Market Commentary
January 2025

English Version

Nation Over Empire: The US Pivot and Its Global Ripples

Exploring the impacts of America's inward turn on markets, regions, and industries.

Quarterly Call Q1 | 2025

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insigneo

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Insigneo

U.S. economic outperformance could outlast U.S. market outperformance.

Executive Summary

Key Themes and Insights

U.S. Policy Shift: The re-election of Donald Trump signals a pivotal shift in U.S. priorities, emphasizing domestic stability and national interests over global dominance ("Nation Over Empire"). This inward focus is reshaping global dynamics, impacting markets, supply chains, and geopolitical stability.

American Exceptionalism: The U.S. maintains its global leadership in innovation, particularly in AI, driving resilience in financial markets and reinforcing its position as the world's largest economy. However, challenges such as rising inequality and fiscal vulnerabilities pose risks to long-term growth.

Global Economic Outlook

U.S.: Projected GDP growth of 2.1%, driven by fiscal stimulus and strong consumer spending, with risks from tariffs and policy uncertainty. AI investment and deregulation could provide growth opportunities.

China: Growth expected to slow to 4.1%, constrained by domestic and external factors, including U.S. tariffs and structural challenges.

Eurozone: Weak domestic demand and trade headwinds limit growth to 0.9%, with structural inefficiencies persisting.

Market Projections

Equities: Moderate returns expected, led by sectors like AI and industrial innovation. U.S. markets to maintain leadership, with a potential S&P 500 target of 6,300. Market volatility anticipated, with opportunities in value and small-cap stocks.

Fixed Income: Anticipated Fed rate cuts make Treasuries attractive. Emerging market debt offers yield opportunities but faces risks from geopolitical tensions and a strong U.S. dollar.

Digital Assets: Bitcoin projected to reach an all-time high of USD 148,000 by year-end, supported by regulatory clarity, adoption, and innovation.

Risks to Monitor: Geopolitical uncertainties, U.S. fiscal vulnerabilities, and potential disruptions in global trade.

Introduction: Nation Over Empire – A Defining Choice for the United States and the World

The re-election of Donald Trump marks a watershed moment in modern U.S. history, signaling a decisive shift in the nation's priorities. This year's Annual Outlook explores the profound implications of America's inward turn, encapsulated in the choice of "Nation Over Empire." **With this pivotal electoral decision, Americans have opted to prioritize domestic stability and national interests over the complex responsibilities of sustaining global hegemony.** The Trump administration's renewed focus on domestic production, re-industrialization, and trade protectionism reflects a recalibration of America's role in the world—from enforcer of global order to a nation intent on rebuilding from within.

Yet, such a choice comes with ripples across markets, regions, and industries. From financial systems adjusting to "America First" fiscal and trade policies to geopolitical uncertainties in Europe, Asia, and the Middle East, the pivot is creating a new global equilibrium. This retreat from the imperial project could offer opportunities for national economic resilience but also challenges in maintaining influence and stability in key regions.

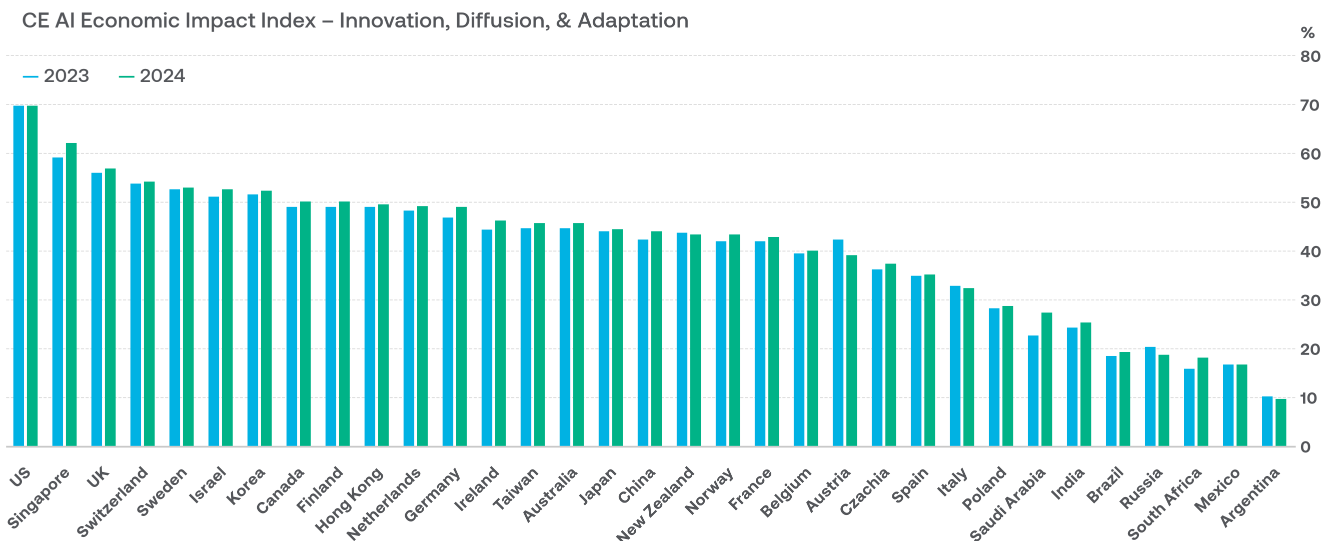
The 2025 Annual Outlook will delve into these dynamics, highlighting how this shift is reshaping everything from supply chains to investment strategies. The report aims to provide investors with actionable insights into navigating the emerging world order, where the American empire takes a step back, allowing markets and nations to recalibrate their roles. As we chart the course of this redefined American identity, the interplay between national priorities and global responsibilities will undoubtedly shape the years ahead. Welcome to a new era of strategic pragmatism, where the United States focuses inward to secure its future while the rest of the world adjusts to its new role on the center stage.

America's Steady Exceptionalism

American exceptionalism has long been a defining narrative of the nation's global role. In recent years,

1. "It should be called the US AI revolution" -Alex Karp, CEO of Palantir

Source: Capital Economics



2. The Empire: World's 10 Largest Companies by Decade

1980: Peak oil	1990: Japan will take over the world	2000: TMT bubble	2010: China will take over the world	2024: US Tech
IBM	NTT	Microsoft	ExxonMobil	Apple
AT&T	Bank of Tokyo-Mitsubishi	General Electric	PetroChina	Microsoft
Exxon	Ind. Bank of Japan	NTT DoCoMo	Apple	Nvidia
Standard Oil	Sumitomo Mitsui Banking	Cisco Systems	BHP Billiton	Alphabet
Schlumberger	Toyota Motors	Walmart	Microsoft	Amazon
Shell	Fuji Bank	Intel	ICBC	Saudi Aramco
Mobil	Dai-Ichi Kangyo Bank	NTT	Petrobras	Meta
Atlantic Richfield	IBM	ExxonMobil	China Construction Bank	Berkshire Hathaway
General Electric	UFJ Bank	Lucent Technologies	Royal Dutch Shell	Eli Lilly
Eastman Kodak	Exxon	Deutsche Telekom	Nestlé	TSMC

Source: Gavekal

this has been underscored by its leadership in the AI revolution. As highlighted in **Graph 1** in the AI Economic Impact Index, the United States continues to dominate innovation, diffusion, and adaptation of AI technologies. Indeed, this leadership translates to tangible global influence, and an innovative ecosystem that remains unmatched. It reinforces the idea that **AI is not only reshaping industries but also acting as a core pillar of U.S. economic power.**

Of course, the story of American exceptionalism is also evident in the financial markets. The S&P 500 continued its dominance as U.S. growth stocks outperformed their global peers for most of 2024. This table in **Graph 2** highlights the shifting landscape of corporate dominance over decades, showing that in the current era, U.S. tech firms dominate the list of the world's largest companies. America's unique ability to regenerate and dominate new economic paradigms, from the post-war industrial boom to the current AI-driven innovation cycle, speaks to its exceptionalism. The relative performance of U.S. assets like equities, treasuries, and the U.S. dollar in 2024 exemplifies this resilience.

