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1st half-year 2025

Special edition

Perspectives

Financial markets analysis

Introduction

In 2024, Perspectives turned 35. We have gone from publishing (almost) monthly to quarterly, but the objective has always remained the same: to analyse the economic and financial environment and draw conclusions for investment decisions.

The world has changed a great deal, and analysis of the traditional economic cycle has become less important in an environment marked by an ageing population, high levels of public debt and a new geopolitical order.

On the financial markets, the obsession with relative performance has taken on worrying proportions. While, in theory, investment decisions are supposed to be taken rationally, in practice they are motivated by the fear of underperforming an index to which investors seem to attribute the infallible science.

Today's major stock market indices are often driven by a limited number of stocks. Their rise is therefore not necessarily representative of the behaviour of equities as a whole. Many indices are close to their highs, while many stocks are not. This clearly argues in favour of active management.

As an active fund manager, BLI - Banque de Luxembourg Investments will henceforth make even greater use of Perspectives as a vehicle for explaining the choices we make within our portfolios. The idea is that the quality of our investment decisions should be judged on the basis of the arguments that led us to make them. At the same time, Perspectives will become a half-yearly publication.

In this issue, we have tried to underline the structural elements that mark the new environment we are facing and their implications for the financial markets.

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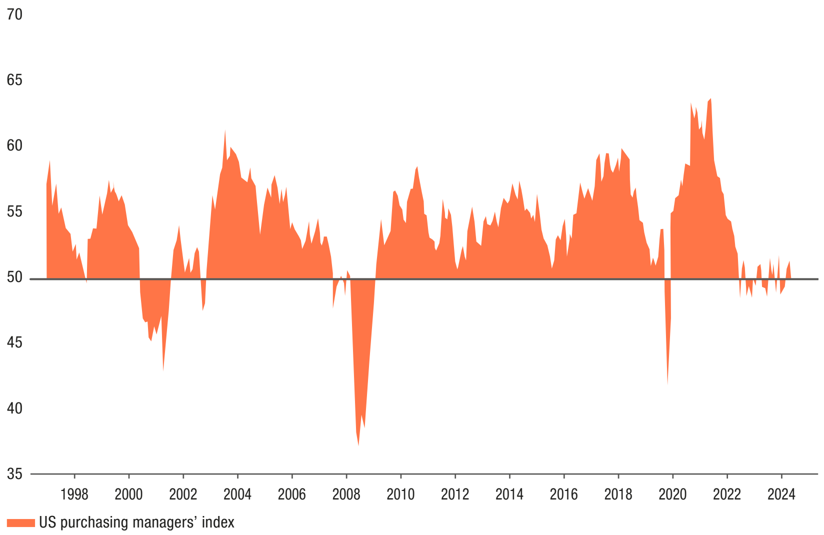
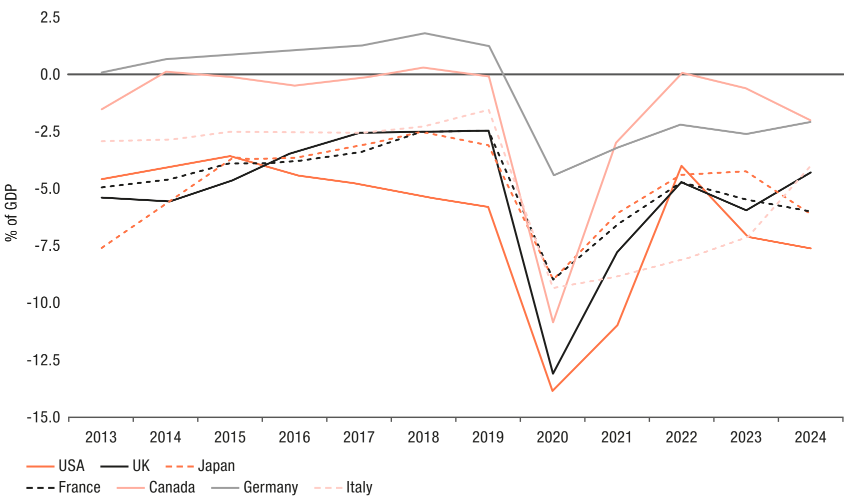
ECONOMIC INDICATORS HAVE BECOME LESS VOLATILE



Source: Piper Sandler

Continued intervention by the monetary and fiscal authorities since the financial crisis has meant that the traditional business cycle has largely disappeared. All the more so as modern economies are largely based on services, which are much less cyclical than industry. Added to this is the fact that under the new Trump administration, there is a risk that the economy will be used as a geopolitical tool, rather than as an end in itself. The continued stable growth of the global economy cannot, however, conceal its intrinsic fragility and profound imbalances.

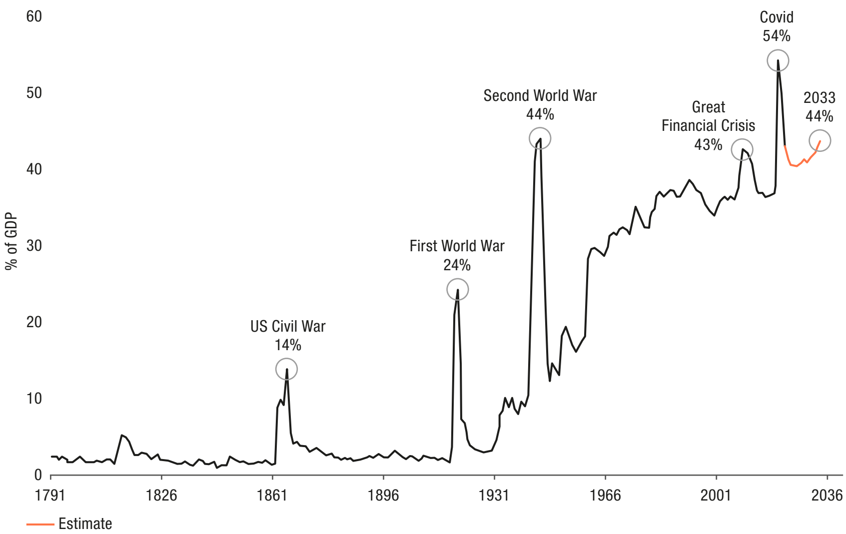
BUDGET DEFICITS IN THE G7 COUNTRIES



Source: Gavekal Research/Macrobond

The trend towards ever higher public spending and budget deficits seems unstoppable at the moment. The Pandora's box that was opened with social transfers during the pandemic will be difficult to close. Despite some four years of economic recovery, 5 of the 7 G7 countries now have budget deficits in excess of 4% of their Gross Domestic Product (GDP).

US PUBLIC SPENDING SINCE 1791



Source: BofA Global Investment Strategy, Bloomberg

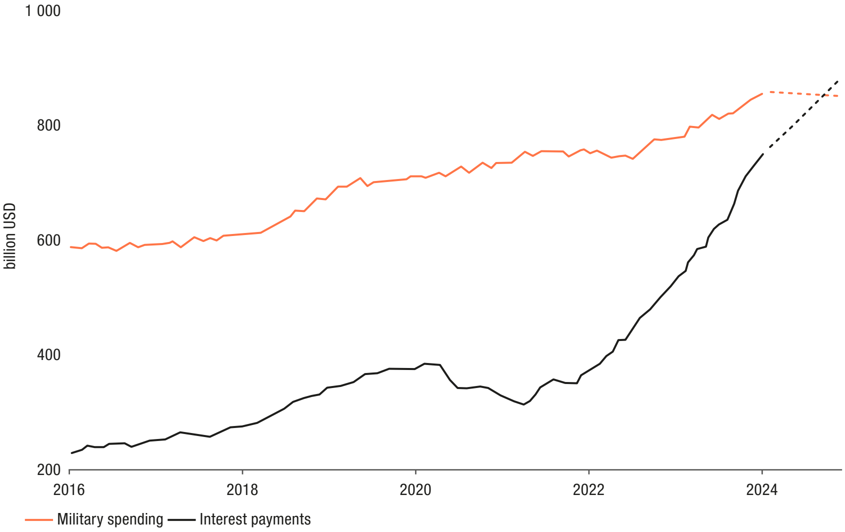
The precarious situation of public finances in most industrialised countries will be further exacerbated by demographic trends. Unless the retirement age is changed, the working population will continue to shrink, leading to a fall in tax revenues (except if there is a sharp rise in productivity) and an increase in the proportion of public spending that will have to be devoted to financing pensions.

A MORE INFLATIONARY ENVIRONMENT

Low inflation (2001-2020)	Higher inflation (2021-...)
• Globalisation • Restrictive fiscal policies • Surplus resources (labour and raw materials)	• Geopolitical tensions • Expansionary fiscal policies • Resource shortages (both in terms of labour and raw materials)

Many of the factors behind the low-inflation environment of recent decades are gradually disappearing. The world seems to have moved from an oversupply to a shortage of resources, whether labour or raw materials, at a time when many public programmes (rearmament, reshoring, energy transition) are raw material- and labour-intensive. The drive to repatriate production chains and re-industrialise Western economies will also lead to inflationary pressures, at least initially.

