A Unique Mind On The Markets

MACRO OUTLOOK 2025

December 9, 2024

Boom Or Bust?
An Investor's Playbook For 2025 & Beyond

Executive Summary

Three big stories are likely to dominate the world economy and markets for 2025 and beyond:

- The U.S. adopts supply-side policies
- Increasing backlash against fiscal conservatism
- The escalating battle between protectionism and globalism

As for financial markets, a corrective phase for the S&P 500 index is likely in the first half. However, this will be followed by another upleg, leading to new price highs in 2025.

President-elect Donald Trump's pro-growth policies, rising productivity, accelerating money supply, and strong AI tailwinds form the basic ingredients for a potential equity bubble. Meanwhile, U.S. stocks will outperform the rest of the world (ROW), where economic growth and corporate profitability are plagued by policy paralysis, structural problems and increasing geopolitical strife.

Treasury bonds will be constrained within a range, with 10-year Treasury yields fluctuating between 4% and 4.5% as the Federal Reserve recalibrates its policy. The central bank could drop rates to 4%, but likely not much lower before switching to a holding pattern.

For the eurozone, German bunds are a better bet than stocks. For Japan, stocks are more attractive than bonds. For China, the government needs to significantly upgrade its stimulus program – this is possible but not certain. For now, we prefer Chinese sovereign bonds to equities.

The dollar will stay strong, and our key currency bet among the majors is to go short EUR/JPY.

Commodity prices will remain out of sync, reflecting differing dynamics. Gold will continue its upward march, crude oil will fall further, and industrial metals will remain flat in 2025.

We expect peace to break out in Europe and the Middle East. North Korea and the Taiwan Strait could become new contentious points. The China-U.S. rivalry will dominate the geopolitical scene.

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The U.S.: Victory Of Supply-Siders

Domestic deregulation, corporate tax cuts, and tariff hikes will be key features of the Trump administration's economic policies. These initiatives are a natural extension of Trump's "America First" doctrine.

Trump's economic policies are rooted in supply-side economics, similar to those applied by former British Prime Minister Margaret Thatcher in the U.K. and former U.S. President Ronald Reagan in the early 1980s. On a broader scale, China's economic policy from the 1980s to the 2000s can also be seen as a triumph of supply-side economics.

The supply-side reforms implemented in the 1980s played a pivotal role in bolstering U.S. labor productivity, reducing inflation, and laying the groundwork for the booming 1990s. Similarly, Deng Xiaoping's decentralization, deregulation and privatization in the 1980s and 1990s drove China's rapid wealth creation and her ascent as a major economic power.

As unconventional as Trump may be, financial markets are optimistic about his election victory because of his policy initiatives. With the GOP controlling both the House and Senate, and Trump securing both the popular and electoral college votes, the administration will have a strong mandate to fulfill campaign promises.

Several key developments may dominate 2025 and beyond:

First, Trump has proposed a broad range of tax cuts, including exemptions for Social Security, tips, auto loans, and overtime pay. He also aims to lower the corporate tax rate to 15% from 21% for domestic manufacturers and potentially for the entire corporate sector.

Chart 1 Corporate Tax Rate Comparison

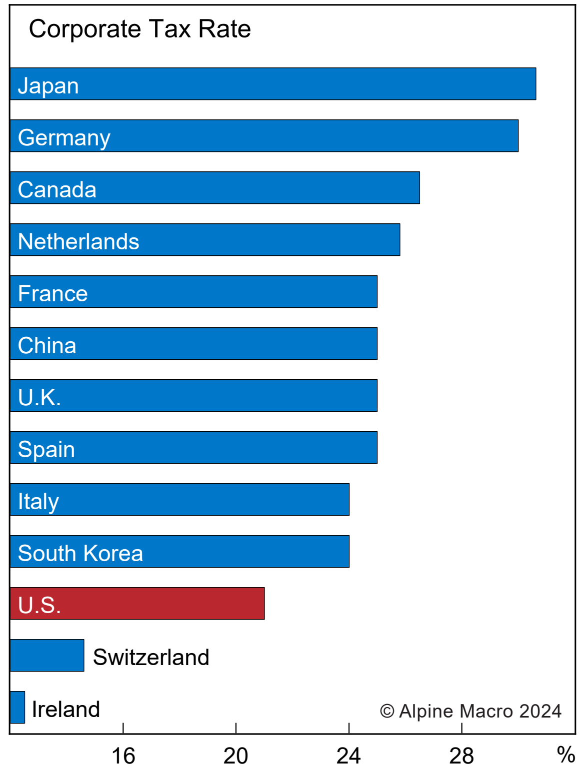
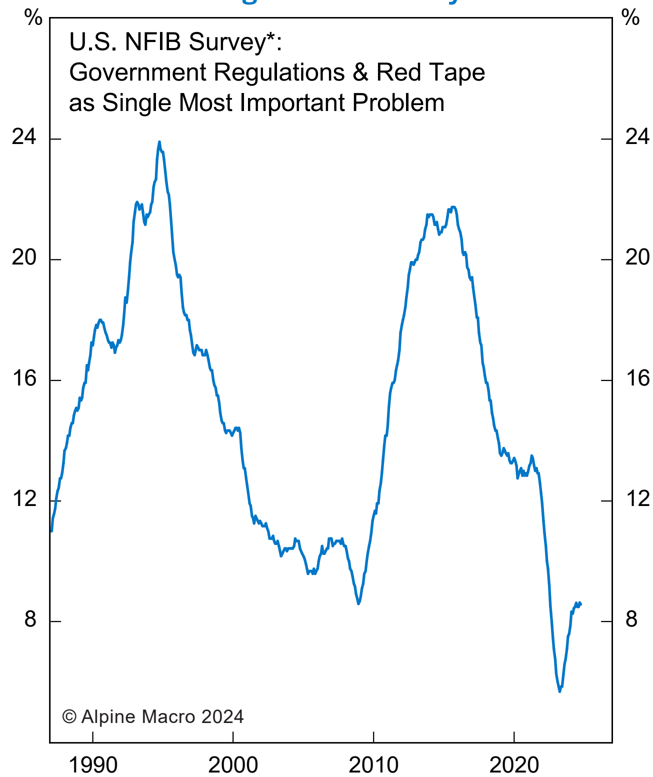


Chart 1 ranks corporate tax rates across major economies. The U.S. corporate tax rate is already lower than all G7 nations. If the rate drops to 15%, the U.S. will have one of the lowest corporate tax rates in the developed world.

This change would make the U.S. a highly attractive and competitive destination for business, potentially triggering a global "race to the bottom" in corporate tax rates, which could be a significant positive for global growth beyond 2025.

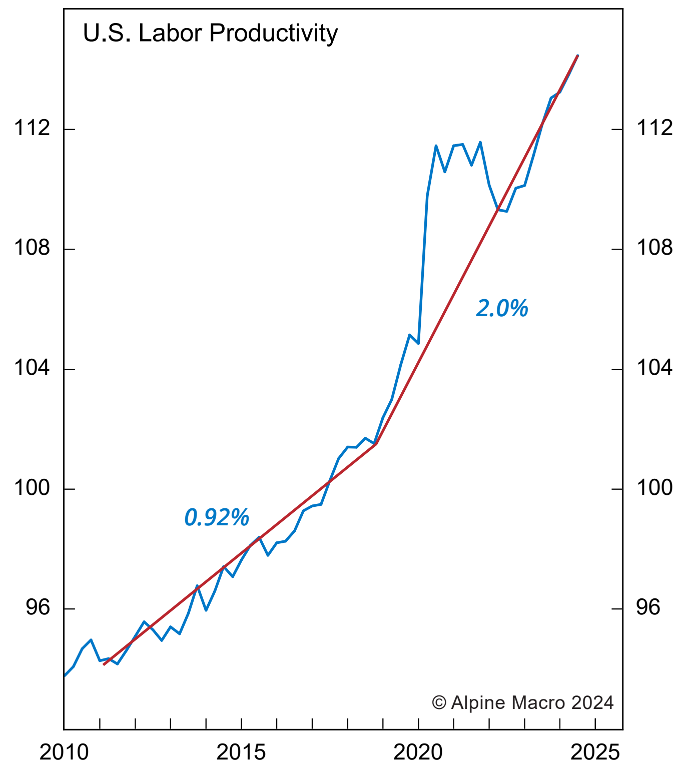
Second, the U.S. is already one of the least regulated economies among G7 nations, and most American businesses do not view overregulation as a significant

Chart 2 U.S. Is The Least Regulated Economy



*Shown as 12-month moving average

Chart 3 U.S. Labor Productivity Since 2010



hurdle (**Chart 2**). Thus, Trump's deregulation efforts will likely be targeted, focusing on financial services, fossil fuels, AI applications and rolling back climate restrictions.

Finally, Trump's economic policies could amplify the growth narrative of the "roaring 2020s" that we have articulated since 2021.[1] Innovations across multiple sectors have the potential to spur productivity growth, and evidence already suggests that U.S. labor productivity has noticeably quickened since the pandemic (**Chart 3**).

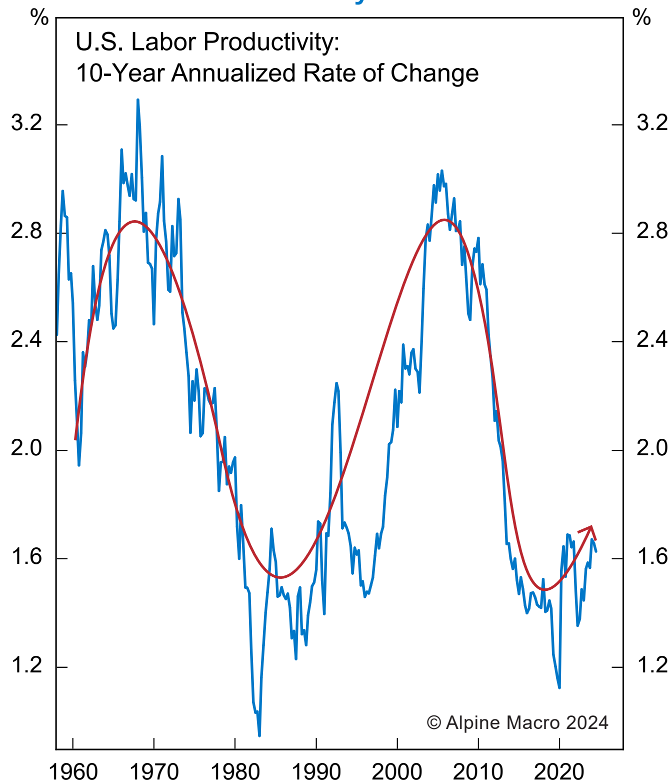
Could U.S. economic growth accelerate to 3%? Yes. With steady labor force growth at 0.5-0.6%, labor productivity growth would need to rise to 2.5% annually from the current 2.0%. This is achievable, as seen in the late 1990s and early 2000s when the Internet revolution drove productivity growth above 3% annually (**Chart 4**).

Today, we are on the cusp of another AI-driven technological wave. With Trump's deregulation, fewer restrictions could hasten AI adoption. Combined with cheap energy and lower corporate taxes stimulating business investment, productivity growth could feasibly accelerate to 2.5% or more.

In a nutshell, the U.S. is the only major economy embracing supply-side economic policies, which is a significant positive for growth. While inconsistencies

1 Alpine Macro *Global Strategy Outlook 2021* "The Post-Pandemic Boom, Manias And Crashes: A Conversation With Johnny On The 2021 Outlook And Beyond" (December 14, 2020).

