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CREATING OPPORTUNITIES

Global Capital Markets
Quarterly Update
26 November 2024

Capital Markets 4Q24 Update

Anything but cash – lock-in yields

Historically, Fed rate cuts prompt significant cash flows into markets, primarily fixed income. Following the "Republican Sweep" higher-for-longer yields offer attractive entry opportunities.

During a gold rush, sell shovels

Gold rush in AI translated into boom of semiconductor stocks. Amid their high valuations, it may be time to look at the different beneficiaries of AI and data centers – utilities.

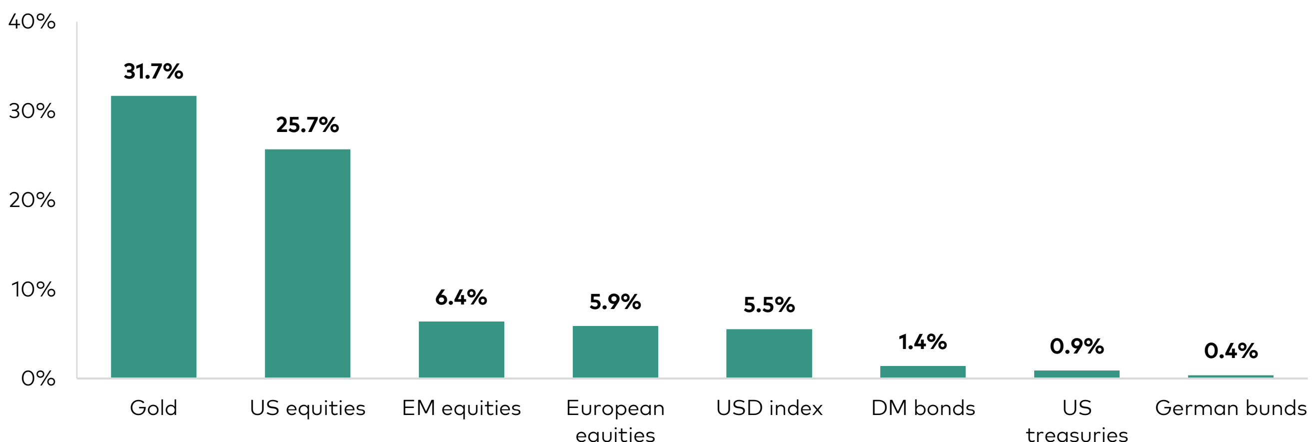
Business cycle risks shall be hedged with factor investing

Prevailing geopolitical and macroeconomic environment come with shift in business cycle phases. It may now be time to rotate the portfolio holdings to quality and minimum volatility stocks.

Summary

- The Fed started its rate-cutting cycle in September 2024, but Donald Trump's "Red Sweep" kept Treasury yields elevated, suggesting higher-for-longer interest rates and a slower pace of Fed rate cuts through 2025.
- Yields on major fixed income categories are at above 5-year averages, offering attractive risk-return characteristics.
- The AI boom is spurring investments in digital infrastructure, benefiting sectors like semiconductors, utilities, and robotics, with long-term gains in economy-wide productivity yet to materialize.
- US economy is moving into the late expansion phase, where growth slows down. During this time, stable and low-risk stocks (quality and low volatility) tend to perform better, making them safer investments.

YTD price performance of select assets (positive sign of bonds & treasuries means that yields decreased)



Source: Bloomberg
Note: Figure illustrates performance of follwing indices: Gold – Gold spot price, US equities – Dow Jones US Total Stock Market Index, EM equities – MSCI Emergin Markets Index, European equities – STOXX All Europe Total market Index, USD index – DXY, DM bonds – S&P Global Developed Markets Corporate Bond Index, German bunds – iShares Germany Government Bond UCITS ETF EUR, US treasuries – iShares US Treasury Bond ETF

Fixed Income

Higher interest rate environment is here to stay

Cooling inflation and softer labor market paved the way for Fed to join its developed markets' peers and start cutting interest rates in September 2024. The Federal Reserve reduced rates by total of 75 bps on its last two meetings and is likely to make another cut on this year's last meeting in December. However, interest rates (and yields) are expected to remain higher for longer than previously anticipated.

