Heading into 2025: Selectivity and Focus in Financials, Credit and Equity.

January 2025

Executive summary

GLOBAL CREDIT

A selective approach heading into 2025

- **Macro**: 2025 brings heightened volatility from U.S. fiscal expansion and European economic divergence.
- **Rate Risks**: Rising U.S. rates and fiscal pressures in Europe make duration risky.
- **Credit**: Select opportunities exist in high-yield segments, with active management. Flexibility and selectivity remain key for navigating fixed income markets.

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FINANCIALS

Financial equity: 2025 remains interesting, with precise stock selection

- **Key themes** include U.S. deregulation, European political uncertainty, and M&A potential.
- **Valuation Opportunities**: European banks trade at historic discounts, with strong yields and consolidation potential.
- **Strategic Focus**: Diverging interest rates highlight the importance of precise stock selection globally.

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GLOBAL EQUITY

Keywords for 2025: Quality, focus and selectivity

- **In US**, opportunities exist beyond the “Magnificent Seven”, despite stretched valuations. Lower rates and supportive fiscal policies could boost growth.
- **Europe**: Attractive valuations meet economic and geopolitical challenges, making value investing and stock-picking key.
- **Asia**: Japan offers value but faces inflation risks, while China’s growth depends on effective fiscal stimulus.
- **2025 Strategy**: Focus on quality, selectivity, and fundamentals to navigate global equities effectively.

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A selective approach heading into 2025

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As we enter 2025, the macroeconomic and fixed income landscape remains fraught with challenges. The recent U.S. elections have increased policy uncertainty, with Donald Trump winning the presidency and the Republican Party taking control of both houses. This political shift brings the potential implementation of anticipated policies on fiscal expansion, trade tariffs, and deregulation, each with significant implications for the U.S. and global economies. While these policies could have a substantial impact on growth, inflation, and markets, their implementation remains unclear—if, when, and how much they will materialize. This uncertainty is likely to drive elevated volatility across asset classes, reinforcing a challenging environment for investors.

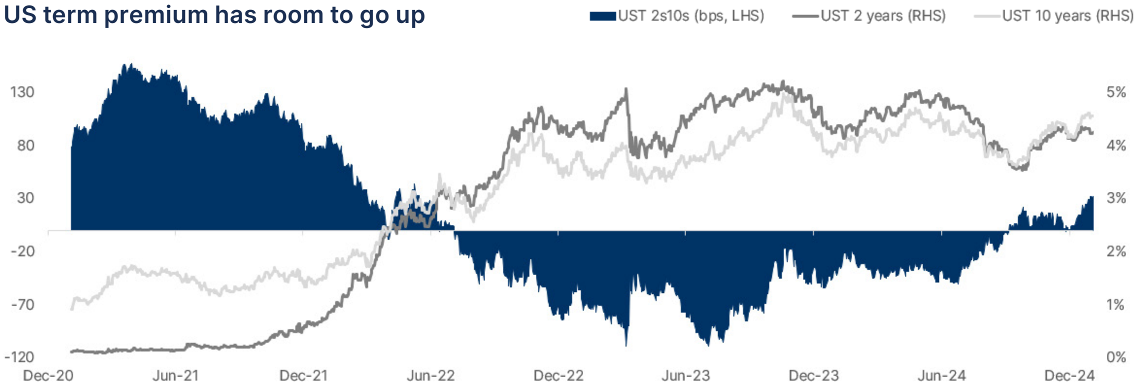
United States: Fiscal Expansion and Rising Rate Volatility

The combination of fiscal expansion and restrictive trade policies under the new administration creates inflationary pressures, adding complexity to the Federal Reserve's monetary policy. Despite recent rate cuts, we believe U.S. monetary policy is still too loose. The Fed's initial 50bp rate cut, for example, likely overshot, as inflation and inflation expectations have been rising since then.

Labour markets remain at equilibrium, and the administration's anti-immigration, anti-trade, and pro-fiscal policies are inherently inflationary. As a result, further rate cuts are unlikely to materialize as initially expected. What seemed to be a deep rate-cutting cycle could instead turn into a mid-cycle adjustment, with total cuts amounting to only 1%. With 75 basis points already cut, the remaining scope for easing is limited—posing challenges for rates markets.