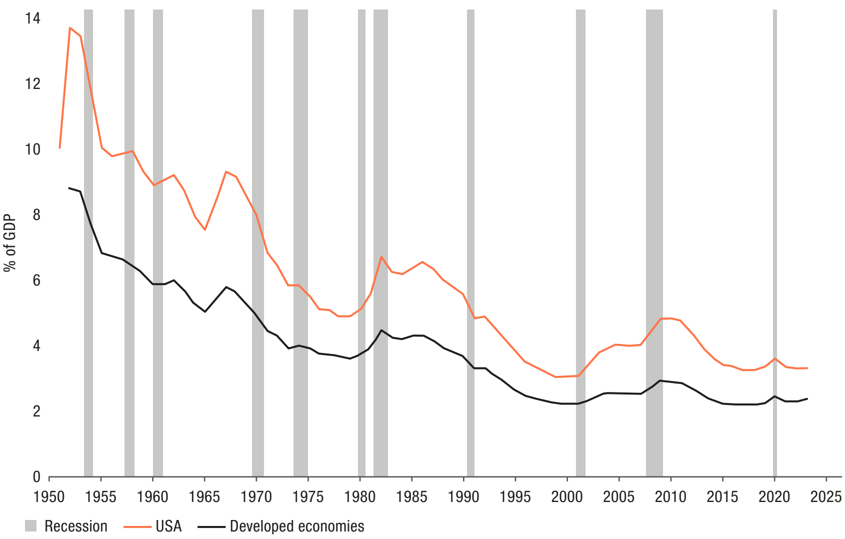
IN THE UNITED STATES, THE COST OF DEBT WILL SOON EXCEED MILITARY SPENDING



Source: Evercore ISI

The Federal Reserve's two traditional mandates – to contain inflation and maximise employment – have been supplemented by two additional mandates: to enable the US government to finance itself at a reasonable cost and to support the stock market, the preferred vehicle for financing pensions and increasingly at the centre of the economy. In the past, a sharp deterioration in economic conditions has often led to a sharp fall in equities. Since the turn of the century, the relationship has been reversed: it is sharp falls in the stock market that have led to recessions.

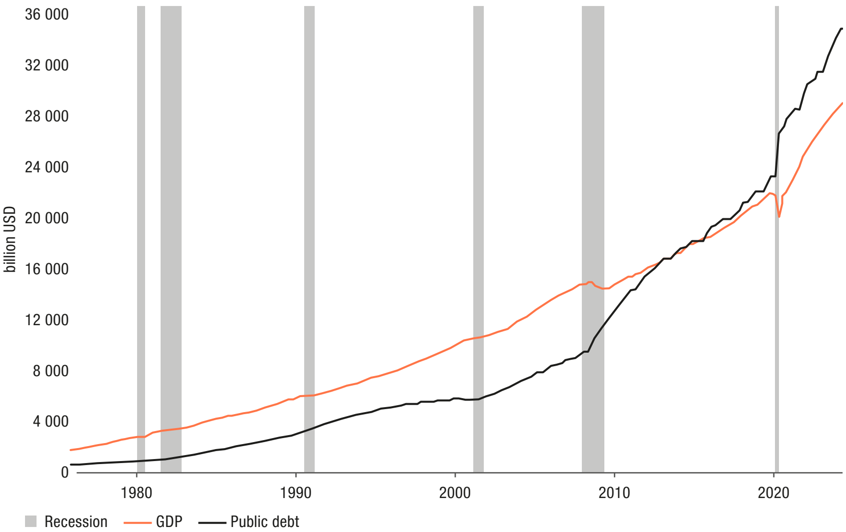
MILITARY SPENDING AS A % OF GDP



Source: Minack Advisors

It follows from the above that the 2% inflation target is no longer really relevant. Or rather, that 2% is a floor rather than a ceiling. The fact that the US central bank cut its key rate by 100 basis points in 2024, despite inflation remaining at around 3%, is a good illustration of this. The combination of pressure on central banks to keep rates low and upward pressure on inflation will lead to a renewed fall in real rates.

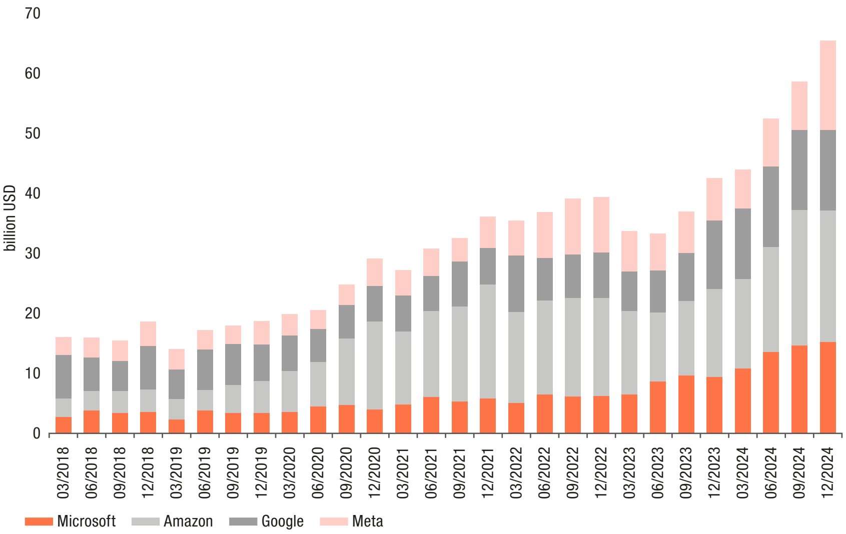
US PUBLIC DEBT AND GDP



Source: Treasury, Bureau of Economic Analysis, Federal Reserve Bank of St. Louis

Current levels of public debt have reached peaks which, in the past, have only been seen in times of war. An examination of historical precedents shows that reducing such debt levels is systematically based on a combination of persistently high inflation and artificially low interest rates, creating negative real interest rates over a long period. At such high levels of indebtedness, a policy of austerity or higher taxation, aimed directly at reducing the amount of debt, becomes impractical, as both stifle economic growth.

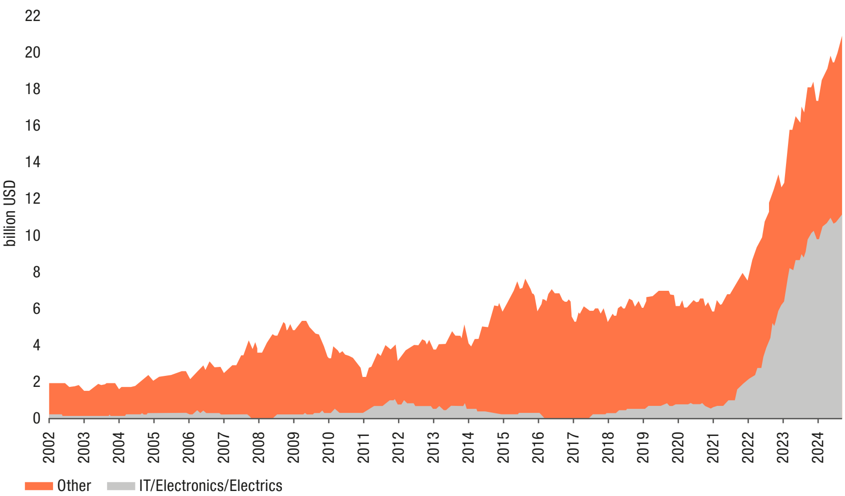
QUARTERLY EXPENDITURES BY MAJOR US TECHNOLOGY COMPANIES



Source: Bloomberg

Technological development will play a key role in the future of the global economy. Against a backdrop of a shrinking working population, an increase in productivity is the only way to achieve sustained real growth. Automation and digitalisation will also act as a brake on inflationary pressures. It will therefore be important to see the promises of artificial intelligence rapidly realised.

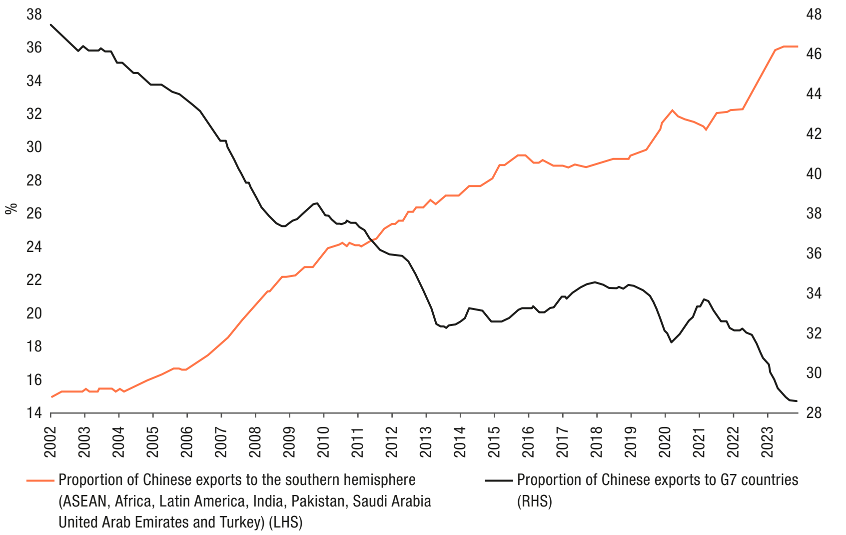
US PRIVATE SECTOR CONSTRUCTION SPENDING FOR MANUFACTURING FACILITIES



Source: US Census Bureau, Bloomberg

In the Western world, the period between the great financial crisis of 2008 and the pandemic of 2020 was characterised by historically low levels of private investment. Despite high profit margins and very advantageous financing conditions, companies were reluctant to expand their production capacity, preferring instead to return money to their shareholders. This trend could change in the years ahead, with the need to secure supply chains and modernise an ageing infrastructure. A sustained upturn in investment would appear to be an essential condition for correcting the current economic imbalances.