Donald Trump retaking the White House and Republicans winning majority in House and Senate ("Red Sweep") had an instant effect on fixed income markets. Trump's pledged policies (on tax cuts, deregulation, immigration, and tariffs) will keep inflationary pressures up, while increasing budget deficit. Consequently, US treasury yields rose despite the Fed cutting rates. Additionally, second waves of inflation are historically common. Hence, Fed is likely to further slow its rate-cutting pace over 2025, effectively leaving yields elevated.

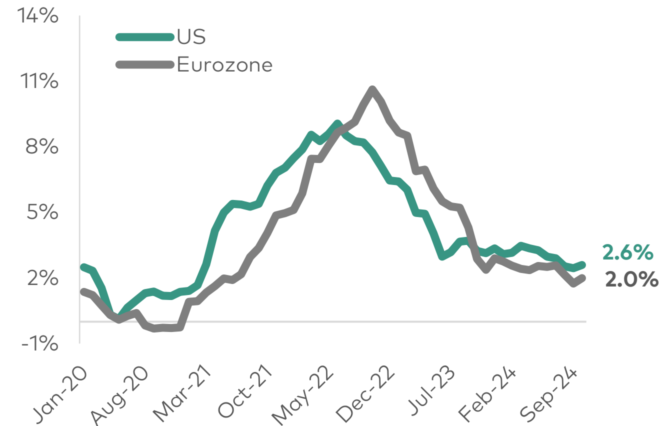
Recently, though, Trump nominated Scott Bessent, a Wall Street veteran to lead Treasury. According to market reactions, investors expect Bessent to soften Trump's plans. As he put it, his priority is to deliver promised tax cuts, while remains open to negotiations on tariff sizes.

Investment implications of higher yields

Despite uncertainties related to future pace of rate cuts, we see attractive entry opportunities across the fixed income markets. For example, US 2y yield stands at 4.28%, which is above the 5-year average. At this level, it is seen as an attractive opportunity for buying.

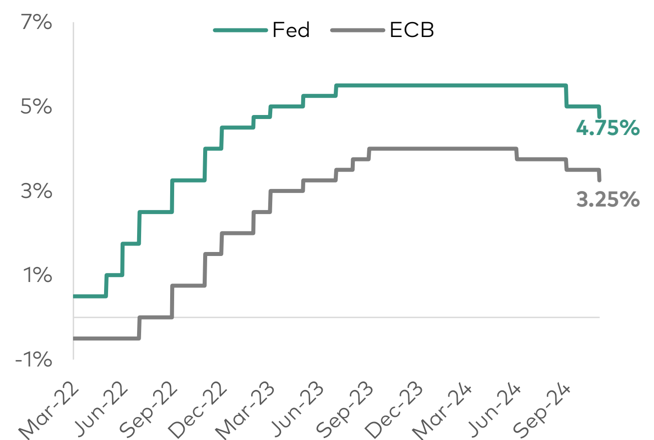
Depending on the investor's risk profile, one may be more interested in Emerging Markets (EM) or High Yield (HY) fixed income that are also yielding above their 5-year average figures.

