Wealth Management

Quarterly Report Sustainable Portfolio Service

Q4 2024

Forward-looking
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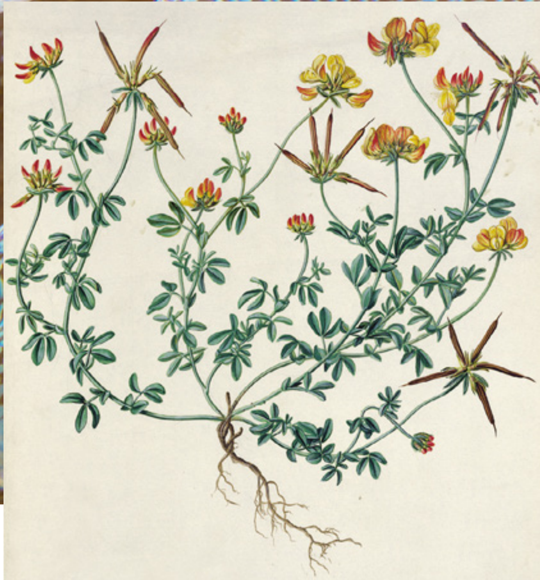

Cover image
Bauer brothers, Hortus Botanicus, detail from "Lotus corniculatus L.," around 1788
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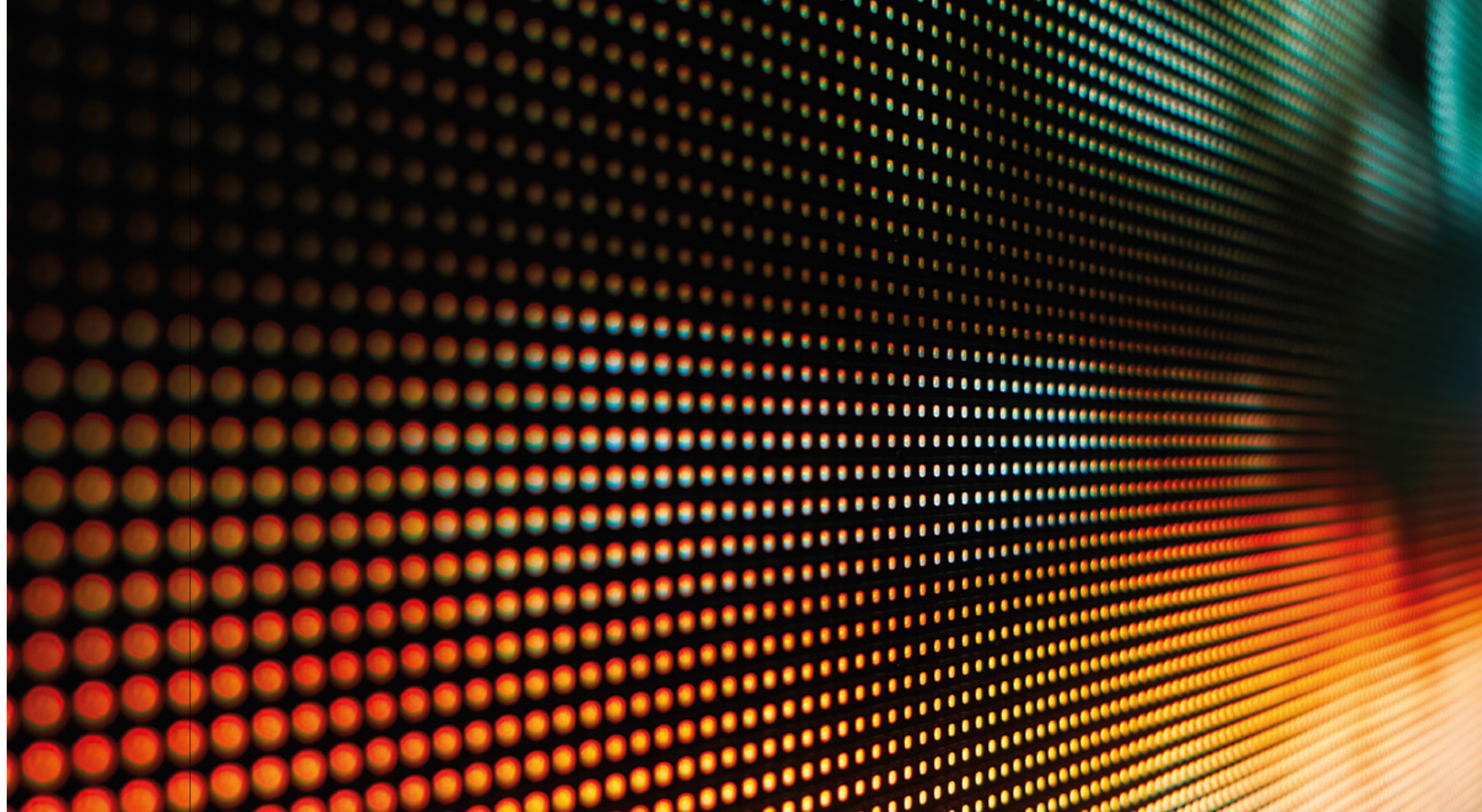
Summary: Q4 2024



