SECULAR OUTLOOK

Economic and investment trends shaping the current decade

Marketing material
Publication date: 29 November 2024, 10:00 CET
Please find important legal information at the end of this document.
Source: Bank Julius Baer & Co. Ltd. (Julius Baer), unless explicitly stated otherwise.

Julius Bär

Contents

Editorial: Trends confirmed 4

Historical secular trends 7

Key macroeconomic trends 9

- Multipolarity and strategic reshoring 10
- Active industrial and fiscal policies 12
- Interest rate normalisation 14
- Innovation super cycle 16
- China's balance sheet recession 18

Key capital market trends 20

- Store-of-value equity markets 21
- Out-of-system assets 22
- USD capital markets 24
- Nasdaq+ 26

Key risk factors 28

Important legal information 30

Editorial
Trends confirmed

Dear Reader,

A look at capital market history reveals that leadership often transitions from one decade to the next, driven by economic and political events that shape the asset class performance hierarchy. It is therefore crucial to periodically reassess the gravitational forces in the system that result in structural trends, bearing in mind that they typically take a few years to emerge. The early 2020s were marked by two major external shocks: the Covid-19 pandemic and the war in Ukraine. These events led to supply disruptions, which significantly impacted Western economies and blurred the line between cyclical effects and structural changes. In 2024, we have witnessed the normalisation of many economic variables, notably inflation and growth, clearing the path for monetary policy easing in the US and Europe. After careful analysis, we have concluded that the secular trends we projected at the end of 2023 can now be confirmed.

The world will remain multipolar in 2025, and active industrial and fiscal policies will continue to steer economies in a context of strategic reshoring, as is evidenced by the increasing number of large government spending programmes in the US, Europe, and China. China has reached the point where the government is prepared to intervene to counter the deflationary forces affecting its private sector, yet high savings and weak domestic demand may persist, keeping the country in a balance sheet recession for much of the decade. Moreover, the innovation super cycle theme remains valid, with a broadening of the sectors that will benefit from advances in artificial intelligence (AI). Finally, the best performances since the start of the decade remain attributable to US assets and out-of-system assets. We have reintroduced a strategic allocation to gold in portfolios because of the structural demand from non-Western investors for liquid assets that diversify their portfolios away from those assets that are potentially at risk of Western government sanctions.

While state-sponsored capitalism still has a strong foothold throughout the global economy, green shoots of a backlash against big government have emerged, notably in Argentina, under Javier Milei, and most recently and crucially in the US. Indeed, the current consensus that the second Trump administration will increase deficits and reignite inflation seems dangerously simplistic. Trump's appointees, including Elon Musk and Vivek Ramaswamy to the new Department of Government Efficiency and Scott Bessent as Treasury Secretary, signal that we may be at the dawn of a radically new era in US economic policy, one focused on libertarian principles of small government and deregulation. This is in stark contrast to Europe, where the median voter still demands more government intervention. At the very least, it will be interesting to see how the ambitions of the incoming Trump administration translate into policy. Uncertainty about the policy outcomes and the equilibrium price of assets has rarely been greater.

The other main change over the past 12 months has been the decline in expected returns in the main asset classes due to the combined effect of falling long-term interest rates and the compression of risk premia. Indeed, we have come a long way in financial markets since a year ago. Except for crude oil and some commodities, all key asset classes delivered positive returns over the period, with gold leading and the Nasdaq 100 and S&P 500 following closely behind (see chart 1). Meanwhile, US interest rates have fallen across the entire maturity spectrum. Against this backdrop, future return expectations have dropped considerably.

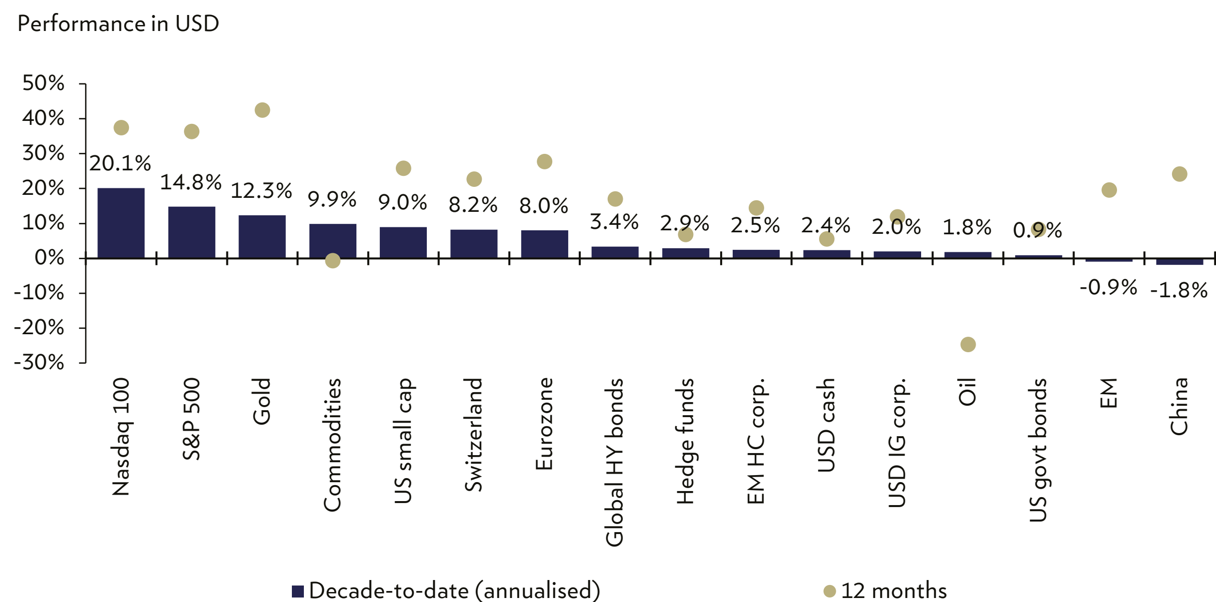
Current market pricing reflects a benign macroeconomic outcome across almost all asset classes. We

view investing as a relative exercise and therefore focus on relative rather than absolute valuation metrics. From a yield perspective, relative to long-term US Treasuries, US equities are less attractive than they have ever been since the Global Financial Crisis. The free cash flow yield advantage of large-cap US equities relative to the yield on 10-year US Treasuries has disappeared. Ultimately, however, the relative race between the two asset classes will largely depend on future inflation. The risk of supply shocks is structurally higher in a multipolar world where the peace dividend has morphed into a conflict tax. As a result, we expect US inflation to settle at a higher average of 3% rather than 2% over this decade, coupled with higher volatility around that level. So while government bonds may look attractive from the outset, equities remain our preferred asset class strategically, which is in line with our fundamental view that real assets should outperform nominal claims in such an environment – as they have indeed done so far this decade (also illustrated in chart 1).