Chart 4 U.S. Long-Term Productivity Growth



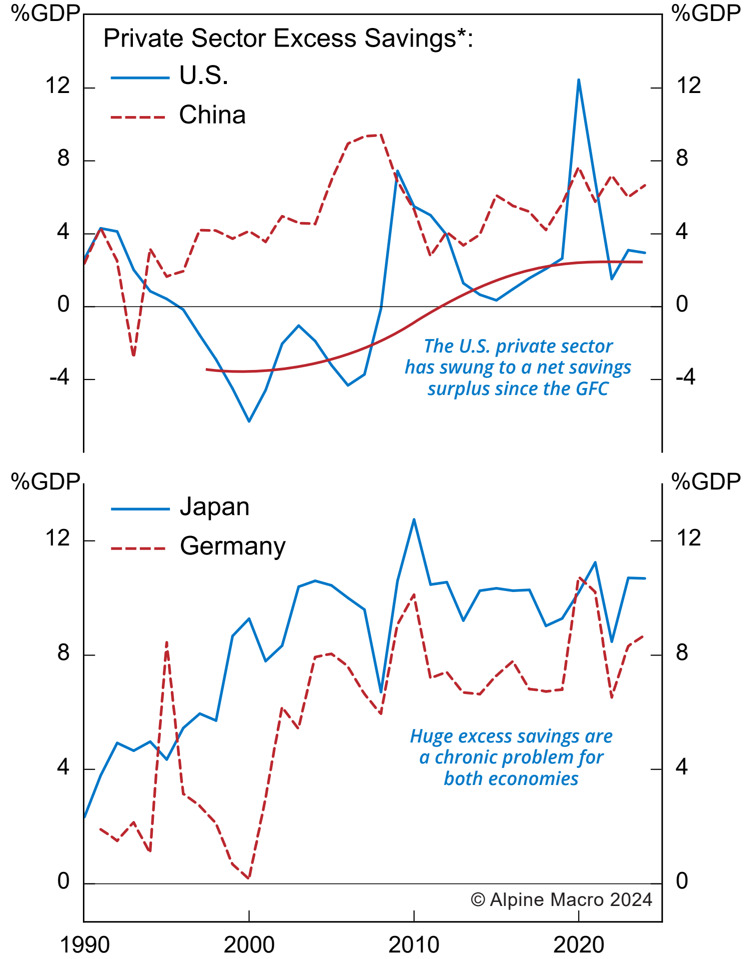
in Trump's policies remain – such as tax cuts versus tariff hikes or GDP growth versus restricted immigration – the overall direction is aimed at boosting productivity, economic growth and asset prices.

We anticipate a mini economic boom in the U.S. next year, not a bust or recession.

The Backlash Against Fiscal Conservatism

There is persistent apprehension about the budget deficit and debt, with most holding the view that a sustained rise in indebtedness will eventually lead to fiscal ruin. As such, governments, politicians, and the public often support fiscal conservatism, which advocates for balanced budgets, and deficit and debt reduction.

Chart 5 Private Sector Excess Savings



*Inferred by current account balance minus fiscal balance

The irony is that countries that have pursued fiscal austerity have experienced economic pain. Budget disagreements have either toppled or significantly weakened incumbent governments, from France to Germany.

In our view, fiscal conservatism presents significant risks in a world still burdened with excess savings. Few investors have noted that private sectors in all major economies are saving far more than they invest (Chart 5). Even in the U.S., traditionally considered an economy with inadequate savings, the private sector has a saving surplus of 2.1% of GDP.

Chart 6A **U.S.: Debt, Deficit And Bond Yields**

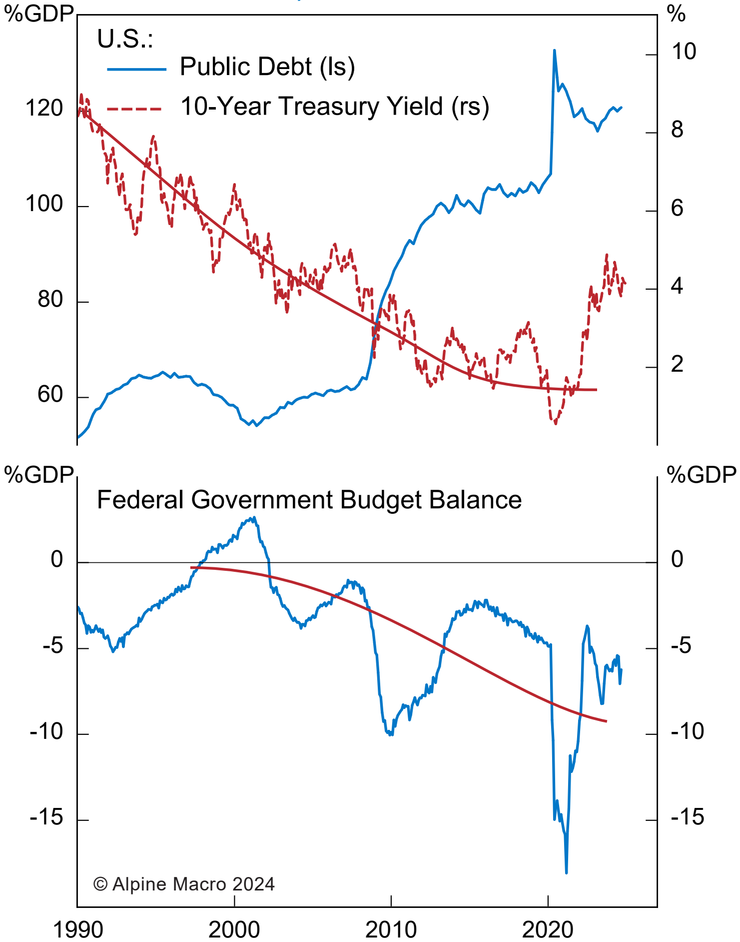
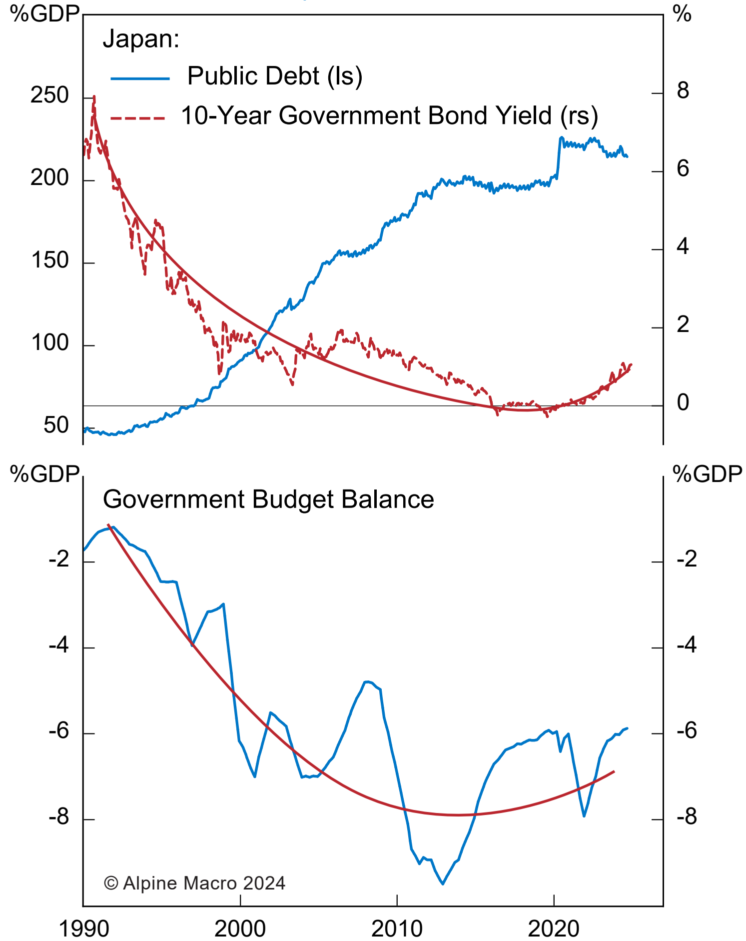


Chart 6B **Japan: Debt, Deficit And Bond Yields**



To contextualize, in Japan, Germany, China, and the U.S. combined, the private sector generates excess savings totaling $1.4 trillion. The over-saving problem is most acute in Japan and Germany, where saving surpluses account for 11% and 9% of GDP, respectively.

There has been apprehension and fear that rising debt and budget deficits will eventually lead to fiscal crises. This is a misperception. **Charts 6A** & **6B** show that budget deficits and debt in Japan and the U.S. have become progressively larger since the 2000s, yet their bond yields have fallen sharply since then.

This underscores the fact that bond yields are a mirror image of the relative abundance of savings rather than the levels of debt or budget deficit of a nation.

Excess savings represent a demand gap that must be filled, and there are only two ways to fill it: either export the saving glut *via* current account surpluses or have the public sector dissave by running budget deficits.

Fiscal conservatives favor balanced budgets and debt reduction, implicitly supporting the export of surplus capacity. For decades, the EU, China,

Chart 7 Germany, Japan And China: Exporting Excess Savings Abroad

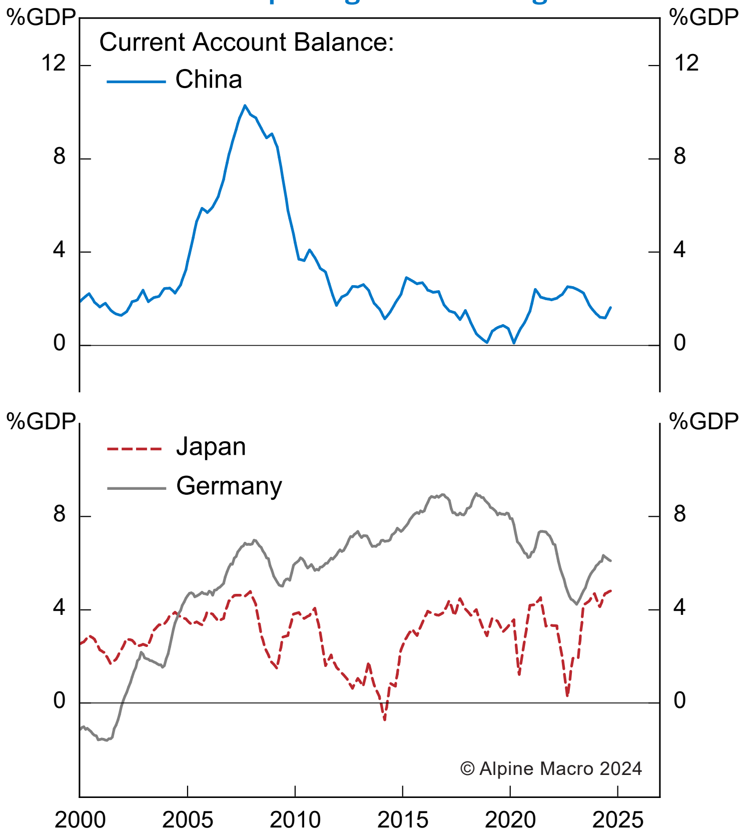
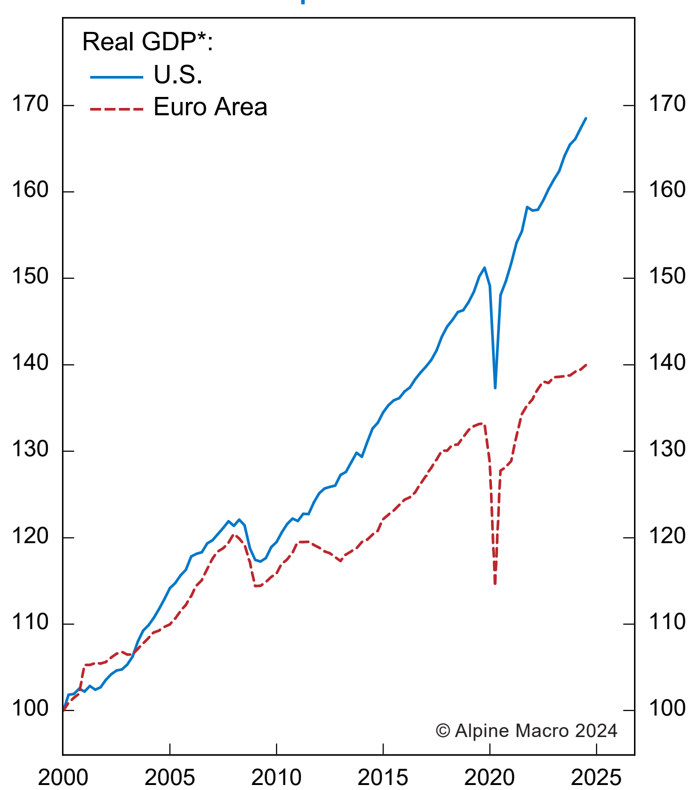


Chart 8 GDP: Europe Has Vastly Underperformed The U.S.