US and Eurozone inflation (headline CPI)



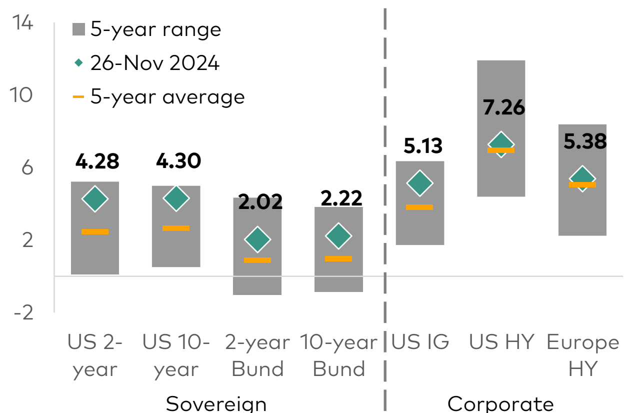
Source: US Bureau of Labor Statistics, Eurostat

Fed and ECB interest rates



Source: Fed, ECB

Yields on different fixed income securities, %



Source: Bloomberg
Note: IG corresponds to corporate investment grade category. HY corresponds to corporate high yield category – higher risk than IG.

Equities

Who benefits from the AI rush?

The rapid expansion of AI capabilities is driving massive demand for digital infrastructure like data centers, cloud services, and cybersecurity. US tech giants are leading this growth, with over $200 bn in capital investments expected in 2024. This marks the start of a multiyear AI investment cycle. However, historical analysis suggests new technology takes 10-20 years to boost economy-wide productivity.

Although many areas of tech are slowly becoming more staples-like, as of now it is wiser to invest in industries directly benefiting from AI investments. Ripple effects from these investments are significant, benefiting server manufacturers, electrical equipment suppliers, and HVAC systems.

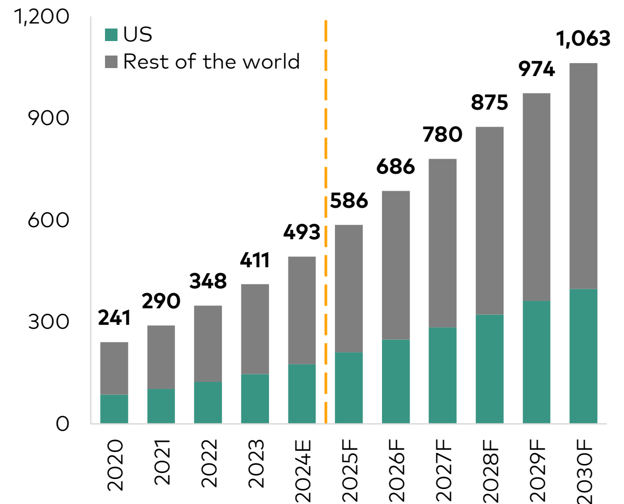
Utilities sector is set to gain, as AI data centers require increasing amounts of electricity. According to Goldman Sachs, global power demand by data centers will more than double by 2030, making utilities a strong option for stable, long-term returns.

Other major beneficiaries are expected to be companies from the fields of digital infrastructure, biotechnology, and robotics & automation. Returns in these fields, although quite strong, are yet to catch up with those early beneficiaries, like semiconductors and Magnificent 7 stocks.

How to invest in these industries?

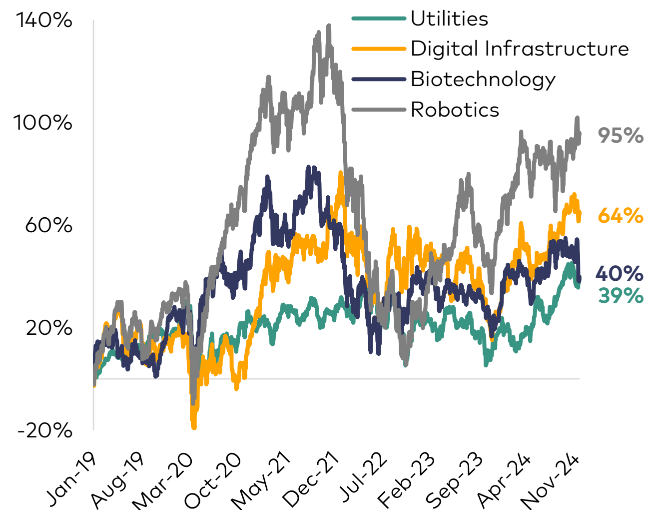
While investing in single stocks is one option, the exchange-traded fund (i.e., ETFs) may be a more practical alternative for many investors. Thematic ETFs, like JXI, IBB, IDGT, and BOTZ (all displayed in the figure to the right) allow investors to invest in diversified portfolios of AI-related industries in exchange for small fees.