A pivotal element in post-World-War-II financial market history is the succession of secular US over- and underperformance cycles. Secular US equity bull markets have been underpinned by major technological innovation cycles, such as the personal computer and the internet from 1982 to 2000. Since 2009, the US has been in another secular bull market, which was initially propelled by smartphones and their ecosystems. More recently, however, applications supported by generative AI, particularly large language models, have paved the way for an extension of the primary secular uptrend for large-cap US equities.

Until 2024, leading US information technology (IT) stocks, with their historically unparalleled return on invested capital and record free cash flows, were chronically undervalued, as investors did not believe in the sustainability of their free cash flows. This is no longer the case, and today the valuation of the major digital platforms reflects the prospect of a continuation of the historical growth and free cash flow generation trends. The shift from a technology cycle to a commodities cycle, and thus from a secular US bull to a US bear cycle, typically occurs alongside a US recession (e.g. 1974, 1983, 2001, 2008). Until such a recession materialises, it is likely that the

Chart 1: Decade opportunity set – total return of key asset classes in USD since the start of the decade



Source: Macrobond, Bloomberg Finance L.P., Julius Baer
Note: Data as at 30.09.2024. HY = high yield; EM = emerging markets; HC = hard currency; IG = investment grade; corp. = corporate bonds; govt = government. Past performance and performance forecasts are not reliable indicators of future results. The return may increase or decrease as a result of currency fluctuations.

trends in force since 2009 will continue, although with a reduced amplitude due to current absolute valuation levels.

Finally, I would like to say a few words about private markets. In 2019, on the cusp of the current decade, we suggested that public markets would outperform private markets during the 2020s. The strong growth of assets under management in illiquid funds during the last phase of financial repression through to 2021 suggested that returns might turn out to be lower than expected for private assets. More recently, private equity portfolios have had mixed fortunes. The interest rate normalisation shock of 2022/2023 has had an impact that is beginning to be felt on the performance of diversified private equity portfolios. At a time when developed market public equities are at all-time highs, the short-term comparison is particularly striking.

Nevertheless, private assets offer a welcome diversification from traditional asset classes. Moreover, given the size of assets under management, investors cannot afford to dismiss private markets altogether. However, to achieve attractive net returns, accounting for the illiquidity premium that unlisted markets warrant, investors must allocate to asset managers in the top performance quartile. As in public markets, the sum of the parts of a portfolio is greater than its individual parts. Fund selection and diversification across different vintage years (i.e. the calendar year in which a fund was launched or raised capital from investors) are crucial. Open-ended or evergreen private debt and private equity funds, which were considered rare a decade ago, are becoming increasingly popular. For the first time, we will be able to objectively compare the returns on these strategies with those of liquid asset classes, thus enriching our investment toolbox.

We hope you will enjoy reading the 2025 edition of the Julius Baer Secular Outlook and that it serves as a useful guide for your investment decisions.

Yours faithfully,

Yves Bonzon
Group Chief Investment Officer
Member of the Executive Board

Historical secular trends

An overview

Every decade is characterised by a different economic and investment environment in which capital markets are shaped by structural socio-economic forces. As a result, some asset classes outperform while others lag behind, and market leadership tends to change from one decade to the next. We should also bear in mind that such periods of dominance can be longer or shorter than ten years.

Chart 2: Historical secular trends

	1960s	1970s	1980s	1990s	2000s	2010s	2020s*
Era	Bretton Woods	Neoliberal era (globalisation, financialisaton, digitalisation)					State-sponsored capitalism
What happened	Bretton Woods	Floating exchange rates Oil shock The Great Inflation	Falling inflation Plaza Accord currency agreement Deng Xiaoping's China reforms	Fall of the Berlin Wall Globalisation Internet Electronic trading	European Economic and Monetary Union Great global imbalance China's rise Structured credit	Managed deleveraging in Western countries Shift from inflation to asset-price targeting Emerging market divergence EUR crisis	Multipolarity and strategic reshoring Active industrial and fiscal policies Interest rate normalisation Innovation super cycle China's balance sheet recession
What profited	US Nifty-Fifty stocks: 50 most popular US large-cap stocks	Small caps Oil stocks Gold, CHF, and JPY	Government bonds Nikkei Index Hong Kong equities	Index funds Nasdaq Swiss stocks USD	Hedge funds Emerging market equities Commodities EUR	Developed market quality equities Private equity High yield 60/40 FAANMG USD	Store-of-value equity markets Out-of-system assets USD capital markets Nasdaq+

Source: Julius Baer
Note: Bretton Woods was established in 1944 and became fully functional in 1958; the Berlin Wall fell in November 1989; European Economic and Monetary Union refers to the launch of the euro; 60/40 = 60% equities/40% bonds; FAANMG: Meta (formerly Facebook), Apple, Amazon, Netflix, Microsoft, and Alphabet (formerly Google). * Julius Baer projection

Key macroeconomic trends

Multipolarity and strategic reshoring

As evidenced by the current wars in Ukraine and the Middle East, geopolitical rivalries have returned with a vengeance in the last few years, extending well beyond a strategic confrontation between the US and China. The new geopolitical landscape is complex and fragile, as countries driven by national interests tend to deviate opportunistically from seemingly strong alliances. With the peace dividend having run out, we expect strategic reshoring initiatives focused on critical supplies to continue.