*Rebased to Q1 2000=100

and Japan have relied on this strategy, running large current account surpluses at various times (**Chart 7**).

However, circumstances have shifted. The incoming Trump administration will no longer tolerate large bilateral trade imbalances. For Japan, the euro area, and China, large-scale public-sector dissaving becomes the only viable option to avoid growth stagnation or deflation, unless their private sector savings rates fall sharply.

Among G7 nations, the U.S. is the only country to have consistently applied counter-cyclical fiscal stimulus during crises or recessions. This approach has helped absorb a significant portion of global excess savings, as the U.S. runs a sizable current account deficit. This fiscal policy agility is a key reason the U.S. economy has consistently outperformed its G7 peers.

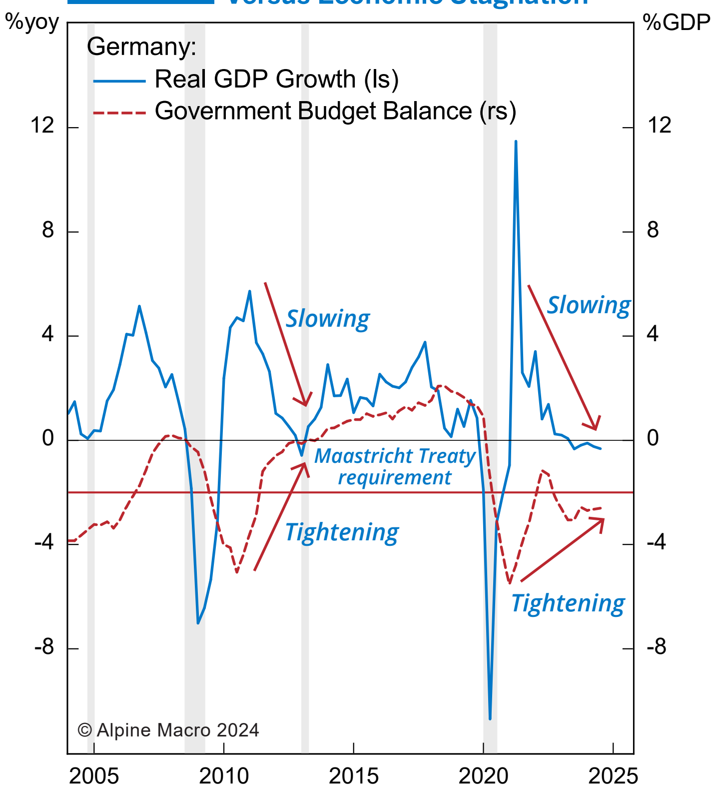
Looking ahead to 2025, the clash between fiscal conservatism and Keynesian demand-management policies could intensify. Key developments include:

1. Euro Area Struggles

The eurozone economy, in long-term decline relative to the U.S. (**Chart 8**), will continue to struggle in 2025. The Maastricht Treaty has institutionalized fiscal conservatism, exacerbating Europe's structural over-saving problem.

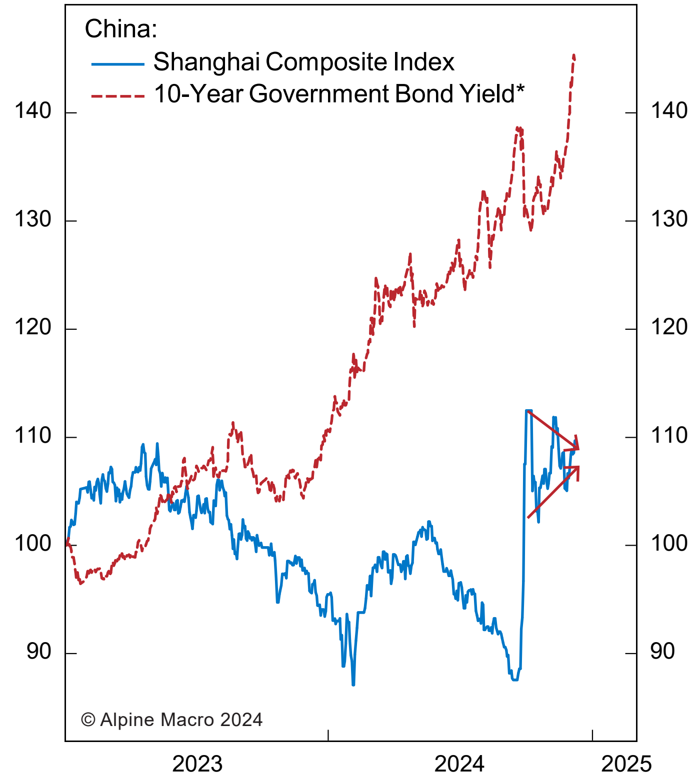
With rising protectionism in the U.S., aggressive fiscal expansion is essential for growth in 2025, but

Chart 9 German Fiscal Austerity Versus Economic Stagnation



Note: Shading denotes German recessions

Chart 10 Chinese Bonds Versus Stocks



*Inverted before rebasing
Note: Both series are rebased to Jan 2023=100

is unlikely to occur under the common currency agreements. Chart 9 shows Germany has been in fiscal austerity since 2021, despite economic stagnation. Without a decisive shift in fiscal policy, more economic pain is expected next year.

It is worth noting that a common currency regime functions similarly to the gold standard because, in both cases, no sovereign nation has the ability or discretion to increase money supply. As such, the central bank cannot act as a "buyer of last resort" for government debt obligations. Under these circumstances, debt crises can, and have often, occurred.

The 2011 eurozone debt crisis was largely influenced by the European Central Bank's (ECB) refusal to purchase bonds from several Southern European countries. This crisis ended quickly after Mario Draghi, the ECB President at the time, made his famous "whatever it takes" statement, signaling the ECB's commitment to stabilize the eurozone economy by purchasing bonds if necessary.

Currently, the French bond market is under stress due to the country's significant budget deficit, which stands at approximately 6% of GDP. Without a clear commitment from the ECB to support French bonds, there is a growing risk of a bond crisis in France unless the government implements severe fiscal austerity measures. Consequently, the euro area's second-largest economy may face a significant economic slowdown in 2025.

2. China: Reluctance To Up The Fiscal Game

Traditionally conservative, China has been forced to run increasing fiscal deficits in recent years due to price deflation, slowing growth, and rising unemployment. However, with nominal GDP growth having fallen below real growth, the economy demands more robust government action.

Financial markets are crying for increased stimulus, as bonds outperform stocks (**Chart 10**) and China's 30-year bond yields fall below Japanese government bond yields of the same maturity (**Chart 11**). Will Beijing take bold actions to get ahead of the curve? Possible but not very likely.

The Chinese government has a deep-rooted fear of debt and will likely move passively. President Xi does not aim at a sharp turnaround in economic growth but rather to prevent a crisis or sharp fall in economic activity. Thus, growth in China will continue to underwhelm financial markets in 2025.

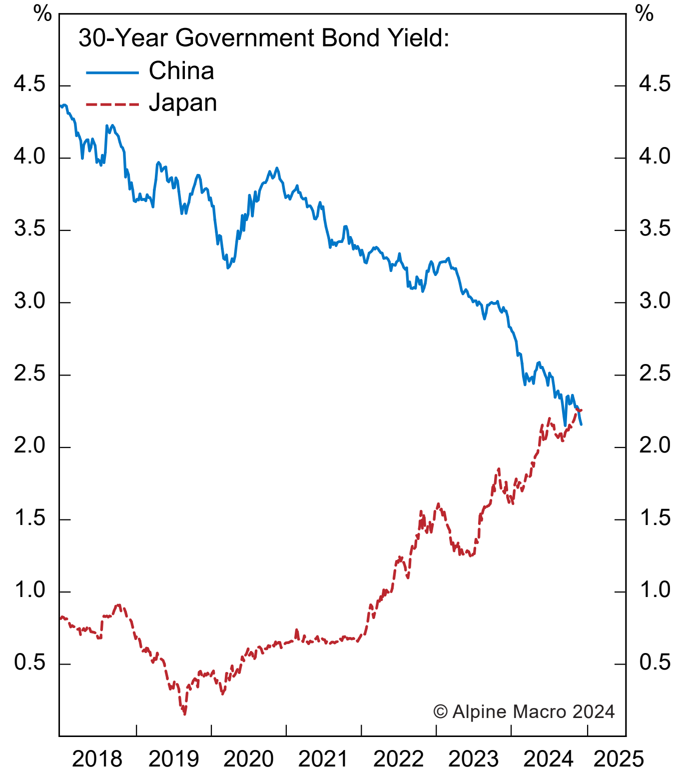
3. U.S.: The Test Of Countercyclicality

The challenge for the U.S. government is different. It lies in aligning fiscal policy with private-sector conditions. Ideally, strong private-sector growth should prompt counter-cyclical fiscal tightening. However, new stimulus, particularly from Trump's proposed tax cuts, may come in 2025.

As a result, maintaining macroeconomic balance and price stability could fall to the Federal Reserve, potentially prompting upward revisions in interest rate expectations for 2025 if Trump's policies trigger an economic boom.

Treasury Secretary nominee Scott Bessent, a fiscal hawk, may act as a counterweight to large-scale fiscal expansion. His nomination has been well-received by the Treasury bond market. This is a hopeful sign that Trump 2.0 will act more prudently than many have feared.

Chart 11 China Versus Japan: 30-Year Bond Yields

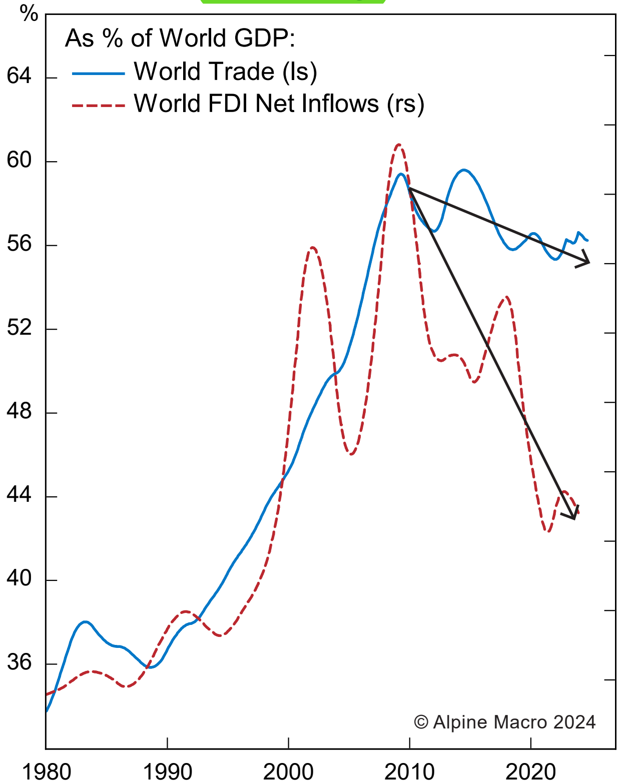


The Battle Between Protectionism And Globalism

The interplay between globalization and protectionism follows a historical pattern: economic prosperity often coincides with rising globalization, while crises and economic distress breed protectionism. The last major protectionist wave emerged in the 1920s and 1930s, when rising tariffs contributed to a global economic collapse.