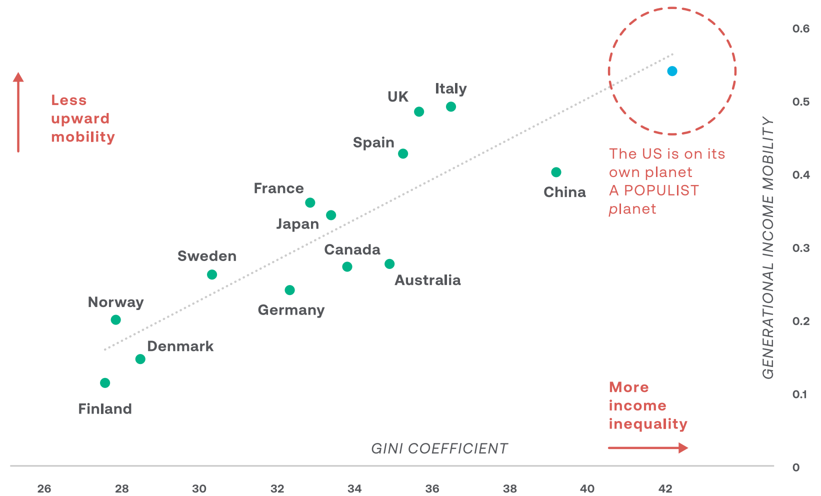
However, exceptionalism is not without challenges and trade-offs. As **Graph 3** shows, rising income inequality and the concentration of wealth in dominant firms pose risks to social mobility, potentially threatening the cohesion that underpins the nation's innovative capacity. Current conditions in the U.S. are a fertile breeding ground for economic populism. With the country now running twin deficits greater than 10% of GDP [**see Graph 4**], how long before the bond vigilantes awaken and demand fiscal discipline? Yes, the U.S. dollar is the world's reserve currency, and investors must hold Treasuries whether they like to or not. But **even the mighty Greenback is subject to debt dynamics, only the day (and perhaps magnitude) of reckoning has been stayed.**

Will Donald Trump end U.S. economic outperformance? We would argue that Trump's policies could slightly hinder U.S. GDP growth over the next few years, noting three key risks. First, a tilt toward isolationist policies might curtail economic benefits derived from trade and immigration. Second, Trump's inability to address the growing fiscal deficit could heighten medium-term fiscal vulnerabilities. Third, his potential dismantling of institutional frameworks could undermine the economic foundations that have supported the U.S.'s rise. However, his re-election is unlikely to threaten the U.S.'s position as the world's leading economy in the long term. Importantly, deregulation initiatives could also support economic growth, though their practical impact may be limited.

Looking beyond the immediate future, the long-term outlook for the US economy remains robust. Structural

3. Rising Income Inequality & Less Social Mobility: The Nation Strikes Back

Social Mobility Vs. Income Inequality



Source: World Bank, global database on intergenerational mobility (2018)

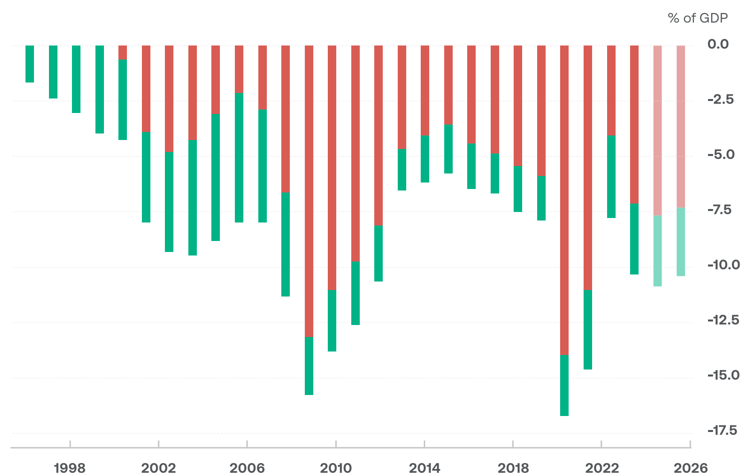
advantages provide a resilient foundation. These factors would require decades to erode significantly, even under adverse policy conditions. Emerging technologies, particularly AI, also play to America's strengths, reinforcing its global leadership. Thus, we anticipate **the US will maintain its status as the largest, wealthiest, and most influential economy for the foreseeable future.**

However, economic outperformance does not guarantee continued stock market dominance. In the near term, U.S. equities may continue to outpace global markets, supported by relatively strong growth and tempered inflation fears. The AI-driven stock market enthusiasm could sustain the current bubble for a while longer, but beyond this boom we are less certain.

2025 Global Macroeconomic Forecast

The global macroeconomic outlook reflects a complex environment in 2025, shaped by geopolitical risks, policy shifts, and innovation-driven growth.

4. US Twin Deficits Will Run ~10% of GDP



■ Current Account Balance
■ General Gov. Net Lending / Borrowing

Source: IMF; Macrobond

5. Insigneo Macroeconomic Scorecard & Forecasts

Real GDP, Annual

COUNTRY/REGION	2024 PREDICTIONS (from 12/31/2023)	2024 ACTUALS (as of 12/31/2024)	2025 FORECAST
US	1.4%	2.5%	2.1%
Eurozone	0.5%	0.7%	0.9%
China	4.5%	4.8%	4.1%
Japan	0.9%	0.6%	1.1%
World	2.5%	3.2%	2.8%

Source: Insigneo

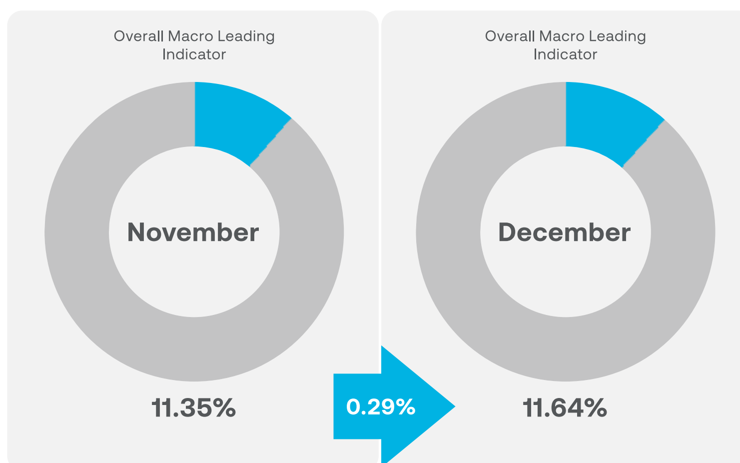
Graph 5 summarizes our world economic outlook. Overall, we expect global growth to moderate to approximately 2.8%, reflecting policy tightening and geopolitical tensions. For example, U.S. tariffs and reduced global trade integration could weigh on growth. The upcoming trade war or even just tariff threats pose significant downside risks globally, particularly for Asia. While traditional sectors slow, innovation-driven industries, particularly AI, remain a bright spot globally, continuing to support select economies.

