Investing for a world of change

Navigating narrow markets: The importance of stock-specific drivers

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What were the key events in 2024 for global equities?

2024 was a strong year for developed market returns, driven by the resilience of the US economy and the underperformance of the Chinese economy, which meant developed markets equities comfortably outperformed emerging markets. In terms of sectors, technology and AI-related sectors were the major winners, not only in the US, but also across other regions. Meanwhile, underperformers could be found within cyclical sectors (energy and materials), as well as within defensive sectors (consumer staples and healthcare).

Market concentration levels, particularly in the US, reached levels not seen since the 1970s, largely due to the performance of US mega caps. Momentum as a style, whether price or earnings momentum, did very well across most regions and sectors, while low-risk or defensive market attributes lagged significantly.

Overall, 2024 will go down as one of the more challenging years for stock pickers given the narrowness of market leadership.

How is the AI trend expected to evolve in 2025?

I think we're all a lot more familiar with AI than we were 12 months ago. We have a better handle on what it is, and what it is not. From a market perspective, given its strong contribution to sector returns, it's tempting to say the AI theme has run its course, and most related stocks must surely be overvalued – none more so than NVIDIA, which has emerged as a clear winner from 2024. NVIDIA's shares have rallied c. 400% over the past three years, but what's interesting is that earnings expectations have lifted by roughly the same level over that period, which implies that performance to date has mostly been driven by earnings rather than the re-rating.

As we head into 2025, we believe it is all about earnings momentum and whether it can continue to surprise to the upside. From our analysis, the fundamental outlook for AI remains sound. However, it is a fast-moving sector that requires close monitoring of industry dynamics.

What are the implications of the US election with Trump as the president-elect?

If we look back at previous administrations, we often see that even when successive governments have polar opposite priorities, this does not necessarily dictate which sectors are likely to benefit. For example, during the Obama years and Trump 1.0, the best and worst performing sectors were virtually identical: consumer discretionary and technology thrived, while the energy sector struggled under both administrations.

If we fast forward to today, and Trump 2.0, it looks as if the playbook could be repeating itself. We certainly expect increased market volatility, but believe that over the medium term, sector and stock performance is likely to be unrelated to party affiliation. I think for us as bottom-up stock pickers, it will ultimately be stock-specific drivers that will matter more in 2025.

What are the current opportunities and challenges in global equity markets?

If we focus on the US market, the margin of safety is lower due to strong market performance, but we still believe the US market presents opportunities by virtue of the high-quality businesses on offer, whether you're looking at the strength of corporate balance sheets or returns on capital that the average business generates. The US also has superior earnings growth relative to other markets. If we compare sectors perceived as expensive, like technology, on a like-for-like basis with other regions, the US valuation premium becomes more palatable. Furthermore, if you look beyond the largest listed stocks in the US index, the valuation premium reduces even further. That is not to say there aren't interesting opportunities elsewhere, outside of the US, and we will continue to look for them.

In terms of investment themes, we are considering areas that stand to benefit from deregulation as well as an anticipated increase in capital market activity heading into 2025. We see opportunities in US financials and in infrastructure as the capex cycle continues to pick up globally. Moving to the consumer, while we could argue about the trajectory of interest rate cuts in 2025, we are most likely at or have passed peak rates today, making the broader consumer cyclical sector interesting. However, as always, we remain focused on bottom-up fundamentals and therefore stock-specific risk will continue to be the primary driver of portfolio returns going forward.

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