Data center power demand, TWh



Source: IEA, Goldman Sachs

Performance of select ETFs since Jan-19



Source: Bloomberg
Note: Figure illustrates performance of following ETFs: Utilities – iShares Global Utilities (JXI), Biotech – iShares Biotechnology (IBB), Digital Infrastructure – iShares US Digital Infrastructure and Real Estate (IDGT), Robotics – Global X Robotics and Artificial Intelligence (BOTZ)

Equities

Global business cycle enters late expansion phase

Major economies maintained steady growth, supported by improved global financial conditions and stable employment trends, even as manufacturing showed signs of slowing. The US, along with key developing economies such as India, Mexico, and Brazil, exhibited characteristics of mid-cycle growth, though the US also reflected notable late-cycle traits, marking its transition to a new phase.

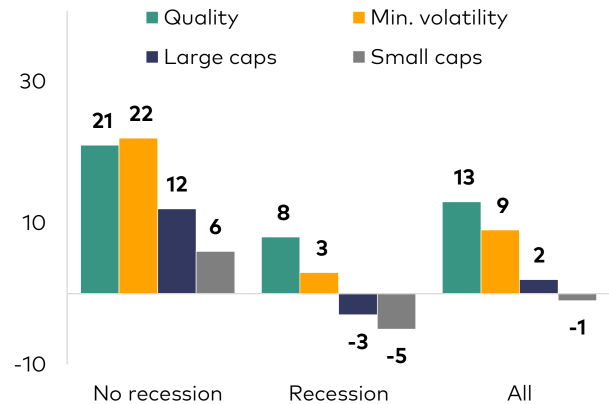
Typically, during the late cycle, growth moderates, credit tightens, and earnings are under pressure. Consequently, during this time markets may struggle to differentiate the growth slowdown from recession, introducing volatility as was the case in August 2024. Summer market volatility challenged investor confidence, but strong fundamentals led to a swift recovery in stock prices.

Quality factor has historically delivered excess return compared to the market during late expansion and recession phases. In addition, quality and minimum volatility (low beta) stocks tend to perform well over the 12 months after the first rate cut. Hence, Fed starting its rate-cutting cycle in September 2024 will also benefit those two. So far in 2024 quality and minimum volatility ETFs are up 24% and 20% respectively. Meanwhile, Factor Rotation ETF that is actively managed is up 32% YTD vs 27% of S&P 500.

How to start factor investing?

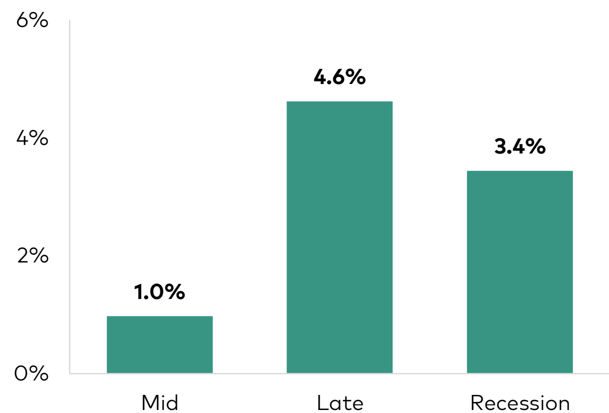
Investors may gain exposure to certain factors by investing in specific ETFs. Examples of the quality factor ETFs are QUAL, SPHQ, and JQUA, while the ETFs of the minimum volatility factor are USMV, SPLV, and FULVX. Alternatively, investors may opt for BlackRock's Equity Factor Rotation Active ETF (DYNF) that seeks to outperform the market through factor rotation.