In the United States, our proprietary Insigneo-Forefront recessionary indicator in **Graph 6** remains subdued, indicating only a 12% chance of a US recession over the next six months, suggesting an environment where it is still prudent to maintain risk in portfolios. Over a twelve-month horizon, the environment becomes murkier as labor demand concerns remain worrisome and on a deteriorating path. For 2025, we expect real GDP to slow but remain robust at 2.1%, above the trend level of growth, primarily driven by fiscal policies, strong consumer spending, and business investment in AI and equipment. Risks include higher rates, tariffs, policy uncertainty, and restrictive immigration policies. The Federal Reserve should continue cutting rates, with the federal funds rate settling between 3.50%-3.75%. Fiscal stimulus, including tax cuts and deregulation, should provide a short-term boost. We expect core PCE inflation to settle around 2.3%-2.4% by year-end, with some upward pressure, potentially, from tariffs and wage growth.

For the world's second largest economy, we project China's real GDP growth to decelerate further to 4.1% from this year's pace of 4.8%, hampered by U.S. tariffs and domestic policy constraints that prevent the government from acting aggressively. Indeed, structural issues such as weak consumption and housing market correction persist. We continue to expect limited

6. Recession Probabilities

2 Calendar Quarters Forward



Source: Insigneo-Forefront Recessionary Indicator

fiscal and monetary measures, insufficient to offset trade disruptions. **For China, the risks of Japanification are mounting.**

— "As we have stated in the past, **Europe's economic model is broken**, and it needs more than just tinkering."

The Eurozone should grow at 0.9%, constrained by weak domestic demand and trade headwinds as well. With inflation pressures easing, we expect more acute monetary policy easing, but persistent structural inefficiencies and reliance on exports should keep growth subdued. As we have stated in the past, **Europe's economic model is broken, and it needs more than just tinkering.**

Global Market Outlook

We expect equity markets to deliver moderate returns throughout the year, driven by strong earnings growth in sectors like AI and industrial innovation. That said, the biggest risk to the equity market remains higher yields.

U.S. equity markets should maintain their leadership as Trump 2.0 policies drive both economic growth and interest rates higher, which we believe will support equities in 2025. **Graph 7** highlights significant financial asset forecasts for the year. Earnings growth, not multiple expansion, will be the key driver, with the S&P 500 potentially reaching 6,300. However, high valuations indicate fragility, with significant market volatility projected despite likely positive annual returns. We also expect a rotation in leadership, favoring value over growth, small over large caps, and cyclical over defensive sectors. **The Magnificent 7 may still perform well, but we see their dominance waning as earnings growth broadens.** AI investment will shift focus from infrastructure to applications and early adopters. Banks, utilities, autos, and industrials would benefit from deregulation and protectionism, while semiconductors face headwinds. Diversified banks and small caps should gain from rebounding capital markets activity.

Europe and China should underperform due to weaker economic fundamentals, geopolitical risks, and various unresolved structural challenges. China's equity market recovery depends on fiscal stimulus and domestic policy improvements, but risks from U.S. tariffs persist. Meanwhile, the Eurozone remains challenged by weak domestic demand, sluggish earnings growth, and political uncertainty. However, **a barbell strategy balancing U.S. equities with selective exposure to certain undervalued and resilient developed markets like Japan is prudent.** Specifically, Japanese equities

7.Insigneo Key Financial Markets & Assets

Forecasts, Q4 2025

Source: Insigneo

US S&P 500	6300	Oil, WTI	USD 69
US 10Y Bond	3.9%	Gold	USD 2800/oz.
US Fed Funds Rate	3.75%	DXY	107
Eurostoxx50	4750	EUR-USD	1.08
Benchmark 10Y Rate	2.1%	Bitcoin	148,000
ECB Deposit Rate	1.75%		

are expected to benefit from corporate reforms, rising real wages, and robust share buybacks, and we expect the TOPIX to deliver strong returns.

In fixed income markets, we expect approximately two to three more cuts by the Federal Reserve this year, slightly more than current expectations of 40 bps. Thus, **Treasuries remain attractive for risk-averse investors.** We also expect a benign, if unspectacular, year for investment-grade bonds, while credit spreads remain uninspiring in high-yield markets. This table in **Graph 8** reflects the expected performance of US rates under various Fed scenarios over the next twelve months. We favor long-duration bonds as rate cuts lower yields, though credit spreads may widen in riskier segments. While emerging market debt offers attractive yield opportunities, it faces material risks from a strong U.S. dollar and geopolitical tensions. Select markets like ASEAN, South Africa, and parts of Latin America offer relative resilience.

Diversification across asset classes, including alternatives, is critical to managing market volatility, particularly in today's environment. We prefer gold over industrial metals and oil due to geopolitical risks and economic uncertainty. However, as **Graph 9** demonstrates, it is quite expensive relative to oil and wages. Ongoing and increasing purchase by central banks around the world give us some comfort that the debasement and reserve diversification trade will continue and support gold prices.

For digital assets, like bitcoin, key drivers of adoption include increasing institutional interest, technological advancements, and heightened consumer awareness. Potential enhancements may be coming down the line that improve transaction speed and reduce costs. They are also compatible with other emerging technologies, such as smart contracts and decentralized finance (DeFi) systems. Obviously, bitcoin's volatility is a significant risk for both retail and institutional investors, and its store of value properties remain aspirational. However, we anticipate the continued evolution of the bitcoin ecosystem, driven by regulatory clarity, technological innovation, and broader adoption. We anticipate that bitcoin will hit an all-time high by the middle of this year and achieve a USD148,000 target by year-end. **In our view, no more than a 2% allocation to digital**

8. US 10-Year Bond Under Various Fed Scenarios

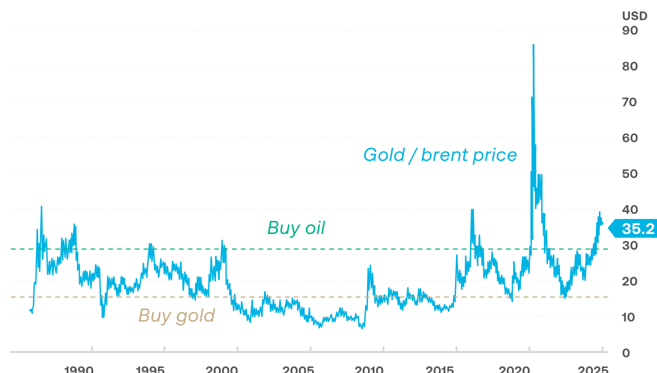
	FED FUNDS RATE SCENARIOS FOR THE NEXT 12 MONTHS	EXPECTED CHANGE IN TREASURY INDEX YIELD* (BPS)	EXPECTED 12-MONTH TREASURY INDEX TOTAL RETURN (%)
RATE CUTS	300 bps	-132.81	12.26
	275 bps	-115.95	11.27
	250 bps	-99.09	10.27
	225 bps	-82.24	9.28
	200 bps	-65.38	8.28
	175 bps	-48.52	7.29
	150 bps	-31.66	6.29
	125 bps	-14.81	5.3
	100 bps	2.05	4.3
	75 bps	18.91	3.31
RATE HIKES	25 bps	86.34	-0.68
	50 bps	103.2	-1.67
	75 bps	120.05	-2.67
	100 bps	136.91	-3.66

