

EQUITY OUTLOOK

1Q 2025



DEFYING GRAVITY



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- The US economy enters 2025 in a strong position, with above-trend growth, but also above-target inflation. This combination is positive for equities, but it is not one that is sustainable. The question is how quickly and in what fashion each reverts to trend.
- US equity index performance since the election reflects the assumed benefits of the policies of the incoming Trump administration for US corporate profits, as well as continued AI-linked spending. Assessing the policy risks of the President-elect will require more information on what the measures actually are. For now, we believe the US equity market is the one with the greatest potential, but a rotation to underperforming markets is likely at some point.
- Outside of the US, earnings growth expectations are modest. Japanese exporters would benefit if the yen continues to weaken. Earnings expectations for the MSCI China index are rising as government stimulus feeds through to demand, while valuations are lower than for other major indices. Potential tariffs are a worry, but companies have diversified their export markets since the first Trump administration.



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Most US equity investors begin 2025 with a view diametrically opposed to the one they had at the start of 2024. Twelve months ago, the expectation was for a US recession — the probability was above 60% by the Federal Reserve Bank of New York’s measure — and negative equity returns. Today, US growth is expected to remain above potential, supporting outperformance of the country’s equity markets. One hopes investors are not as mistaken this year as they were last.

We should note that the NY Fed’s recession probability was still 29% at the end of December, well above the long-run average of 15%. While investors are clearly hopeful that deregulation and tax cuts will lead to strong earnings growth, the risks are numerous.

Even if the more positive scenarios play out, the year is likely to see fewer cuts in the fed funds rate than expected before the US election and stronger inflation, resulting in higher yields across the curve. Higher yields should not prevent US equities from gaining as the yields reflect stronger economic growth, and inflation translates into higher (nominal) profits.

The adjustment to higher yields, however, has entailed a pullback in equities. This process began at the end of last year when the 10-year US Treasury yield rose from 4.1% to 4.6% and the S&P 500 dropped by 3%. But once the higher discount rate for earnings has been priced in, a rising earnings trend should reassert itself and lead to a resumption in index price appreciation.

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US Treasury yields have risen to reflect higher economic growth and inflation, prompting a drop in equities

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Optimism about the outlook for US equities has history to support it. During the first Trump administration, US equities outperformed the rest of the world. This also occurs typically in the year following the beginning of a Fed cutting cycle.

The problem is that the current combination of economic growth and inflation is likely not sustainable. In the third quarter of 2024, real GDP rose by 3.1% (seasonally adjusted annual rate), and the latest Atlanta Fed GDPNow forecast is for 2.7% in the fourth quarter. This contrasts with the Fed’s estimate of long-run trend growth — gravity as far as the economy is concerned — of 1.8%. Core PCE (personal consumption expenditure) inflation is 2.8%. The markets will not be able to defy gravity forever; both growth and inflation will have to fall. The question is simply when and how?

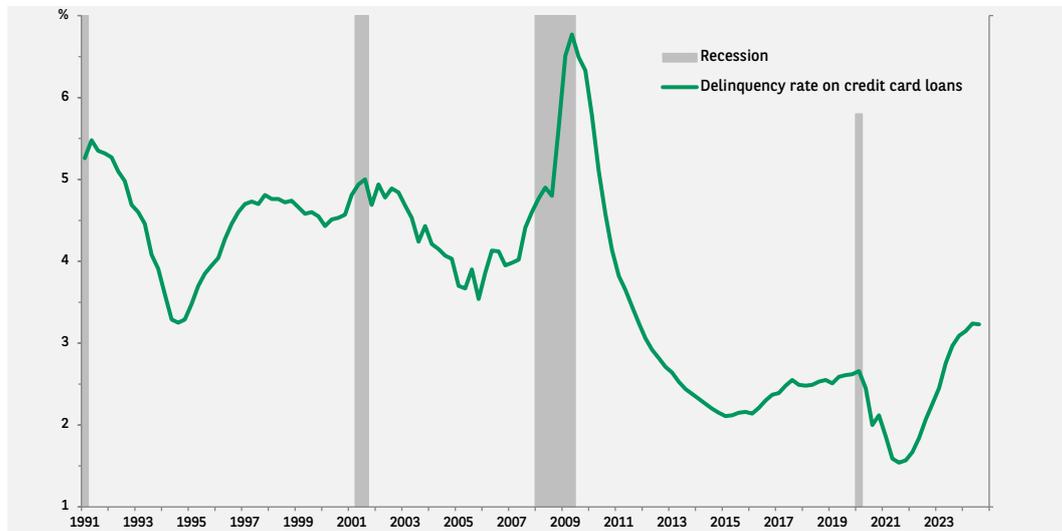
In the near-term, one risk is that economic activity and inflation rise if the Trump administration is too successful in stimulating growth, a replay of what occurred after the Biden administration’s USD1.9 trillion American Rescue Plan. This could lead the Fed to hike rates (as it did following the first Trump tax cuts in 2017), resulting in a more abrupt slowdown in growth.