Average performance of stock factors in US one year from first rate cut, %



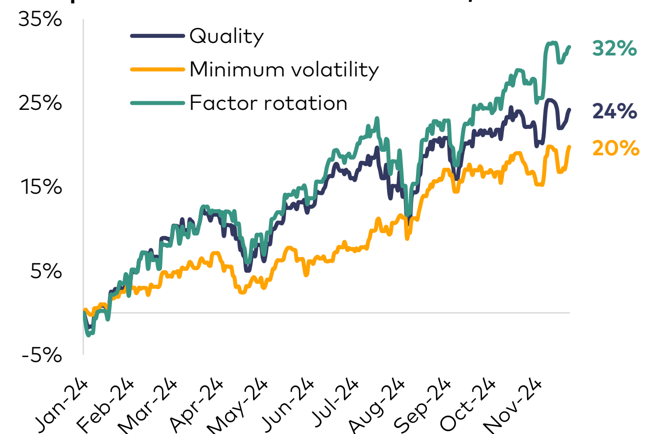
Source: BlackRock, Refinitiv
Note: Analysis based on 6 rate cutting cycles since 1984

US quality factor return vs. market, 1986-2020



Source: Bloomberg, Fidelity

YTD performance of select factor ETFs, %



Source: Bloomberg
Note: Figure illustrates performance of following ETFs: Quality – iShares MSCI US Factor ETF (QUAL), Minimum volatility – iShares MSCI USA Minimum Volatility Index Fund (USMV), Factor rotation – iShares US Equity Factor Rotation Active ETF (DYNF)

Forecasts for 2025

Fixed Income:

Analysts forecast a decline in yields throughout 2025, both in the US and in Europe. By the end-2025, a 2-year US Treasury yield is expected to touch 3.56% (down from current 4.28%), while a 2-year German bund yield is expected to fall to 1.86% (down from current 2.03%).

Equities:

According to BlackRock Investment Institute, the European market should underperform compared to other regional markets during the next 6 to 12 months. Meanwhile, the outlook remains neutral for the Emerging Markets equities and positive for US, Japan, UK, and China.

In terms of S&P 500 sectors, Charles Schwab analysts expect Financials, and Materials to outperform the rest of the market. Meanwhile, Consumer Discretionary is forecasted to deliver weaker performance as compared to the overall index.

FIXED INCOME

Yield forecasts (%)

	Last	1Q25F	2Q25F	3Q25F	4Q25F
US treasuries					
30-year	4.48	4.47	4.40	4.36	4.33
10-year	4.30	4.24	4.15	4.11	4.10
5-year	4.20	4.07	3.93	3.85	3.79
2-year	4.28	3.96	3.76	3.64	3.56
SOFR	4.52	4.08	3.76	3.54	3.41
German bunds					
10-year	2.22	2.27	2.25	2.28	2.30
2-year	2.03	1.95	1.87	1.86	1.86
EURIBOR	3.02	2.46	2.17	2.10	2.07

Source: Bloomberg

EQUITIES

12-month outlook

S&P 500 Sectors	ETF	Outlook
Financials	XLF	Positive
Materials	XLB	Positive
Energy	XLE	Neutral
Technology	XLE	Neutral
Consumer Staples	XLB	Neutral
Communications	XLK	Neutral
Utilities	XLV	Neutral
Industrials	XLP	Neutral
Health Care	XLRE	Neutral
Real Estate	XLU	Neutral
Consumer Discretionary	XLI	Negative

Source: Charles Schwab

6-12 month outlook

Regional Markets	ETF	Outlook
US	SPY	Positive
Japan	EWJ	Positive
UK	EWU	Positive
China	MCHI	Positive
Emerging Markets	EEM	Neutral
Europe	IEUR	Negative

Positive Neutral Negative

Source: BlackRock Investment Institute

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