The latest wave of globalization began in the 1960s, accelerated in the 1990s after the fall of the Berlin

Chart 12 Globalization Topped Out A Decade Ago

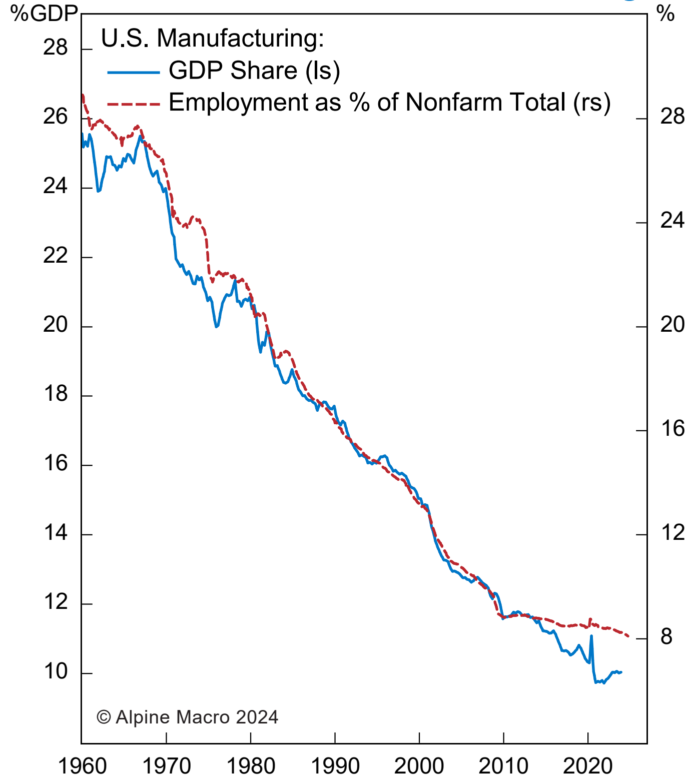


Note: Both series are shown as 3-year moving average; source: Netherlands Bureau for Economic Policy Analysis, World Bank

Wall, and peaked in the 2000s following China's entry into the WTO. The 2008 global financial crisis (GFC) marked its decline, with trade and FDI flows as a share of world GDP peaking and then falling (**Chart 12**). Trump's first term initiated trade wars, accelerating the shift toward protectionism.

Ironically, the U.S. has led the anti-globalization charge despite having the strongest economy and lowest unemployment rate in years. U.S. corporations have arguably benefited the most from globalization. Rising discontent over income inequality and stagnant middle-class living standards have fueled anti-globalization sentiment, with Trump's rise symbolizing this underlying frustration.

Chart 13 Tariff And Protectionism Have Failed To Revive Manufacturing



Going into 2025, the backlash against globalization will continue, and tensions between protectionism and globalism will escalate.

First, while Trump's domestic policies are pro-growth, his trade policies are not. Trade wars and retaliatory tariffs are unlikely to create American jobs and can hinder growth.

So far, past protectionist efforts since Trump 1.0 to "bring back" manufacturing have failed: U.S. manufacturing GDP as a share of the economy continues to decline, while manufacturing job creation remains stagnant at historically low levels (**Chart 13**).

With U.S. labor costs high and the dollar expensive, it is hard to rebuild America's manufacturing industry unless the corporate tax rate is slashed sharply. Even with lower taxes, most low-end manufacturing jobs will never return to the U.S.

Second, unlike Biden's ideologically driven policies, Trump's approach is transactional, viewing trade surpluses with the U.S. as exploitative. Therefore, countries with large bilateral trade surpluses with the U.S. are likely targets for tariffs. China, Mexico, Vietnam, Germany, Ireland, Japan, Taiwan, South Korea and Canada are all possible targets for higher tariffs.

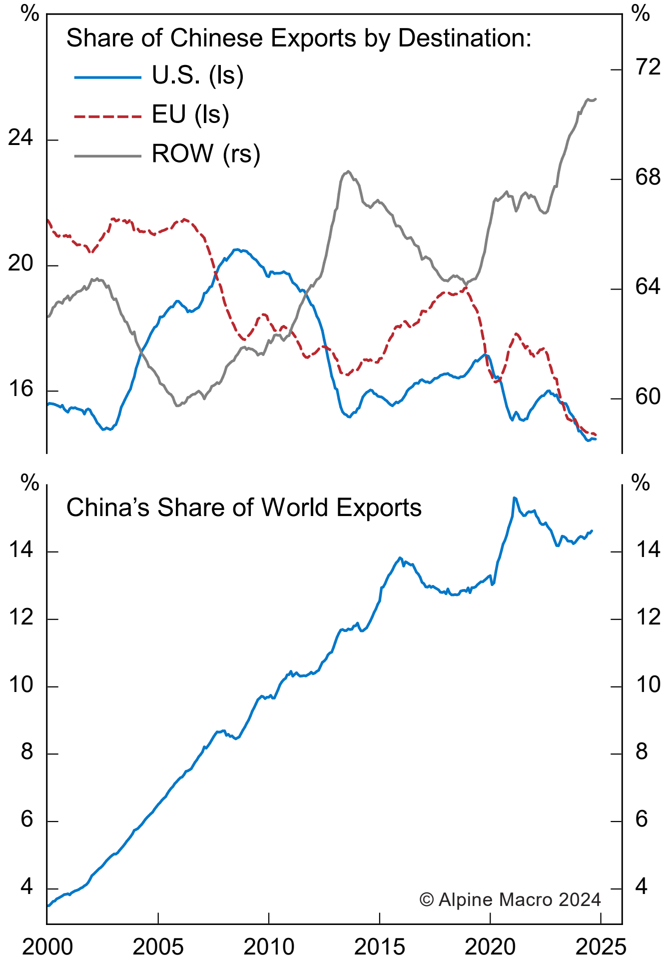
Third, tariff hikes will not eliminate the U.S. trade and current account deficit, which reflects the domestic savings-investment gap. As long as the U.S. government dissaves more than the private sector saves, the current account and trade deficit will persist. Targeting certain countries with heavy import duties will merely shift the composition of the trade deficit, rather than eliminating it.

Fourth, as long as the world can avoid a 1930s-style trade war, the impact of the trade tensions in today's monetary and financial system should not be exaggerated. There are many coping mechanisms to deal with tariff hikes – currency deprecation, tax rebates and non-tariff incentives for exporters. Central banks can also ease aggressively to compensate for the drag from higher foreign tariff rates. It is very different from the gold standard where a tariff hike means an immediate reduction in real income, either from higher import prices or from lower trade/income flows.

Fifth, concerns that trade wars will drive inflation are misplaced. Inflation stems from sustained excess demand, while tariffs represent a relative price shock akin to a VAT hike – a one-time event. Besides, foreign currency depreciation can offset tariff-induced price increases for the importing nation, neutralizing inflationary impacts. In short, a tariff hike may cause a one-time spike in import price inflation, but this increase is transitory. However, the change in price levels could be permanent.

Finally, China and other developing nations, the primary beneficiaries of globalization, will continue to champion it. China has reduced its reliance on U.S. and European trade (Chart 14), redirecting efforts toward Asia, Latin America, Africa, or the so-called Global South.

Chart 14 China Has Been Diversifying



Note: All series are shown as 12-month moving average

Whether China can form a new free trade bloc to counter U.S. protectionism, or whether such efforts will exacerbate tensions with Washington, remains a long-term question with significant market implications. For now, it seems that both are happening, and therefore, we will see more U.S.-China economic decoupling in 2025 and beyond.

In sum, with Trump returning to the White House, global trade relations will grow more volatile and unpredictable. However, the world has gained experience in navigating Trump's trade style, and financial markets seem to believe that the positives from Trump's economic policies outweigh the negatives from his trade policies.

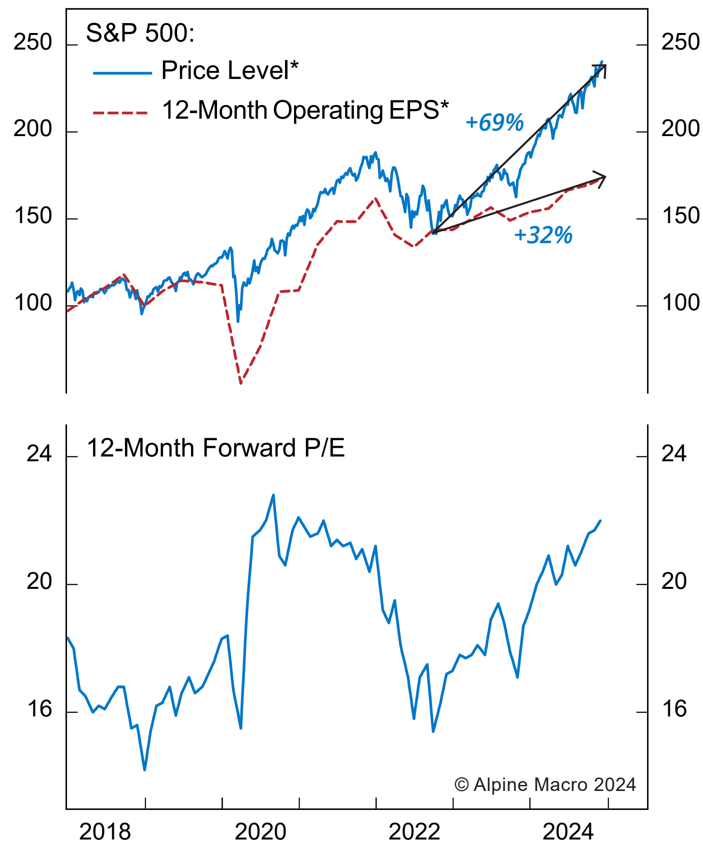
U.S. Equities In 2025: Correction First, New Highs Later?

To put the bull run in stocks into perspective, the S&P 500 index has risen 69% since its 2022 lows, while operating earnings have increased 32%. So far this year, per-share earnings have risen 13%, while stocks are up 29%.

In other words, there has been a sizable P/E expansion over the last two years, with a significant portion of the multiple increase taking place in 2024 (Chart 15). Therefore, the U.S. equity market has been front-running policy shifts that have not yet occurred, in addition to many potential positive developments in the economy.

Going forward, economic fundamentals and the policy environment remain bullish for U.S. equities, making it more likely that the bull market in stocks will persist rather than end in 2025. However, there are emerging signs of price exhaustion in the U.S. equity market in the near term, signaling potential corrections of unknown duration and magnitude.

Chart 15 U.S. Stock Market: Prices, Earnings & Multiples



*Rebased to Jan 2019=100

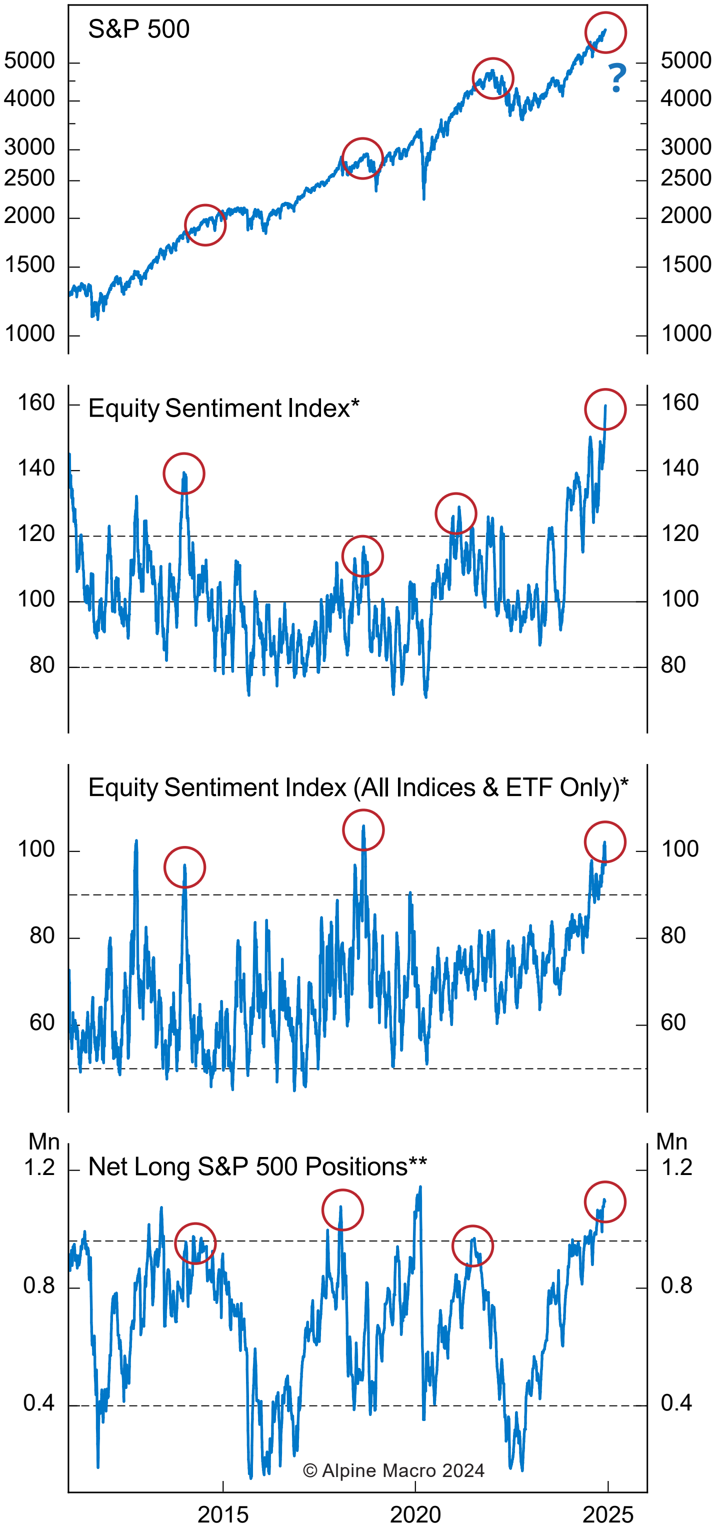
In a nutshell, expect turbulence in the first half of 2025, followed by new highs.