Moreover, the U.S. yield curve currently lacks a fiscal premium. The 2-10 spread sits near zero,

US term premium has room to go up



Source: Algebris Investments, Bloomberg Finance LP.. Data as of 03.01.2025.

suggesting the market is not pricing in sufficient compensation for holding long-term treasuries over shorter-term ones. As markets begin to realize the seriousness of Trump's tax cuts, spending increases, and fiscal interventions, bond vigilantes are likely to demand higher premiums. This shift could drive long-term interest rates higher, negatively impacting duration.

In summary, monetary policy is becoming less accommodative while fiscal policy is loosening. The net effect is rising interest rates, which makes us cautious on duration.

Europe: Diverging Dynamics and Central Bank Intervention

Europe diverges from the U.S. Slowing growth and declining inflation are expected to drive a more dovish stance from the European Central Bank. Short-term rates are likely to stabilize or decline further, while the euro could face additional downward pressure. The long end of the curve presents a mixed picture. On one hand, short-term rate cuts could push the long end lower. On the other hand, rising fiscal spending in countries like France and Germany could increase concerns about fiscal sustainability, creating upward pressure on long-term rates.

Overall, fiscal policy, which has remained a subdued topic in recent years despite growing public deficits, is likely to return to the forefront of market discussions, impacting duration and increasing rate volatility.

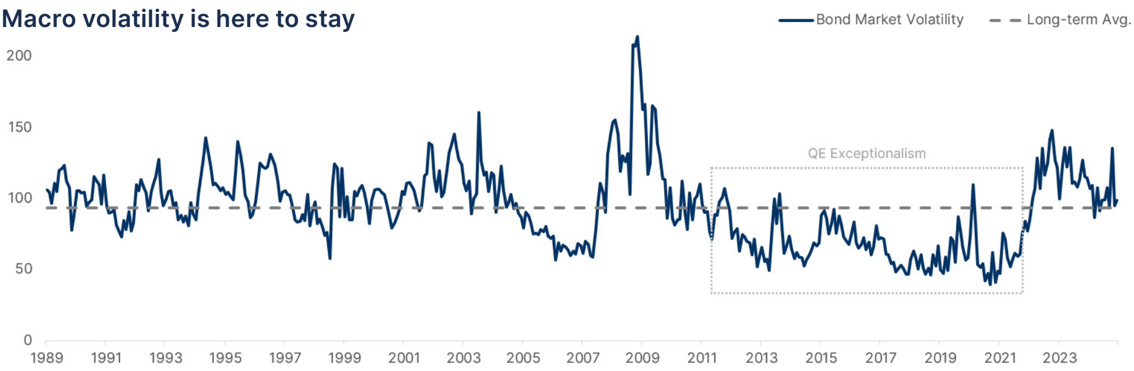
Credit Markets: Opportunities Require Selectivity

Compared to duration, credit markets are relatively better positioned due to historically high yields and decent spreads. However, the narrowing of spreads over the past 18 months has left them near the lower end of their five-year range; this compression means the premium for holding credit risk has diminished, making the risk-reward trade-off less favourable than it was 12 months ago.

> **There are pockets of value in emerging markets, corporates, and financials where yields exceed 7-8%. This dispersion creates opportunities for active managers.**

The good news is that dispersion has increased. While average investment-grade yields in Europe remain around 3.5%, there are pockets of value in emerging markets, corporates, and financials where yields exceed 7-8%. As the pool of attractive assets narrows, the focus will need to be on flexibility and active management to capture these opportunities. Credit markets remain investable, but the broad-based rally seen in 2024 is largely over, shifting the focus to bond selection and tactical positioning.

Macro volatility is here to stay



Source: Algebris Investments, Bloomberg Finance LP.. Data as of 03.01.2025.

Conclusion: Flexibility and Selectivity for 2025

Heading into 2025, duration carries more risks than rewards, with rate and macro volatility expected to remain high. A flexible, reactive fixed income strategy will be crucial for navigating these challenges. Credit markets are in a relatively better position, but the broad-based long trade of 2024 has played out. The next phase will require a more selective approach, with bond pickers identifying assets that still offer value amidst tighter spreads.

