CITY OF LONDON
Investment Management Company Limited

Developed Markets Quarterly Outlook

February 2025*

Overview

Truth Wars

Several important macro themes may disrupt or reaffirm US equity leadership this year. US tariffs are currently the most dominant theme and are expected to increase market volatility. In addition, recent Artificial Intelligence (AI) innovations from China challenge US big tech's perceived advantages. Finally, the US government must provide a credible plan to manage the fiscal deficit while supporting US growth. Overall, we remain neutral the US. This quarter, we upgraded Japan to overweight, upgraded the Eurozone to neutral, downgraded Canada to underweight, and reduced the size of our EM overweight.

Asset allocators must navigate several potential catalysts this year that could shift trends from prior years. US equities and the technology sector underperformed the All Country World Index (ACWI) in January, a brief blip from the recent US exceptionalism. There is a reasonable risk that the US equity leadership could be challenged this year, but the long-term trend is still moving in favour of the US (see Chart 1). Several developing macro themes may potentially disrupt or reaffirm US equity leadership in 2025.

US tariffs are one prominent theme that could impact global trade and various markets. At the time of writing, US trade policy is evolving quickly, with Mexico, Canada, and China attempting to avoid tariffs. Europe may join this group soon based on Trump's recent comments. As with Trump's first term, his social media posts will likely swing towards and against deals and resolutions. Our baseline view assumes political uncertainty and elevated volatility similar to the 2018-19 US-China trade war period. For reference, the VIX Index averaged three points higher over 2018-19 compared to the prior two-year period. A rise in tariffs is a reasonable expectation over the next four years; however, as highlighted in our previous quarterly, the Trump administration faces different constraints this term.

A larger fiscal deficit, higher inflation, expensive dollar, and elevated US equity valuation are all factors that may influence policy and constrain the Trump administration's options. The result may be less severe tariffs than expected. For example, if Trump considers the S&P 500 an important barometer of success, tariffs could be problematic given the index's significant international exposure (41% of revenues are non-US as of Q3 2024). Furthermore, US households are more exposed to the equity market. Chart 2 shows that US household wealth has grown with US equity strength (outpacing home price appreciation). In Trump's first term, 2018 marked a brief cyclical peak for the S&P 500, and the latter part of the year saw a 19.5% drawdown as the US-China trade war escalated (see Chart 3). Note that this period also included Fed hikes, and the S&P 500 subsequently rebounded ahead of the Phase 1 US-China trade deal in January 2020. In addition, it is notable that US manufacturing activity weakened over the period. Still, if US equities have a comparable response to tariffs in the future, a market decline could prevent Trump from pursuing the most severe tariff threats.

Global Equity Allocation Breakdown

	Chg	-2	-1	0	+1	+2
US	-			■		
Canada	↓		■			
Eurozone	↑			■		
Switzerland	-				■	
UK	-		■			
Japan	↑				■	
Australia	-		■			
EM	↓				■	

Note: Up/down arrows indicate a positive/negative change in our asset allocation compared to the previous quarter. A dash indicates no change.

Source: CLIM

International Equity Allocation Breakdown

	Chg	-2	-1	0	+1	+2
Canada	↓		■			
Eurozone	↑			■		
Switzerland	-				■	
UK	-		■			
Japan	↑				■	
Australia	-		■			
EM	↓				■	

Note: Up/down arrows indicate a positive/negative change in our asset allocation compared to the previous quarter. A dash indicates no change.