Source: Expected change in Fed Funds rate as discounted in the overnight index swap curve; Source: BCA Research, Bloomberg Barclays Indices

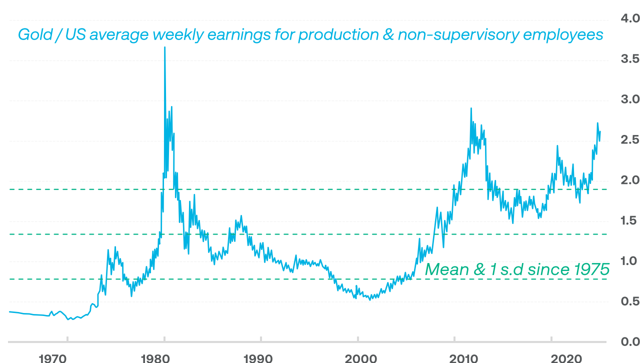
9. Gold is Expensive, Historically Speaking

Source: Macrobond; Gavekal

Gold is expensive relative to oil...



... as well as relative to the average US worker's wage



assets is warranted at this time.

In addition, we expect continued interest in real estate and private assets as monetary easing stabilizes the macroeconomic environment. Private equity faces valuation pressures, but newer vintages focusing on cash flow and cost discipline remain attractive. Finally, the U.S. dollar should remain strong in the short term but could peak mid-2025. **Graph 10** demonstrates **that longer-term investors should focus on rebalancing portfolios to strategic asset allocation targets and maximizing diversification among stocks, bonds, real assets, hedge funds and private illiquid investments.** It reflects expected annualized returns for various assets over the next ten to fifteen years based on a hypothetical 2.5% inflation scenario. It suggests that **financial asset performance over the next decade should be less robust than it was over the previous one.** ■

10. Asset Return Projections Over the Next Decade

50% Equities
30% Bonds
20% Alternatives

Source: BCA; based on hypothetical 2.5% inflation

COMPOUND % RETURN PER YEAR

	Historical 20-Year Annualized Return	Assumed 10-15 Year Annualized Return	Portfolio Weight
US Equities	10.7	3.2	30
Other Developed Market Equities	7.4	5.1	15
EM Equities	9.3	4.8	5
10-Year US Treasuries	2.7	4.5	20
Corporate Bonds	4.6	5.4	10
Alternatives	10.1	8.6	20
Total Portfolio	7.8	5.1	
US Inflation	2.0	2.5	
Total Portfolio Real Return	**5.8**	**2.6**	

Mauricio Viaud
Senior Investment Strategist
and PM

Trump 2.0: The Case for Owning Small and Mid-Cap Equities

The election of President Trump could prove to have meaningful consequences for the US economy and its equity markets, which could be either positive or negative.

On one hand, we envision a business-friendly scenario that nurtures growth through a combination of lower taxes and lower regulation.

Strong consumer demand could spur growth, but it could also potentially lead to higher inflation, exacerbated by the prospect of increased tariffs.

Adding mid and small-cap equities to increase diversification and complement existing large cap exposure in portfolios will be important for the years ahead.

> *"It was the best of times, it was the worst of times... it was the spring of hope, it was the winter of despair."*
> Charles Dickens

The election of President Trump could prove to have meaningful consequences for the US economy and its equity markets, which could be either positive or negative. Scenarios with stark contrasts prevail in the current investment environment. On one hand, we envision a business-friendly scenario that nurtures growth through a combination of lower taxes and lower regulation. This scenario could boost consumer income, leading to increased domestic consumption, in turn leading to increased revenue and margin growth for US companies. Domestic-based companies would also be able to enjoy higher growth rates in the face of lower regulation. However, stimulus is just like champagne at a New Year's Day party, a little bit goes a long way, too much can spoil the evening. Strong consumer demand could spur growth, but it could also potentially lead to higher inflation, eventually suffocating the very flames of economic progress. Add the prospect of increased tariffs to the mix, and inflation could become a real problem.

Higher inflation could have a dual effect on the markets. Over time, it could decrease consumer purchasing power and erode company profit margins. In the short term, however, stubborn inflation could have a more direct impact on equity markets, limiting the Federal Reserve's ability to lower interest rates. If interest rates remain higher for longer, companies could continue to find themselves with limited access to capital needed for growth, especially if it is needed to take advantage of a friendlier business environment. In essence, too much stimulus could negate the very benefits that it is attempting to create.

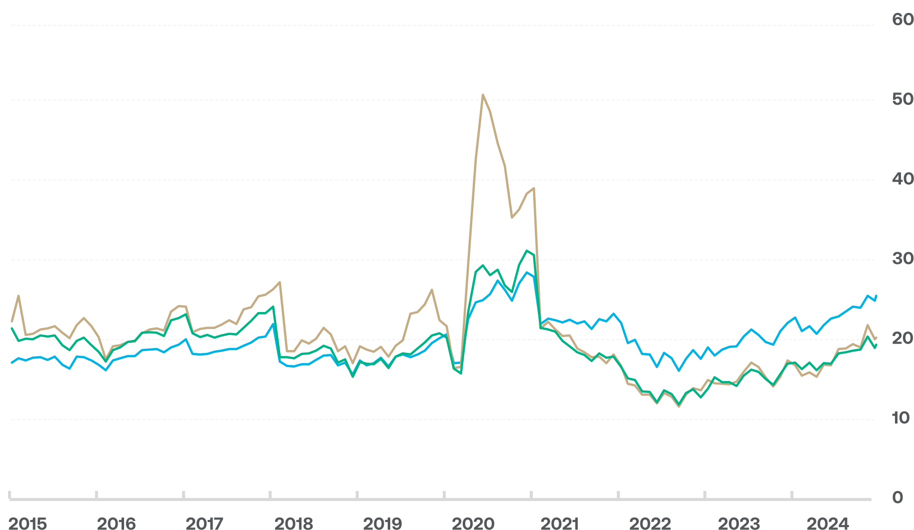
So, the question is how do we get exposure to US equities considering the contrasting scenarios mentioned above? First, it is important to note that we

— "...we expect **pro-growth policies to propel markets higher,** while tariffs and trade wars could create potential headwinds."

believe that US exceptionalism and pro-growth policies from the new administration will likely continue to drive US equities higher over the near-term. However, we do believe that there will be bumps along the way.