Market Indicators

There are several reasons why the current bull run in U.S. stocks may lead to a corrective phase.

First, financial markets have already discounted many positives. For prices to continue rising, the market will need validation through actual policy shifts — a "show me the money" moment. These changes may not occur as quickly as markets have anticipated.

Chart 16 Market Indicators



*Shown as 4-week moving average
**Asset Manager/Institutional
Source: International Security Exchange, CFTC

Second, most measures of equity market momentum indicate overbought conditions, and sentiment has turned excessively bullish. The VIX is at a very low level, and sentiment indicators are at a bullish extreme (**Chart 16**). U.S. equity ETF inflows have surged as the recent rally has emboldened retail investors to take on more risk. These factors typically signal an intermediate-term top in prices.

Third, portfolio positions are also at a bullish extreme. Virtually no institutional investors are underweight U.S. equities, with net long positions spiking to multi-decade highs. Our own investment surveys in recent months have also confirmed this.

It is difficult to pinpoint what might trigger a correction. Perhaps, while markets anticipate a tax cut, Trump might impose tariff hikes on U.S. trading partners first, unsettling investors. The perky inflation outlook might dissuade the Fed from cutting rates as much as the market expects, especially given the recent uptick in non-shelter core PCE inflation (**Chart 17**). Or a renewed selloff in bonds could upset stocks.

Whatever the reason, this is not the right time to deploy large amounts of fresh capital into the U.S. equity market, particularly with prices having just surged. Therefore, for those concerned with short-term portfolio performance, we recommend reducing equity exposure from an aggressive pro-growth 70/30 split between stocks and bonds to a more standard pro-growth 60/40 mix.

From a cyclical perspective, however, there are many reasons to believe the bull market remains intact. "Buying on dips" remains the appropriate strategy.

Chart 17 U.S. Inflation Is Perky

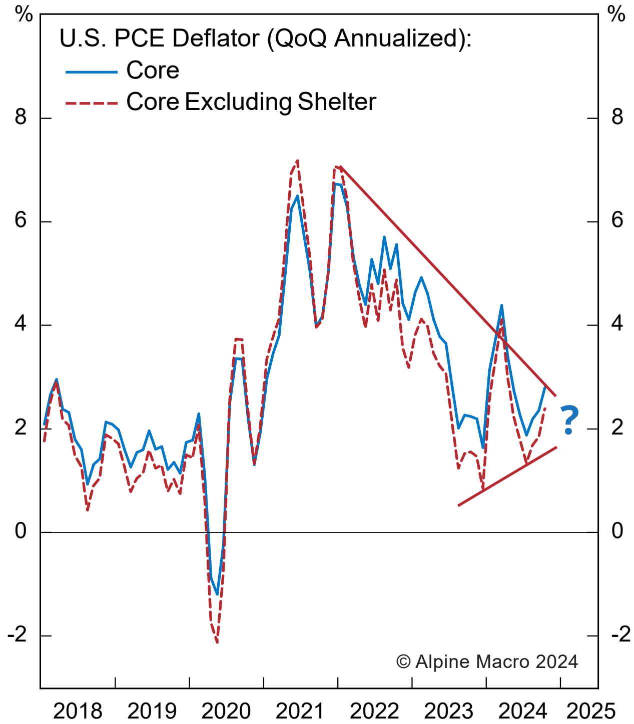
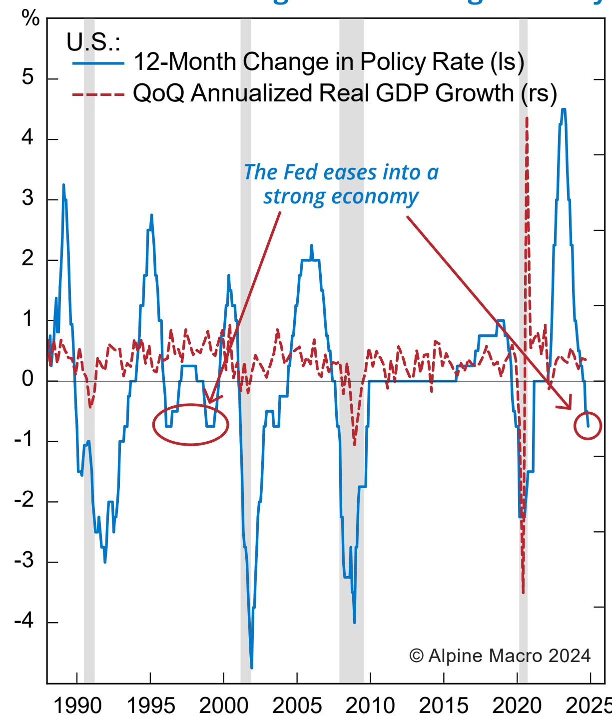


Chart 18 Today Versus The 1990s: Fed Easing Into A Growing Economy



Note: Shading denotes U.S. recessions

Market Fundamentals

We see a frothy environment for equities in 2025, driven by remarkable macro similarities to the second half of the 1990s when the bull market became parabolic, culminating in the dot-com bubble. These parallels include:

- The Fed eased into a growing economy in 1995, sparking an explosive equity rally that propelled technology stocks to new highs. We face a similar policy backdrop today (**Chart 18**), with the Fed having also eased into a strong economy.
- The internet boom of the 1990s and the artificial intelligence boom today (**Chart 19**) both represent transformative technologies that directly impact labor productivity. The recent rise in U.S. labor productivity growth may be linked to the broader adoption of AI.
- A globally divergent economy: In the 1990s, the U.S. was strong while Japan, Germany, and emerging markets struggled. Today, Europe and China are weak spots, while the U.S. economy is robust. This divergence drove up the dollar in the 1990s and is doing so again today.
- Market leadership and concentration: The 1990s stock market rally was led by the "Four Horsemen" – Intel, Cisco, Microsoft, and Dell, with these four stocks accounting for 15% of the market capitalization. Today's market is dominated by the "Magnificent 7" (Mag 7). Just as the "Four Horsemen" drove the 1990s bubble, the Mag 7 could do the same in the future.

Finally, Trump's deregulation and tax cuts could significantly impact the economy and stock prices. If Trump broadens his tax cut proposal to include

Chart 19 Technology Boom: Today Versus The 1990s

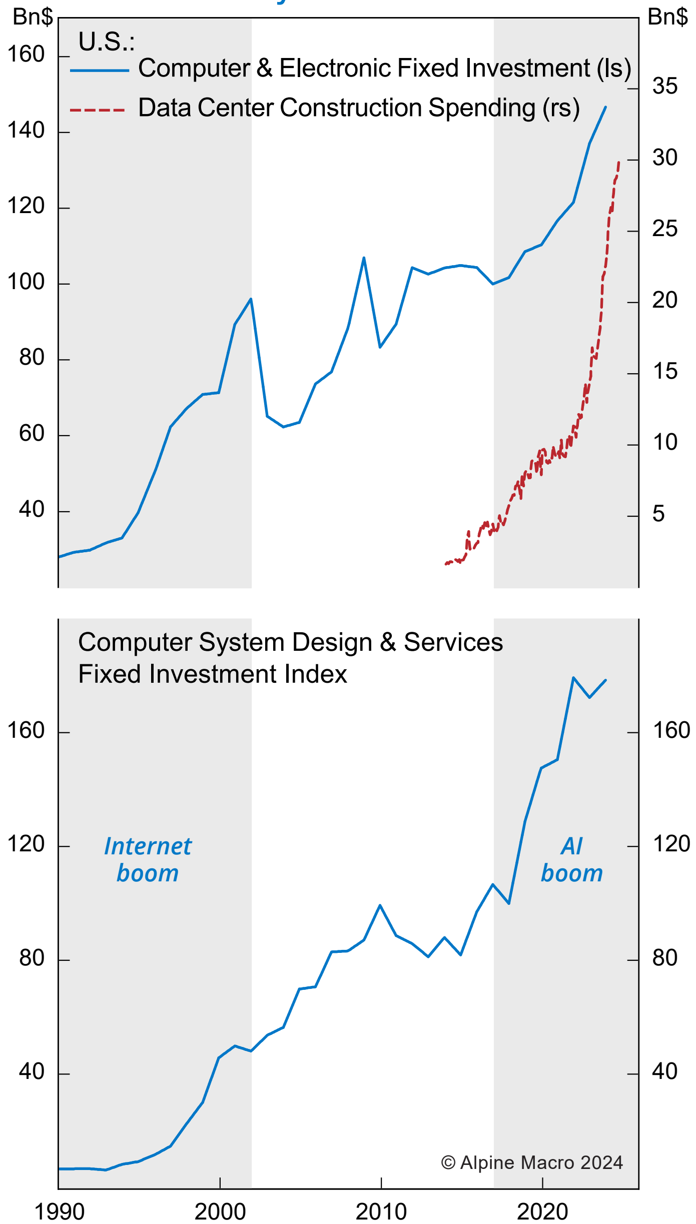
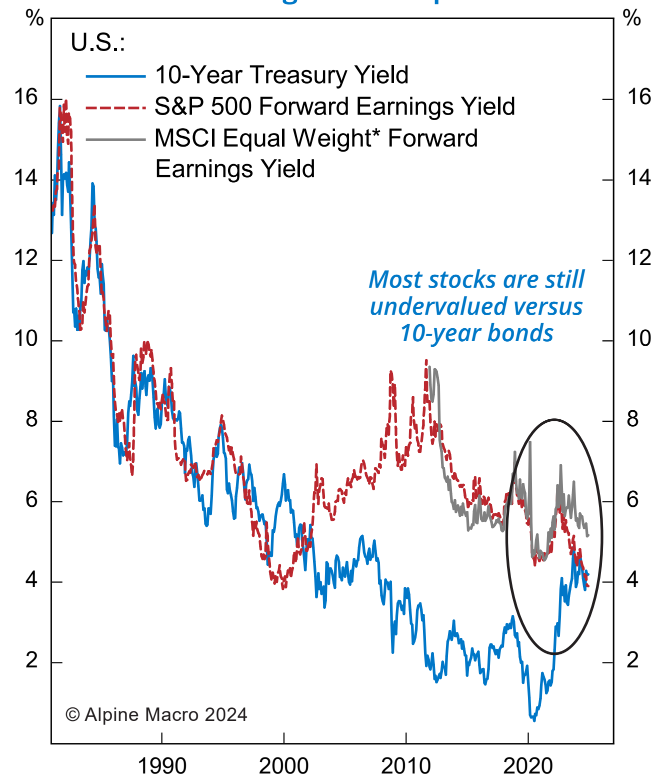


Chart 20 Stocks Versus Bonds: A Long-Term Perspective



*Mid & Large Caps

the entire corporate sector, reducing the corporate tax rate from 21% to 15%, it could boost EPS by 7.6%.

The market is currently projecting operating EPS of $290 by the end of 2025. A tax cut to 15% could push EPS to $312, reducing forward multiples to 19.2x based on estimated Q4 2025 earnings.

Although projections carry inherent uncertainties, the overarching point stands: economic policy profoundly affects the stock market, and Trump's proposals are largely pro-growth.

Bottom Line: We see striking parallels to the second half of the 1990s. This suggests the U.S. bull market could evolve into a bubble.