Source: CLIM

**This publication reflects asset performance up to 31 January, 2025, and macro events and data releases up to 8 February, 2025, unless indicated otherwise.*

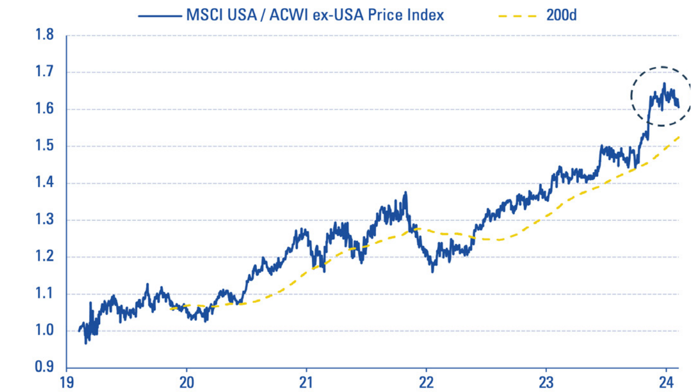
AI and US tech leadership are also important market themes and a national security issue for the Trump administration. The US big tech firms were assumed to be the clear leaders in AI, given their exclusive access to advanced chips and large pools of capital for research. We still hold this view to some degree. However, the improvements in China's Large Language Models (LLMs) are a potential threat to the US firms' perceived AI advantage. The recent versions of LLMs appear to be cheaper and more efficient, providing more competition for US big tech. The implications are a less obvious 'moat' for richly priced US tech stocks. Any threat to US tech dominance is a risk to the US market.

Lastly, the US fiscal deficit should come under renewed scrutiny as Congress pushes through spending and tax cuts. A positive fiscal impulse contributed to US growth under the Biden administration. The current government will have to manage possible spending and tax cuts to prevent a bond market selloff as net interest payments continue to rise. The Republican-controlled Congress will attempt to deliver a tax cut package with a slim House majority. The deceleration in nominal GDP growth and increase in bond yields (see Chart 4) create further challenges for the US fiscal outlook (see Chart 5).

Some members of Trump's team view tariffs as a potential source of revenue, but we are sceptical that this revenue source will be sustainable in the long term. Trade may divert away from the US, while US consumers or corporates absorb higher prices. An alternative path is Treasury Secretary Bessent's "gradual tariffs" and "3-3-3" plan for strong growth, a gradual deficit reduction, and lower oil prices. This plan still requires careful execution and some good fortune from factors outside the government's direct control (e.g., an OPEC+ production boost and loose Fed policy). Bessent has indicated multiple times publicly that he is "focussed on the 10-year Treasury". He has been less explicit about the US dollar's direction other than reiterating the importance of remaining "the world's reserve currency". If real rates fall later this year, we suspect the US dollar may come under some pressure (see Chart 6). However, the Trump administration will likely first explore the effectiveness and limits of tariffs, providing support for the dollar in the near term.

Market Strategy: Various macro crosscurrents should keep the market volatile and potentially create new investment opportunities for active managers. Investors from Trump's first term will recall his tweets (now referred to as truths on Truth Social) shift regularly. Our strategy focuses on vulnerabilities and constraints to identify opportunities. The US market and the US dollar remain expensive and indicate vulnerability from a purely valuation perspective. We have downplayed this longer-term metric, given the relative strength of US earnings and advantages in the AI space. This year could present some challenges for the most richly priced US stocks, but the US still justifies a valuation premium based on various metrics. We, therefore, maintain a neutral allocation.

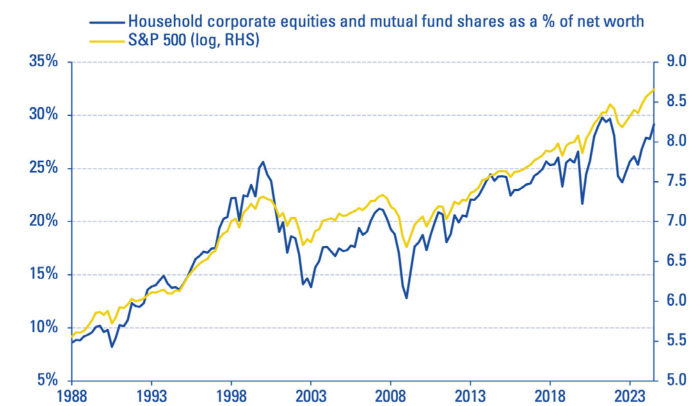
Chart 1: MSCI USA Index relative to ACWI ex-USA



Data as of Feb 6, 2025.