Next, let us start by studying the past. As Mark Twain once said, "History does not repeat itself, but often rhymes." During the first Trump administration, US equity markets posted strong gains, with large cap stocks, represented by the S&P 500, ending the four-year period close to 60% higher. Mid cap and small cap stocks, represented by the S&P 400 and S&P 600 respectively, ended the period 30% higher. Keep in mind that this period also encompassed the brunt of the Covid-19 pandemic, which saw meaningful pull backs in financial markets. If we look at the performance of US equity markets over the entire first Trump administration, it is easy to see that large cap stocks outperformed their small and mid-cap counterparts over that period. However, if we take a more nuanced approach, we find that during the first half of the administration, small cap and mid-cap stocks were the clear winners. In fact, through the first full year of the administration, small cap stocks had already risen 30%, outperforming large caps by 5%, while mid-caps found themselves in the middle. What disproportionately helped small and mid-cap stocks over the early part of the first Trump administration was a pro-growth environment, specifically, lower taxes and increased deregulations, two dynamics that are likely to repeat themselves during the second administration. In fact,

11. Buy After the First Shots Ring Out



Source: Insigneo/Bloomberg (as of January 6, 2025)

small and mid-cap stocks, led most of the way through late 2018, when trade wars with China heated up and investor risk appetite decreased. Interestingly, we now find ourselves in a similar situation, where we expect pro-growth policies to propel markets higher, while tariffs and trade wars could create potential headwinds. The one unknown variable that is present this time, which was not meaningfully present last time, is stubborn inflation.

What can we learn from the past that we can apply to the future? In sum, the importance of having small and mid-cap equities in our portfolios to complement existing large cap exposure. So far over the past two years, earnings growth has been concentrated in large cap stocks, particularly within the Magnificent Seven. A recent study published by JP Morgan noted that in 2024, the Magnificent Seven were responsible for almost 75% of the earnings growth in the S&P 500. In 2025, this number is expected to drop to 33%. This reduction in earnings growth contribution is expected to be a result of a broadening out of earnings growth, as companies across the economy benefit from pro-growth policies. Many of the pro-growth policies seen during the first Trump administration tend to favor domestic oriented industries such as financials, industrials, and energy, as well as domestically focused consumer discretionary companies. Domestically oriented companies tend to be heavily represented in mid and small-cap indices, which is one of the reasons why we would not be surprised if mid-cap and small-cap equities prove to once again be strong performers during the second Trump administration. Another reason why we believe that an allocation to mid and small-cap equities is appropriate is the valuation gap between these stocks when compared to their large cap peers. **Chart 11** shows a 10-year valuation comparison between large, mid, and small-cap stocks, represented by the S&P 500, S&P 400, and S&P 600, respectively. As we can see from the chart, before the Covid-19 pandemic, small and mid-cap stocks had traded at higher levels than their large-cap brethren. This dynamic reversed after the pandemic, where large cap companies outpaced mid and small, particularly over the past two years. In fact, based on forward earnings, the current 20% discount between large and small-cap stocks, and 25% discount between large and mid-cap stocks, represent some of the wider discounts over the past decade. Domestically oriented pro-growth policies from the new administration, which are likely to disproportionally benefit small and mid-cap companies, should narrow this discrepancy. That is not to say that large cap companies will not benefit as well. A business-friendly environment with lower regulations and lower corporate taxes is likely to benefit companies in the technology and healthcare sectors, many of which tend to be large cap in nature.

Our US equity strategy for the next four years does not advocate an all-out sale of large cap equities. It encourages shifting or adding exposure to small and mid-cap equities. Maintaining a diversified long-term oriented approach is key to our strategy. We believe that the market will continue to see a pro-growth environment as a "spring of hope". However, if inflation becomes a major issue and the environment turns into a "winter of despair", it will pay to stay diversified. ■

Melissa Ochoa Cárdenas
Investment Strategist
Insigneo

France and Germany – The Aftermath of the Budget Debacle

France's political instability, highlighted by a government crisis and unresolved 2025 budget issues, has deteriorated its fiscal position. Meanwhile, Germany faces its own political and fiscal challenges, including a snap election, and debates over its strict debt brake policy.

Both nations are dealing with unresolved fiscal uncertainty, leading to increased market volatility, steepening sovereign curves, and diminished appeal for their respective sovereign bonds.

Investors may find more attractive opportunities in other European fixed-income markets that offer more stable fiscal outlooks and competitive yields.

Last year witnessed major political upheavals globally and Europe was no exception. The two biggest economies of the European Union have been in the eye of the storm amid government collapses, budget deficits that threaten fiscal stability, and the rise of right-leaning alternatives that were not considered probable a couple of years ago. Thus, we decided to zoom in on both situations, hoping to assess the fiscal and fixed income implications of current developments while we observe how the Nation over Empire move previously observed in the US translates into the French National Rally and the German AfD disrupting the European political landscape.

France has faced a challenging environment since June 2024, when President Emmanuel Macron dissolved the National Assembly and called early elections. The election outcome was a divided Lower House, almost evenly split between three conflicting blocs: the leftist New Popular Front alliance, Marine Le Pen's far-right National Rally, and a smaller group of centrists that supported the President.

Against this backdrop, in early December, the French government faced a vote of no confidence that led to Prime Minister Michel Barnier's resignation after he used a constitutional tool to bypass the voting on the 2025 budget, which did not sit well with the opposition.

Newly appointed Prime Minister François Bayrou has formed a new government by announcing his new cabinet members while also juggling with establishing a new 2025 budget, which he aims to present by mid-February. In the meantime, a special law will be enacted to roll over the 2024 budget into the initial months of 2025, with this law only permitting vital spending necessary to fund essential public expenditures.

The importance of the 2025 budget has been increasing as France's fiscal situation has deteriorated and run afoul of EU targets. According to some estimates, France's 2025 budget deficit will be around 5.4% of

GDP. Even if that figure is expected to be an improvement from 2024's deficit of 6.1%, it is still non-EU compliant. As a reminder, the EU requires member states' debt-to-GDP ratio to be below 60% and their deficits to run below 3%.

— "Even if that figure is expected to be an improvement from 2024's deficit of 6.1%, **it is still non-EU compliant.**"

Once seen as the fiscal and economic powerhouse of the EU, Germany's current situation falls far short of its reputation. The current government crisis led to the SPD-led government coalition losing a confidence vote and to snap elections that will be held in February 2025. Additionally, the ruling coalition could not agree on a 2025 budget. Amid this situation, the discussions around its debt brake, better known as *Schuldenbremse*, have gained relevance because of the brake's capacity to constrain Germany's fiscal flexibility and ability to respond to economic shocks.

Essentially, the debt brake was implemented to limit Germany's structural annual deficit to 0.35% of GDP against a backdrop of recommendations from the OECD and the IMF that Germany needs to increase government spending and reskill its workforce. It is worth mentioning that in 2023, Germany's government budget deficit was 2.5% of GDP, and according to market forecasts, its budget deficit is expected to stand at 2.2%, 2.0%, and 1.8% of GDP for 2024, 2025, and 2026, respectively. Even if these figures are EU-compliant, they would be far from the brake's more rigorous threshold.

