CG insights

Quarterly perspectives from the CG team

1st Quarter 2025

cgam

Macro Developments

Isn't America already great?

Will the juggernaut roll on?

In recent years, the US has been an economic juggernaut particularly when compared to the rest of the world. You can easily see this by the relative trend in US PMIs vs. the rest of the world. This has been driven by a mixture of American exceptionalism, cheap and abundant energy, and large monetary and fiscal stimuli. These features remain in place for the short term.

This combination has driven both the US stock market and the dollar to very high levels. **The question from here is whether this will continue beyond the short term, or, alternatively, what might eventually undermine this?** There are plenty of things to worry about, but we can have no great confidence when or whether any of them will come to pass.

First there are tariffs. The extent to which tariffs will be implemented is unclear and so is the practical effect. Conventional wisdom suggests they will cause higher inflation, lower consumption, and lower growth. But the Chinese economy – the main target of Trump tariffs – is already suffering. China may elect to devalue its currency in response to tariffs, to protect exports, in which case the cost of tariffs will be borne by China while the US benefits. More generally, tariffs will likely hurt the rest of the world more than the US economy.

Turning to fiscal policy, the Treasury Secretary nominee wants to bring the deficit down to 3% over three years. If he is serious and Trump/Congress play ball, this would be highly contractionary. The US savings rate is already low and so could not provide much relief.

Third, interest rates have repriced higher recently. Mortgage rates are well above 7%. Credit card delinquencies are at 10-year highs.

Finally, if deficits are not brought under control, **there is the risk that the bond market cannot absorb the huge supply of Treasuries being issued to finance the deficit and the yield curve steepens**. This may have the consequence of crowding out private investment.

US Composite PMIs vs. Rest of World[1)]

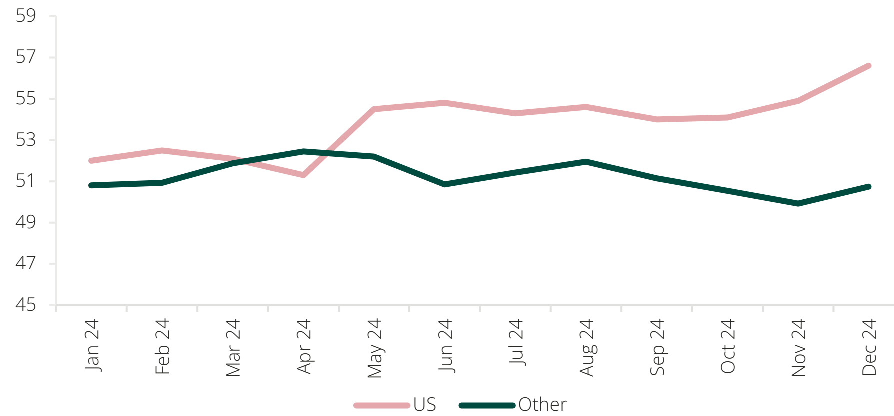

Chart takeaway: Business activity surveys make clear that the US economy is enjoying considerable momentum.

Our Investment Judgement

1. The US economy has shown considerable momentum and this is likely to continue in the short-term. The key uncertainty is whether US exceptionalism can continue beyond this point.
2. There are plenty of factors which could derail the US economy, however we have low conviction as to their timing and probability. We therefore proceed with caution.

1. Composite Purchasing Manger Indices for US and Rest of World. Rest of World is a simple average of UK, China, Eurozone & Japan

Extreme positioning demands extreme caution

American equities are priced for perfection

For the 15 years running up to the dot com boom in the year 2000, American equities outperformed the rest of the world. Silicon valley was the emerging powerhouse of an information technology revolution and sky-high equity prices stimulated a capital expenditure boom focused on communications infrastructure. **The internet revolution duly unfolded; however, the profits did not follow** (at least not for a decade). From 2001 to 2010 American equities underperformed the rest of the world with profits weighed down by bankruptcies, write offs and sagging valuations.

In 2010 the cycle turned again and for the last 15 years American equities have been extraordinarily ascendant. Silicon valley is the powerhouse of the AI information revolution and sky-high valuations are encouraging a capital expenditure boom. Goldman Sachs anticipates $1trn of capital expenditure on AI infrastructure over the coming few years, with Microsoft alone expected to spend $90bn of capex in 2025; essentially all of its prodigious cashflows. AI is likely to revolutionise society, but **it remains unclear which companies and products will be the winners and whether sufficient profits can be generated to deliver the expected returns on $1trn of investment**.