Source: Bloomberg

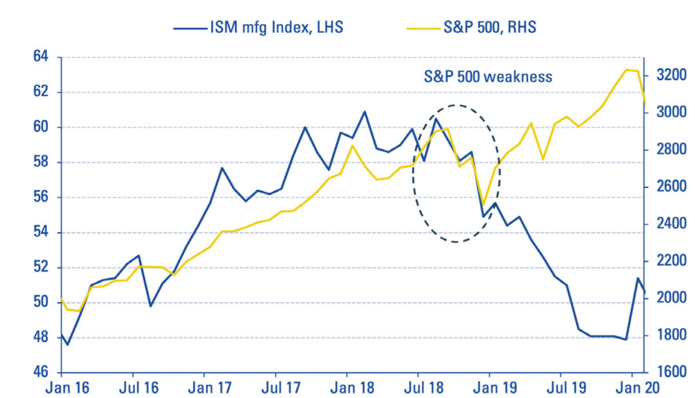
Chart 2: US Household Equity Ownership



Data as of Dec 31, 2024.

Source: Bloomberg

Chart 3: S&P 500 and ISM Manufacturing 2016-20



Source: Bloomberg

Outside of the US, we made the following changes this month:

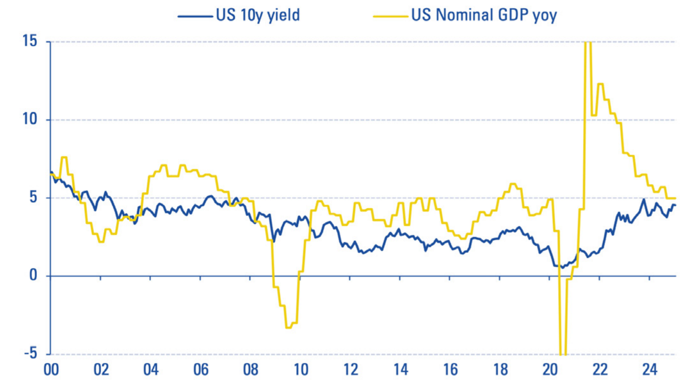
- Upgrade **Eurozone** to neutral. The Eurozone presents various reasons to be cautious, including lacklustre growth, political instability, energy dependency, and potential tariff risks. However, we are mindful that valuations reflect these factors to a large degree. In addition, improving global manufacturing activity and a change in the upcoming German elections are potential catalysts for a recovery. Intra-Europe, we maintain a small overweight to the Netherlands funded from the rest of the euro bloc.
- Upgrade **Japan** to overweight. We have previously held a positive bias towards Japan, given its progress on corporate governance reform and positive earnings growth. As the yen appears to be stabilising, the entry point is more compelling to add exposure.
- Downgrade **Canada** to underweight. Canada has come under pressure from tariff threats, but we expect the US and Canada to resolve these issues eventually. Our downgrade is primarily due to non-US trade-related factors. The MSCI Canada Index is screening rich on our metrics, particularly financials, which remain vulnerable to housing market stress. In addition, should the US succeed in weakening oil prices, Canadian energy will also underperform.
- Reduce the **EM** overweight in response to elevated geopolitical risks and tariffs. EM remains our preferred overweight exposure given attractive value, exposure to semiconductors and AI, and our expectation for the US dollar to weaken later this year. However, we are mindful that various EMs will be or are currently in the Trump administration's sights for tariffs, and the US dollar's path may be stronger in the near term.