FINANCIALS

Financial equity: 2025 remains interesting, with precise stock selection

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2024 has been a very positive year for global financials, marked by significant outperformance. Two major top-down themes have driven the narrative: politics and interest rates.

Politics played a pivotal role, with elections in India, France, and the United States acting as material market drivers throughout the year. Meanwhile, interest rate volatility was another dominant theme, as the US 10-year yield experienced a 100-basis-point spread between its high and low points. From a bottom-up perspective, the environment has been relatively stable and supportive. Earnings expectations have steadily improved, particularly in Europe, where 2025 EPS forecasts are now 10% higher than at the start of 2024. Notably, M&A activity has returned as a key area of interest, signalling renewed optimism for growth and strategic consolidation.

Looking Ahead: Key Themes for 2025

As we move into 2025, many of these themes are expected to persist:

- **Political Landscape**: The Trump presidency will continue to influence markets, with expectations of looser US regulations creating a favourable environment for M&A activity. However, valuations already reflect much of this optimism, with PE multiples expanding by over 30% since mid-June. In Europe, political uncertainty remains prominent, including ongoing challenges in France and a pivotal German election on the horizon. These factors will be significant for the growth and reform outlook within the broader EU.
- **Valuations and Opportunities in Europe**: European banks are trading at historically low valuations relative to their US counterparts, despite strong balance sheets and double-digit yields. While political opposition to recent M&A proposals in Europe is disappointing, consolidation could strengthen the banking sector and generate shareholder value if executed at the right price.
- **Diverging Performance**: With the global interest rate environment evolving, 2025 will likely see divergent performance across economies, banks, and business lines. This dynamic enhances the appeal of bottom-up stock selection, as the profitability profile of banks adjusts to life beyond zero or negative rates.

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In conclusion: an attractive setup for global financials

Overall, the setup for global financials in 2025 remains attractive. The transition to a new interest rate regime has transformed the profitability profile of banks; this environment amplifies the importance of precise stock selection. We expect significant opportunities across geographies and business lines.

GLOBAL EQUITY

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United States: Opportunities Beyond the Magnificent Seven

We remain broadly optimistic about opportunities in global equities. While valuations in the US market are somewhat stretched—2024 being an exceptional year with the best performance since 1980—there are still attractive opportunities. Outside of the so-called “Magnificent Seven”, the valuation gap between these high-growth companies and the rest of the market has narrowed in the second half of the year. Looking ahead, we believe that a potential path toward lower interest rates, combined with supportive fiscal policies expected from the Trump administration, could reinvigorate the economic cycle. This backdrop strengthens our positive outlook.

Europe: A value-driven but cautious approach

Europe presents a different narrative: Valuations in European equity markets are undeniably more appealing than in the US, yet they are accompanied by a weaker economic environment and a more challenging geopolitical landscape. For this reason, we remain cautious. Europe represents a strong case for value investing, where the role of active, selective stock-picking becomes even more crucial than in the US.

> **We remain broadly optimistic about opportunities in global equities.**

Asia: Diverging Paths for Japan and China

Japan offers a nuanced picture. Over the past year, the Japanese market has benefited from encouraging developments, including a pickup in inflation and improvements in corporate governance, which have increased investor interest. However, a significant uncertainty remains around the rise in inflation and if this will compel the Bank of Japan to raise interest rates. Such a move could weigh on the scenario, and while Japan continues to present a compelling value case, we remain cautious about its prospects.

In China, much attention is focused on whether its economy can return to a sustainable growth trajectory. The question is whether the recently introduced fiscal stimulus by the Chinese government will be sufficient to restore the economy to a growth cycle. A key factor to watch will be the effectiveness of these measures in driving GDP growth and boosting consumer spending.

Three guiding principles for 2025: Quality, focus, selectivity.

Maintaining a disciplined approach to identifying companies with strong fundamentals and attractive valuations will remain at the core of portfolio decisions, ensuring resilience and growth in a complex and dynamic global market.

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