At a glance:

- Trump wins US election
- Central banks diverged, with rate cuts slowing
- European politics destabilised
- The outperformance of the US persisted

Rate cuts

2024 saw US economic growth gather steam as the Federal Reserve (Fed) orchestrated a soft landing, creating an environment where earnings and corporate confidence supported equities and credit markets. Alongside this, central banks lowered interest rates as inflation made a gradual retreat. The quarter highlighted the diverging interest rate paths across the developed market central banks, with the Fed indicating a slower pace of cuts in 2025 relative to the European Central Bank (ECB), which opted to cut rates sequentially. This, together with looser fiscal policy, meant bonds struggled to gain traction over the quarter.

Politics

Donald Trump won the US election, with the Republicans securing the trifecta of the presidency, the House and the Senate. This should give him significant power to enact his agenda, although his slim House majority means the Republicans could struggle to pass some of the more extreme promises that Trump made during his campaign. Markets reacted quickly, with both equities and the dollar rising due to Trump's pro-growth strategies, while Treasuries sold off over concerns of higher deficits, which in turn could result in higher inflation. Since winning the election, Trump has made his intentions clear on social media, declaring he will impose substantial tariffs on Canada, Mexico and China.

In 2024, voters globally expressed discontent with incumbent governments, which is common after periods of high inflation. This was illustrated in the UK as the British public voted to end 14 years of Conservative rule in favour of the Labour party. Meanwhile in other European nations, much like the US, major economies saw a shift towards right-wing parties. The political turmoil did not end at elections, as several European coalitions dissolved in the fourth quarter. Prime Minister Michel Barnier's French government collapsed following his proposed 2025 budget, as did Chancellor Olaf Scholz's government in Germany after a no confidence vote. The upheaval was not confined to Europe, as South Korea's President Yoon Suk Yeol was impeached after declaring martial law on 3 December, leading to widespread protests.

Equities

US equities, particularly the Russell 2000 index, surged after Trump's victory, rising over proposed tax cuts and deregulation, although only finished the quarter up just under 1%. Over 2024, the Russell 2000 rose 12%. The S&P 500 had a strong quarter, benefiting from Trump's victory, but also from robust quarterly earnings, which helped propel 2024 gains to 25%.

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>
> Sanjay Rijhsinghani, Chief Investment Officer