*Justin Kariya***

February 8th, 2025

***This document includes contributions from Tom Traill.*

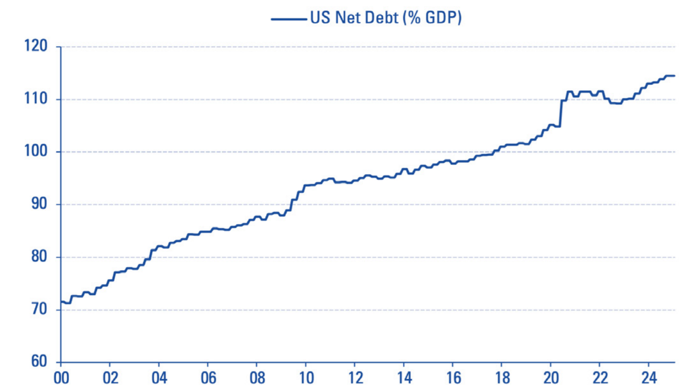
Chart 4: Nominal GDP Growth vs US Bond Yield



Data as of Jan 31, 2025.

Source: Bloomberg

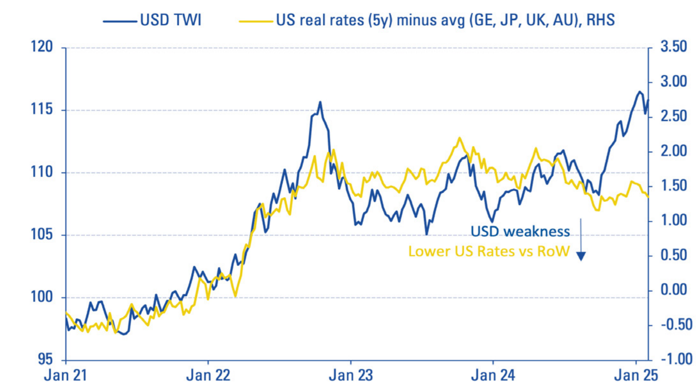
Chart 5: US Net Debt (%GDP)



Data as of Jan 31, 2025.

Source: Bloomberg

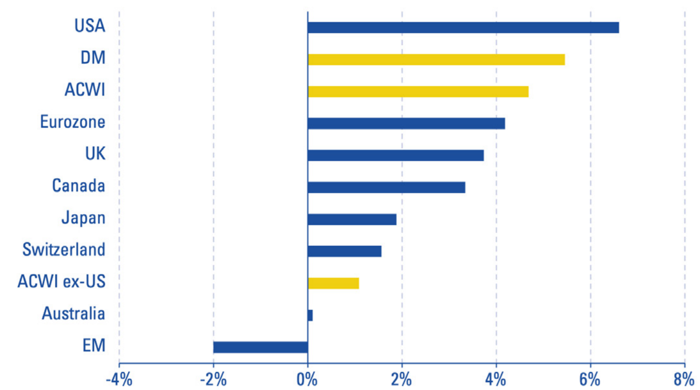
Chart 6: US Dollar vs Real Rate Differentials



Data as of Jan 31, 2025.

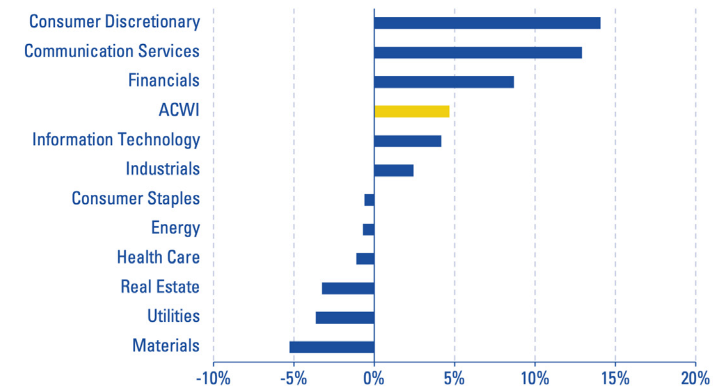
Source: Bloomberg

MSCI ACWI, Net Total USD Return, Nov-Jan, %



Source: Bloomberg

MSCI ACWI Sectors, Net Total USD Return, Nov-Jan, %



Source: Bloomberg

United States

NW (Global Index)