Even if the Fed pauses its policy rate reductions, real rates will remain restrictive. With prices far higher than they were prior to the pandemic, and consumer excess savings having largely been exhausted, the slowdown in consumption anticipated for last year could finally occur. Credit card loan defaults and delinquency rates have risen (see Exhibit 1).

Exhibit 1

Delinquency rates are rising

Seasonally adjusted data through 3q 2024



Data as at 31 December 2024. Sources: St. Louis Federal Reserve, BNP Paribas Asset Management.

Ideally, an economic deceleration would come in the form of the ‘soft landing’ that was supposed to have occurred last year, with both growth and inflation reverting to trend. But the significant uncertainties about the Trump administration’s policies on tariffs, taxes, and immigration raise the probability that the slowdown is not only bumpy but goes further, culminating in a recession.

For now at least, investors are focusing on the growth potential while being mindful of the risks. Earnings expectations had already been rising steadily for US growth stocks (red line in Exhibit 2) as the AI (artificial intelligence) boom accelerates investment and demand in the sector. The trend was less strong excluding the ‘Magnificent 7’ companies (dark blue line), though it has picked up since the US election.

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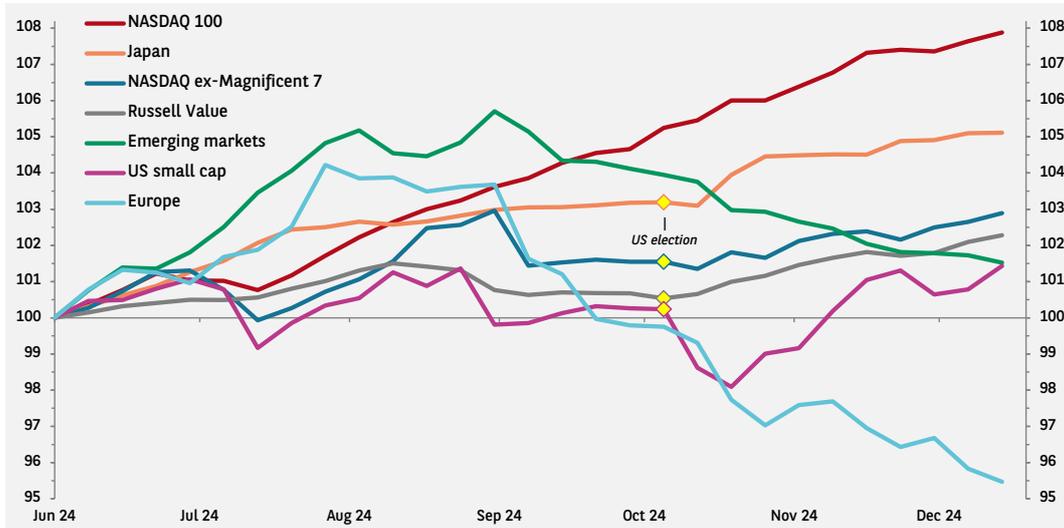
**The current combination of GDP growth and inflation
in the US is likely unsustainable; the only question
is how it changes and when**

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Exhibit 2

Expectations for earnings next year rising except for emerging markets and Europe

Next-twelve-month EPS estimate in local currency terms except for EM in USD



Data as at 12 January 2025. Sources: FactSet, BNP Paribas Asset Management.

There has been a bigger upswing for US small cap stocks (purple line). Forward earnings estimates have risen by 4% from recent lows in anticipation of stimulus to domestic demand through onshoring initiatives from the Trump administration, tariffs, and a stronger dollar.

The impact of the stronger dollar could also be behind the rising earnings expectations for Japanese equities (orange line). A weakening yen was a key driver of the outperformance of the market last year and with the dollar likely to remain strong, domestic exporters should benefit from the currency translation.