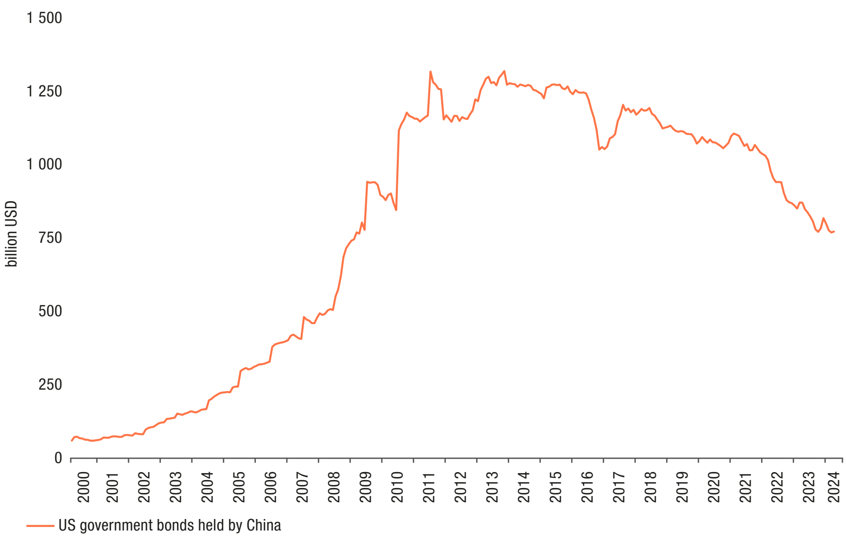
CHINESE EXPORTS BY DESTINATION



Source: CEIC, General Administration of Customs, Jefferies

The unipolar world that followed the end of the Cold War and led to globalisation is increasingly giving way to a multipolar world made up of blocs of countries based on different economic models and/or political ideologies. China wants to establish an alternative to the Bretton Woods financial system, based on the dollar and US government bonds. It has therefore signed trade agreements allowing transactions in renminbi with several partners and undertaken major initiatives, such as the creation of the Asian Infrastructure Investment Bank in 2014 and the launch of the New Silk Road, aimed at reducing dependence on international financial institutions dominated by the United States.

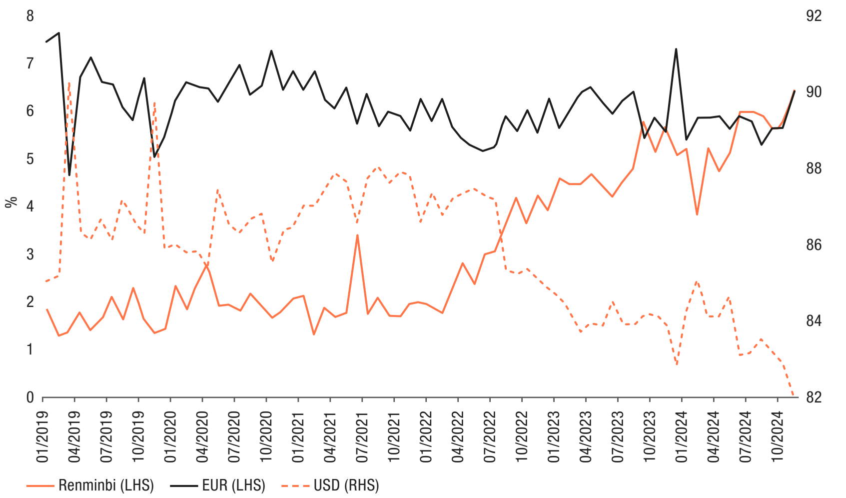
US GOVERNMENT BONDS HELD BY CHINA



Source: Macrobond/Bloomberg

The osmosis between the United States and China has clearly been broken. This osmosis saw China register a large trade surplus with the United States and recycle the resulting dollars into US government bonds. This mechanism benefited both powers: while China supported its industrial development, the United States benefited from low interest rates and reduced production costs thanks to relocation to Asia. This tacit equilibrium began to falter when the United States perceived the rise of China as a threat to its hegemony.

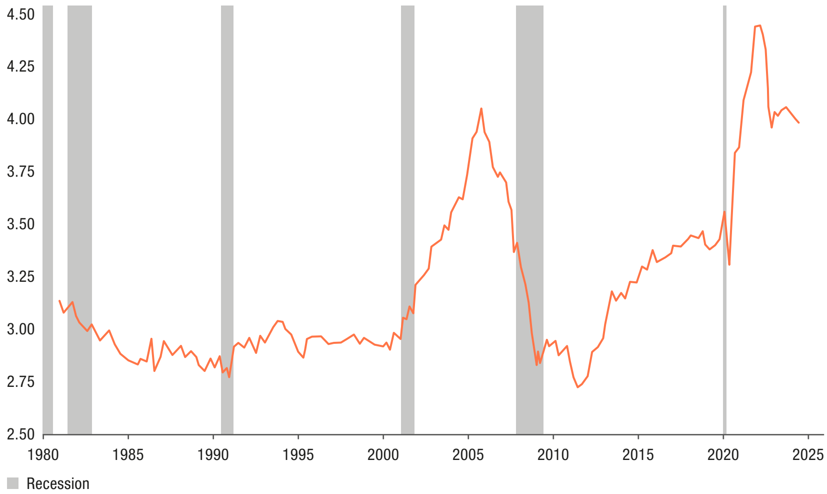
SHARE OF GLOBAL TRADE FINANCE-RELATED TRANSACTIONS VIA SWIFT



Source: SWIFT

Dismantling the current order would have a major impact on capital and investment flows worldwide. However, such a dismantling remains complex for both parties. The West is heavily dependent on China for the production of many essential goods, and will need massive investments to repatriate these production lines. China depends on Western markets to sell its products. It is therefore difficult to imagine how the current system would actually disintegrate.

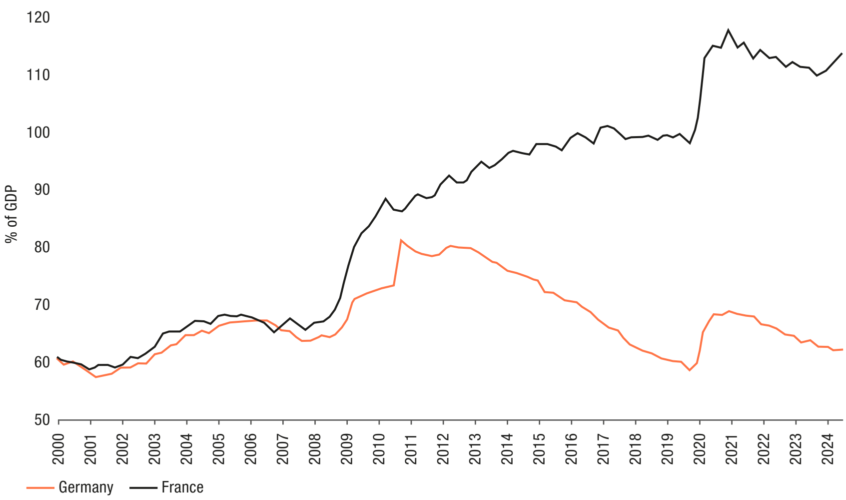
US EXISTING HOUSE PRICE BY MEDIAN FAMILY INCOME



Source: Piper Sandler

Within most countries, social inequalities continue to grow and explain the rise of populism. The post-pandemic recovery has again advantaged a narrow circle of beneficiaries to the detriment of an increasingly disenchanted majority. At household level in the United States, the top third in terms of income now account for almost 60% of consumer spending, while the richest 10% alone account for a quarter. The disparities are just as marked in the corporate world. The record profits of the major companies in the S&P 500 contrast with the falling earnings of small and medium-sized businesses.