For much of the second half of the last century, the US and Soviet superpowers battled for global supremacy. With the dissolution of the Soviet Union in 1991, this battle was eventually settled, and the Cold War came to an end, giving way to a unipolar world order with the US as the undisputed hegemon. In the ensuing post-Cold-War period, the global economy benefited from the so-called 'peace dividend'. The decline in political and macroeconomic uncertainties allowed for a greater degree of globalisation, which reduced inefficiencies, dampened inflationary pressures, and ultimately strengthened economic prosperity globally.

Since the Russian invasion of Ukraine in February 2022, however, it has become painfully clear that the peace dividend has run out. Today's world order is fundamentally multipolar, with more and more countries choosing to opportunistically prioritise their own national interests rather than habitually adhere to one bloc or another. The number of countries involved in interstate conflicts is on the rise again after a relatively quiet last decade, with the escalation of violence in the Middle East being the most recent tragic example. This paradigm shift is also evident in military spending, which has risen relentlessly since the mid-2010s. Geopolitical confrontation as a permanent condition is fertile ground

'Today, as protectionist measures proliferate, the global economy is subject to fragmentation. However, the idea that multipolarity means the end of globalisation is clearly misleading.'

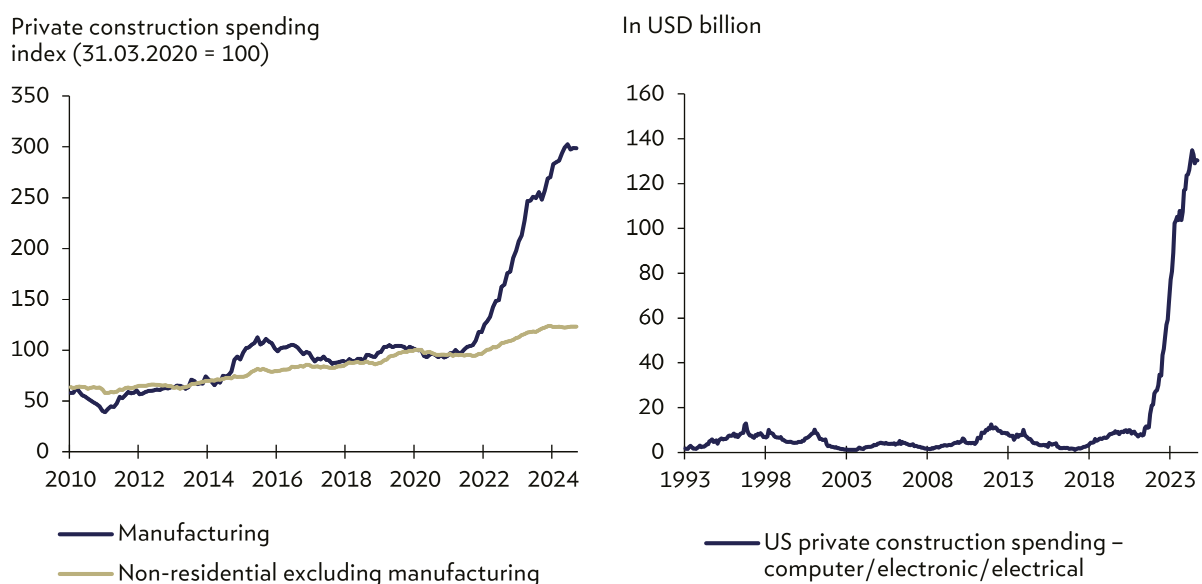
Yves Bonzon, Group Chief Investment Officer

for mishaps, because the more actors there are, the harder it is to predict their behaviour towards each other. As a result, the risk of supply shocks is structurally elevated.

Today, as protectionist measures proliferate, the global economy is subject to fragmentation. However, the idea that multipolarity means the end of globalisation is clearly misleading. It is true that the number of trade restrictions globally continues to increase, but global superpowers cannot expect stable alliances among states to push in the same direction to enforce tariffs or quota restrictions. On the contrary, individual third countries would rather help to circumvent such frictions, thereby facilitating indirect trade between the global superpowers. Indeed, China has increased its foreign direct investment in intermediaries, such as Vietnam and Mexico, in order to gain access to the US market through non-aligned countries. Put simply, trade wars do not work in a multipolar world.

More generally, global supply chains are too intertwined, complex, and mutually profitable for countries to fully rebalance their operations. The exceptions are sectors deemed as critical to national security, such as IT – which can be weaponised – or energy. The latest US construction data suggests that strategic reshoring activities are well underway, as manufacturing facility construction in the computer, electronic, and electrical industries has increased sharply in recent years (see chart 3). In these sectors, we are likely to continue to see government policies designed to reshore supply chains and increase resilience, as well as curtail the efforts of non-aligned competitors to thrive. For investors, this means that political and geopolitical factors will increasingly overtake endogenous market signals, resulting in increased macroeconomic and financial market volatility.

Chart 3: The US is ramping up manufacturing construction, particularly in strategically important sectors



Source: US Census Bureau, Bloomberg Finance L.P., Macrobond, Julius Baer
Note: Data is as at 30.09.2024 and has been seasonally adjusted.

Active industrial and fiscal policies

Supercharged by two major external shocks, fiscal policy has taken centre stage in the management of economic cycles in the early 2020s. Active industrial and fiscal policies are central elements of state-sponsored capitalism, whose future scope and reach are likely to diverge across regions. More fundamentally, the appetite for fiscal activism is amplified when geopolitical collisions become the new norm rather than the exception.

With the transition to the current decade, there was a significant paradigm shift in how economic cycles are managed. Prior to this, dating back to the 1980s when Ronald Reagan and Margaret Thatcher led the charge towards neoliberalism, large-scale government intervention was viewed as ineffective and undesirable. For the record, in the neoliberal era, monetary policy was a tool for fine-tuning economic cycles, while fiscal stimulus was used only to smooth out economic downturns. However, in recent years, fiscal policy has been used procyclically by design, under the guise of addressing structural problems in advanced economies, such as record inequality, ageing demographics, and stagnant growth.