The earnings trend for European equities (light blue line) has been negative since the summer and there is little recent news to change the perception of a challenging profit outlook. Worryingly, the negative earnings revisions span every sector in the index. The imposition of tariffs by the Trump administration could drive estimates down even further.

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**Even before Trump's re-election earnings expectations
for European companies were falling,
reflecting the challenges facing the region**

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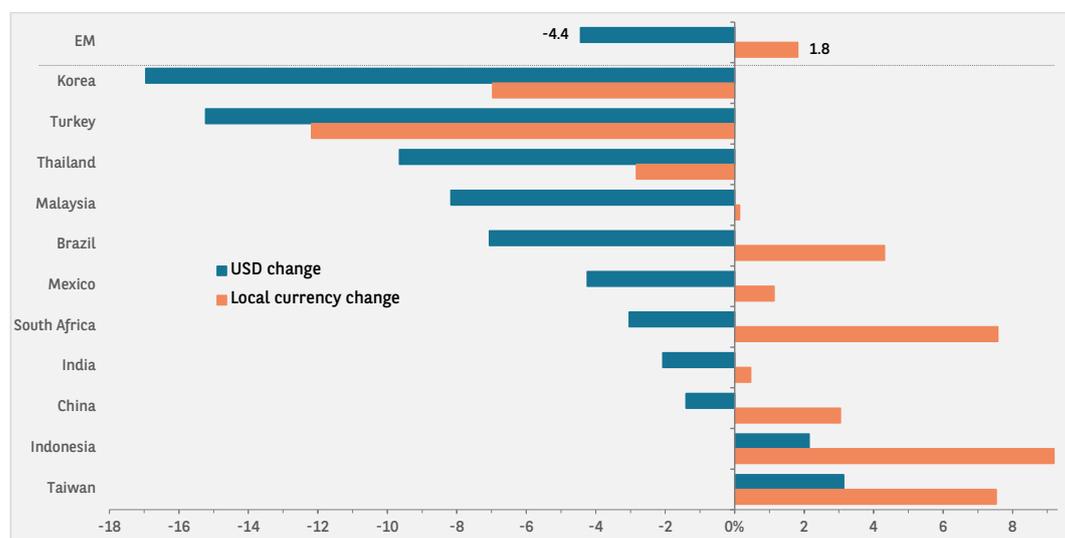
Forecasts look similarly pessimistic for emerging markets (green line), but the outlook is not as negative as it appears. Firstly because there is a great deal of variation, with analysts raising estimates for some markets while lowering them for others. Secondly, much weaker emerging market currencies relative to the dollar have had a significant impact on the US dollar value of earnings estimates (the J.P. Morgan Emerging Market Currency Index has fallen by 5% since the election).

The forward earnings-per-share (EPS) estimate for emerging markets shown in Exhibit 3, in US dollar terms, has declined by 4.4% from its peak at the end of September, but in local currency terms, estimates have in fact risen by 1.8% (see Exhibit 3). The appreciation of the dollar has been so strong that in some cases a rising local currency EPS estimate has been turned into a negative one in US dollar terms (e.g., Brazil). While a rising local currency EPS can reflect the higher domestic value of international sales (as mentioned for Japan), it can also reflect a positive outlook for domestic corporate profits, a perspective that is lost if one only considers EPS in USD.

Exhibit 3

Stronger dollar has turned rising local currency estimates into falling ones

Change in next-twelve-month EPS since since 30 September 2024



Data as at 12 January 2025. Sources: FactSet, BNP Paribas Asset Management.

It is worth highlighting that despite concerns about the prospects for Chinese growth with the incoming Trump administration, the increase in earnings estimates over the last several months is above average. While US tariffs would undoubtedly have an impact on Chinese corporate profits, investors should recall that the US accounts for just 2.8% of revenues according to FactSet (5.2% for the MSCI Hong Kong index), while 86% of sales are within China. Ninety percent of export sales go to the rest of Asia.