The December 2024 Bank of America ('BOA') Global Fund Manager Survey recorded the largest ever overweight allocation to US equities. Often BOA equity strategists identify these types of extreme investor sentiments as contrarian indicators but not so this time. BOA is forecasting double digit US equity returns in 2025 with the US outperforming other markets, while US corporate insider sales are at record levels. **Perhaps this time is different however the historical record suggests positioning this extreme demands extreme caution.**

S&P500 returns relative to MSCI World Ex US[1]

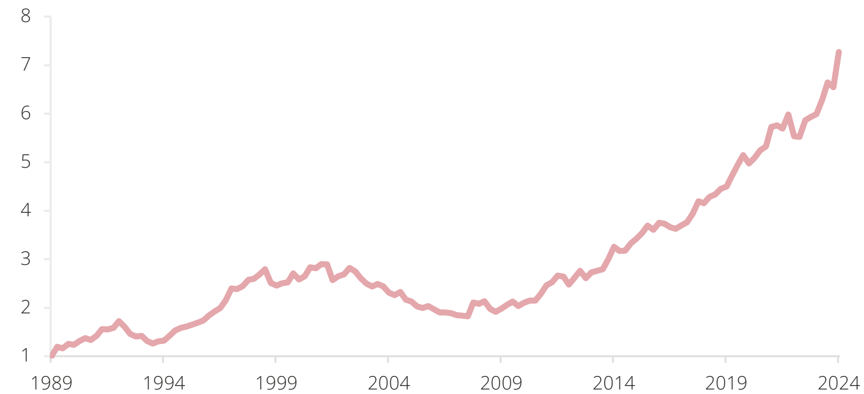

Chart takeaway: The scale sheer scale of the US equity outperformance is rare in the historic record and has moved into extreme levels

Our Investment Judgement

1. US equities are fully priced on almost any metric with an extraordinary concentration in the Magnificent Seven.
2. Investor behaviour is becoming increasingly speculative.
3. Our equity exposure strongly underweights the US markets.
4. We have been reducing risk assets against a frothy backdrop, even though investment trust discounts remain compelling.

1. Data is normalised at a factor or 1 as of December 1989. Source: Bloomberg

Beware the curve steepener

The US yield curve may flatten before it steepens

Over the past year, US Treasury market participants' anxieties have flipped between near term recession and longer-term fiscal policy unsustainability. Both sets of concerns pointed to the same thing – yield curve steepening – either through falling short-term interest rates, rising long-term interest rates, or (most likely) a combination of both.

Then, in November, the result of the US election came out decisively in favour of President Trump. While the exact contours of Trump's economic policy remain to be determined, several features are clear: policy will be (i) stimulative (low taxes, focus on domestic manufacturing, cheap energy); (ii) inflationary (tariffs on imports); and ultimately (iii) focused on restoring fiscal sustainability (planned adjustment to a 3% deficit).

The FOMC, designed to be apolitical, is not supposed to take expectations of government policy into account until they have been announced. This has created a conundrum: **while monetary policy has recently focused on cutting short-term interest rates, forward expectations of government policy suggest at a minimum a need to temper rate cut expectations**. The December update to the FOMC's monetary policy outlook (the "Dot Plot"), which suggested only 50bp of rate cuts for 2025, was a nod in this direction.

The latest official estimates of US economic performance suggest that the US continues to run with a positive output gap (realised real GDP growth exceeds full employment GDP growth). This is important: **positive output gaps are associated with flat yield curves**. While the output gap has been closing over recent quarters, several of the policies discussed by the Trump administration would likely prolong the positive output gap (e.g. low taxes, cheap energy, constrained immigration). Bond market participants should prepare for the contingency that the yield curve may flatten before it steepens.