	3Y history	Latest	
GDP, % qoq saar		2.3	Q4
PMI, index		50.9	Jan
CPI, % yoy		2.9	Dec
Policy rate, %		4.38	Jan
MSCI USA*		1.9%	Jan
EPS, % yoy		8.1	Jan
Trailing P/E		27.7	Jan

**US$ total return relative to MSCI ACWI. Latest is three-month return.*

Source: Bloomberg

- US economic policy remains uncertain. Tariffs are an evolving policy tool, and we may see more tax cuts and reductions in government spending. US policy rates seem more likely to fall than rise, but inflation remains above target. The economy has been strong, but a severe disruption to global trade or any fiscal tightening are risks for the US.
- Earnings expectations remain positive, and the return on equity has been impressive. However, the release of DeepSeek, a Chinese AI model, illustrated that US Big Tech is vulnerable with elevated valuations.
- Historically, the US tends to outperform in a slower growth environment, given its positive correlation to lower rates, and it has a smaller weighting to highly cyclical sectors compared to some other DM markets. However, the reliability of this signal is less clear in a slowdown given that a long US equity positioning is one of the most crowded trades. We remain *neutral*.

Eurozone

↑NW (Global and Global ex-US index)

	3Y history	Latest	
GDP, % yoy		0.9	Q4
PMI, index		46.6	Jan
CPI, % yoy		2.5	Jan
Policy rate, %		2.90	Jan
MSCI Eurozone*		-0.3%	Jan
EPS, % yoy		-4.1	Jan
Trailing P/E		14.7	Jan

**US$ total return relative to MSCI ACWI. Latest is three-month return.*

Source: Bloomberg

- The Eurozone has struggled with several headwinds, including French political discord, the threat of American tariffs, and sluggish export growth. The European manufacturing cycle remains weak, but recent PMI data indicates some potential evidence of a bottom. Further ECB cuts and the weaker euro are historically supportive with a lag.
- Equity valuations have cheapened significantly, and there are some potential upside catalysts. For example, the upcoming German elections could shift the German fiscal outlook to a more stimulative stance. Early signals of a recovery in the industrial cycle are a potential risk for underweight exposure. We, therefore, upgrade our exposure to manage this risk.
- We continue to see value in the Tech hardware space, which is most apparent in the Netherlands. We take a neutral position for the Eurozone overall, with a small Netherlands overweight funded from a small *underweight* in the bloc's other countries

Emerging Markets

↓OW (Global and Global ex-US index)

	3Y history	Latest	
GDP, % yoy		4.2	Q3
PMI, index		50.8	Jan
CPI, % yoy		5.5	Dec
Policy rate, %		6.90	Jan
MSCI EM*		-6.7%	Jan
EPS, % yoy		11.6	Jan
Trailing P/E		14.0	Jan

**US$ total return relative to MSCI ACWI. Latest is three-month return. Economic indicators are GDP-weighted with the exception of PMI, which is value-added-weighted.*

Source: Bloomberg

- US ambitions to close their trade deficits would be helped by weakening the dollar, which remains richly valued. We suspect the Trump administration may eventually favour a weaker dollar to support domestic manufacturing, but they are currently focussing on tariffs to influence trade. While unilateral action is difficult, the US can influence the dollar trend. A weaker dollar is generally accompanied by EM equity strength.
- EMs are vulnerable to the introduction of American tariffs, as seen for China. However, they continue to offer tech exposure at more appealing valuations than their DM counterparts. Taiwan and Korea are integral to manufacturing cutting-edge semiconductors and high-bandwidth memory (HBM) and are well-positioned to benefit from further growth in the semiconductor cycle.
- Relative to other markets, earnings expectations remain robust (13.6% in 2025). Despite solid earnings expectations, the current 12m forward P/E ratio for the MSCI EM Index is still below its five-year average. We remain *overweight*, but to a lesser extent than before.