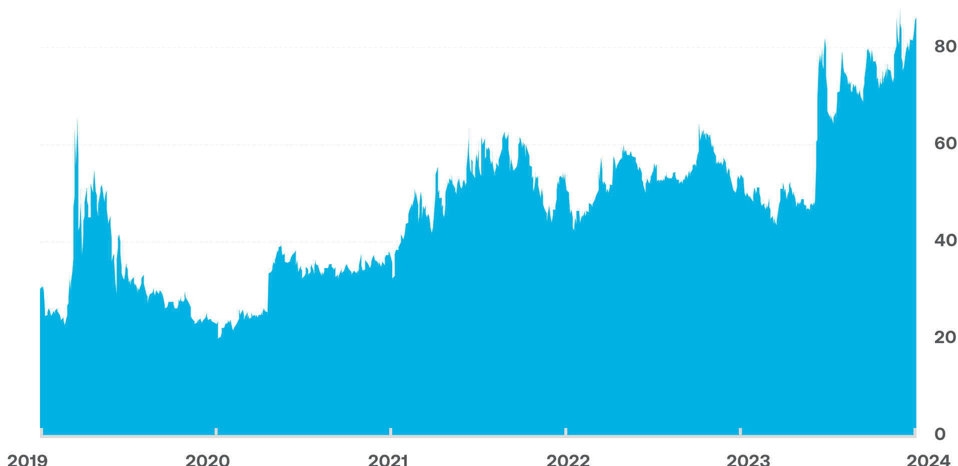
Moreover, the center-right CDU/CSU coalition leading the polls for the upcoming elections does not include a reform of the debt brake in its program; rather, it proposes tax cuts and supply-side reforms aimed at eliminating unnecessary processes while increasing labor supply, investment, and maintaining the debt brake. On the other hand, while the SPD and the Greens favor demand-side stimulus, this coalition aims to reform the brake rule. Given the lack of agreement over the initially presented 2025 budget, Germany's finance ministry announced that the government finances would be managed through a provisional budget until the new government outlines its own. This situation resembles what we previously highlighted in France, where the government can only disburse funds that are either already committed or needed to keep the country functioning. Meanwhile, the AfD party, the extreme-right alternative currently second in the polls, also advocates for maintaining the debt brake; however, it proposes to reduce Germany's contributions to the EU and to examine current asylum policies.

Market Reaction

Germany recently announced it will reduce its debt sales by 13% in 2025. However, this plan presented by the German Finance Agency will be subject to change once the new administration takes office and adopts a potentially new budget. German fixed income digested the news of reduced issuance for 2025 positively

12. Political uncertainty is translated into market risk perception

French-German 10yr bond spread



Source: Bloomberg. Data as of January 6, 2025

since a reduced government debt supply can imply a flatter sovereign curve. Nonetheless, it is worth stressing that German finance ministry officials do not expect a regular budget until the second half of 2025, and that potentially positive scenario is subject to change.

In the case of France, uncertainty around the functioning of the new cabinet has been high, which has translated to the spread between the French and the German debt to widen substantially since the government crisis began. (**See graph 12**)

Such high uncertainty and an inability to agree on a budget for 2025 are expected to remain a key feature of the French political landscape throughout the year.

Moreover, this may take a toll on long-term French bonds since current market expectations are penciling in a steeper sovereign curve in 1Q25 that only continues to steepen throughout the year. This, in turn, may lead to wider spreads between German and French debt.

In sum, considering that the political situation in both countries remains unresolved, we would stay on the sidelines in terms of holding either German or French sovereign bonds. We believe other European countries, such as Spain, currently offer a more benign fiscal scenario that, coupled with more attractive yields, could make for a more profitable alternative when looking for exposure to European fixed income. ■

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Latin America: A Three-Cushion Billiards Game

The implementation of tariffs is expected to weaken local currencies as a way to offset higher product prices.

Brazil and the US have taken different approaches that have led Brazil to occupy a low-priority role for the US. Thus, Brazil has developed a closer relationship with China, who is now Brazil's main trading partner.

Since taking office, President Milei has sought to balance closer ties with the U.S. to secure IMF support and pursue a potential free-trade agreement, while deepening Argentina's relationship with China to leverage commodity demand and extend fresh funding access.

President Trump's intention to use tariffs as a tool to address immigration has sparked tensions with Mexico. Both nations face significant economic interdependence, with Mexico being the U.S.'s largest trade partner and key investor, making any tariff-driven trade war mutually detrimental.

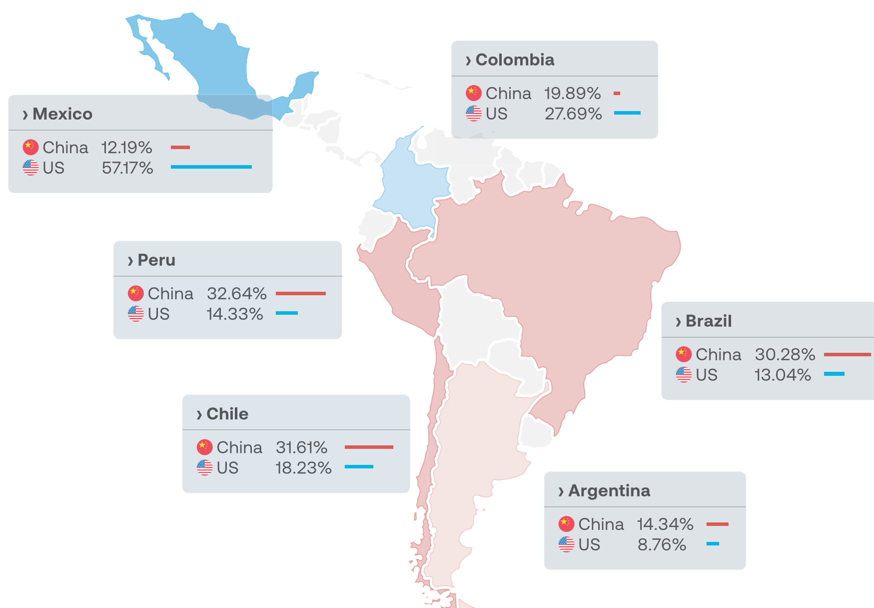
Despite the mounting tariff risks, the economic ties between the US and Mexico are unlikely to break, as shared interests in countering China's regional influence and historical cooperation reinforce their partnership.

Much as in the first Trump administration, it is likely that the current situation involving a trade war between the U.S. and Latam will be resolved at the negotiating table.

U.S. trade relations are crucial for Latin America, with nations such as Nicaragua and the Dominican Republic relying on the U.S. for over 50% of their exports. As shown in **graph 13**, most major economies in the region are engaged in a two-front trade dynamic with both the U.S. and China. For countries heavily exposed to China, the proposed 60% tariff on Chinese exports and the outcome of China's fiscal stimulus plan are critical. These factors will influence China's growth

13. Latam: A Game of Thrones

Main trading partner for select Latam countries



Source: Bloomberg. Data as of 3Q24

and its demand for commodities, which will, in turn, affect commodity-exporter countries like Chile.

Tariffs will create first- and second-order effects. First-order effects are immediate price changes and supply chain disruptions, while second-order effects are more long-term, including foreign exchange (FX) rate adjustments and inflation. **For Latin America, second-order effects are significant, given the region's reliance on exports to the U.S. and China. The implementation of tariffs is expected to weaken local currencies as a way to offset higher product prices, eventually driving inflationary pressures across the region.**

Beyond economic consequences, tariffs will also shape the political landscape in Latin America over the next two years. Similar to what is happening in Mexico and Canada, the U.S. may use tariffs as a tool to negotiate better trade deals. This will coincide with a number of key elections: Chile and Ecuador will hold presidential elections in 2025, and Colombia, Peru, and Brazil will follow in 2026.

Argentina and Brazil – a tale of two countries

Argentina and Brazil, two of the main economies of Latin America, are facing starkly different dynamics with the arrival of a Trump 2.0 administration.