Currently, most stocks are trading at reasonable valuations. Chart 20 shows that the earnings yields for the equal-weighted equity index are still much higher than 10-year Treasury yields, suggesting that stocks are cheaper than the levels implied by long-term bond yields, based on historical correlations in the 1980s and 1990s. The cap-weighted index, however, seems to be fully priced because of high multiples of large-cap growth stocks.

Equity Allocation: Opportunities Still In The U.S.

Globally, U.S. equities are likely to outperform in 2025. The U.S. economy has proven more resilient than other G7 economies, and pro-business policies under the incoming Trump administration will further strengthen growth. No other major economy is expected to follow a similar policy trajectory.

While the U.S. equity market may seem the most expensive, Chart 21 shows that EAFE and emerging market equities trade at 40% and 50% discounts, respectively. However, the U.S. P/E premium reflects superior EPS growth, which has outpaced EAFE and EM by 106% and 160%, respectively, since 2010.

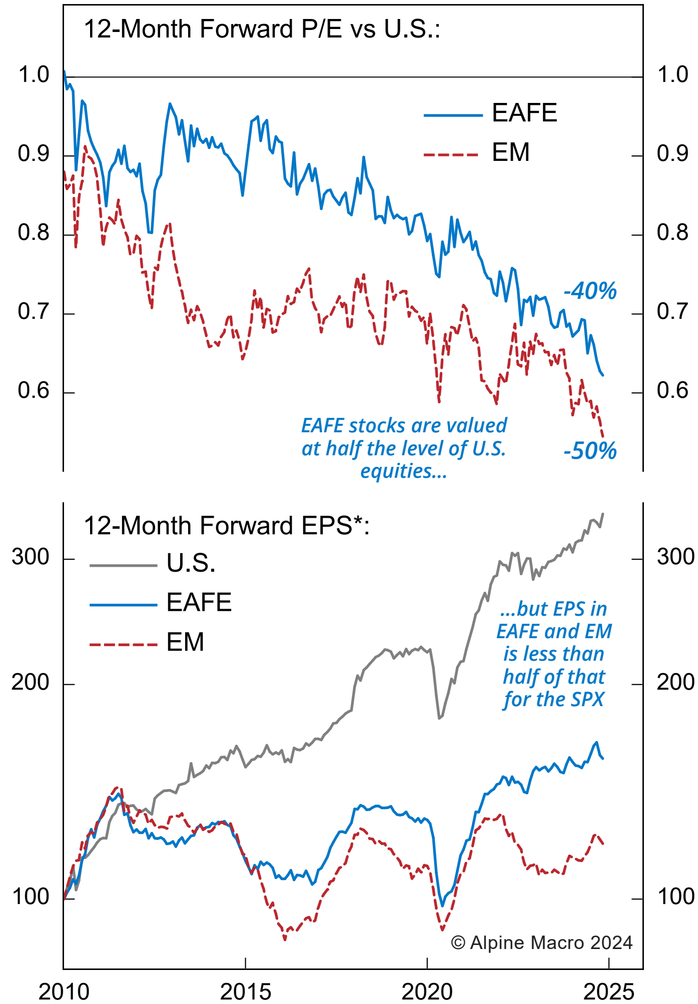
In other words, while EAFE and EM stocks appear cheaper and are worth only about half of what their U.S. counterparts are, their underperformance in earnings growth is also about 50%. This suggests that U.S. equities may not be pricier than their international counterparts.

Equity Strategy: Continue To Barbell Up

If our 2025 outlook proves accurate, investors should barbell their portfolios, combining large-cap growth stocks with value or small-cap stocks. Large-cap growth equities, as leaders of a potential bubble environment, have a proven record of earnings growth, strong balance sheets, and are well-positioned to benefit from the AI boom.

That said, growth stocks have been highly volatile. Adding financials or small-cap stocks can reduce portfolio volatility while offering exposure to sectors that could benefit from earnings broadening and

Chart 21 EM Versus EAFE Valuation & Earnings Picture



*Rebased to Jan 2010=100
Note: MSCI Mid & Large Caps for EAFE & EM, S&P 500 for U.S.

Trump's policies. Deregulation will support banks, while tax cuts and protectionism will favor small caps. Chart 22 shows both sectors have rallied recently, a trend that will likely persist into 2025.

Our *Equity Strategy* team also favors sectors aligned with domestic cyclicality, including Real Estate, Financials, Discretionary, and Industrials (Transports and Defense). These sectors should benefit from Fed easing and the potential for stronger economic growth in 2025.

Chart 22 Banks And Small Caps: Outperfomance To Continue

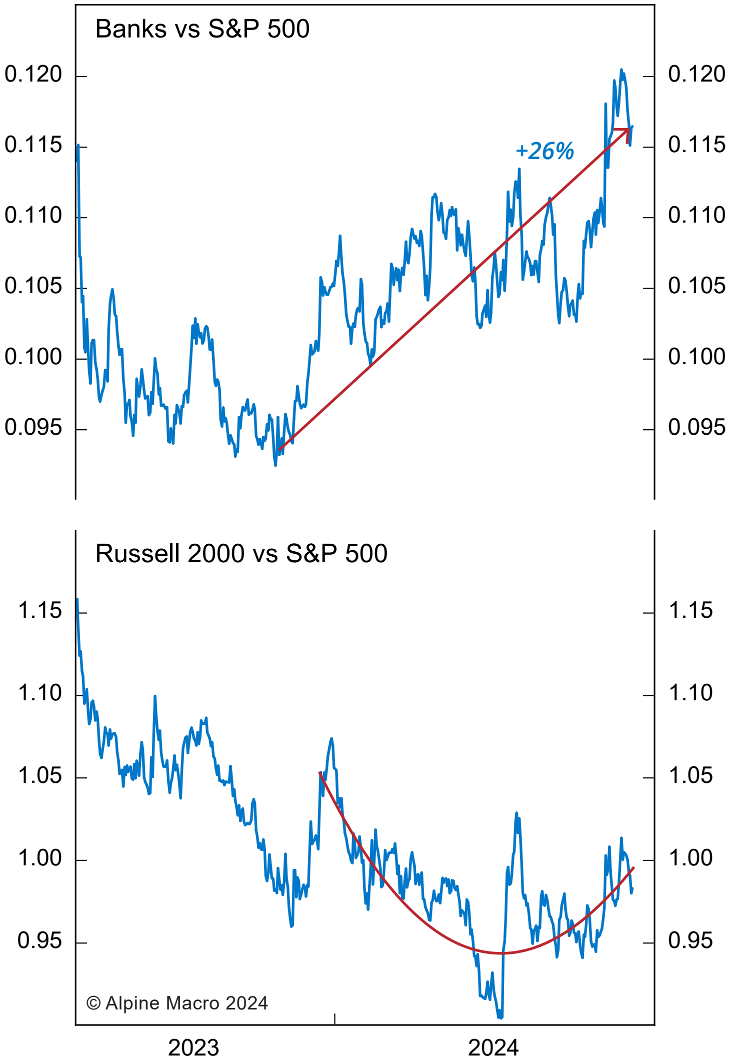
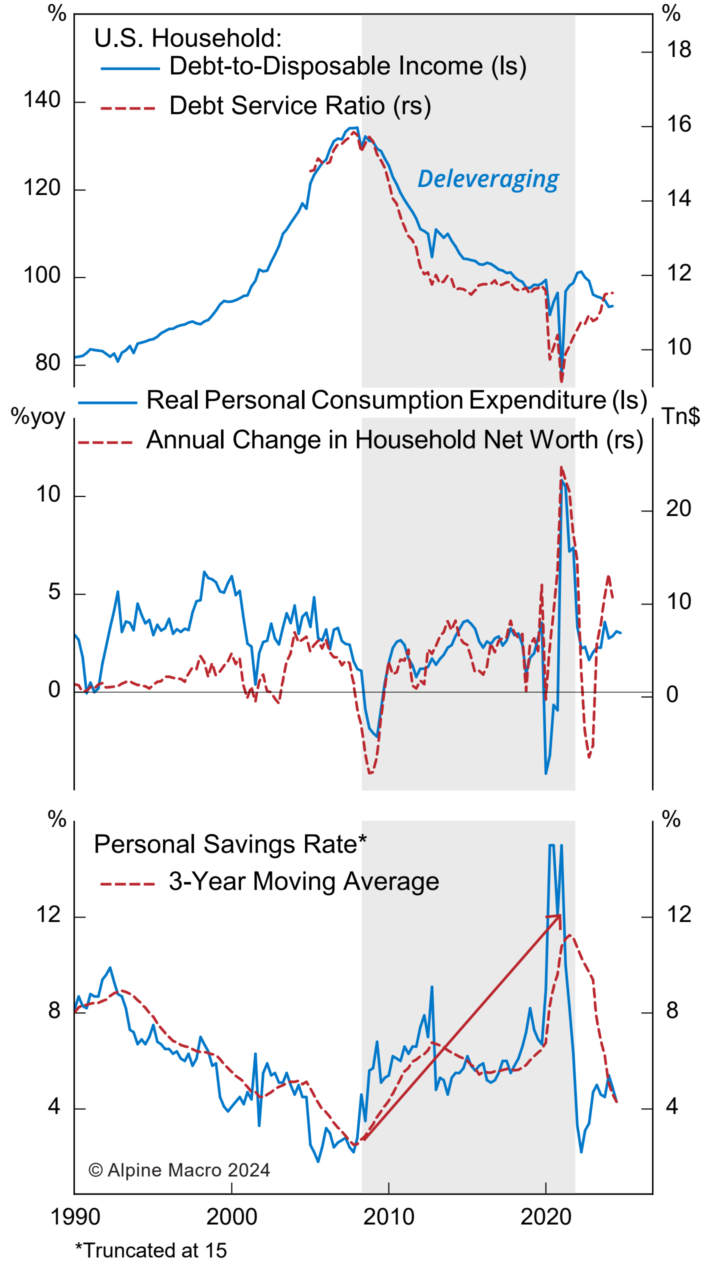


Chart 23 U.S.: The Case For A Higher R*



U.S. Fixed Income: A Higher R*

For 19 months, from March 2023 to November 2024, the U.S. economy operated in an environment where short rates were at or above 5%. Yet, there are no signs that the overall economy is about to fall over a cliff. Meanwhile, stocks have soared for more than two years, even as bond yields have stayed well above 4%.

The economic and financial market performance reveals that the U.S. economy's ability to cope with rising rates is much stronger than most anticipated. In other words, the steady-state interest rate, or the so-called R*, has risen. Several factors contribute to the higher R* since the pandemic crisis.

First, there is clear evidence of rising U.S. labor productivity growth. This is discussed extensively in previous sections. The key point is that higher productivity means higher growth potential and, therefore, a higher R*.

Second, the household deleveraging process, which has plagued the U.S. economy since the 2008 GFC, is over. U.S. consumers are no longer under pressure to save more and spend less to pay down debt. Soaring household net worth and a much-reduced debt load encourage consumers to spend more (Chart 23).

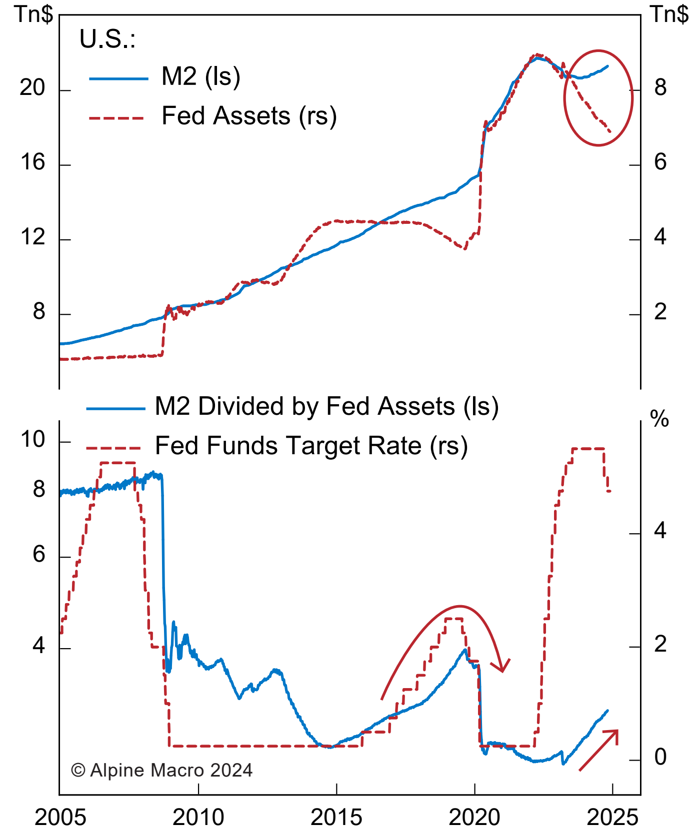
Third, the U.S. economy has broken away from the so-called liquidity trap. Classic signs of an economy stuck in a liquidity trap include zero interest rates and a wholesale collapse in the money multiplier. Nominal R* falls to zero in such scenarios. Chart 24 shows that the U.S. fell into a liquidity trap between 2008 and 2020.