Japan

↑OW (Global and Global ex-US index)

	3Y history	Latest	
GDP, % yoy		0.5	Q3
PMI, index		48.7	Jan
CPI, % yoy		3.6	Dec
Policy rate, %		0.50	Jan
MSCI Japan*		-2.8%	Jan
EPS, % yoy		16.4	Jan
Trailing P/E		15.6	Jan

**US$ total return relative to MSCI ACWI. Latest is three-month return.*

Source: Bloomberg

- Japan's ongoing corporate governance reforms seek to unlock shareholder value, and if firms continue to be successful, then a higher multiple is justified. There are promising signs, with the number of companies publishing their initiatives rising. Trump's goal is to lower oil prices and rates, which has historically favoured Japan.
- FX volatility has been a concern for the market, raising uncertainty and the potential for currency moves to negate USD-based equity returns. However, the yen appears undervalued on several FX metrics and equity markets have become more positively correlated with the yen – an appreciating yen could lead to outperformance. The Bank of Japan is the only DM central bank currently looking to tighten.
- The equity market has cheapened, while earnings in Japan have outperformed other non-US markets over the past year. We move Japan to *overweight*.

United Kingdom

UW (Global and Global ex-US index)

	3Y history	Latest	
GDP, % yoy		0.9	Q3
PMI, index		48.3	Jan
CPI, % yoy		2.5	Dec
Policy rate, %		4.75	Jan
MSCI UK*		-0.7%	Jan
EPS, % yoy		-6.3	Jan
Trailing P/E		13.0	Jan

**US$ total return relative to MSCI ACWI. Latest is three-month return.*

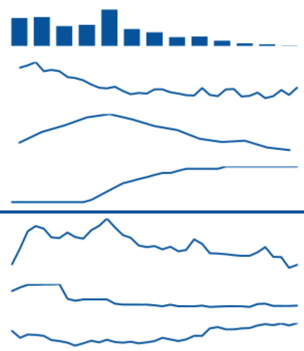
Source: Bloomberg

- Higher global rates have historically favoured the more value-oriented UK large-cap stocks. If global central banks continue cutting rates, this would be expected to be less supportive. The UK small and mid-cap stocks could benefit from tentative signs of improvement in the industrial cycle.
- The UK also has a comparatively high weight in the energy sector, and any weakness in global economic growth and continued excess capacity could negatively impact this. Indeed, President Trump is also seeking to lower energy prices as part of his efforts to curb inflation.
- UK valuations remain cheap, but they are likely to stay cheap. Earnings expectations are a lacklustre 5.7% in 2025, well below the global estimate and the UK's P/E multiple is consistent with this weak earnings growth. We remain *underweight*.

Australia

UW (Global and Global ex-US index)

3Y history



	Latest	
GDP, % yoy	0.8	Q3
PMI, index	50.2	Jan
CPI, % yoy	2.4	Dec
Policy rate, %	4.35	Jan
MSCI Australia*	-4.6%	Jan
EPS, % yoy	-6.4	Jan
Trailing P/E	20.2	Jan

**US$ total return relative to MSCI ACWI. Latest is three-month return.*

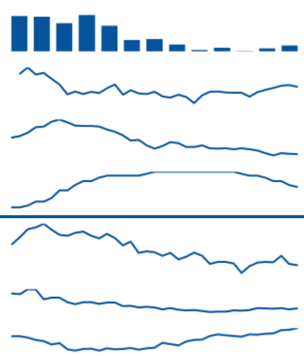
Source: Bloomberg

- Historically, Australia has been a beneficiary of Chinese economic strength. Currently, their demand for commodities is reduced, and there are limited near-term prospects of another property boom to drive a new ‘commodity supercycle’. Chinese growth is expected to remain steady and slow gradually over time and is more likely to be consumption orientated, favouring direct exposure to mainland China rather than Australia.
- The MSCI Australia Index trades at a multiple that appears unduly high for the level of earnings that are forecast (+2.2% in 2025). Australia will likely de-rate if earnings do not surprise to the upside.
- We remain *underweight*, believing the index is unattractively priced and likely to underperform.