The two major external shocks at the start of this decade, the Covid-19 pandemic and the war in Ukraine, have decisively accelerated this trend. In response to the Covid-19 pandemic, governments around the world implemented significant financial support measures, with particularly large efforts in the US. However, the US government has embarked on a more active fiscal policy approach that goes well beyond the immediate response to the global health crisis. Since President Biden took office in 2021, significant public resources have been devoted to strengthening domestic industrial capacity, such as investments in clean energy through the Inflation Reduction Act, infrastructure modernisation through the bipartisan Infrastructure Investment and Jobs

‘We are confronted with a worldwide race for the onshoring of strategically important industries through the use of state-sponsored subsidies.’

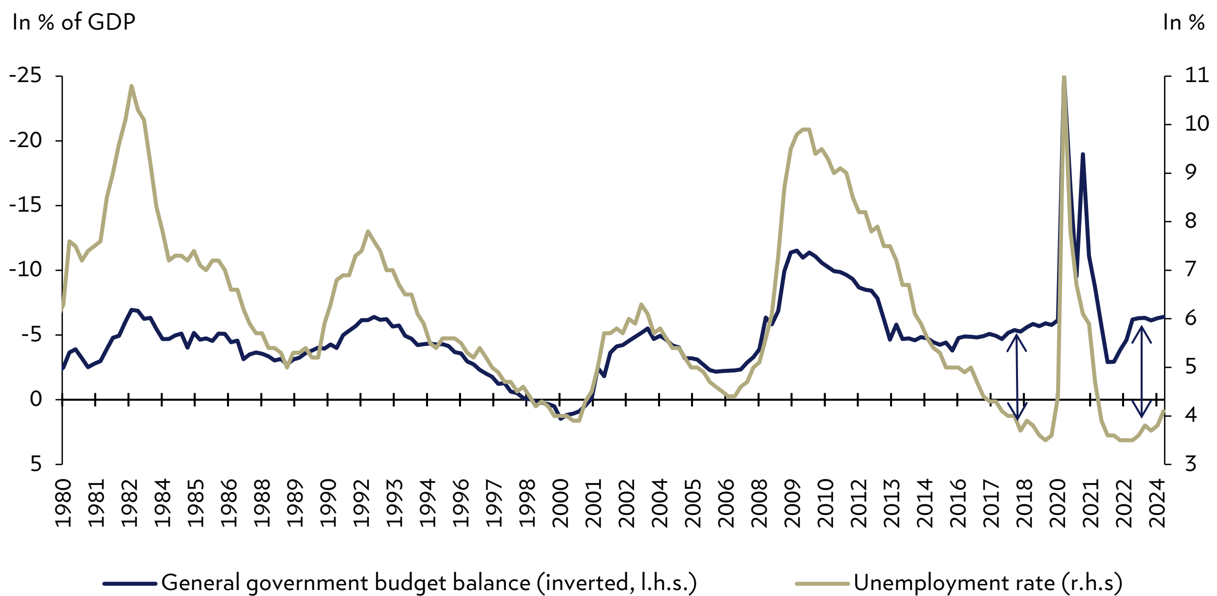
Yves Bonzon, Group Chief Investment Officer

Act, and advanced manufacturing (e.g. semiconductors) through the CHIPS and Science Act. However, the turning point came before that. In fact, it was during Donald Trump's first term as president that we witnessed the first procyclical fiscal stimulus in the US in more than half a century (see chart 4).

Active industrial and fiscal policies are not unique to the US. At present, we are confronted with a worldwide race for the onshoring of strategically important industries through the use of state-sponsored subsidies and protection measures. Europe is also participating in this race, as is evidenced by the European Chips Act. In fact, the voices of dogmatic austerity have quieted considerably in Europe, as the bloc is seeking greater energy and military security. Moreover, the former president of the European Central Bank Mario Draghi published a report in September that was commissioned by the European Union (EU). It recommends massive additional injections into the region over the next few years to address structural impediments to growth and improve economic competitiveness. The required investments should focus on four key areas: technological capabilities, defence, decarbonisation, and energy infrastructure. These investments are expected to amount to nearly 5% of the EU's annual gross domestic product (GDP) – significantly exceeding the 1%–2% allocated under the Marshall Plan, a post-World-War-II US economic development programme aimed at rebuilding Europe.

Today, there is a significant transatlantic divide about what social consensus expects from their respective governments. While the median voter in Europe wants an increase in the size and scope of government intervention in capitalist systems, the median voter in the US has just voted for the opposite. At the same time, green shoots of a backlash against big government have begun to emerge, notably in Argentina, under Javier Milei, and most recently and crucially in the US. On the one hand, the principles of macroeconomic policy in Europe still firmly reflect state-sponsored capitalism, but on the other hand, in the US, we may be on the verge of a radical shift in economic policy.

Chart 4: Fiscal stimulus has turned procyclical



Source: US Bureau of Economic Analysis, US Bureau of Labor Statistics, Macrobond, Julius Baer
Note: data as at Q2 2024.

Interest rate normalisation

The big question confronting investors is whether we will see a return to financial repression or whether interest rates have moved sustainably higher. The resilience of Western economies to a normalised cost of capital suggests higher-for-longer rates, yet disinflationary forces (e.g. digitalisation, ageing demographics, and, crucially, financialisation) persist. Absent a major external shock or recession, we see no reason for interest rates to drop significantly. The four-decade-long secular bond bull market is over, opening the door for yields to cyclically move to higher levels.

After the Global Financial Crisis, Western central banks began using ultra-low, or even negative, interest rates in combination with large-scale asset purchase programmes to support ailing economies. Such action was necessary to prevent deflationary pressures, as private sector agents were deleveraging their balance sheets. Both the US federal funds rate and the 10-year US Treasury yield reached record-low levels during that time, deviating from historical averages of around 3%–5% for the 10-year yield and slightly below 5% for the federal funds rate since 1954. The rapid increase in interest rates through 2022 and 2023 has thus been a return to the mean for both measures. In retrospect, the last decade was an experimental period for monetary policy.

2024 has proven to be a year of continued normalisation, with inflation and growth subsiding from post-pandemic highs, allowing central banks to begin lowering their policy rates again. Indeed, after peaking at 5.25% in mid-2023, the Fed embarked on its easing cycle with a 50-basis-point rate cut to the federal funds rate in September 2024, lowering it by a further 25 basis points in November. The 10-year US Treasury yield, which peaked at 5% in October 2023, stood at 4.3% a year later. The big question still confronting investors is whether we will ultimately return to the realm of financial repression or whether interest rates have sustainably shifted to levels closer to their historical average.