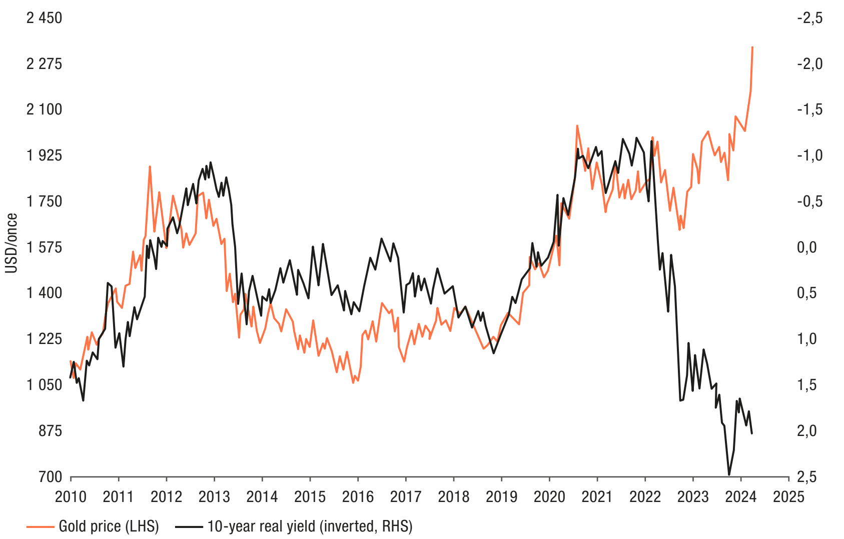
PUBLIC DEBT AS % OF GDP IN GERMANY AND FRANCE



Source: Deutsche Bundesbank, French National Institute of Statistics and Economic Studies (INSEE)

Almost 26 years after its creation, the euro remains fragile, resting on incomplete institutional foundations. During the crisis of 2012, the survival of the single currency depended on a bold intervention by the European Central Bank, which acted at the limit of, and even beyond, its legal mandate. At the beginning of 2025, the single currency once again finds itself in a critical situation. Germany is experiencing serious economic problems, while France's fiscal situation is particularly worrying. All this at a time of great political instability in both countries.

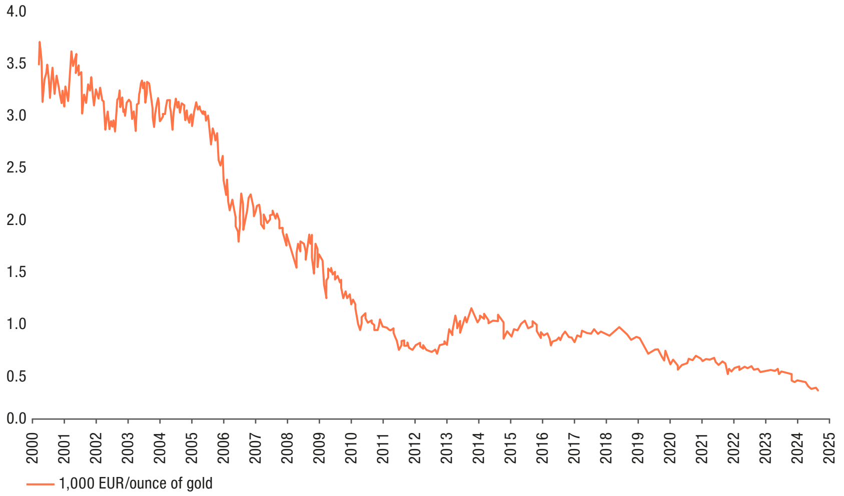
GOLD PRICES AND REAL RATES



Source: Bloomberg, NBER, Minack Advisors

Major secular trends are increasingly determining the behaviour of financial markets, and are challenging the prism through which investors tend to assess the main asset classes and the correlations between them. For example, the price of gold has risen despite the strength of the dollar and the rise in real interest rates, and stock markets have advanced despite the tightening of monetary policy and the rise in long-term interest rates.

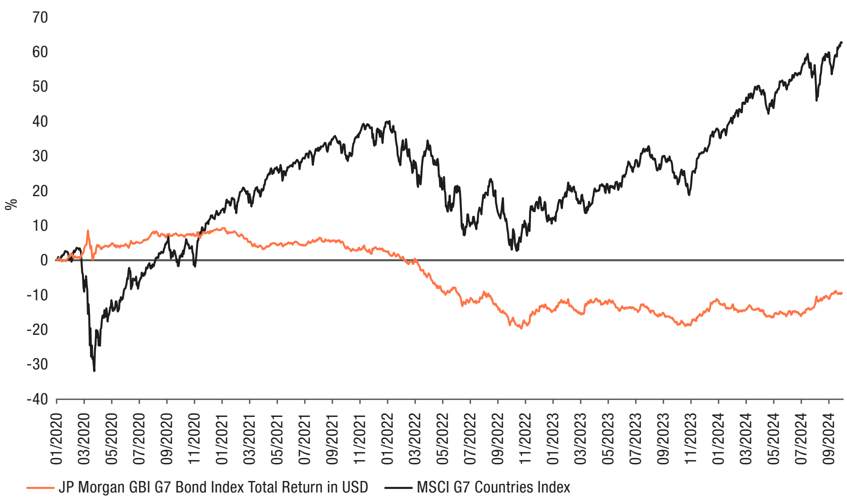
DEPRECIATION OF THE EURO AGAINST GOLD SINCE THE BEGINNING OF THIS CENTURY



Source: Macrobond/Bloomberg

The rise in stock markets in recent years largely reflects the depreciation of paper currencies. Since the turn of the century, the euro and the dollar have lost around 50% of their value in terms of purchasing power. The price of a coffee at Starbucks has risen from $2.5 to $5.25 in the United States, and from 2.2€ to 4.5 - 5€ (depending on the country) in the eurozone. The loss of purchasing power of these currencies is even greater in terms of property prices. Equities, as real assets, have enabled investors to counteract this loss of purchasing power.

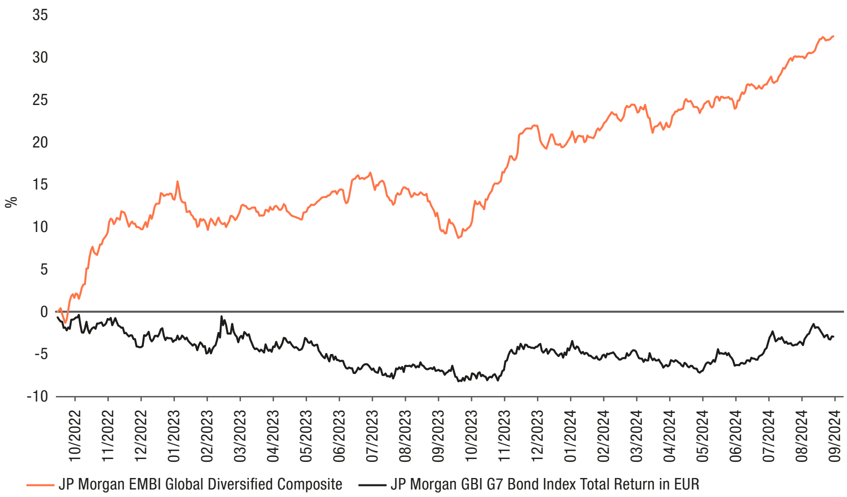
PERFORMANCE OF G7 STOCK AND BOND MARKETS SINCE THE PANDEMIC



Source: Macrobond/Bloomberg

The notion that government bonds in industrialised countries are risk-free assets is clearly being called into question, given the deterioration in public finances. This asset class will be increasingly caught between ever-increasing supply and diminishing demand. All the more so as the yields on offer often remain unattractive, but a sharp rise in these yields would cause the cost of debt to skyrocket. The logical conclusion could be a return to quantitative easing by central banks. In the absence of natural buyers, they will have to buy.

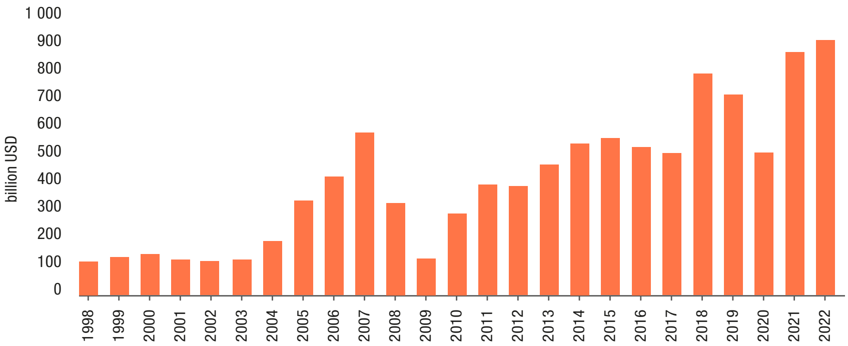
GOVERNMENT BOND MARKETS BETWEEN 2022 AND 2024: G7 VERSUS EMERGING COUNTRIES



Source: Macrobond/Bloomberg

Government bonds from industrialised countries may still play a tactical role in investors' portfolios at times (in the event of a sharp economic slowdown, for example), but the main theme for bond markets in the years ahead will be to think outside the box. The sovereign bonds of certain emerging countries, whose credibility has been enhanced by their ability to respond to a succession of crises of various kinds in recent years and by their willingness to maintain responsible monetary and fiscal policies, could be an avenue worth exploring. For investors unwilling to accept the volatility of these bonds, inflation-linked bonds from industrialised countries represent an interesting alternative.