Canada

↓UW (Global and Global ex-US index)

3Y history



	Latest	
GDP, % yoy	1.5	Q3
PMI, index	51.6	Jan
CPI, % yoy	1.8	Dec
Policy rate, %	3.00	Jan
MSCI Canada*	-1.3%	Jan
EPS, % yoy	-0.1	Jan
Trailing P/E	20.6	Jan

**US$ total return relative to MSCI ACWI. Latest is three-month return.*

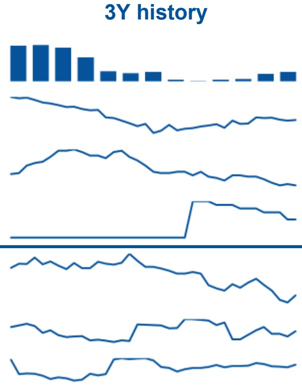
Source: Bloomberg

- Canada has moved into the headlines due to the US threats of 25% tariffs. If implemented, the Canadian economy would be materially impacted with nearly 80% of exports going to the US. Given the close historical and geographical ties, we expect the US and Canada to resolve their issues eventually. However, the upcoming USMCA renegotiation should keep policy uncertainty elevated for this year. In addition, Canada may struggle to make firm commitments until new federal elections are held and the new Prime Minister and government have a stronger mandate.
- Canada has a high weighting to financials, which have performed better in recent months. Subsequently, the index is now screening relatively rich, despite ongoing vulnerabilities linked to the leveraged housing sector. The energy sector, which also has a high weight in the index, is vulnerable if the Trump administration can successfully steer the oil price lower.
- MSCI Canada is currently trading at a smaller discount relative to ACWI than normal. It appears particularly unattractive relative to DM ex-US. We move to an *underweight* position.

Switzerland

OW (Global and Global ex-US index)

3Y history



	Latest	
GDP, % yoy	1.7	Q3
PMI, index	47.5	Jan
CPI, % yoy	0.6	Dec
Policy rate, %	0.50	Jan
MSCI Switzerland*	-3.1%	Jan
EPS, % yoy	2.5	Jan
Trailing P/E	20.3	Jan

**US$ total return relative to MSCI ACWI. Latest is three-month return.*

Source: Bloomberg

- The Swiss index is defensively tilted due to its sectoral composition – with high weights in healthcare and consumer staples. The market is likely to be more insulated from global policy uncertainty weighing on growth. Also, the CHF should benefit from safe-haven demand.
- The Swiss index underperformed in the past quarter but outperformed in January as the Trump administration started threatening and implementing tariffs on countries.
- Swiss earnings expectations have held up in recent months and are expected to grow at around 10% in both 2025 and 2026. We maintain a small *overweight* position.