Even if both countries made conscious efforts to improve their bilateral relationship, internal political forces have made the Brazil-US relationship a more complicated one. Amid the development of diplomatic challenges like the Russia-Ukraine war, **Brazil and the US have taken different approaches that have led Brazil to occupy a low-priority role for the US. Thus, Brazil has developed a closer relationship with China** to the extent that China represents 30% of Brazil's total trade; in contrast, the US represents only 13% **(see graph 13)**. Still, market analysts from Bloomberg forecast that the potential 20% tariffs the US plans to impose on Brazil would mainly affect goods such as oil, metals, and transportation equipment. Moreover, the same Bloomberg analysts expect Brazil to raise its exports to the rest of the world to offset the effects of tariffs,

even if the Lula administration cannot help exporters via manufacturing subsidies or by decreasing import taxes.

Meanwhile, it should be noted that Brazil's exports are concentrated in commodities such as soy, iron ore, and oil. Since the US also exports soy to China, Brazil could benefit from the increased tariffs that would be put in place once the new administration takes office, assuming China retaliates, using Trump's first trade war as a baseline.

Furthermore, the fact that the European Union and members of Mercosur reached a trade agreement that is expected to establish one of the largest trade zones in the world while becoming the EU's biggest trade agreement needs to be monitored. Even if this could be viewed positively, it is worth noting that the European Parliament still has to ratify the agreement, which may take some time.

On the other hand, Argentina represents a different set of challenges and opportunities. **Ever since President Milei took office, he has made it a clear objective to become the newest ally of President Trump in Latam without compromising Argentina's business relationship with China.** Milei's idea of having close ties to the US aims to receive President Trump's support to negotiate a new deal with the IMF. Last year, the IMF announced it would review Argentina's current aid program in January 2025. Moreover, Milei stated he would try to negotiate a free-trade agreement with the US, considering that both nations signed a Trade and Investment Framework Agreement in 2016.

However, what started as a pragmatic stance with China has evolved into a warmer relationship, given China's interest in some of the commodities that Argentina produces, and the pressing need of the Milei administration to get fresh funding through an extension of its swap line for USD 5bn through 2026. It is worth noting that China is Argentina's second-largest trading partner after Brazil, accounting for 14% of Argentina's total trade (**see graph 13**).

Mexico- A Trade-Based Mexican Standoff

> "*On January 20th, as one of my many first Executive Orders, I will sign all necessary documents to charge Mexico and Canada a 25% Tariff on ALL products coming into the United States…*" – President Donald Trump, November 25, 2024

President Trump posted this message late last year, announcing his intention to use tariffs as a tool to enforce immigration. The following day, Mexican President Claudia Sheinbaum replied that "*neither threats nor tariffs will solve the issue of migration or drug consumption. Imposing one tariff would mean another comes in response, continuing like this until we put shared companies at risk.*" This rhetoric sounds like the opening salvos of a trade war, using the ammunition of tariffs. **President Trump is likely to openly use tariffs as a negotiating tool and will stand by his word to implement these if other parties are not willing to negotiate. At the same time, President Sheinbaum is likely to openly resist tariffs, using her stance to win political points both within the government and with the Mexican people.** At first glance, this situation would appear to be a real-life, trade-based, Mexican standoff. Beneath the surface, however, things are likely to be different.

In 2023, Mexico became the United States' largest trade partner, sending USD 475bn worth of exports to the US that year alone, breaking China's sixteen-year hold of that title. According to the American Society Council of the Americas, nearly 80% of Mexico's exports went to the US in 2022. At the same time, according to the U.S. Department of State, the United States is

Mexico's largest source of foreign direct investment. Equally important to the United States, Mexico is the second largest destination for US exports. If tariffs were to be implemented as stated, their effects would be felt on both sides of the border. Mexico's northern states of Nuevo Leon, Coahuila, and Chihuahua would be negatively impacted by the reduction in nearshoring demand for technology-oriented goods. At the same time, in the United States, Texas, New Mexico, and California would be negatively impacted from decreased trade flowing into these states.

However, **the reality is that the United States and Mexico depend on each other for more than just commerce.** As we traveled throughout Mexico last year, we were asked numerous times the following question: "*Do you think that the United States will abandon Mexico?*". Our answer was and continues to be "*no, we do not think so*". Commerce is important, but so is geopolitics. China is knocking on the door of many Latin American countries, attempting to expand its influence in the region. **Given the historically strong ties between both countries, as well as Mexico's geographical proximity to the US, we do not believe that the United States will abandon Mexico and risk allowing China to gain influence over its closest neighbor.** Our view is further reinforced by President Trump's pick for US ambassador to Mexico, Ambassador Ron Johnson, a proven individual with extensive experience in diplomatic and military affairs across Latin America.

The Best of the Rest

Chile's economy is closely linked with copper prices, with Bloomberg reporting that nearly 40% of Chilean Peso (CLP) volatility is explained by copper price movements. As Chinese tariffs are assessed in early 2025, the CLP is expected to weaken. However, CLP is expected to find some relief buoyed by China's fiscal stimulus plans. Chilean political uncertainty leading up to the presidential election will add some risk premium to the FX with markets anticipating a rally if a market-friendly candidate prevails. Polls show conservative Matthei and former president Bachelet leading the race.

Colombia, Peru, and Ecuador are less exposed to tariffs, as their exports primarily consist of commodities like oil and minerals, which are less vulnerable to trade barriers and can be redirected if necessary. However, Colombia faces challenges as its interest rates converge with those of the U.S., leaving little room for cuts. Once Colombia exhausts its ability to reduce rates, weak fundamentals will put pressure on the exchange rate. In Peru, political uncertainty persists as President Dina Boluarte potentially faces impeachment after July 2025. Ecuador's February 2025 elections will also be crucial, with President Noboa slightly leading leftist candidate González. A Noboa victory could improve Ecuador's relationship with the U.S. and increase market access.

In Central America, migration policies represent a greater risk. For example, 11.7% of El Salvador's population lives in the U.S. without authorization, and any rise in deportations could hurt domestic economies. In Uruguay, the new government's expansionary fiscal and monetary policies are expected to intensify inflation, adding further pressure to an already fragile economy.

Much as in the first Trump administration, it is likely that the current situation involving a trade war between the U.S. and Latam will be resolved at the negotiating table. However, both parties must be willing to negotiate to reach a mutually beneficial outcome. As was said in "Game of Thrones": "No one can survive in this world without help. No one." ■

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A Chain Reaction 2.0

(We recommend visiting our 2Q24 "A Chain Reaction" article here for additional information)

> Nuclear power stands out as a more efficient alternative to traditional renewable energy sources.

> Hyperscalers like Amazon, Microsoft, Google, Oracle, and Meta are now advocating for nuclear energy as part of their zero-emission targets.