If anything, the past 12 months have confirmed the resilience of Western economies, particularly the US, to a normalised cost-of-capital environment. To the surprise of many, the US economy continues to expand, albeit at a slower pace than 12 months ago and with a cooling labour market. Nonetheless, it is supported by solid private consumption, while inflation is descending closer to the central bank's 2% target. Underpinning this resilience is the continued strength of private sector balance sheets, which were deleveraged in the previous decade with the help of financial repression policies. At the same time, the expansion that followed the brief Covid-19-related recession was fuelled by government transfers on the one hand and by income and profit growth on the other. This contrasts with previous expansion cycles, such as the ones that ended in 2001 and 2007, which were driven by debt creation in the private sector. As a result, developed economies are much less sensitive to interest rates in the current economic cycle.

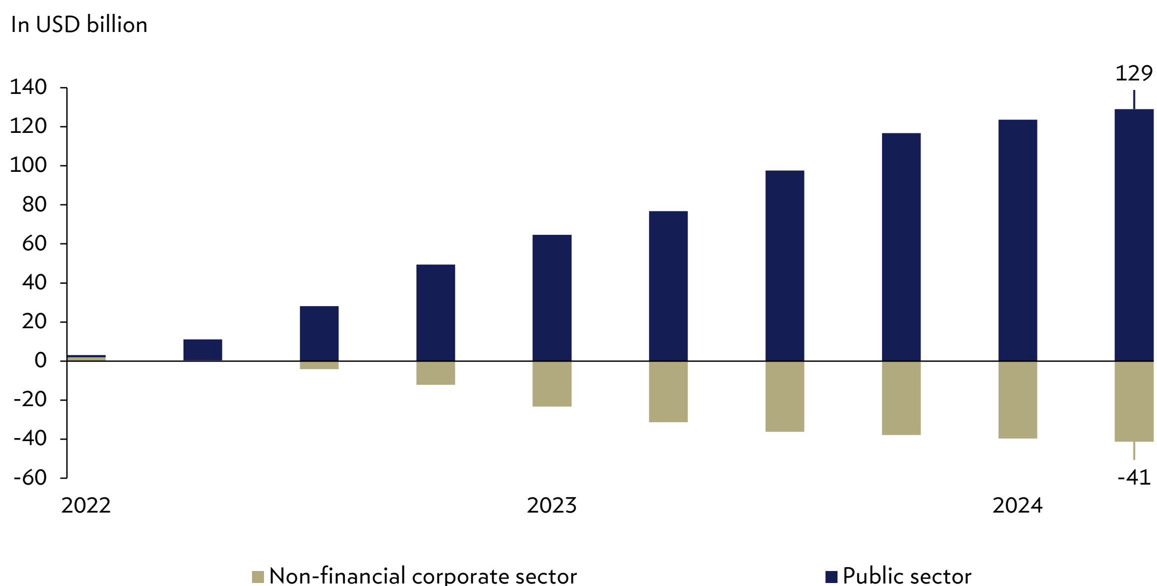
That alone, however, is not a sufficient condition to conclude that the era of lower interest rates is behind us. Many of the trends that were in force prior to the 2020s and drove the decades-long decline in interest rates are still well engrained, including ageing demographics and digital disruption, which continue to exert disinflationary pressure in developed economies. The extreme financialisation of modern economies is another central element. We maintain that 'the tail is wagging the dog', i.e. that financial assets have a disproportionate influence on the global economy, representing six times global GDP. Furthermore, with global debt standing at USD 315 trillion (public and private), higher interest rates pose considerable risks due to increased refinancing costs. This is especially true for business models that relied on low financing costs in the past to survive or leverage up and inflate their profits, such as those in the small-cap space or

private market funds. The good news is that central banks' ability to respond to systemic risk flare-ups has substantially improved, going beyond large asset purchase programmes to the use of targeted liquidity facilities aimed at nipping systemic issues in the bud, as we witnessed during the US regional banking crisis in 2023. Still, central bankers cannot afford to be complacent, as the provision of sufficient amounts of liquidity has become an imperative in the modern economic paradigm, which makes the wind-down of what are seen as bloated central bank balance sheets wholly counterproductive. Crucially, while household and corporate balance sheets are strong, government balance sheets have substantially deteriorated and have borne the brunt of the increase in financing costs that was generated from interest rate normalisation (see chart 5). Ultimately the level of central bank interest rates (and resulting inflation) is a political choice, which can be used to alleviate the government's debt burden.

Additionally, the question of productivity comes into play. Although measuring it accurately can be challenging, the post-pandemic productivity boost seems to be holding in the US. The rapid development of AI capabilities feeds the narrative that we have turned the tide on declining productivity and are moving towards an era of more dynamic and higher neutral real interest rates. However, as we explain in the next section, the jury is still out on how much and when the innovation super cycle, and AI in particular, is going to translate into a sustainable productivity boost.

That said, barring a major external shock or a US recession, which is not our current base-case scenario, we do not see a reason for interest rates to decrease substantially for now. We believe that the secular bull market in bonds, which had dominated the past four decades, has come to an end. This means that higher yield levels (e.g. on government bonds) have become more likely, at least on a cyclical basis.