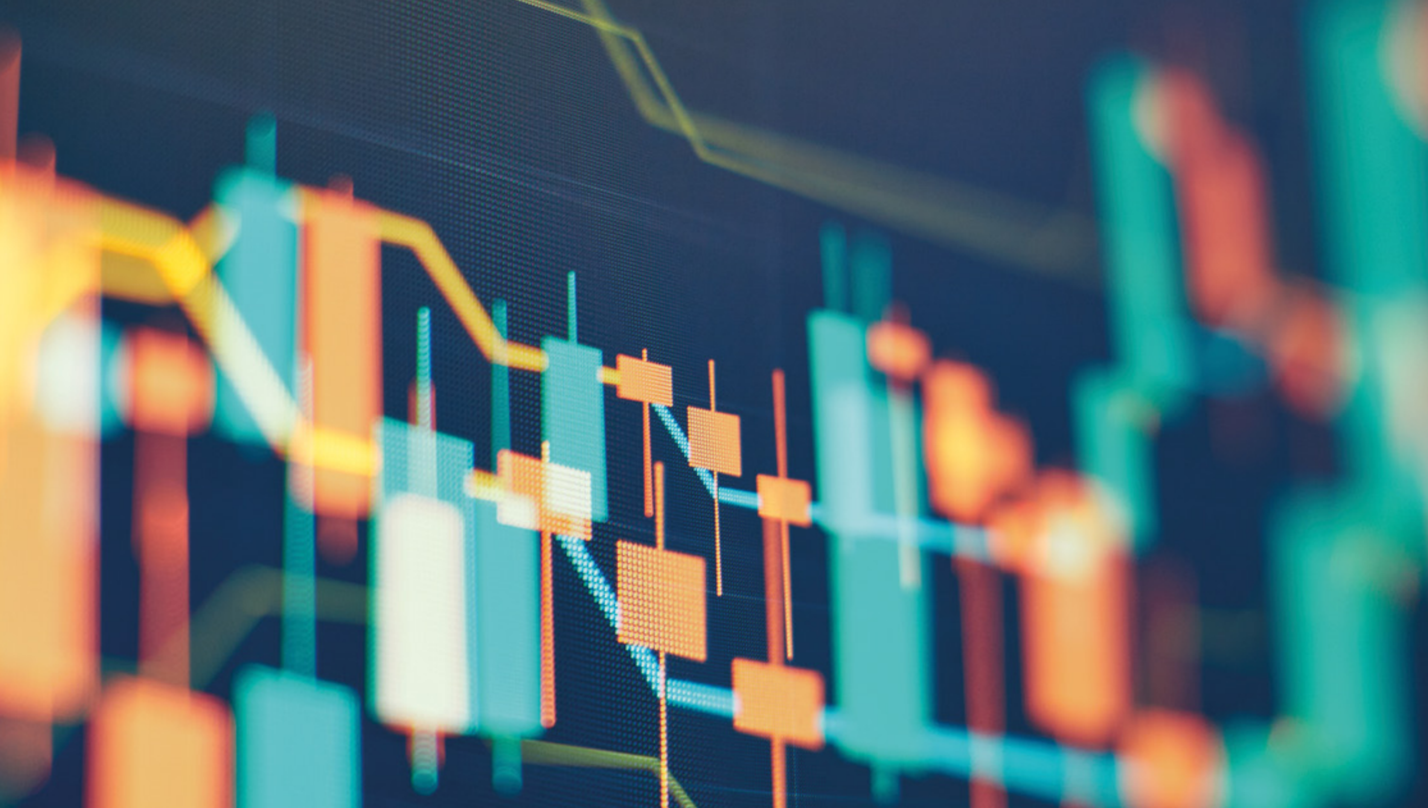
The fourth quarter was tough for European equities due to dollar strength, with the FTSE 100 close to flat and the Eurostoxx 600 dropping nearly 3%. This brought 2024 total returns for the FTSE to 9.6% and the Eurostoxx just shy of 10%. After picking up some pace in their interest rate cutting regime earlier this year, markets witnessed some divergence between central banks in the fourth quarter of 2024. The Fed cut rates in their final meeting in December, their third consecutive cut. In total, they lowered rates by 1% in 2024. But this may be the last cut for some time, with Chairman Jerome Powell signalling the pace of rate cuts may slow in 2025 as inflation remains above the Fed's 2% target rate. Sticky inflation kept the Bank of England (BoE) on hold in December, whilst the ECB lowered rates for the fourth consecutive time. Markets are anticipating the ECB will continue lowering rates at every meeting until June, as the continent faces sluggish economic growth.

Initial enthusiasm over China's third quarter stimulus announcements — including monetary, property and equity market intervention — abated somewhat in the fourth quarter. Markets await further clarity on President Xi Jinping's plans to ensure the 5% GDP growth target is met, along with Trump's approach towards China. The Shanghai Composite was flat in the quarter but rose 16% in 2024 overall.

Fixed Income

Political and macroeconomic events contributed to significant bond market volatility during the final quarter of the year. Yields of most major developed market government bonds ended the quarter higher than where they started, making the fourth quarter a painful period for fixed income investors.

In the US, Treasuries sold off on expectations that the incoming administration will impose higher tariffs and continue with deficit spending, which will likely push inflation higher. Ten-year Treasury yields peaked at 4.50% in November following the election, indicating interest rates may remain higher for longer. However, by month end, 10-year Treasury yields fell back to 4.17% as economic data showed that inflation remained moderate and employment data robust. The Fed reduced interest rates just days after the election. This was the second reduction of the year, and this latest occurrence signals that officials believe inflation is under control. Trump's victory, however, means the Fed's path ahead remains uncertain. Fed Chairman Jerome Powell reiterated that the central bank is independent from the government, and said the bank's immediate path would be driven by economic data and not Trump's policy plans.



In their final meeting of the year, the Fed cut rates for the third time, bringing rates to between 4.25% and 4.5%. Powell signalled the pace of rate cuts may slow in 2025. The Fed had forecasted four rate cuts in 2025 as recently as September, but as Trump's agenda may include deregulation and tax cuts, we are now seeing a more cautious approach.