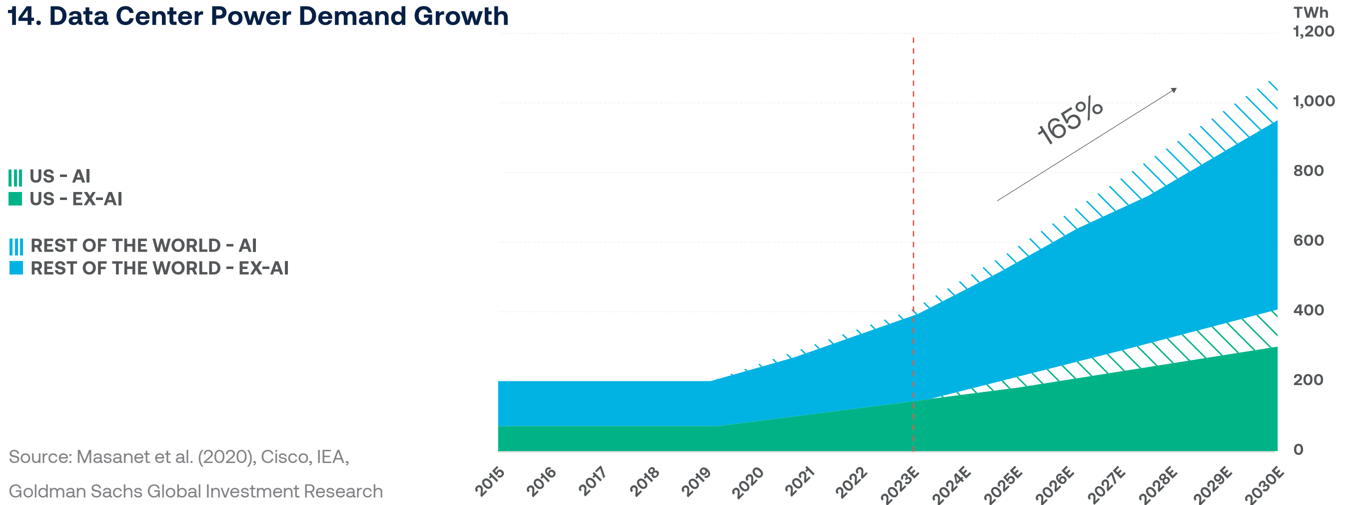
> Long-term outlook for uranium remains bullish, short-term volatility will rely on geopolitical factors.

As discussed in our 2Q24 quarterly call, nuclear power has been poised for a renaissance, awaiting the right catalyst. The Russian-Ukraine war provided the spark, while Artificial Intelligence has ignited the flames. As shown in **graph 14, AI is expected to drive energy infrastructure growth in the years ahead. With countries striving for green economies, nuclear power stands out as a more efficient alternative to traditional renewable energy sources,** offering low-carbon emissions, high energy density, and a small land footprint. A single nuclear plant can generate as much energy as three large wind or solar farms.

Since the COP28 summit in December 2023, over 20 nations, including the United States, have pledged to triple global nuclear capacity by 2050. Using 2020 as the baseline, this goal requires adding 740 GW in less than three decades—a remarkable feat given it took 70 years to build the current 390 GW. **Achieving this will demand significant acceleration in financing, development, and capital expenditures.** In this context, nuclear power has become a global race, with China leading the way.

China's dominance in nuclear development stems from its ability to construct plants in an average of seven

14. Data Center Power Demand Growth



Source: Masanet et al. (2020), Cisco, IEA, Goldman Sachs Global Investment Research

years, far outpacing Europe's ten-year average and the U.S.'s 15-year timeline. For context, the U.S. has completed only one nuclear plant in 30 years—the Vogtle facility in Georgia—which faced a seven-year delay and USD 17bn cost overrun. China's edge lies in extensive expertise, reliance on state-owned enterprises, low-cost financing, and affordable labor. Additionally, China is advancing toward fast reactor technology, a fourth-generation innovation that recycles uranium and plutonium as fresh fuel. This breakthrough could significantly reduce nuclear waste, addressing one of the primary safety concerns of nuclear power.

While the U.S. has been slow to progress, **hyperscalers like Amazon, Microsoft, Google, Oracle, and Meta are now advocating for nuclear energy as part of their zero-emission targets. Due to the long timelines required to build traditional nuclear plants, these**

15. Nuclear Power Capacity Under Construction

REGION	UNDER CONSTRUCTION	PLANNED	PROPOSED	TOTAL CAPACITY GROWTH	CURRENT CAPACITY	TOTAL GROWTH AS A % OF CURRENT
China	29.8 GW	44.7 GW	186.5 GW	260.9 GW	57 GW	457%
Russia	4 GW	8.9 GW	37.7 GW	50.6 GW	26.8 GW	189%
India	7.2 GW	7 GW	32 GW	46.3 GW	8.2 GW	565%
EU	2.1 GW	13.6 GW	28.4 GW	44.1 GW	101.7 GW	43%
Japan	2.8 GW	1.4 GW	11.6 GW	15.7 GW	33.1 GW	47%
USA	0 GW	0 GW	10.5 GW	10.5 GW	95.8 GW	11%
Brazil	1.4 GW	0 GW	8 GW	9.4 GW	2 GW	473%
United Kingdom	3.4 GW	3.3 GW	2.3 GW	9.1 GW	5.9 GW	154%
Rest of the World	17.7 GW	9.4 GW	47.2 GW	74.3 GW	64.1 GW	116%
TOTAL	**68.3** GW	**88.3** GW	**364.1** GW	**520.8** GW	**394.6** GW	**132%**

Source: World Nuclear Association, Morgan Stanley

companies are focusing on a developing technology called Small Modular Reactors (SMRs), which have a capacity of up to 300 MW—about a third of traditional reactors. SMRs are versatile, faster to deploy, and expected to become commercially viable by 2028. The Asia-Pacific region is leading SMR development, positioning its companies to dominate the supply chain for U.S. projects. Other initiatives include nuclear fusion, which, unlike traditional reactors, generates energy by pushing atoms together. This process uses light gaseous elements as fuel, reducing costs and the risk of meltdowns. Microsoft recently signed a Power Purchase Agreement with Helion Energy, a fusion startup backed by OpenAI's director Sam Altman. While skepticism remains about the pace of advancements in this field, Helion aims to commercialize fusion energy by 2028.

On the commodities side, uranium prices have recovered from 2016 lows but remain below early-2000s peaks. **With AI driving demand, uranium consumption is projected to double by 2040.** However, uranium requires enrichment to become usable fuel, a process dominated by a few companies. Russia controls 44% of global enrichment capacity, followed by China at 10%. Recent U.S. legislation restricting Russian-enriched uranium imports has boosted prices. While the long-term outlook for uranium remains bullish, short-term volatility will rely on geopolitical factors, particularly the resolution of the Russia-Ukraine conflict. ■

House Views Matrix

	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
Global Asset Allocation		
Equities	NEUTRAL	OVERWEIGHT
Fixed Income	NEUTRAL	OVERWEIGHT
Cash	NEUTRAL	NEUTRAL
Regional Breakdown		
US Equities[1]	OVERWEIGHT	OVERWEIGHT
European Equities	NEUTRAL	NEUTRAL
Japanese Equities	OVERWEIGHT	OVERWEIGHT
Emerging Market Equities	UNDERWEIGHT	UNDERWEIGHT
Chinese Equities	NEUTRAL	NEUTRAL
US Treasuries[2]	NEUTRAL	OVERWEIGHT
Investment Grade Fixed Income	NEUTRAL	NEUTRAL
High Yield Fixed Income	NEUTRAL	NEUTRAL
Emerging Market Sovereign	NEUTRAL	NEUTRAL
US Dollar	OVERWEIGHT	NEUTRAL
Energy[3]	UNDERWEIGHT	UNDERWEIGHT
Precious Metals	OVERWEIGHT	OVERWEIGHT

[1] Relative to global equities in USD
[2] Relative to aggregate fixed income markets in USD
[3] Relative to an overall commodity allocation

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