US Treasury 2s10s spread vs. US output gap[1]

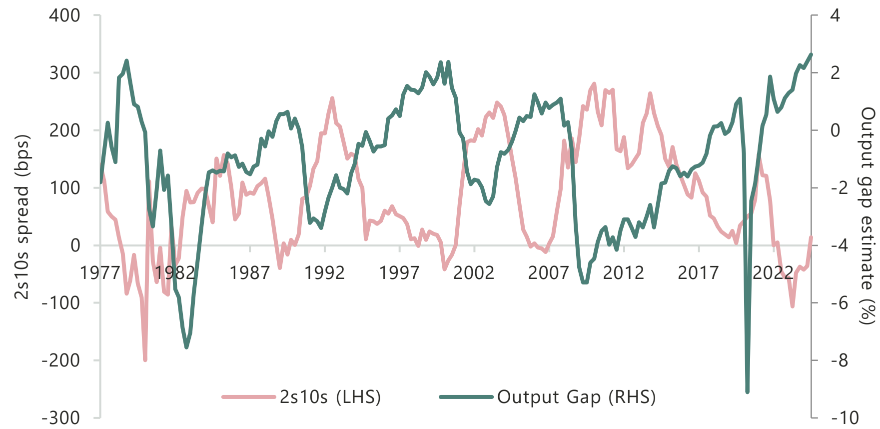

Chart takeaway: Positive output gaps, associated with stronger economic performance, are correlated with flatter yield curves (narrower 2s10s spread).

Our Investment Judgement

1. Our medium-term expectation is that the US yield curve must steepen. But we are alive to the risk that the curve flattens first.
2. A flatter yield curve leads us to prefer a barbell strategy. This means that we can advantage of: i) higher short-term interest rates; and ii) convexity at the long end of the curve. We underweight the belly, given the lack of yield roll-down as maturities shorten.
3. Our TIPS portfolio is barbelled to a duration of 8 years. This allows us to achieve a higher running yield for the given duration.

1. Sources: Bloomberg Finance L.P., Federal Reserve Bank of St Louis FRED Database.

What's Changed

Recent changes to multi-asset portfolio positioning

Portfolio Category	Asset Classes	Changes in Portfolio Positioning
Dry Powder (31%)[1]	Cash & Treasury Bills Short investment grade credit Preference shares	• Overall dry powder was unchanged at 31% of the portfolio • Weighting to preference shares and credit reduced by 1% to 8% of the portfolio as several ZDPs matured over the quarter including the Utilico Finance 2024s and the NB Private Equity 2024s • As credit spreads continued to narrow proceeds were largely recycled into treasury bills which have increased by 2% to 21% of the portfolio
↑ Index Linked Bonds (38%)[1]	Sovereign inflation linked bonds UK, US and other developed markets	• Allocation to index linked bonds increased by ~4% over the quarter • 2.5% was added to UK index linked bonds where duration is 4.7 years • 2% was added to US TIPS where duration was shortened to 7 years • Holdings in Canadian index linked bonds were exited
↓ Risk Assets (31%)	ETFs Investment Trusts Non-investment grade credit Gold	• Overall risk assets were reduced by 4.6% over the quarter • Conventional equity exposure was reduced by 3.4% across all major geographies including the UK, US, Japan and the energy equities sector • Exposure to infrastructure was reduced by 1.5% to 6.3%, largely from renewables • Several merger-arbitrage opportunities including Balanced Commercial Property and Aberdeen Property Income Trust matured • Profits were also taken in investment trusts including BH Macro and RIT Capital • Gold exposure was reduced to 1% of the portfolio

1. Data refers to Capital Gearing Trust. Weighting to index-linked bonds in ICAV funds is 33% with the balance invested in dry powder (36%)

Asset Valuations and Investor Behavior Summary

Asset Class Valuations and Summary

	UK	US	Japan	Europe	CG View
Investment Trusts Discounts	Attractive				Discounts are attractive alongside a record return of capital and numerous engagement opportunities to target
Equity markets	Fair	Unattractive	Fair	Fair	CAPE: UK(18), US (37), Japan (23), Europe (22) US domination of equity markets and high valuations suggest elevated risks
Short Government Bonds	Fair	Fair	Unattractive	Unattractive	UK T-Bills offer a risk free 4.7% return
Long Index Linked Bonds	Unattractive	Attractive	Unattractive	Unattractive	Favour US on valuation grounds but medium-term concerns about stability of long end
Currency	Base Currency	Fair	Attractive	Unattractive	Yen is still attractive but faces near-term headwinds from tariffs, weak growth and stronger competition from Europe and China
Credit	Unattractive	Unattractive			Credit spreads are historically tight with unfettered issuance. Loan defaults by leveraged borrowers have increased markedly in the US
Investor Behaviour	Fair	Unattractive	Attractive	Fair	Investor sentiment and risk-taking remains bullish in the US. Shareholder engagement and corporate reforms in Japan have proved constructive

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