SHARE BUYBACKS BY S&P 500 COMPANIES



Source : S&P Dow Jones Indices

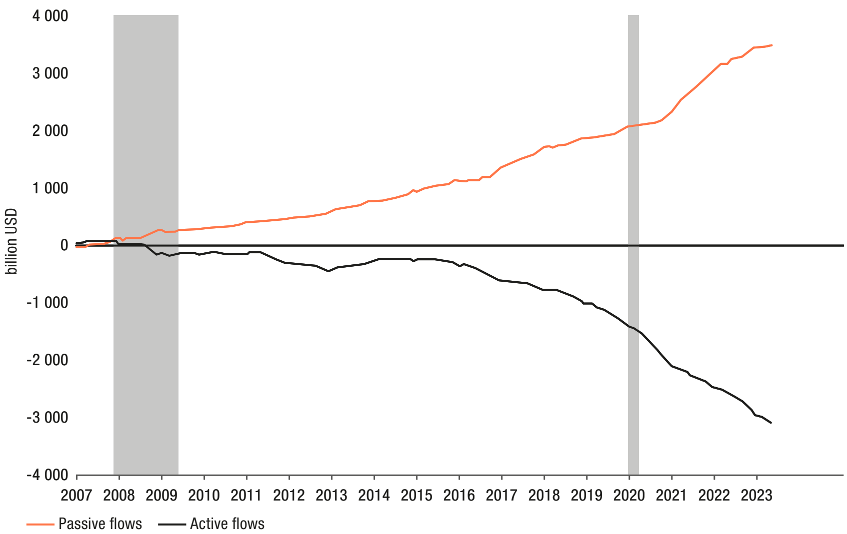
A simple supply/demand analysis shows that investors should continue to favour equities over bonds, or more precisely shares of quality companies over government bonds. With continued high budget deficits, the supply of government bonds will only increase, while the supply of quality equities will only decrease between mergers and acquisitions and share buybacks. As an investor, we should favour scarcity over abundance.

WHICH SHARES TO BUY?

INVESTMENT	versus	SPECULATION
Take a long-term stake in a company based on its fundamentals and the price to be paid		Buying a stock with the aim of selling it at a higher price

The question then becomes, which shares should one buy? To answer this question, it is important to distinguish between investment and speculation. Investing is characterised by an analysis of company fundamentals, with an emphasis on valuation. Speculation takes little interest in these elements and is more concerned with momentum, i.e. buying an asset with the idea of selling it relatively quickly to someone else for a higher price. At the moment, we are clearly in an environment dominated by speculation.

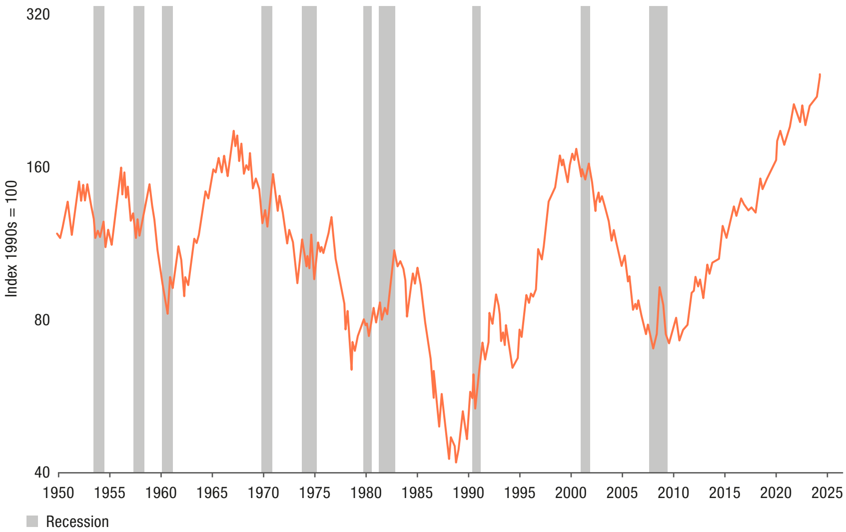
EQUITY FUND FLOWS



Source: Minack Advisors

The importance of passive management only reinforces this. Passive management is largely valuation agnostic, with the aim of buying stocks in proportion to their weighting in an index. And insofar as in many of these indices (starting with the S&P 500), the weight of stocks is determined by their market capitalisation (the number of stocks times the share price), the stocks that have risen the most attract the most capital, leading to a risk of overvaluation, the opposite being true for stocks that have fallen out of favour.

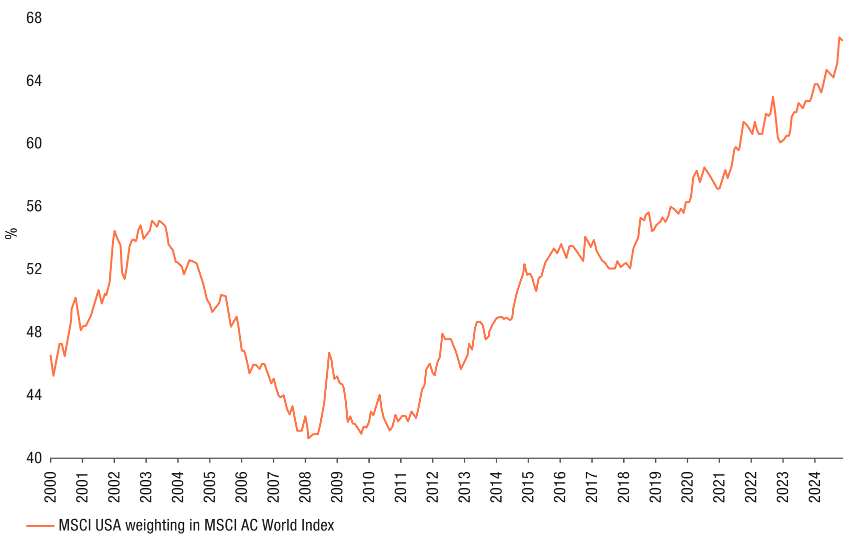
15 YEARS OF US MARKET OUTPERFORMANCE



Source: Minack Advisors

Two factors have contributed to the trend towards indexing. Firstly, the worrying situation regarding public debt and budget deficits has led many institutional investors to reallocate from government bonds to equities. At the same time, many foreign investors prefer to recycle the dollars from their trade surpluses with the United States into equities rather than bonds. We can legitimately assume that, since these two categories of investors are not specialised in equities, they have preferred to buy the index rather than individual shares.

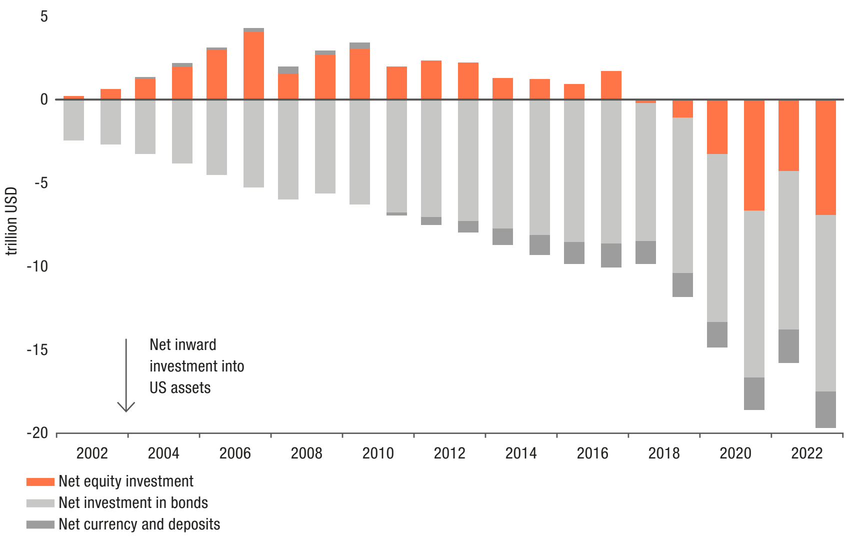
MSCI USA WEIGHTING IN MSCI AC WORLD INDEX



Source: Factset, MSCI, Jefferies

The United States accounts for around 20% of the world's Gross Domestic Product, but the US market represents almost 70% of the world index. Such an imbalance has not been seen since the late 1980s, when Japan accounted for less than 10% of GDP but nearly 50% of the world index. The US market has become such an important part of the world index that the main question for an equity investor is whether to overweight or underweight it. And more specifically, whether to overweight or underweight the big technology companies.

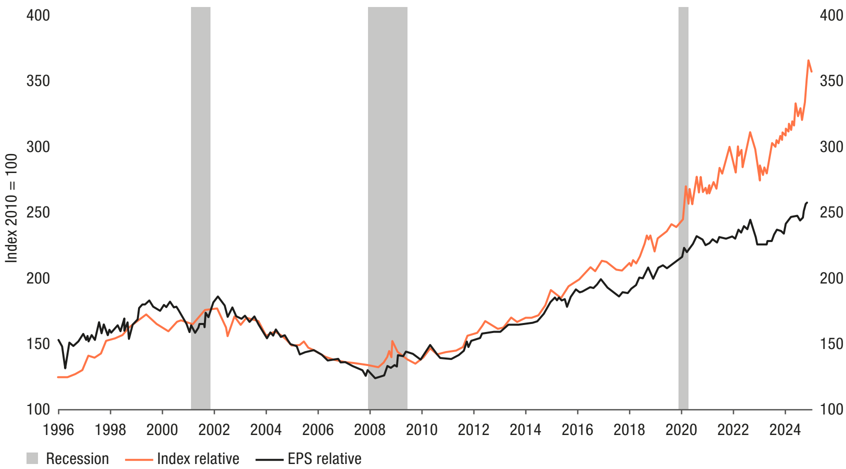
US NET INTERNATIONAL INVESTMENT POSITION



Source: J.P. Morgan

The arguments generally put forward in favour of the American market revolve around "American exceptionalism". The idea is that the United States has certain fundamental advantages, such as lower energy costs, a very large domestic market and the fact that it controls the reserve currency and world trade, which means that it has no constraints on financing its deficits. Added to this is the fact that US businesses seem to dominate the digital economy. More recently, the election of Donald Trump is expected to bring a new wave of deregulation and tax cuts favourable to the US market.