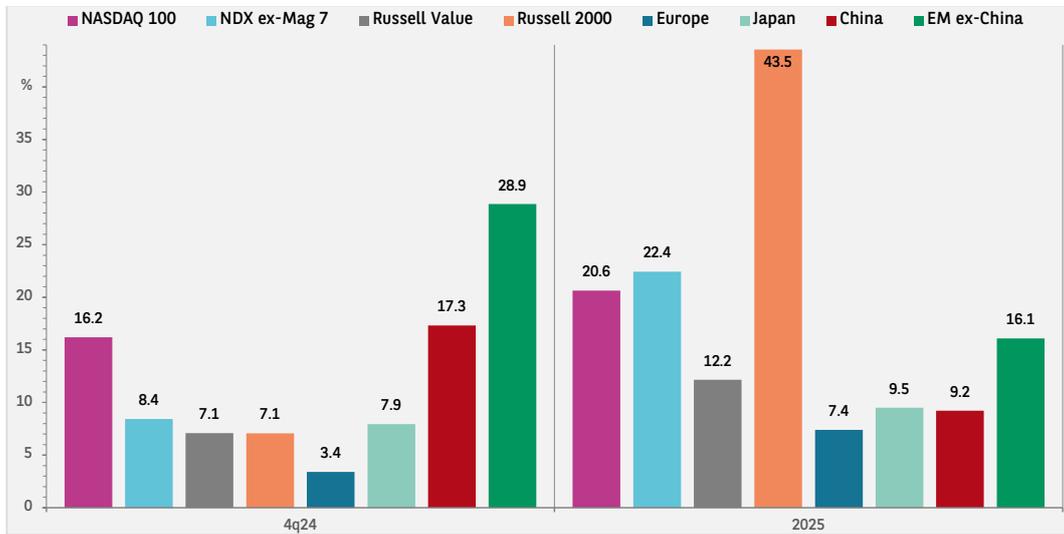
This configuration may help explain why earnings are expected to rise by more than 9% in 2025 (see Exhibit 4). For the remaining emerging markets, however, the gain is 16.1%. The Chinese government still faces significant challenges in stimulating domestic demand given problems in the property market. Nonetheless, we anticipate further support from Beijing over the course of the year and real GDP growth of around 4.5%.

Given that valuations are low (forward price-earnings ratio of 9.6x at time of writing versus a long-run average of 12x; see Exhibit 5), a negative reaction by the market to the imposition of tariffs could present an opportunity.

Exhibit 4

Positive earnings growth expectations for 2025

Consensus year-on-year percent change, local currency except for emerging markets (USD)



Data as at 12 January 2025. Sources: FactSet, BNP Paribas Asset Management.

The 2025 year-on-year earnings growth forecasts for the Russell 2000 index shown in Exhibit 4 are extremely high, over 40%, which may overstate the potential for index price appreciation simply due to higher earnings. Large swings in EPS are not unusual for the small cap index. The gain expected this year follows two years declines and only leaves EPS 13% higher than it was in 2022. But even if the gains are not as large as forecast, rising profits should provide solid support for the index.

Valuations are not likely to be a key factor in markets returns this year insofar as price-earnings (P/E) ratios are neither extremely high nor low for most markets (see Exhibit 5). This may surprise some when it comes to the NASDAQ 100 index as many investors believe that tech sector valuations are high.

While there may always be extreme individual stock valuations, for the most part the NASDAQ 100's price gains over the last year have been more than matched by higher earnings expectations. While those forecasts may turn out to be over-optimistic, we do not believe they are radically out of line and consequently, are not unduly concerned about multiples.

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**Valuations for most markets are around historical averages,
with the key exception of the Russell 1000 Growth index**

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Exhibit 5**Valuations are around average for most markets**

z-score for forward price-earnings ratio

Market	P/E
United States	1.3
Russell Value	1.1
Developed Markets	1.0
US Small Cap	0.6
EM ex-China	0.5
Japan	0.4
NASDAQ	0.4
Europe	-0.1
Emerging Markets	-0.2
China	-0.7

Below average	Average	Above average
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Data as at 12 January 2025. Note: MSCI indices unless otherwise noted. Sources: FactSet, BNP Paribas Asset Management.

One part of the US market that is expensive are value stocks, which would seem to be a contradiction in terms. The price gains for the companies in the index, particularly banking stocks, have simply outpaced earnings.

The current configuration of US equities, with high valuations for the S&P 500 stemming from the value rather than the growth part of the market, is unusual. It suggests to us that a combination of NASDAQ and US small caps, rather than the S&P 500, is another way to take advantage of US growth.

Active management should be particularly useful in this environment as it allows a portfolio to avoid more leveraged companies and their vulnerability to higher interest rates, while focusing on companies able to profit from robust US economic growth.

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