The U.S. economy may have emerged from the liquidity trap in 2018, only to be abruptly disrupted by the pandemic crisis.

It is crucial to note that broad money supply has been accelerating since 2023, even though the Fed has been shrinking its balance sheet and short rates have been lifted far above zero. These are unmistakable signs that the U.S. has moved out of the liquidity trap, which, by definition, implies a higher R*.

Unfortunately, R* is not directly observable and can only be inferred by observing how the economy and financial markets respond to certain levels of interest rates. Our estimate is that it is about 4%, consisting of 2% steady-state inflation and 2% real economic growth.

Chart 24 U.S. Has Exited A Liquidity Trap



If this estimate is accurate, the Fed is unlikely to ease much next year, especially if the Trump administration pursues fiscal stimulus through tax cuts. If there is an economic boom with inflation proving stickier than expected, the Fed may need to resume hiking rates.

Regardless, there is limited upside potential for long-term bonds. We view current bond yields at 4.15% as very close to equilibrium.

If the Fed cuts rates to 4%, long bond yields should settle around 4.2-4.3%, with term premiums ranging between 20-30 basis points on top of short rates. If bond yields rise toward 5%, investors should add duration above the benchmark. Similarly, if yields fall toward 4% or lower, investors should reduce duration.

Chart 25 Overweight Bunds, Underweight JGBs

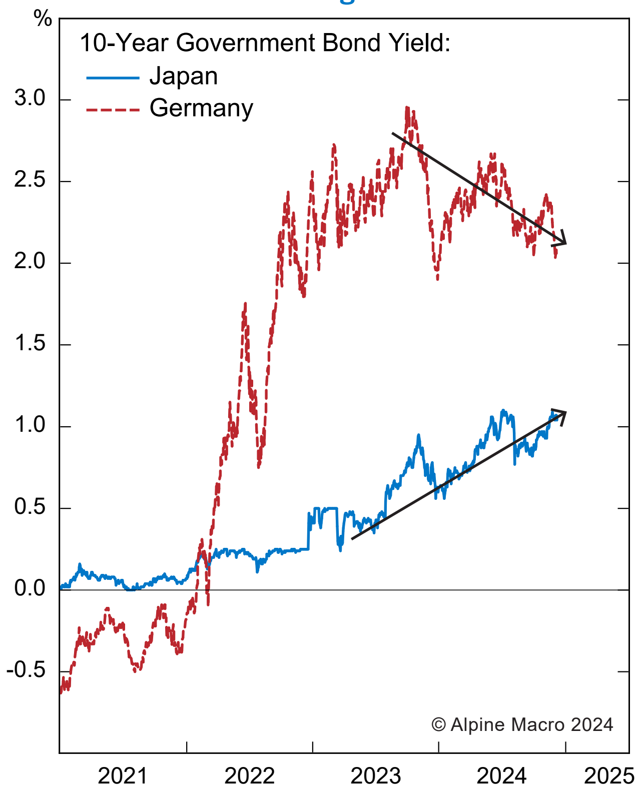
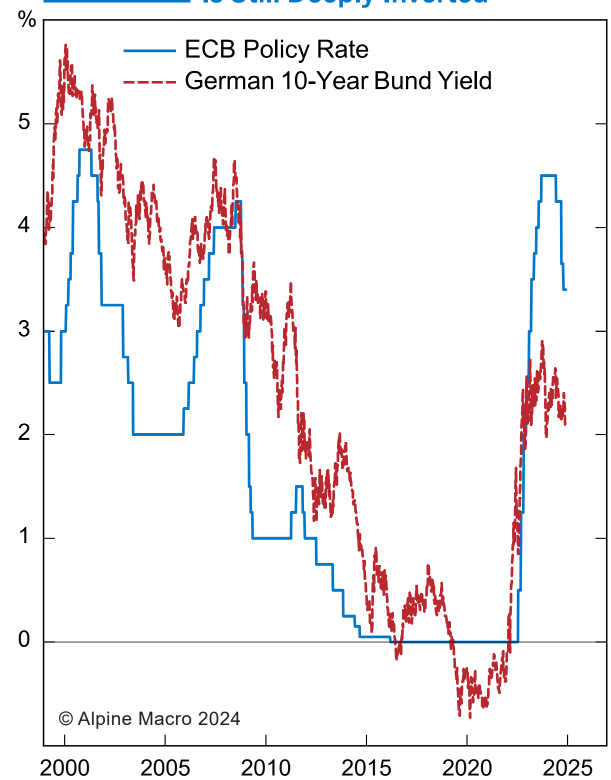


Chart 26 Germany: Yield Curve Is Still Deeply Inverted



Sovereign Bonds: Germany Versus Japan

German bunds represent the best buying opportunity among G7 sovereign markets, while Japanese JGBs are a long-term short or underweight. Alpine Macro has been long Germen bunds versus JGBs for some time, and there are more gains to be made heading into 2025 (**Chart 25**). Bond managers could overweight long-term German bunds to add duration.

Key reasons include the following:

Most euro area economies are constrained by the Maastricht Treaty, preventing them from providing the fiscal stimulus needed to offset the over-saving problem. Additionally, the ECB policy rate is far above 10-year bund yields (**Chart 26**), suggesting that substantial cuts in short rates are inevitable. This will pave the way for a large rally in German bunds.

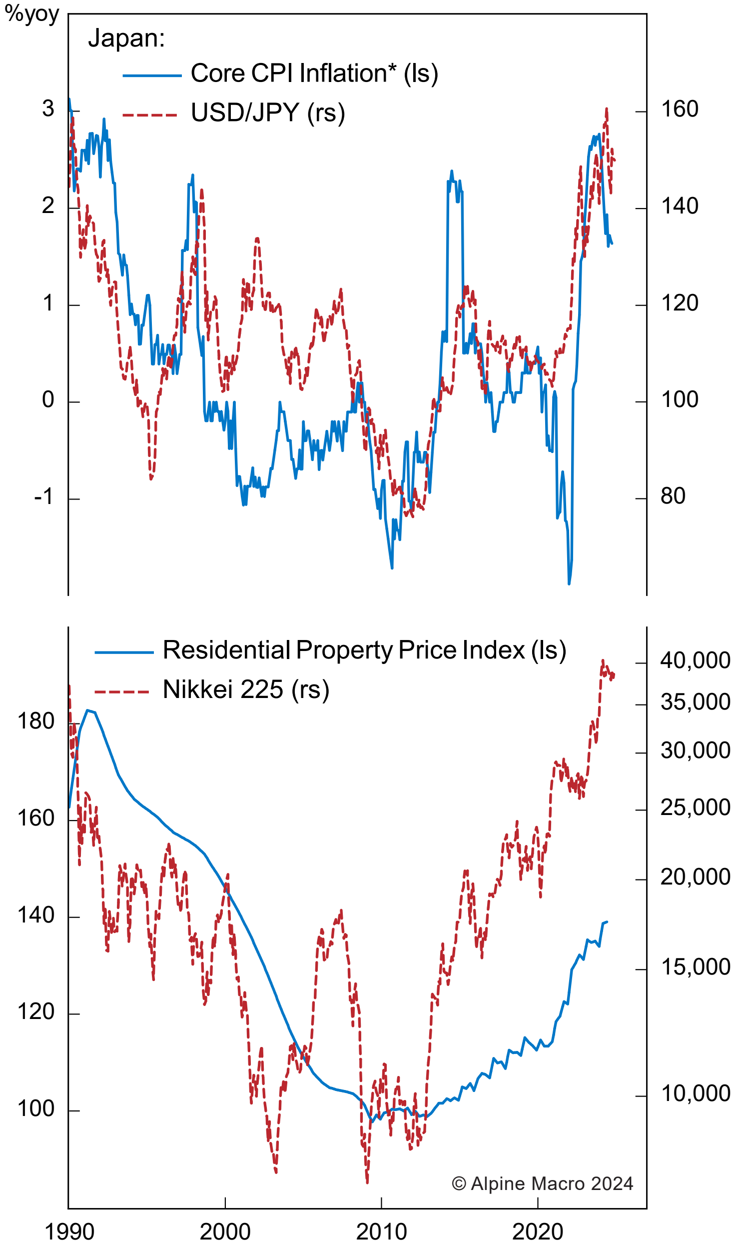
Japan, meanwhile, is undergoing a major experiment in "nominal reflation". This experiment, initiated by the late Prime Minister Shinzo Abe in 2013, involves the Bank of Japan (BoJ) printing large sums of money to devalue the yen and boost domestic CPI levels and asset values (**Chart 27**).

With the yen deeply undervalued and CPI rising, the central bank is likely to nudge rates higher, which will put downward pressure on the bond market.

U.S. Corporate Bond Strategy

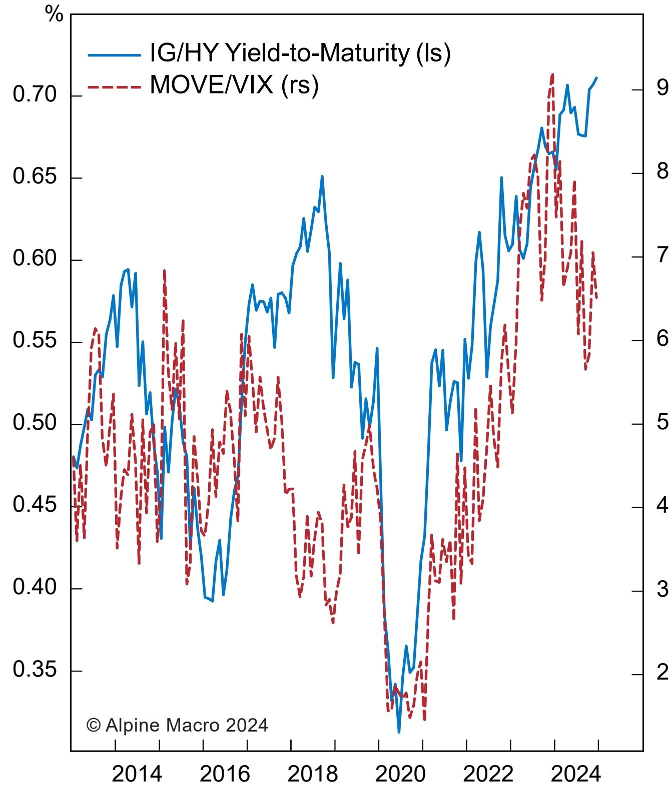
Relative-return fixed-income investors face challenges entering 2025. While the macro and policy backdrop are likely to remain constructive for spread products, much of the good news has already been priced in, and risky spreads are razor-thin, particularly

Chart 27 Japan Experiments With Nominal Reflation



*Excluding fresh food, energy, and tax effects

Chart 28 Favor IG To HY As A Trade



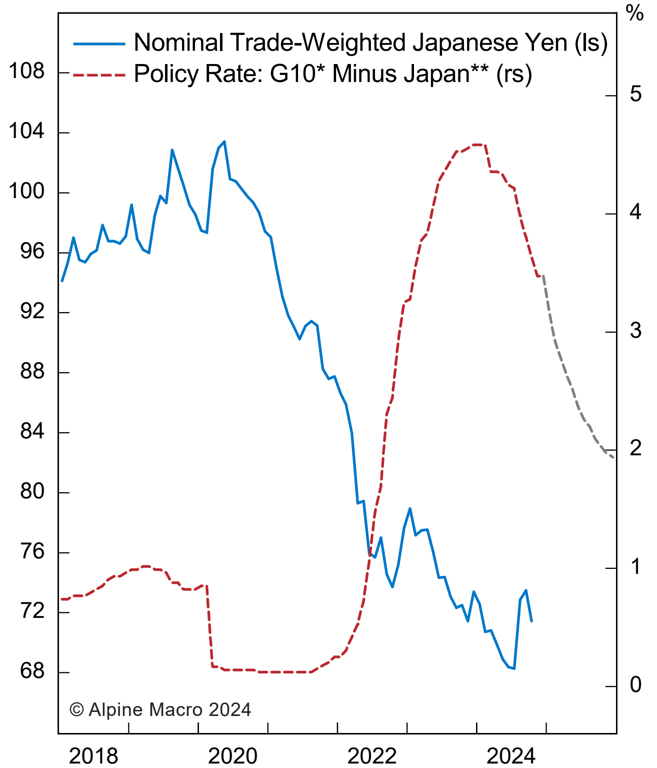
in corporate bonds. Spreads are at all-time tights for investment-grade issuers and approaching record levels in high yield. The market has entered bubble territory.