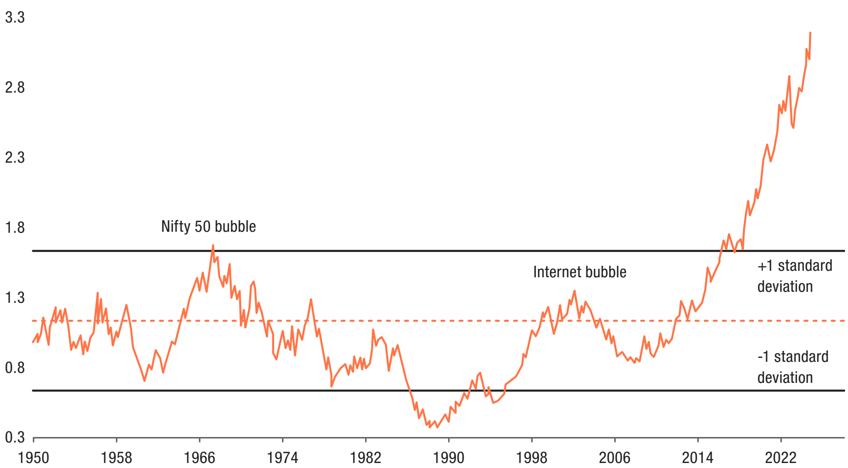
RERATING HAS DRIVEN US OUTPERFORMANCE



Source: MSCI, IBES/DataStream, NBER; Minack Advisors

The fact is, however, that since 2017, the outperformance of the US market has been due to multiple expansion, and not to significantly higher earnings growth (just as higher economic growth in the US is primarily the result of a significantly higher budget deficit). As a result, based on most valuation ratios, the US market premium is now historically high. Another point to note about the US market's performance is that it is driven by a very limited number of stocks. This narrowness can even be seen in the technology sector. Last year's outperformance was based essentially on a single stock, Nvidia.

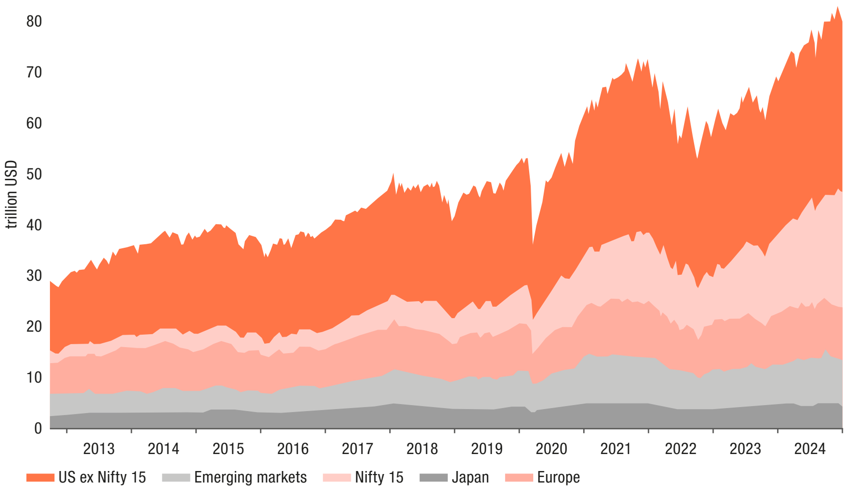
75-YEAR-HIGH IN US STOCKS VERSUS REST-OF-WORLD



Source: BofA Global Investment Strategy, Global Finance Data, Bloomberg

The outperformance of the US market illustrates the well-known phenomenon that 'markets make narratives'. The factors behind the rise of a market are then cited to justify further gains. Technology stocks are a good example. They seemed to be losing their splendour in 2022 before the theme of artificial intelligence breathed new life into them. There is no doubt that the major US technology stocks are, on the whole, very good companies. They have competitive advantages and generate recurring revenue streams and high returns on capital employed. However, they are now very expensive, and their earnings growth is starting to decline. It is also worth noting that, with the advent of the cloud and artificial intelligence, these companies are beginning to compete more closely with each other, whereas until now each had a virtual monopoly in its core business.

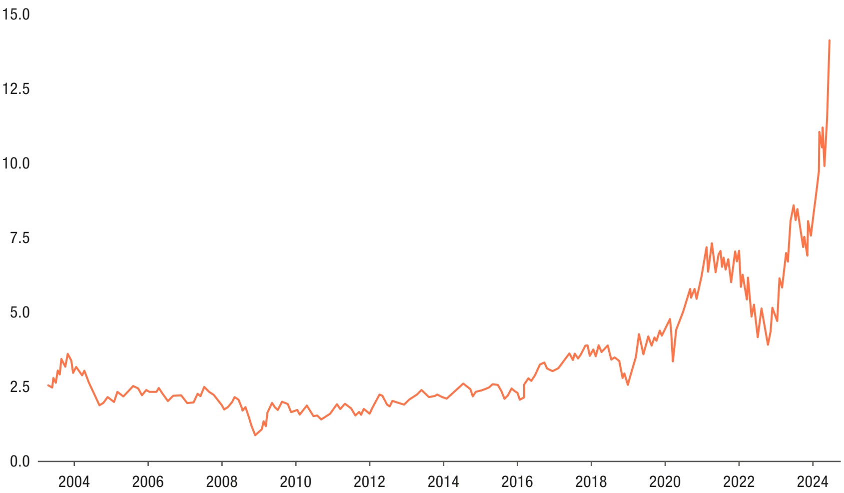
THE 15 LARGEST US COMPANIES ACCOUNT FOR NEARLY AS MUCH AS THE EUROPEAN, JAPANESE AND EMERGING MARKETS COMBINED



Source: Gavekal Research/Macrobond

Numerous examples demonstrate the absurdity of the current situation: the market capitalisation of the 15 largest US companies is equivalent to that of the European, Japanese and emerging markets combined; the 27 largest semiconductor companies now have a total market capitalisation that exceeds that of the energy and materials sectors combined; Tesla's market capitalisation has increased by $850 billion in two months, which is as much as the total market capitalisation of the 10 other largest car manufacturers.

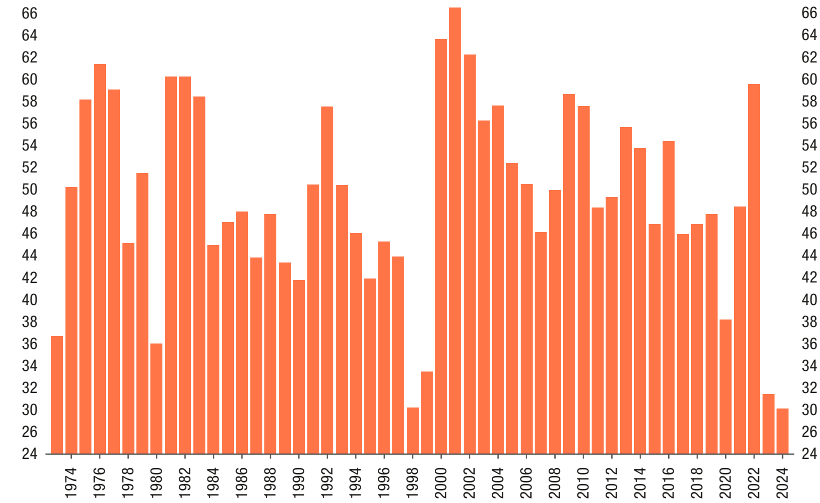
PRICE/SALES RATIO OF SEMICONDUCTOR COMPANIES



Source: Gavekal Research/Macrobond

In 2000, companies like Cisco Systems and Sun Microsystems were trading at more than 10, or even 20, times their sales. Over the following 3 years, their share price fell by 75% to 90%, and Sun's boss had this to say: *"At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Do you realise how ridiculous those basic assumptions are?"* Today, the number of shares trading at more than 10 times sales is once again very high in the technology sector.