GLOBAL EQUITY - KEY ECONOMIC AND FINANCIAL INDICATORS

	Developed Market	Annual GDP Growth	Quarterly GDP Growth QoQ*	Industrial Production Growth	Consumer Price Index	Budget Balance % of GDP 2025F**	Trade Balance	Current Account Balance	Foreign Reserves 2024 Latest	Foreign Reserves 2023 Year Ago	Currency vs $ 2025 Latest	Currency vs $ 2024 Year ago	Short-Term Interest Rates	Sovereign Rating S&P	% MSCI ACWI Net***	Stock Market Index (MSCI ACWI Net) US$	Change since 12/31/24 US$	Change since 12/31/24 Local	2025 P/E Forecast	3 month Currency vs $ +/-
		Macroeconomic Data: % change on year ago				Latest 12 months									Market Performance				Forecast†	
		%	%	%	%		$ Bns	$ Bns	$ Bns	$ Bns			%		Jan. 31, 2025	Jan. 31, 2025	%	%		
Overweight	EM	4.2	n.a.	3.9	5.5	-4.6	723.2	484.1	7916.15	7670.98	1738.14	1723.89	6.90	n.a.	9.73	584.14	1.79	1.60	13.8	n.a.
Overweight	JAPAN	0.5	1.2	-1.1	3.6	-3.8	-35.7	192.7	1092.31	1170.44	152.56	147.92	0.35	A+	4.75	8753.56	1.56	0.07	15.6	+
Overweight	SWITZERLAND	1.7	1.6	3.5	0.6	0.3	68.8	53.8	808.03	779.97	0.90	0.87	-0.75	AAA	2.08	19188.67	8.15	8.36	19.4	-
Neutral	DENMARK	2.9	3.6	-2.9	1.9	1.5	39.4	59.2	97.01	96.78	7.19	6.94	2.35	AAA	0.57	52286.86	-1.61	-1.93	22.3	-
Neutral	EUROZONE	0.9	0.0	-1.9	2.5	-3.0	1.9	4.6	310.64	298.24	1.04	1.08	0.73	n.a.	7.21	475.63	7.69	7.27	15.1	-
Neutral	HONG KONG	2.4	3.2	-0.1	1.4	-1.3	-48.5	122.1	424.96	424.43	7.79	7.82	3.83	AA+	0.39	55190.46	-2.29	-2.01	12.3	-
Neutral	ISRAEL	-1.1	4.0	-21.9	3.2	-5.2	-34.2	66.3	214.56	200.09	3.54	3.65	4.51	A	0.20	215.41	4.57	3.56	13.2	-
Neutral	NEW ZEALAND	-1.5	-3.9	0.6	2.2	-3.4	-4.7	-16.9	18.84	12.11	0.57	0.61	3.83	AA+	0.04	585.80	-1.65	-2.54	109.0	-
Neutral	NORWAY	3.1	2.0	1.4	2.2	11.0	68.8	89.5	72.83	71.69	11.27	10.60	4.53	AAA	0.13	10547.23	8.02	7.52	10.4	-
Neutral	SINGAPORE	4.3	13.6	10.6	1.6	-0.1	193.0	106.4	363.57	331.29	1.35	1.34	3.20	AAA	0.35	1587.66	4.55	4.01	14.8	-
Neutral	SWEDEN	0.7	1.2	2.8	1.0	-1.0	6.3	46.5	41.56	41.68	10.91	10.52	2.31	AAA	0.79	34065.90	9.77	9.85	18.5	-
Neutral	UNITED STATES	2.5	2.3	0.6	2.9	-6.5	-918.4	-1055.3	34.87	37.32	1.00	1.00	4.14	AA+	66.41	17311.74	3.02	3.02	26.1	uc
Underweight	UK	0.9	0.0	-1.8	2.5	-3.8	-33.3	-81.8	102.68	108.77	1.25	1.26	4.55	AA	3.15	8947.86	5.21	6.05	12.8	-
Underweight	CANADA	1.5	1.0	1.4	1.8	-1.3	-5.3	-7.3	94.51	87.53	1.44	1.35	2.88	AAA	2.68	8971.00	2.80	3.52	17.4	-
Underweight	AUSTRALIA	0.8	1.2	0.2	2.4	-1.1	45.1	-28.3	39.58	40.90	0.63	0.65	3.20	AAA	1.56	5799.04	5.09	4.32	19.1	+

*Note: All data shown are as at February 6, 2025 unless otherwise stated. S&P credit rating shown is long-term foreign currency rating. * % change in GDP on previous quarter, annual rate. **Bloomberg consensus forecast. ***MSCI All Country World Index Daily Total Return Net. ****IP data from CPB; Currency level from MSCI EM Currency Index; GDP, CPI, budget and interest rate data from Bloomberg.*

†Any forecasts are based on Bloomberg consensus forecasts, where available, and assumptions. Actual results may vary from any such statements or forecasts. Past performance is no guarantee of future results.

Source: Bloomberg, CLIM

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