The favorable macro backdrop is offset by the reduced scope for Fed easing. Marginal borrowers will not benefit from significantly lower interest rates next year. This could impact lower-quality corporate bonds, non-Agency CMBS, and ABS as the year progresses.

Conversely, stabilization of mortgage rates, even at high levels, will benefit agency mortgage-backed securities as bond volatility declines. Implied bond volatility remains elevated both in absolute terms and relative to the VIX (**Chart 28**). A mean reversion in this gap would favor IG corporates over junk bonds.

The dollar has surged 6% since September when financial markets anticipated a Trump win. Although the dollar is now expensive, its strength is expected to persist through 2025, with the DXY likely moving above 110.

Chart 29 The Case For Being Short EUR/JPY



*Equal-weighted average of G10 excluding Japan
**Gray line denotes market expectations from OIS curves

The Trump administration's mix of higher tariffs and easier fiscal policy will likely bolster the dollar. Both USD/CNY and the DXY index trended higher from 2018 to early 2020 due to two factors:

1. Eased fiscal policy enabled the Fed to raise interest rates. The combination of looser fiscal policy and tighter monetary policy typically strengthens a currency.

2. Tariffs failed to address the fundamental savings and investment imbalance in the U.S. economy. As a counterbalance, the dollar strengthened, keeping imports attractive and exports less competitive, neutralizing the tariffs' effect on the trade balance.

Additionally, the U.S. has the least excess savings among G7 economies, giving it the best growth profile. Interest rate differentials between the Fed and other central banks make shorting the dollar prohibitively expensive.

The euro is likely to weaken, with a break below parity possible. The eurozone economy is nearing recession, and higher U.S. tariffs will hit European exporters. Easier monetary policy and a weaker euro will be needed to support the economy.

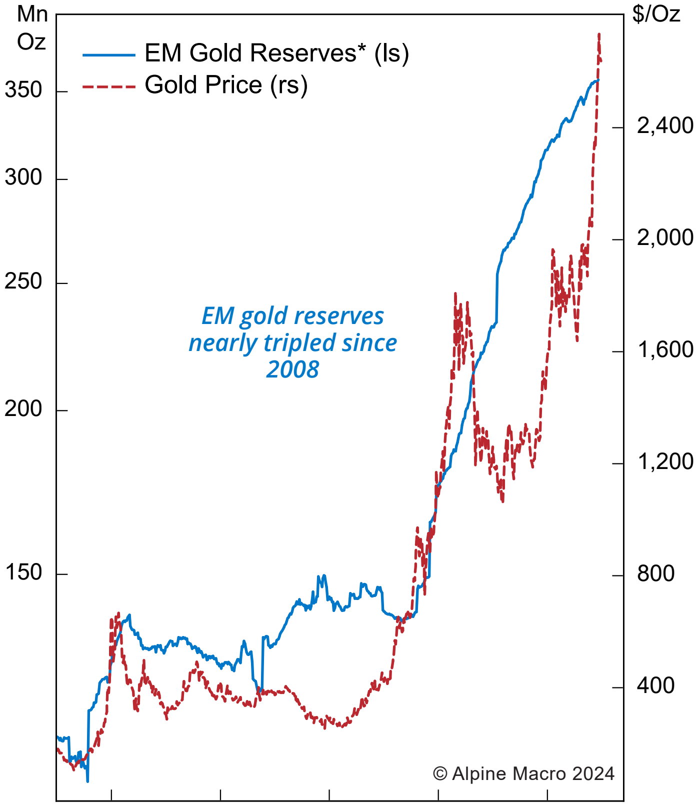
The Japanese yen, however, may remain resilient against a strong dollar. Its undervaluation suggests recovery potential, with the BoJ being the sole G10 central bank hiking rates (Chart 29). Shorting EUR/JPY looks particularly attractive, benefiting from declines in both EUR/USD and USD/JPY.

Commodities: Diverging Trends In Crude, Gold, And Industrial Metals

The macro backdrop for commodities will continue to diverge, and investors can no longer take a simplistic approach to generalize market trends. We believe crude oil and gold are being driven by unique forces, while general materials prices will be dictated by other economic factors.

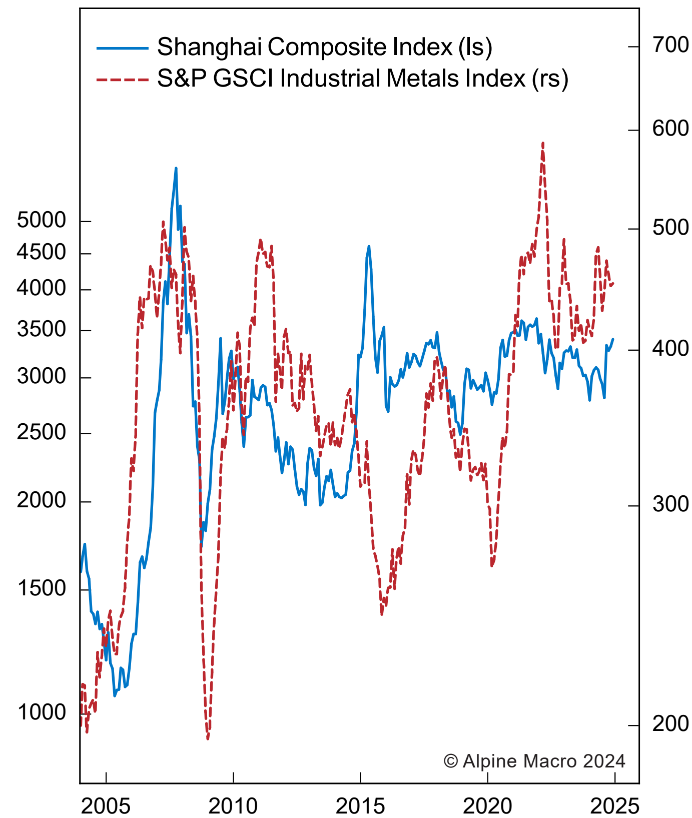
Crude oil prices will likely drop in 2025. The Trump administration is expected to deregulate the fossil fuel industry and encourage increased oil production. The Treasury Secretary nominee, Scott Bessent, has a well-known "3-3-3" plan, one component of which is to increase crude production by 3 million barrels per day.

Chart 30 Bullish Case For Gold



*Source: IMF

Chart 31 The Industrial Metal-China Connection Remains Visible



The U.S. remains the largest oil producer and the most important swing supplier in the crude market. With the Trump administration focused on cheap energy to fuel economic growth, the odds are high that crude oil prices will trend downward.

Additional negatives for the crude oil market include a strong dollar, a soft Chinese economy, and a continued slump in global manufacturing.

Gold prices will likely continue to advance. Gold demand remains high due to central bank purchases, ongoing wars, and geopolitical tensions. **Chart 30** highlights that most gold purchases since 2008 have come from central banks in developing countries.

Since the Russia-Ukraine war, there has been heightened apprehension among the Global South that the West can easily weaponize the dollar and the financial system for geopolitical purposes. This fear has fueled central bank demand for bullion.

Gold continues to be viewed as a safe-haven asset. During times of intensifying geopolitical strife, gold prices typically rise.

For other industrial commodities, developments in China and trends in the dollar will be key factors. **Chart 31** highlights the close correlation between industrial metals and Chinese share prices. Historically, the dollar has also played a significant role in the commodities market, but in recent years, the correlation has weakened: the dollar has soared while commodity prices have remained flat (**Chart 32**).

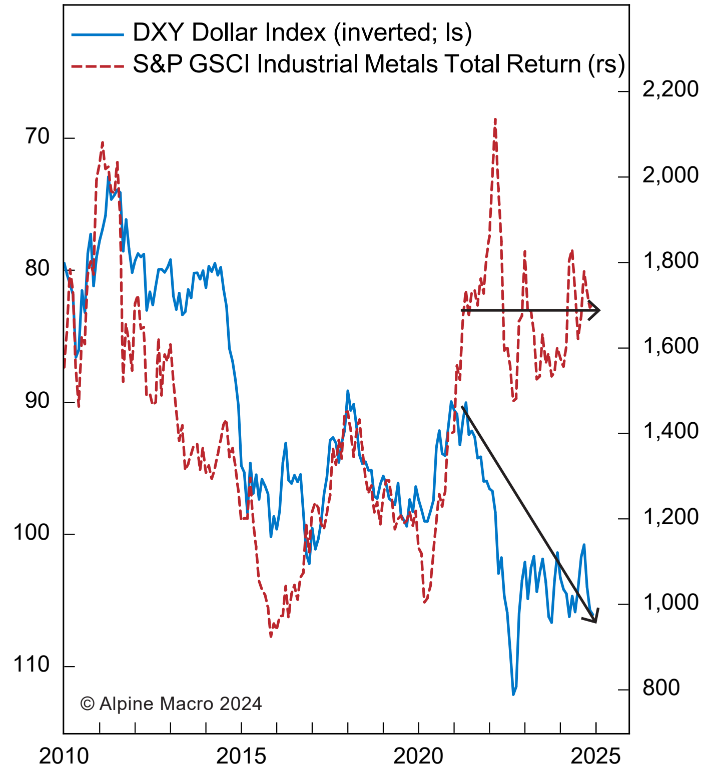
We believe industrial commodities are likely to remain range-bound. Beijing is unlikely to implement significant fiscal stimulus to engineer a sharp economic rebound. Instead, the Chinese government will likely continue pursuing incremental measures to prevent a catastrophic economic decline. As a result, Chinese demand growth for commodities will probably flatten.

Of course, if Beijing changes tactics and adopts a more aggressive reflation and stimulus strategy, we will reassess this outlook. For now, industrial commodities, such as copper, are expected to remain range-bound.

Chen Zhao
Chief Global Strategist

On behalf of the Alpine Macro Research Team

Chart 32 Changing Correlation Between The Dollar And Commodities



Investment Recommendations						
Tactical Investment Positions (3 - 6 months)						
Recommendations	**Open Date**	**Open Levels**	**Stop**	**Closing Date**	**Closing Levels**	**P&L Since Inception**
Long U.S. Regional Banks (ETF: KRE)	12/04/2023	48.12	Rolling -8%	-	-	42.7%
Long U.S. Financials (ETF: IYF)	08/19/2024	101.30	-	-	-	15.9%
Long Russell 2000 (ETF: IWM)	08/19/2024	215.20	-	-	-	11.4%
Long 10-Year German Bunds/ Short 10-Year JGBs	10/07/2024	2.3%/0.93%	-	-	-	2.6%
Short Brent Oil	10/22/2024	76.00	-	-	-	6.4%
Long Gold (ETF: GLD)[1]	12/09/2024	-	-	-	-	18.9%[2]
Stop-Sell EUR/JPY[3]	-	-	160	-	-	-

Note: P&L is calculated using daily closing prices.
[1] We are initiating an outright buy for Gold (ETF: GLD).
[2] Return is calculated based on a continuous long position, first initiated on 04/01/2024 and stopped out on 11/11/2024.
[3] We are initiating a stop-sell for EUR/JPY at 160.

A Unique Mind On The Markets