PERCENTAGE OF S&P 500 COMPANIES THAT HAVE OUTPERFORMED THE INDEX



Source: Ned Davis Research

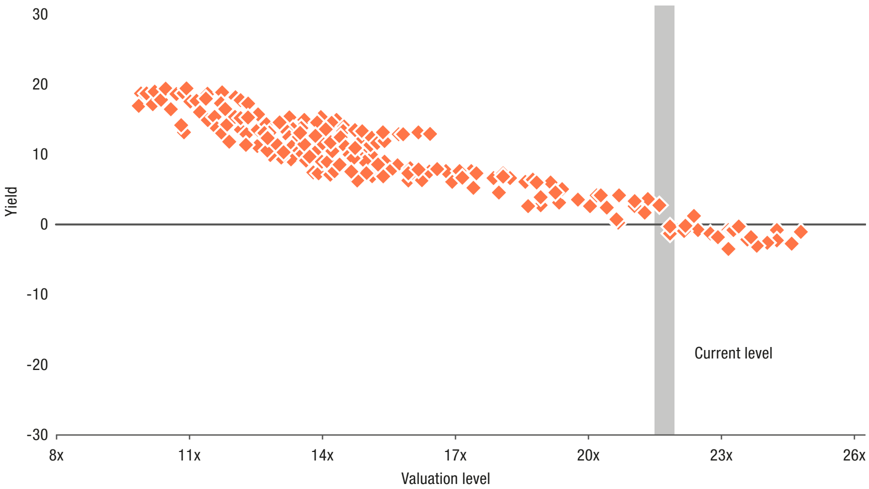
In some respects, the current environment resembles that at the turn of the century. Many professional managers are making decisions based not on their convictions, but on the fear of underperforming an index and losing their clients or their jobs. The result is a new investment paradigm characterised by fear of missing the upside, rather than analysis of fundamentals. While in theory investment decisions are supposed to be made rationally, in practice the democratisation of finance means that they are increasingly made on the basis of emotion. This raises concerns about the stability of financial markets, which are becoming more and more like casinos, and about the stability of the financial system as a whole.

US DOLLAR INDEX: 2024-2025 VERSUS 2016-2017

Source: Bloomberg – The Mad King

For a bubble to continue, it needs to attract more and more capital. Of the many risks hanging over the US market in general and the technology sector in particular (rising interest rates, high expectations, potential disappointments surrounding artificial intelligence), that of a depreciating dollar seems to be the most important. The correlation between a rising dollar and the outperformance of US growth stocks is currently very high. However, a strong dollar is incompatible with the Trump administration's objective of reindustrialising the United States. Donald Trump has said on several occasions that the US currency is overvalued. The current situation resembles that which existed at the start of his first term in office.

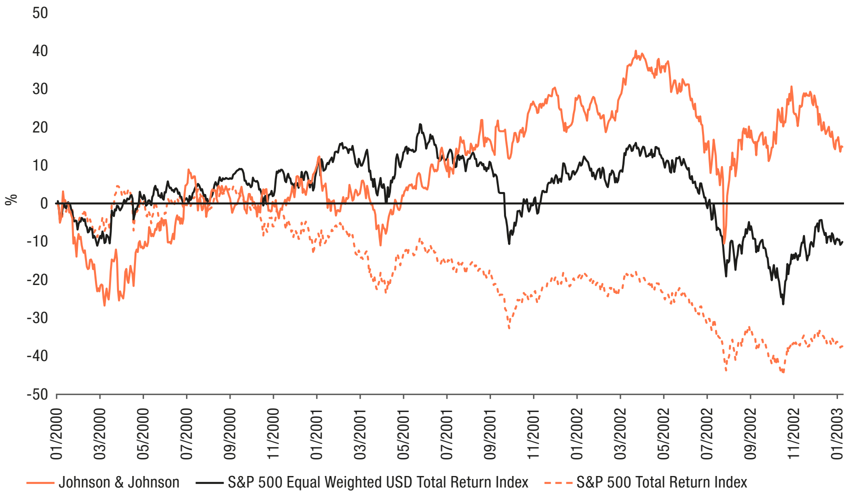
S&P 500 FORWARD P/E RATIOS AND SUBSEQUENT 10-YEAR RETURNS (% ANNUALISED TOTAL RETURN)



Source: J.P. Morgan

There is a close correlation between valuation and long-term returns (but not between valuation and short-term returns). The valuation of the US market is so high that the return an investor can reasonably expect is particularly low. It is important to note, however, that the high valuation of the US market is due to the disproportionate weight of a limited number of stocks. In other words, while the index is expensive, many US stocks are not. In this respect, it is important to note that even in a bear market, there are stocks that rise.

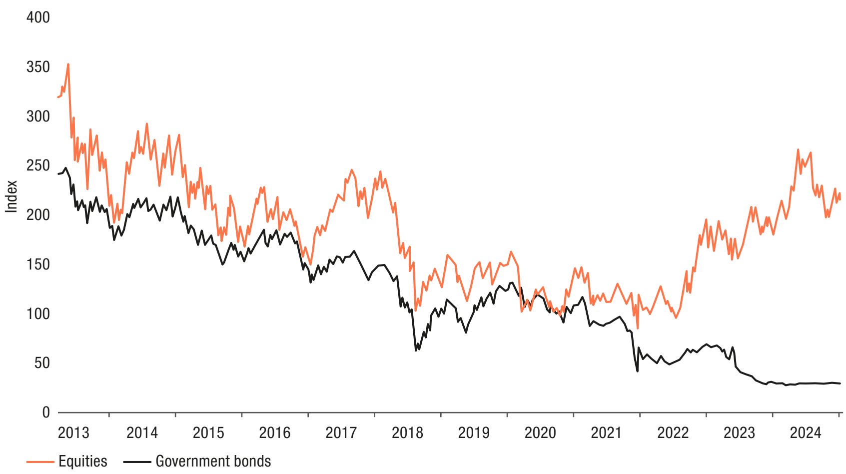
THE BENEFITS OF ACTIVE MANAGEMENT: S&P 500, S&P 500 EQUAL WEIGHTED AND JOHNSON & JOHNSON BETWEEN 2000 AND 2002



Source: Macrobond/Bloomberg

The combination of an environment favourable to equities and expensive stock market indices is a clear argument in favour of active management, even if it is illusory to think that such management can sustainably outperform as long as passive investing continues to increase its market share. Investors now have a choice between playing the momentum card, with the associated risks, or opting for a fundamentals-based strategy, with the risk of underperforming indices, at least in the short term.

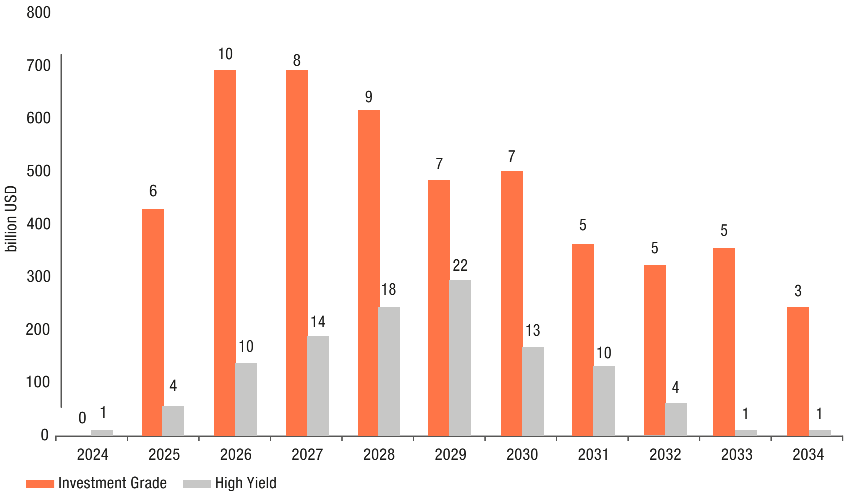
IN TURKEY, EQUITIES HAVE HELPED TO OFFSET CURRENCY DEVALUATION OVER THE PAST 3 YEARS



Source: ICE BAML, Gavekal Research/Macrobond

The arguments in favour of equities are not those traditionally associated with a bull market. The global economy is not in good shape, the financial system is very fragile, the geopolitical situation is uncertain and equity market valuations are often high. The reasons for buying equities today relate to the need to protect one's purchasing power in an environment of continuing debasement of fiat currencies.

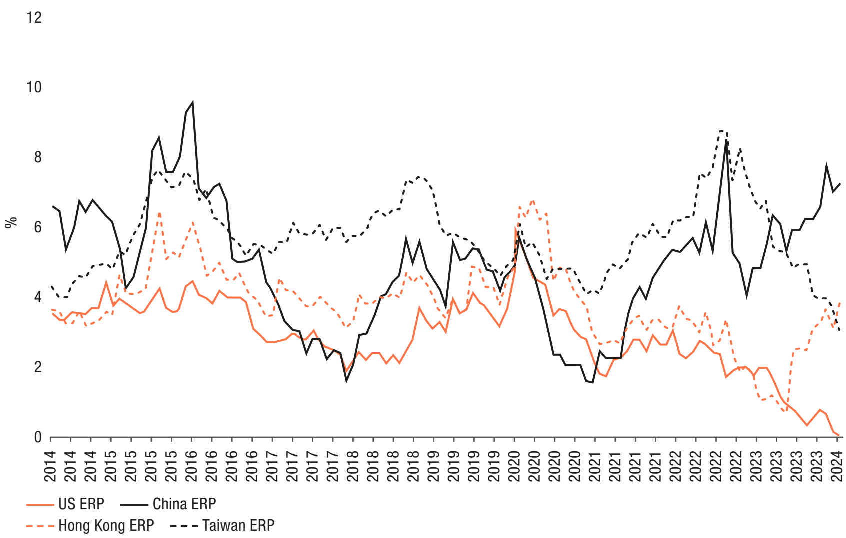
US CORPORATE BOND MATURITY PROFILE



Source: Minack Advisors

It follows from the above that, over the long term, equities should be favoured over bonds. However, this does not mean that stock markets will go on rising. The short-term environment is likely to become much less favourable for equities. Apart from the unpredictability of the new US administration, the main danger for the markets could come from a drying up of liquidity. While the markets have benefited from abundant liquidity since the end of 2022, the situation will begin to change in 2025 with the need to refinance a large proportion of public and private debt. Once again, the US market seems to be the most at risk, given that it has benefited most from the increase in liquidity.