October saw the UK inflation rate fall to its lowest level since April 2021, justifying the 0.25% cut to interest rates delivered in the November meeting. Despite the progress made on inflation which has historically been positive for bond prices, Gilts rose significantly over the quarter following the new Labour government's budget. The Chancellor unveiled additional spending on infrastructure and public services, funded by GBP 40 billion from increased taxation and GBP 28 billion from increased borrowing, sending bond yields higher. The UK 10-year bond rose by 0.63% over the quarter to 4.6%. Expectations for further cuts to interest rates into 2025 were also reduced.

The ECB cut rates by 0.25% in October, marking its first back-to-back cut since the euro crisis in 2011. ECB President Christine Lagarde noted the fall in inflation surprised the central bank and said this meant a cut was needed to ensure a soft landing. The bond market reaction to the decision was muted as the cut was fully priced in ahead of the meeting. During November and December, slowing economic growth, weak consumer data and fears of higher tariffs caused investor concerns to shift away from persistent inflation and focus on deteriorating economic conditions. The ECB acted as expected in December by cutting rates again by 0.25% to 3.0%. The ECB also signalled further cuts to interest rates are likely to continue into the new year. European government bonds reacted by falling at the short end of the curve to reflect the increase in future rate cuts.

From a portfolio perspective, the fixed income component was the weakest performing asset class in the portfolio over the quarter. Given the significant move higher in UK and US government bond yields, holdings in UK Gilts and US Treasuries detracted from performance. Despite yields in the US climbing higher than those in the UK over the period, US Treasury exposure outperformed UK Gilt holdings due to positioning at the shorter end of the yield curve where the sensitivity to movements in interest rates is reduced.

Turning to credit markets, credit spreads contracted further over the quarter from an already tight starting point. In the US, higher yielding corporate debt outperformed lower risk investment grade bonds following the election. The market expects business-friendly fiscal policy in the US to increase the likelihood of corporates repaying their debt obligations. Corporate bond exposure with a lower duration outperformed over the period.

Equity

The fourth quarter saw a dispersion in regional equity market returns, influenced by factors such as the US election outcome and its potential impact on the economic outlook of individual countries. The divergence in monetary policies among developed markets created some market volatility towards the end of the year, with the Fed signalling a slower pace of interest rate cuts in 2025.

Despite the market sell-off during December, the theme of US exceptionalism, the outperformance of the US in comparison to other global markets, persisted. This was largely driven by the outperformance of the largest US companies. This trend benefitted US exposure and in particular large technology companies.

US smaller companies outperformed their large cap peers following the US election result, owing to the expected benefits of future corporate tax cuts, stronger domestic US growth, and the fall in interest rates improving the strength of company balance sheets. However, this outperformance was eroded by the end of the quarter due to the potential for higher for longer interest rates.

European markets faced numerous headwinds, including a weaker domestic economy, rising political uncertainty in France and Germany, and concerns over the potential impact of US tariffs. All of which dampened sentiment in the region. At the company level, several of the largest index constituents also posted weak performance. Novo Nordisk (-20.9%) dropped sharply after disappointing results from its latest anti-obesity drug trial and ASML (-9.3%) announced weak orders and a slower recovery in the semiconductor market. Our active managers were able to mitigate some of these large market moves but struggled to match the strong returns driven by the US's largest companies.

Following a very strong prior quarter, returns from our Asian exposure was more muted. Key political events in China, including the Politburo meeting and the Central Economic Work Conference, did not result in the announcement of significant stimulus measures with the expectation for more pro-active monetary and fiscal policies pushed further into 2025.

The lack of detailed Chinese stimulus measures and concerns over potential incoming tariffs led to a decline in metal prices, which negatively affected the performance across industrial and material sectors.

The re-narrowing of market return drivers during the final quarter of the year created a more challenging environment for our active fund managers. Nevertheless, we remain confident that a diversified core collection of actively managed funds focused on quality investments complemented by satellite positions made up of high conviction best global investment ideas, will provide a durable return profile from the equity component of the portfolio over the long term.

Alternatives

Performance has been a mixed bag within alternatives this quarter, with the Bloomberg Commodity Index down -2.5% in USD terms. Precious metals such as gold, silver and copper detracted performance, whereas WTI Crude and natural gas fared particularly well, ending the quarter up +5.4% and +18.1% respectively.

Brevan Howard Absolute Return continued to maintain its position as a top performer in the fourth quarter, generating impressive returns on the back of its exposure to rising yields following Trump's victory. Its low correlation to global equities and holistic investment approach allows investors to diversify away from idiosyncratic risks without needing to sacrifice higher returns.