Chart 5: Cumulative change in net interest payments since the start of the 2022 Fed rate-hike cycle



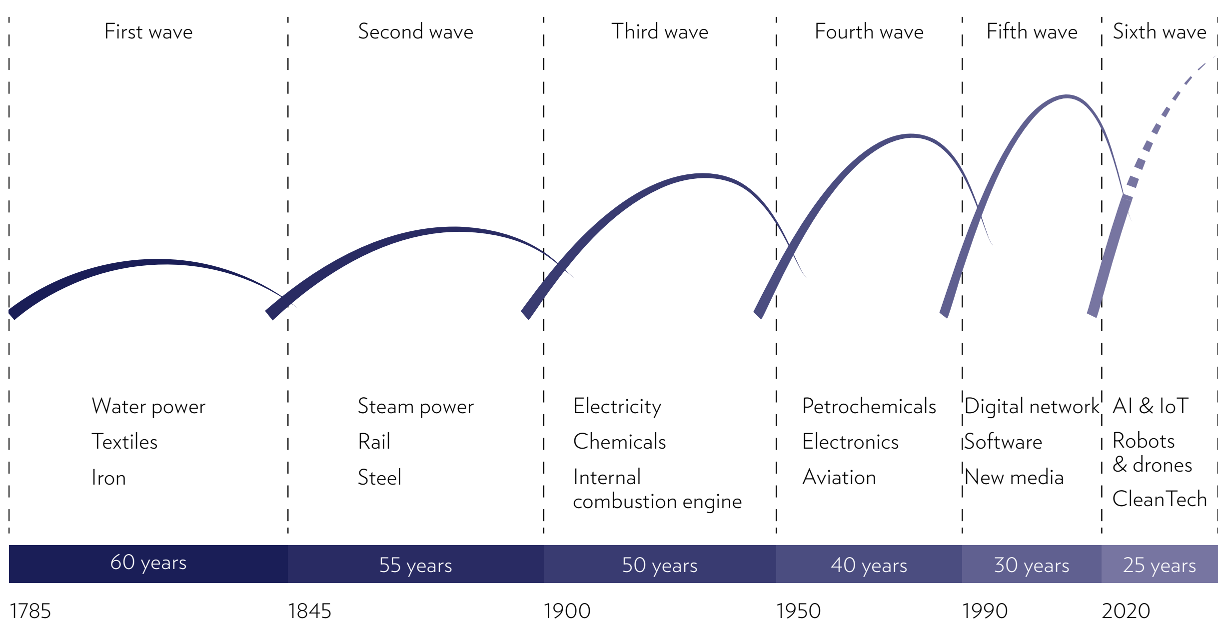
Source: US Bureau of Economic Analysis, Macrobond, Julius Baer
Note: Data as at Q2 2024.

Innovation super cycle

The pace of innovation has accelerated in recent decades, and this is expected to continue in the future. The combination of exponential growth in computing power at decreasing costs and the proliferation of Big Data provides fertile ground for increasingly powerful generative AI systems. As a result of the convergence of several disruptive technologies, we expect to see profound breakthroughs across multiple industries that will reshape the way we live and work.

To suggest that innovation is a key trend confined to a single decade would be preposterous. Innovation has always been the driving force propelling humanity forward, igniting economic progress, and fostering evolution in countless domains. What makes the current decade special is that the pace of innovation has markedly accelerated, partially due to external shocks such as the Covid-19 pandemic, which exacerbated the need to innovate as the world came to a temporary standstill. Beneath the surface, we see a convergence of multiple technologies leading to severely disruptive forces. The combination of exponential growth in computing power at decreasing costs and the growing abundance of data provides a fertile ground for disruptive change, including through increasingly powerful generative AI systems. Generative AI models, as exemplified by ChatGPT, have been adopted at an unprecedented speed, and the associated use cases are plentiful. AI in its conventional form is a general-purpose technology that is already applied across a multitude of industries. Interestingly, when ChatGPT was revealed to the broad public in November 2022, AI experts were not surprised by the chatbot itself but by the public's outburst of enthusiasm for something that they see as just another step on the long scientific road to human-like machine intelligence.

Chart 6: The history of innovation cycles



Source: Edelson Institute, Julius Baer

When it comes to evaluating progress at a time when the pace of innovation has accelerated dramatically, it is crucial to recognise what we know and what we do not know. In bilateral conversations, we keep hearing that AI is an investment no-brainer and that investment managers who did not understand the implications two years ago should reconsider their career choice. In reality, we believe that no one knows the medium-term implications of the rise of generative AI to any remotely useful extent. What we know is that the race among hyperscaling US technology platforms to build AI computing solutions and capacity has triggered a gigantic capital expenditure cycle. These companies cannot, therefore, afford to raise doubts about the relevance of their considerable AI investments, as their valuations would come under instant pressure. According to Julius Baer Research, the market should start demanding a monetisation of these investments around 2027. They also expect meaningful write-downs as the space matures, meaning that some of the companies currently driving the innovation will not succeed, much like in previous cycles of technological innovation. In this sense, AI is big indeed, but it would be dangerous to consider it an investment no-brainer. While we expect a broadening of the sectors that will benefit from advances in AI, we need further evidence to assess the actual impact it will have on different industries and the economy as a whole.

The innovation super cycle we defined a year ago is not only about AI. Another key topic that has been with us for some time now is the energy transition, which aims for a shift towards net-zero carbon emissions. We have argued that the energy transition is likely to be inflationary in the short term given the required investments but deflationary in the long term due to expected productivity gains. While this view still holds, we might actually already be further advanced in transitioning our economies than is commonly assumed. Both solar and wind energy costs have fallen dramatically and are expected to continue to do so, and the energy market continues to prove its resilience thanks to its truly globalised nature. While this does not mean that we will become independent of fossil fuels in the 2020s, it does imply that we could see an additional structural disinflationary impulse come into play sooner than was previously expected.

Continuous innovation is also taking place in other areas, such as healthcare, mobility, and food, but at a smaller scale for now. In the end, we believe that the innovation super cycle, which is driven by the convergence of several of the disruptive technologies outlined above, will reshape the way we live and work and, as such, will profoundly impact both productivity and economic growth in this decade.