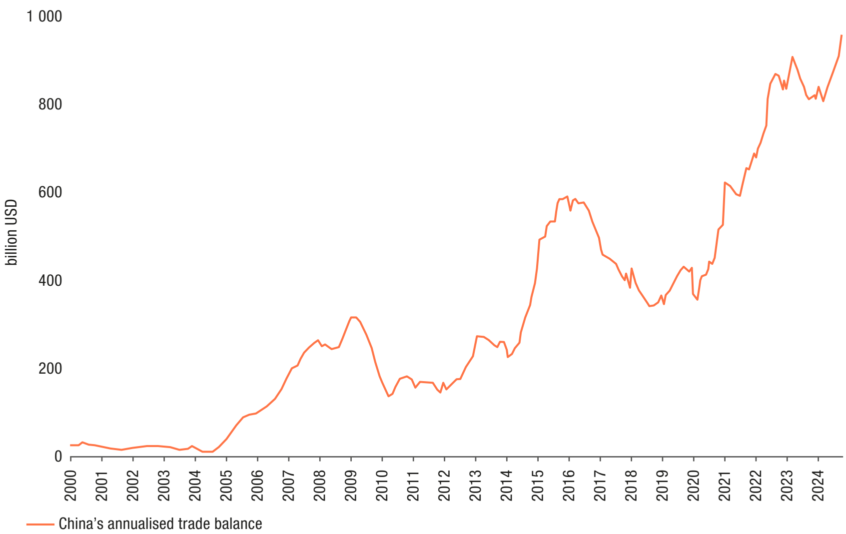
CHINESE EQUITY RISK PREMIUM



Source: Bloomberg, MSCI

If the US market is expensive, the Chinese market is not. The risk premium offered by Chinese shares is particularly high. In China, the interests of the Party clearly outweigh the interests of shareholders. This does not mean, however, that the interests of the two are necessarily incompatible. On the contrary, the authorities need a dynamic private sector to achieve their growth objectives and efficient financial markets to reinforce their credibility and establish themselves as the centre of a financial system competing with that based on the dollar.

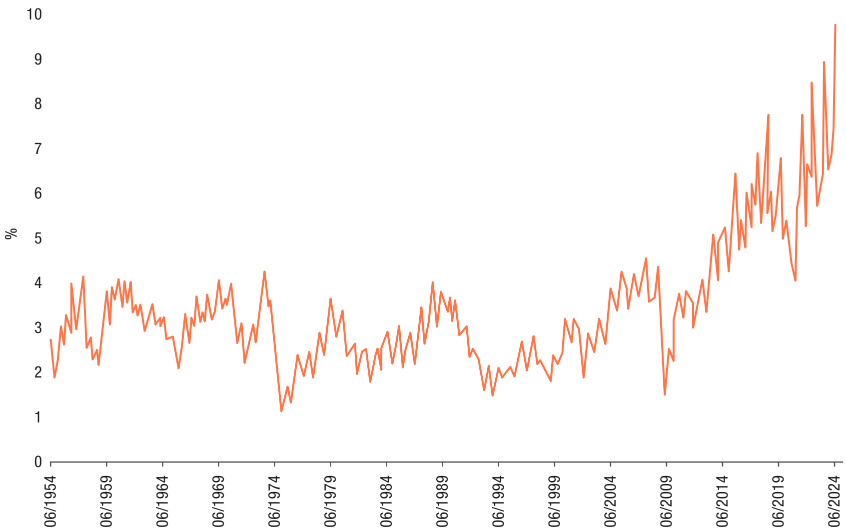
CHINA'S TRADE SURPLUS



Source: CEIC Data, General Administration of Customs

China's record trade surplus testifies to the competitiveness of Chinese companies. The days of China producing low-cost, low-quality products are clearly over. For an investor, the business models of major players in online commerce, video games or social media seem particularly attractive, especially as these players are generally not very dependent on the US market.

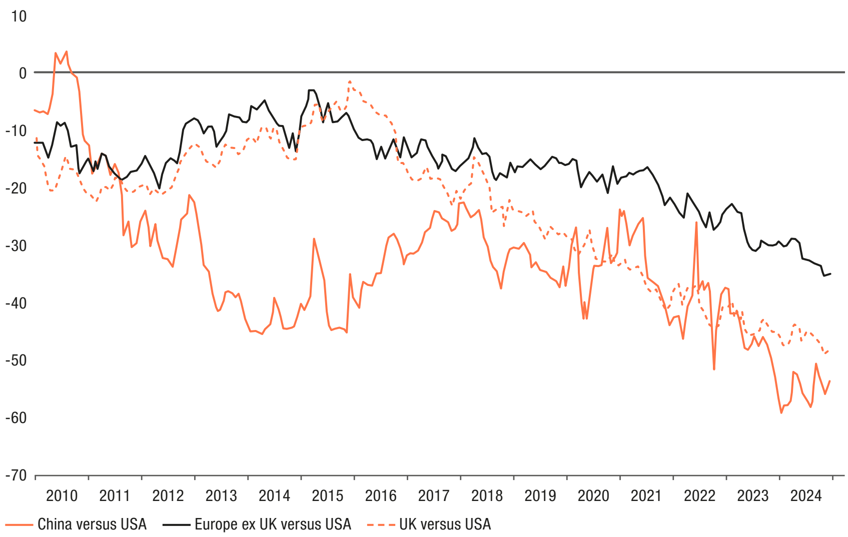
GROSS PROFIT MARGINS OF JAPANESE COMPANIES



Source: CLSA, Ministry of Finance

Improved corporate governance is likely to underpin the Japanese market in the years ahead. This is reflected in higher returns on invested capital and better treatment of shareholders. For foreign investors, Japanese shares also have the advantage of being quoted in a particularly undervalued currency. And history has shown that the Japanese market can perform very well during periods when the yen is appreciating, provided that this appreciation is not too rapid and too sharp.

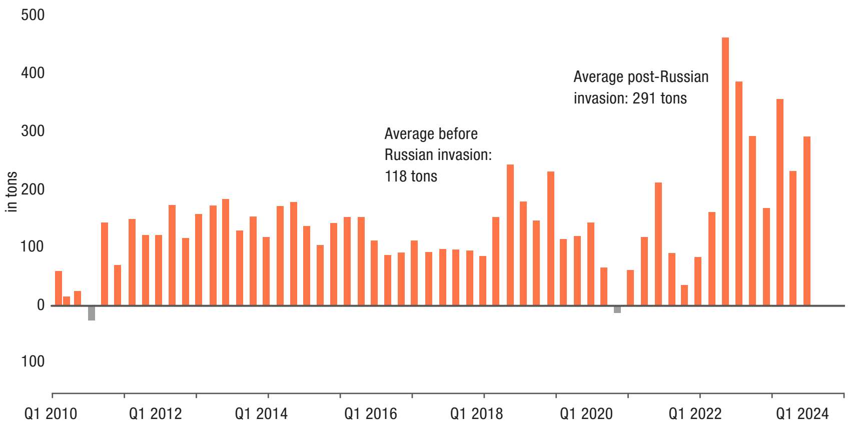
DISCOUNT VERSUS US MARKET (BASED ON FORWARD P/E RATIO)



Source: J.P. Morgan

The European market is trading at a significant discount to the US market, leading a growing number of European companies to consider listing in the US. A large part of this discount is due to the composition of the indices, with a much greater weighting of growth sectors in the US and value sectors in Europe, which continues to suffer from a shortage of growth stocks. But even within the same sectors, there are major differences in performance in 2024, with Novo Nordisk down 11% compared to Elli Lilly up 33%, and ASML down 2% compared to Nvidia up 177%. Generally speaking, the valuation levels of quality European companies are now more attractive than they were a year ago.

GOLD PURCHASES BY CENTRAL BANKS



Source: World Gold Council, Incrementum AG

The emerging geopolitical landscape continues to favour gold. Central bank purchases are less price sensitive and form part of a strategy recently formulated by the BRIC bloc to recycle their trade surpluses through channels other than US Treasuries, which have lost their lustre as safe, neutral assets. Efforts to reduce dependence on the dollar are only just beginning. Financial demand could return once it becomes clear that central banks will be forced to cut rates and resume their sovereign debt purchase programmes. As a currency, the yellow metal, whose supply cannot be increased at will, also benefits from the fact that it presents no counterparty risk.

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