With yields close to 15%<sup>11</sup> despite default rates of only around 3%<sup>12</sup>, this cohort offers interesting opportunities for rigorous and selective investors.

### SUBORDINATED FINANCIAL BONDS

Last quarter's results once again demonstrated the solid fundamentals of the European banking sector<sup>13</sup>. Within financial bonds, we prefer subordinated AT1\* bonds in particular, which offer yields deemed attractive in absolute and relative terms compared to corporate bonds of the same rating (with an estimated average spread difference of 150 bps<sup>14</sup> between AT1s and corporate bonds of the same rating).

Within the banking sector, we are focusing on top-tier European banks that are well capitalized and have healthy solvency levels. We also remain exposed to peripheral banks, such as those in Spain and Portugal, which have made considerable efforts to clean up their balance sheets in recent years.



\*Although these products have performed well, they still carry a very high credit risk that needs to be taken into account.

**For the time being, we are maintaining a limited sensitivity to interest rates:** the relative flatness of the credit curve reduces the attractiveness of longer maturities<sup>15</sup>. Moreover, rate volatility could be the main channel for stress transmission in 2025, given high levels of budget deficits and the ambitions of the Trump administration.



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<sup>10</sup> Bloomberg, data as of 15/11/2024

<sup>11</sup> Bloomberg, data as of 15/11/2024

<sup>12</sup> Moody's, Goldman Sachs Global Investment Research, data as of 06/30/2024

<sup>13</sup> Bloomberg, data as of 15/11/2024

<sup>14</sup> Bloomberg, data as of 15/11/2024

<sup>15</sup> Bloomberg, data as of 15/11/2024

## How to invest in equities?



**Overall, we are highly selective within equities, given the high valuations that leave investors little room for error.**

Nevertheless, there are opportunities in these very dislocated equity markets:



**In the U.S., the technology sector remains essential in an equity allocation. In addition, Trump's planned fiscal easing coupled with the Fed's rate cuts could prove beneficial to US cyclical companies, including small caps.**



**In Europe, faced with a historic discount compared to US markets, the emerging concepts of sovereignty, autonomy and resilience present investment opportunities in sectors such as defense, technology, pharmaceuticals, infrastructure and energy. What's more, the luxury goods sector, hit hard by the Chinese slowdown, could regain a positive dynamic.**



### HOW TO INVEST IN THE TECHNOLOGY SECTOR?

The technology sector has enjoyed an impressive rally in recent months, driven largely by the euphoria surrounding artificial intelligence and investors' conviction that it will usher in a new era of strong growth. This conviction has led to high valuations, with the MSCI World Information Technology index trading at 36.6x earnings<sup>16</sup>, compared with a price/earnings ratio of 21x for the MSCI World index<sup>17</sup>.

However, this segment represents a major opportunity for expansion in our view, with many companies posting double-digit growth rates<sup>18</sup> particularly in online advertising and the Cloud. In this sense, **the growth bastion of technology remains essential, and exposure to it is crucial according to us.**

<sup>16</sup> Source: Bloomberg, data as of 21/11/2024

<sup>17</sup> Source: Bloomberg, data as of 21/11/2024

<sup>18</sup> Source: Earnings releases from companies in our universe, data as of 09/30/2024.

**As far as artificial intelligence is concerned, the outlook for the sector lacks visibility, in the face of optimistic market expectations.** We therefore favor indirect exposure to mitigate any potential disappointment that may emerge around this theme:

- On the one hand, if a revolutionary application were to be developed, capable of radically transforming our daily lives, it would probably emanate from one of these major players, making it an unprecedented opportunity
- On the other hand, these efforts would enable them to improve their current offering (for example, by offering a better online search tool), while maintaining a business model that remains relatively independent of the success of this technology.

A second strategy is to turn to companies for whom artificial intelligence represents an additional, but not essential, growth driver. One example is Accenture<sup>19</sup>, specializing in supporting companies in their digital transformation.



## DEREGULATION, TAX RELIEF: TOWARDS A REVIVAL OF SMIDS?

The small-cap universe has massively underperformed since the rise in interest rates in 2022<sup>20</sup>. **A rare phenomenon, the valuation of small caps is now lower than that of large caps<sup>21</sup>**. And yet, the Trump administration's proposed tax easing could prove particularly beneficial to US small-cap companies. What's more, these companies are direct beneficiaries of the «relocation» trend, while also potentially regaining favorable market dynamics as rate cuts continue.



## EUROPEAN EQUITIES: A HISTORICAL DISCOUNT TO US EQUITIES

**Negative investor sentiment, underexposure and the historically large discount compared to the US all point to a favorable entry point for investing in European equities. In this sense, the negativity seems to be already largely reflected in prices, and these unfavorable factors have the potential to pivot (such as China, tariffs, growth, Germany).**

The luxury goods sector, for example, has massively underperformed the rest of the market<sup>22</sup>. Indeed, stocks in this sector seem to be suffering the consequences of the deterioration of the Chinese economy, despite the fact

that this market segment offers a cohort of companies that we consider to be of high quality. In this respect, if this contraction were to be reversed, fuelled among other things by the various announcements coming from China (fiscal, monetary and budgetary stimulus), this could once again create a favourable dynamic for the sector.

At the same time, the emergence of the notion of European sovereignty is opening up new investment opportunities on the old continent. To this end, the European Commission and member states have launched various initiatives aimed at investing colossal sums in certain sectors identified as strategic, including defense. In our view, investing in European companies that would benefit from these investments, such as Airbus<sup>23</sup> or Rheinmetall<sup>24</sup>, could generate long-term performance.

**This unprecedented environment for investors will be synonymous with strong market dispersion: more than ever, fundamental analysis and selectivity will be essential both credit and equity markets.**

<sup>19</sup> The companies mentioned are used for illustrative purposes only, and do not constitute an investment recommendation or investment advice

<sup>20</sup> Bloomberg, data as of 15/11/2024

<sup>21</sup> Bloomberg, data as of 15/11/2024

<sup>22</sup> Bloomberg, data at 15/11/2024

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