> ‘The race among hyperscaling US technology platforms to build AI computing solutions and capacity has triggered a gigantic capital expenditure cycle.’
>
> **Yves Bonzon, Group Chief Investment Officer**

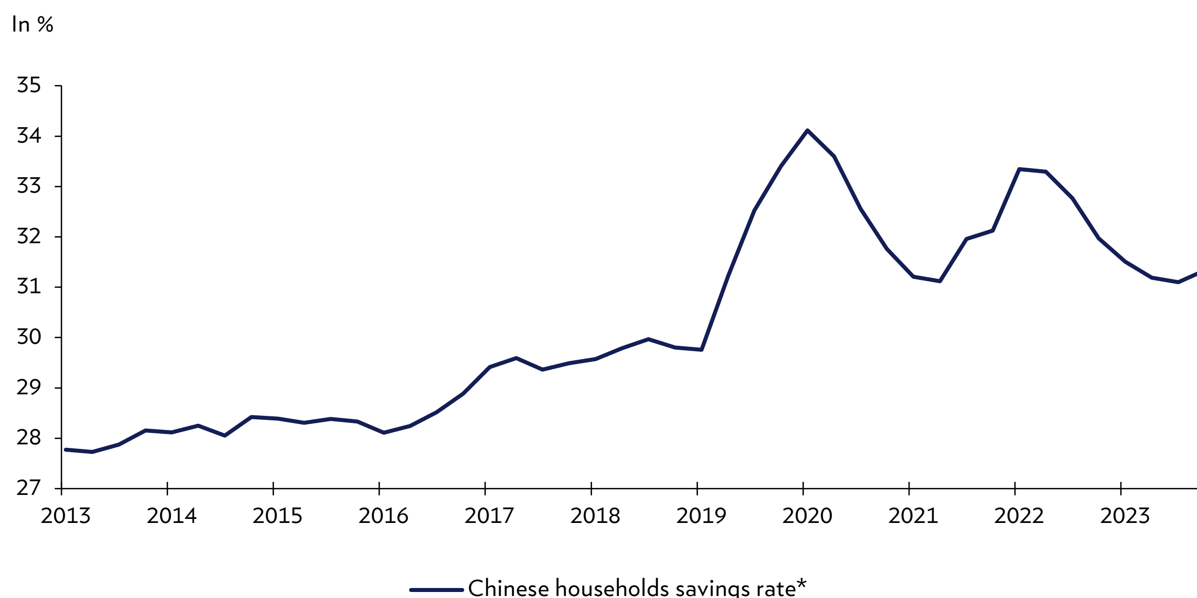
China's balance sheet recession

The recent policy easing in China has failed to sustainably revive confidence among private businesses and households. With the highly indebted private sector focusing on hoarding cash rather than spending or investing it, China has entered a balance sheet recession. Additionally, adverse demographic and economic developments are adding structural headwinds, reinforcing our cautious view on Chinese capital markets.

In 2021, we decided to reduce our strategic positioning in Chinese assets and eventually removed them altogether from our strategic and tactical asset allocation in early 2022. There were two reasons behind this decision. The first reason was the Chinese government's shift towards 'common prosperity', and the second one was the risk of permanent capital loss in light of potential sanctions by Western governments. In hindsight, this was the right decision, especially since we continue to see broad evidence that China is in a balance sheet recession. Such a situation is characterised by the private sector prioritising debt minimisation over profit maximisation despite low or zero interest rates, which would normally encourage new borrowing.[1] It typically occurs after the bursting of an asset bubble, which leaves a large number of private sector agents with unrealised losses (since they carry liabilities on their balance sheets, while the assets they have bought using the borrowed funds have collapsed in value). As can be seen in chart 7, this situation is reflected by a high and increasing household savings rate in China. In

[1] For a comprehensive overview of the theory of balance sheet recession, see Dr Richard Koo's book 'The Other Half of Macroeconomics and the Fate of Globalisation' (Wiley, 2018).

Chart 7: The Chinese household savings rate is high and increasing



Source: National Bureau of Statistics of China, Macrobond, Julius Baer
Note: Data as at Q3 2024. * Four-quarter moving average, calculated as disposable income minus expenditures as a share of disposable income.

a balance sheet recession, conventional monetary policy is essentially powerless. As long as the private sector is repairing its balance sheets, the public sector must step in, borrow the private sector's excess savings, and make the necessary investments to avoid potentially devastating deflationary outcomes. In fact, fiscal stimulus becomes a necessity to avoid a contraction of nominal GDP growth.

In late September of 2024, the Chinese authorities eventually reached the pain point at which they were willing to provide support to the ailing economy and depressed asset prices, announcing a broad stimulus package. While the first set of measures was centred around monetary policy easing, it was followed by a surprisingly sharp rhetorical shift towards fiscal policy. Clearly, this was a step in the right direction, as fiscal accommodation is the only effective way to counteract deleveraging trends in the private sector. Admittedly, it is much more challenging for investors to understand the implications of fiscal policy as compared to monetary policy. There are often considerable discrepancies between initial intentions and actual implementation, so investors are well advised to take big announcements with a grain of salt.

It is important to note that one-off fiscal transfers to the private sector do not ignite a self-feeding credit and consumption cycle. Therefore, high savings and weak domestic demand may persist, keeping the country in a balance sheet recession for much of the decade. Even if the Chinese authorities were to act quickly and efficiently enough to address the balance sheet recession, structural issues remain a major concern. China's population is shrinking, the country faces geopolitical tensions with the West, its regulatory environment has become unpredictable, and its economy is increasingly likely to be subject to a 'middle-income trap', i.e. the failure to make the transition from a middle-income to a high-income economy.

Unless there is sufficient evidence that Beijing is embarking on a true paradigm shift, Chinese equities will likely remain rangebound, with alternating sharp reratings followed by prolonged consolidation periods, similar to Japanese equities in the 1990s. We thus believe that Chinese equities have entered a cyclical, not a structural, bull market, which reinforces our cautious view on Chinese capital markets.