Sustainability update

How will the 'year of elections' shape 2025?

2024 saw elections held in more than 70 countries, with an estimated four billion people being eligible to vote, making it the 'the year of elections'. As we move into 2025, we anticipate we will learn more about the implications of this seismic political year, the key events, and what this will mean for markets and the sustainability landscape.

The fall of incumbents

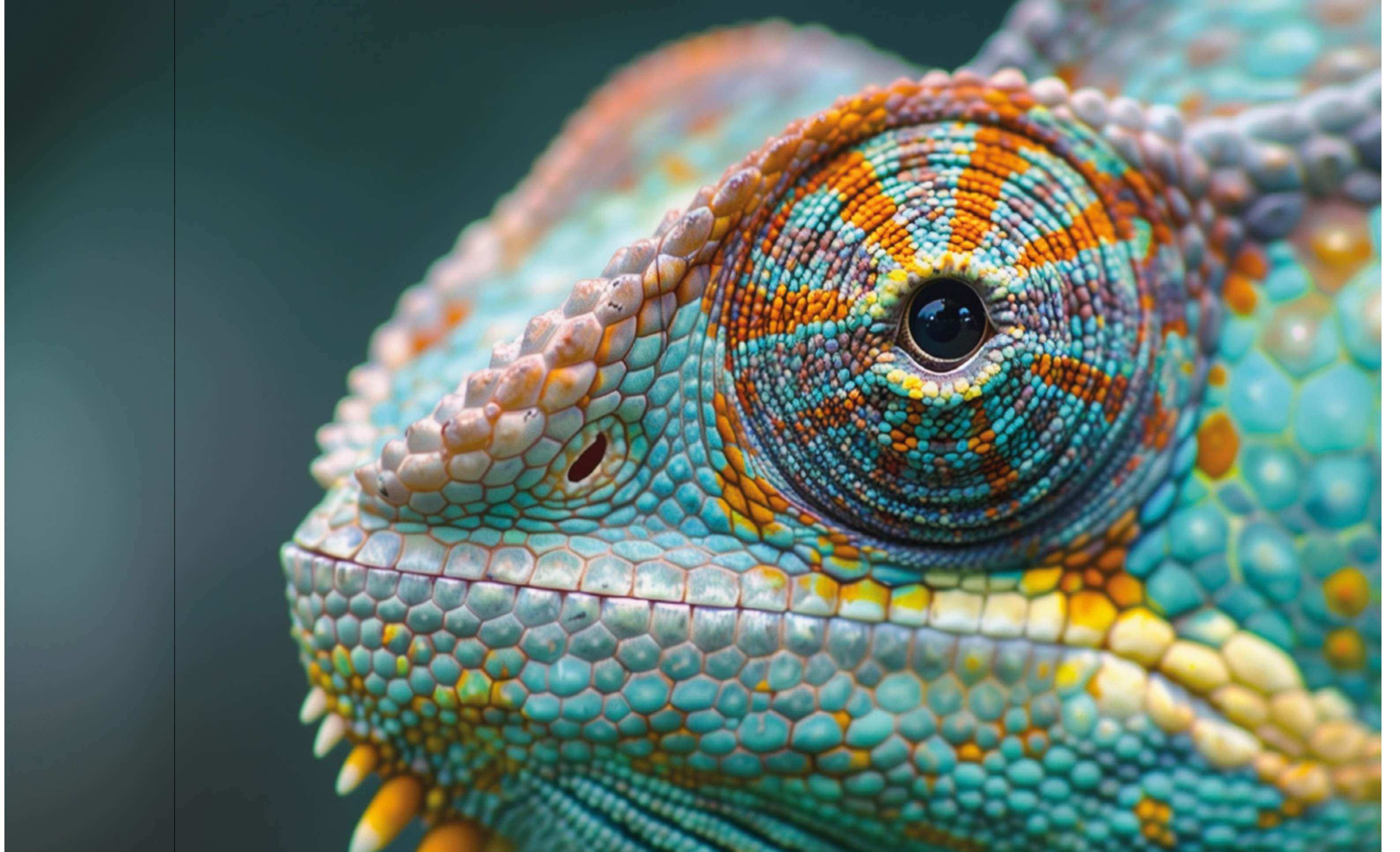
One of the key trends seen around the world was the fall in vote share for incumbents resulting in a high proportion of governments being voted out. This is not too surprising, particularly in western economies where the last two years have seen high inflation and economic uncertainty, leading to growing frustration with existing governments. Even in the US where the economy has been very robust, polls showed that voters felt the impact of rising prices more than the strength of the economy overall. Regardless of who or what created inflation, the blame tends to be placed at the presiding government's door. Following the large number of incumbents being voted out, a wave of new governments have been voted in which will mean significant geopolitical change this year.

Change creates uncertainty

Whilst we can try and forecast the direction of policy from campaign rhetoric and manifestos, ideologies and campaign promises rarely translate fully into policy action. In the US, the new administration's historically more unpredictable style has led to increased uncertainty around the outlook for the year. The market's perception is that we will see tax cuts, de-regulation and protectionist trade policies. However, the extent of these policies is yet to be determined. Meanwhile, the UK's transfer of power to the Labour Party has resulted in a meaningful shift in fiscal policy, and on the continent, we have seen the governments of France and Germany come under immense strain. This trend is coinciding with a period of elevated geopolitical tensions given the ongoing conflicts in Ukraine and the Middle East creating an altogether more insecure and unpredictable political landscape as we move into 2025.

Change also creates opportunity

The power of a strong narrative can be highly appealing and also disruptive, and it is more important than ever to look beyond the narratives of politicians, and focus instead on the practicalities of what is needed to deliver robust and resilient economic growth. The US is a great example of this with the incoming President being seen as a climate-sceptic and thus, a potentially negative prospect for those targeting more sustainable economic outcomes. Whilst we do not deny the rhetoric that would lead to this conclusion, we believe the media and market narrative inflates the risks whilst ignoring the opportunities that the incoming administration's actions may offer to key growth trends. For example, the focus on protectionist trade policies, which is also being adopted in other regions, will require a domestic-focussed re-industrialisation of Western nations leading to greater self-sufficiency. This will require significant investment in building manufacturing capacity i.e. more factories, processing plants and distribution networks. This creates an interesting opportunity for areas of our investment landscape, from energy-efficient machinery and robotics, to software and solutions that will minimise energy and resource usage in a more fractured global economy. This presents a myriad of opportunities, and also lends itself towards reducing industrial emissions, particularly linked to transportation.



Conclusions

While policy and politics play important roles in advancing a sustainable economy, they are not the only factors. The impact of last year's elections will continue to unfold throughout 2025 presenting both challenges and new opportunities, and these opportunities will emerge in regions governed by both progressive and non-progressive administrations. We believe our diversified approach, centred on identifying quality companies with a genuine economic purpose and competitive advantages, positions us well to successfully navigate this period of uncertainty.

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>
> Jordan Kelly, Sustainable Portfolio Manager

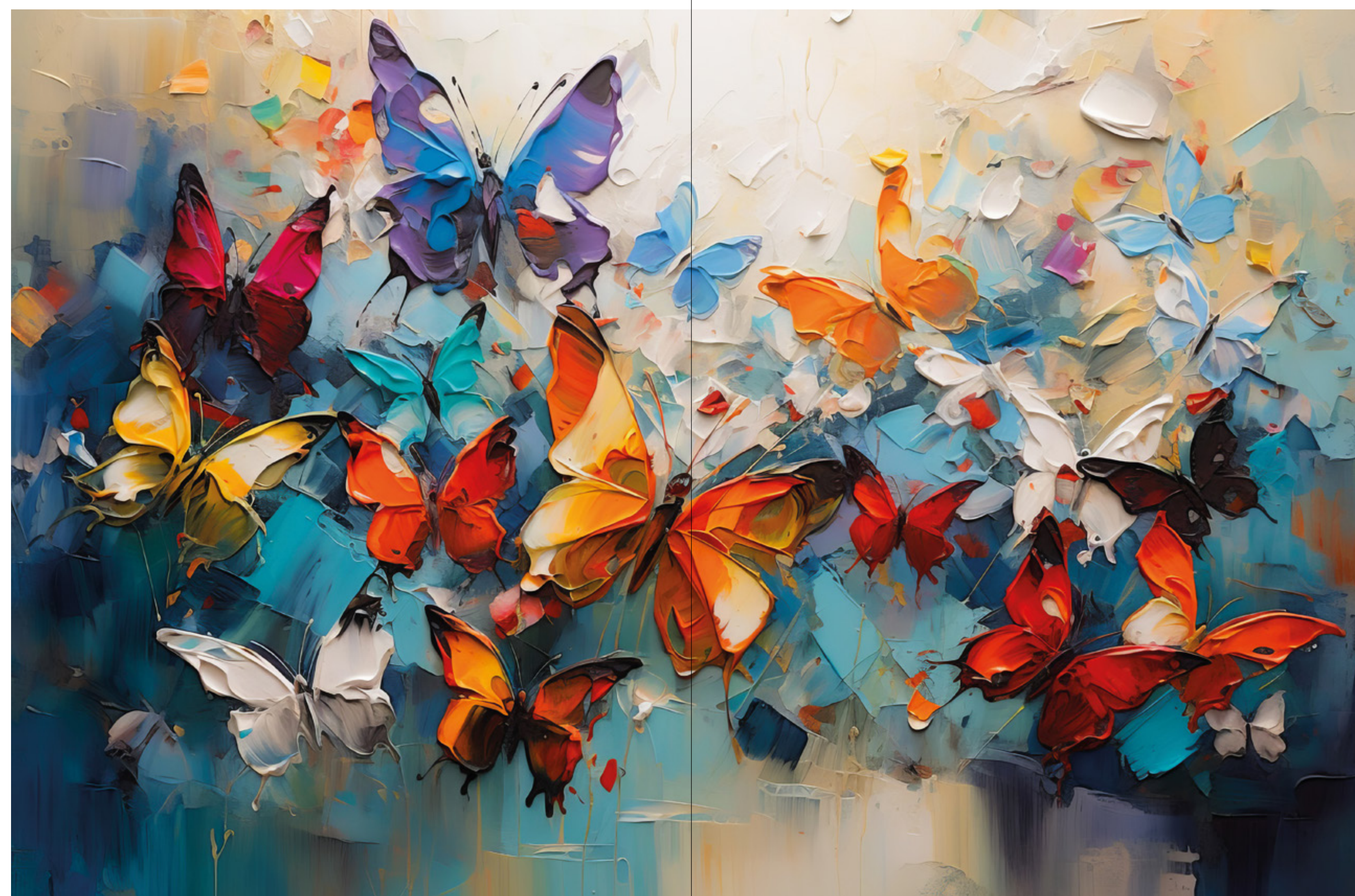
Conclusion

If the key theme of 2024 was an economy and market environment beating low expectations, 2025 will likely be defined by trying to meet high ones. Donald Trump's second term will begin with a backdrop of a US equity market at elevated levels of bullish sentiment, valuations and earnings expectations. These expectations may well prove justified – the macro backdrop appears to be benign – but they, along with a higher level of geopolitical uncertainty, may result in an environment where volatility is higher than investors experienced in 2024.

Whilst Trump's second term will be an important source of both signal and noise for global markets, investors will do well to not overestimate his potential impact on markets relative to other factors. He faces the same constraints of inflation being stubbornly above target, a Fed that is more inclined to 'wait and see' rather than cut rates aggressively and similar political division (he enjoys a majority of just two seats in the House) as his predecessor. With regards to the policies the market is most concerned about – namely tariffs and immigration – these constraints could prove useful for investors. For stock markets, Trump's presidency may prove less impactful when compared to the question of the so-called Magnificent 7 delivering on their earnings expectations after a period of unprecedented capital expenditure.

Trump has a tendency to escalate to deescalate, and his methods of communication and perceived ruthlessness will keep markets on their toes over the next four years. These factors also create a wider dispersion of potential outcomes than would have otherwise been the case – this points to the need to be fully invested in a diversified set of assets. Having finally enjoyed a soft-landing, investors must remain on their guard and be invested in assets that will help in the event of either an external, geopolitical or natural shock event or a recession, as well as the opposite – a re-emergence of inflation. The former points towards a meaningful allocation to government bonds, the latter to alternative assets and commodities. The key to diversification is owning assets that you like over the medium term, regardless of how things play out, whilst knowing that in the short term they can deliver outsized returns if risk scenarios emerge.

December saw the reassertion of a theme that dogged global equity markets throughout 2024 – concentrated returns, as capital was sucked out of broad markets and into the narrow theme of the Magnificent 7. Save for a reprieve in July and August, the story of the year has been outsized gains for the mega cap technology companies linked to artificial intelligence (AI), and decent but much more limited gains for everything else.



This dynamic has caused many to give up on stock picking altogether and switch to predominantly passive solutions. Despite being the right approach for 2024, we think the moment will arise when these large stocks inevitably underperform the index for a period, as they did in the third quarter. These stocks represent very large position sizes, and the index is now an undiversified bet on AI, with high expectations built in.

We prefer a more mixed approach – combining a balance of predominantly active managers to create a core allocation to global equities, with passive and quasi-passive products that balance our preference for both high-quality stocks and being diversified, whilst reducing our total expense ratio. We combine this with specific 'satellite' regional or sector positions for us to capture themes that we like.

We also believe in another concept that has been unfashionable of late – regional diversification. We know there will be uncomfortable periods where a particular geography will outperform but we also know that no style or region holds a permanent advantage over the rest. With all the talk of US exceptionalism, combined with political turmoil in Europe and a pronounced economic slowdown in China, it may seem unthinkable to imagine a period where US stocks underperform. But with the US market now representing over 70% of the world index, and a yawning gap in both relative valuations but also expectations, we certainly would not rule it out.

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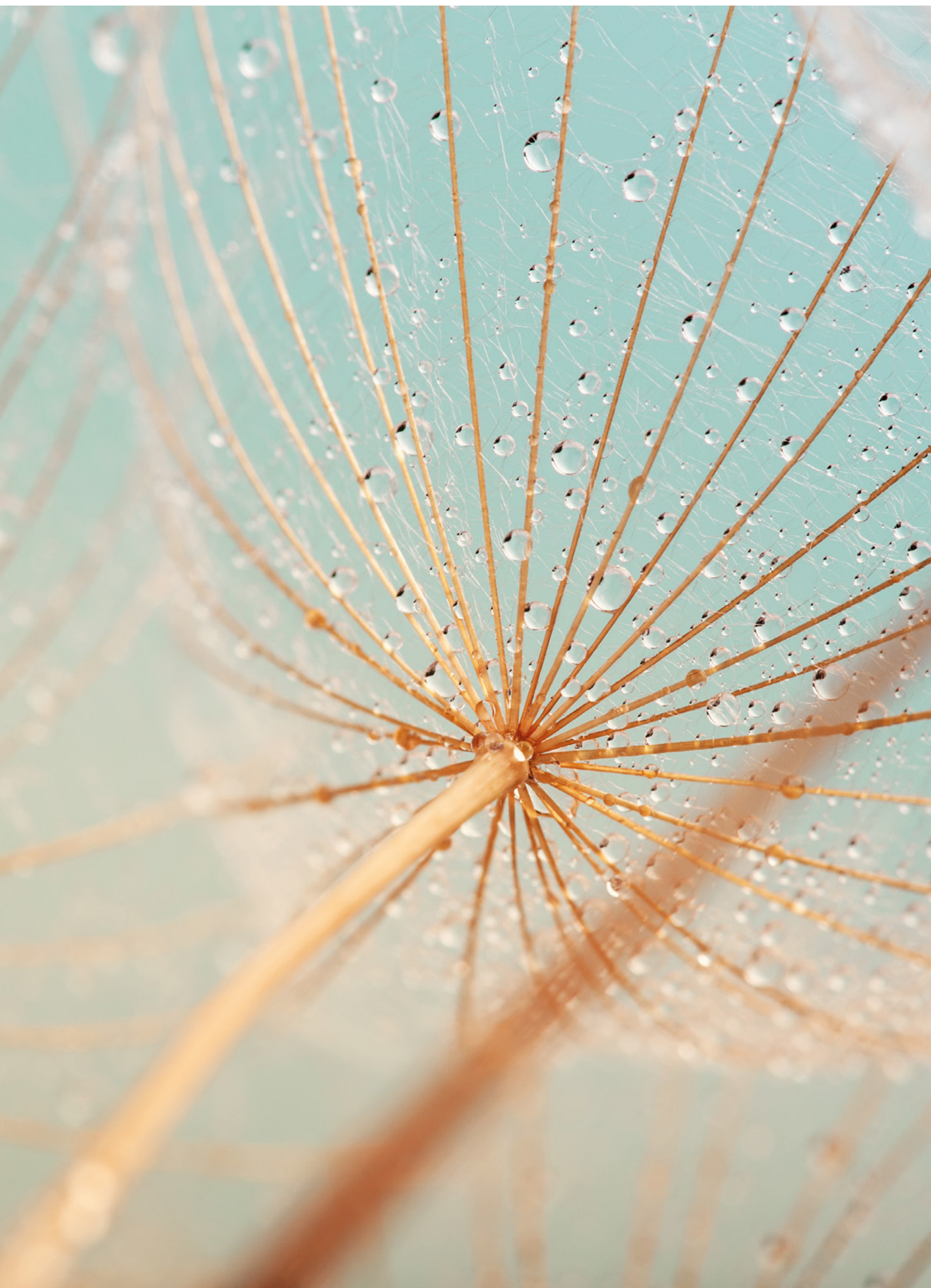
> Jordan Kelly, Sustainable Portfolio Manager



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