Key capital market trends

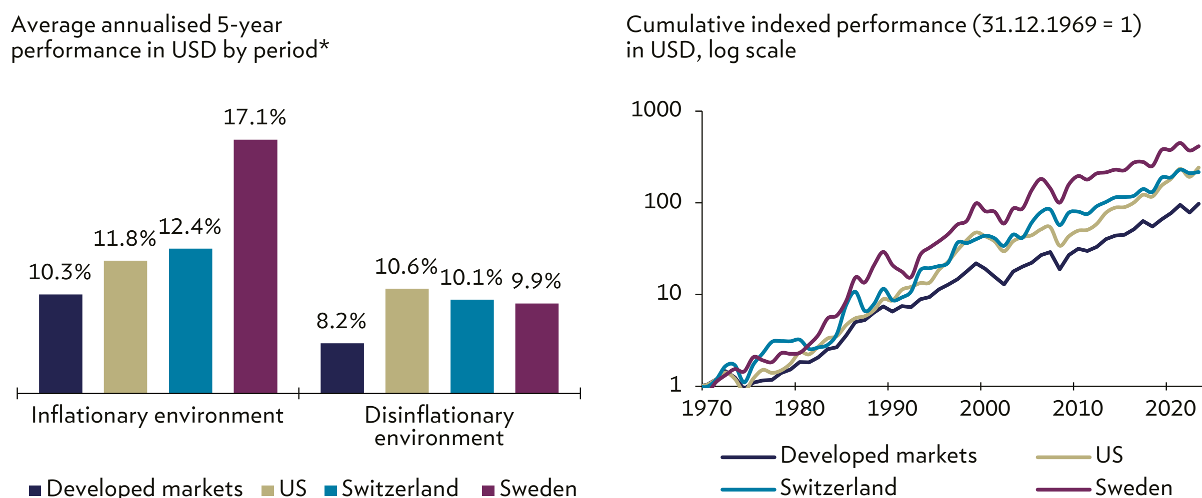
Store-of-value equity markets

With the increase of geopolitical conflicts in a multipolar world, the investment opportunity set has shrunk. Investors should continue to favour real assets over nominal claims in jurisdictions where they are comfortable with the relevant political risk. The required quality of investments should be found predominantly in so-called 'store-of-value' equity markets, such as the US, Sweden, and Switzerland.

In times when globalisation is expanding and geopolitical tensions between the world's largest economies are subdued, investors benefit from not having to pay much attention to international diplomatic disputes when making investment decisions. In such periods, the primacy of profit maximisation means that conflicts can reliably be set aside to preserve business interests. However, in a multipolar world characterised by opportunistic manoeuvring on the geopolitical stage, which keeps macroeconomic and financial market volatility high, it is better for investors to focus on capital markets where the playing field is familiar and where the rules of the game are stable and known.

In this sense, even though we do not see a full-blown deglobalisation with unconditional reshoring activities coming into play, we reiterate our view that store-of-value equity markets should profit. We use this as an umbrella term for markets in countries where shareholder value and property rights are well protected and there is a strong institutional framework, sound governance, and efficient allocation of capital. Our preferred examples are the US, Sweden, and Switzerland, all of which have an exceptional track record of shareholder value creation. In US dollar terms, their respective flagship stock indices have outperformed both global equities and gold, not only over the 40 years of neoliberalism but also consistently before that, including in the more inflationary and geopolitically intense decades, such as the 1970s and 1980s (see chart 8).

Chart 8: Store-of-value equities have outperformed global markets



Source: JST Macrohistory Database, Bloomberg Finance L.P., Macrobond, Julius Baer
Note: Based on annual data up to 2023. *The inflationary environment comprises the periods 1970–1990 and 2021–2023. The disinflationary environment comprises the period 1991–2020. Past performance and forecasts are not reliable indicators of future results. The return may increase or decrease as a result of currency fluctuations.

Out-of-system assets

Active industrial and fiscal policies, coupled with normalised interest rates, are significantly impacting public finances, which results in increasingly weak government balance sheets. Meanwhile, the current multipolar world and associated geopolitical tensions have prompted Western authorities to frequently instrumentalise the centralised financial system for sanctioning purposes. This benefits so-called 'out-of-system' assets, which are characterised by limited supply and insulated from potential Western sanctions.

Since we last updated our Secular Outlook publication 12 months ago, gold has topped the cross-asset performance league table. A similar picture emerges when going further back and looking at performance figures since the beginning of this decade, where gold has only trailed the major US large-cap indices.[2] Remember that gold's most valuable characteristic – when held in physical form – is that it does not represent a claim against anyone else. Consequently, the yellow metal is the ultimate counterparty risk hedge; it protects against systemic risk, as it did during the 2008 Global Financial Crisis and the European debt crisis of the early 2010s. Yet gold's sustained relative outperformance so far this decade is fundamentally at odds with the lack of evidence of systemic problems in Western economies. In contrast to previous episodes of gold strength, its traditional drivers (i.e. a weaker US dollar, lower US real interest rates, and heightened investor risk aversion)

[2] Excluding digital assets.

Chart 9: Gold decoupled from its habitual drivers following weaponisation of the USD-based financial system

Source: US Treasury, Macrobond, Julius Baer
Note: Past performance and performance forecasts are not reliable indicators of future results. The return may increase or decrease as a result of currency fluctuations. Data as at 04.11.2024.

have been largely absent during this year's exceptional price surge (see chart 9).

All of this suggests that we have entered a new investment regime driven by two structural forces: weak government balance sheets and the intensive use of the centralised financial system by Western governments for sanctioning purposes. A sky-high US budget deficit at a time of full employment, coupled with normalised interest rates, has caused the cost of servicing US debt to rise by more than 50% since the Fed began raising interest rates in March 2022. In reality, the upward trajectory of public debt is a widespread global issue, and contrary to conventional belief, increasing interest rates are currently hurting public finances and balance sheets more than those of private entities – disproportionately so. Anticipation of repressive measures by governments, such as targeting interest rates to ensure the smooth functioning of the refinancing of their public debt, provides an incentive to diversify away from government bonds and structurally shift investor capital from public balance sheets to private ones.

At the same time, we are witnessing a bifurcation in the investment reaction functions of Western and non-Western investors. Given the unprecedented weaponisation of the global financial system by Western nations in response to Russia's invasion of Ukraine in 2022, non-Western pools of capital may have decided to move some money out of that system and into assets where Western governments do not have the ability to freeze or seize them. Quite simply, when investors are more concerned about the return *of* their capital rather than the return *on* their capital, the premium required to hold out-of-system assets, even if they are unproductive, shrinks. Given that the US administration is demonstrating an ever-increasing appetite for using capital markets for sanctioning purposes, we must work with the hypothesis of increased structural demand for out-of-system assets that protect against its consequences, e.g. precious metals, led by gold, as well as Bitcoin[3]. We have introduced a strategic allocation to gold in portfolios to capture this trend.

[3] Investments in digital assets are exposed to elevated risk of fraud and loss and to price fluctuations.

'When investors are more concerned about the return *of* their capital rather than the return *on* their capital, the premium required to hold out-of-system assets, even if they are unproductive, shrinks.'

Yves Bonzon, Group Chief Investment Officer

USD capital markets

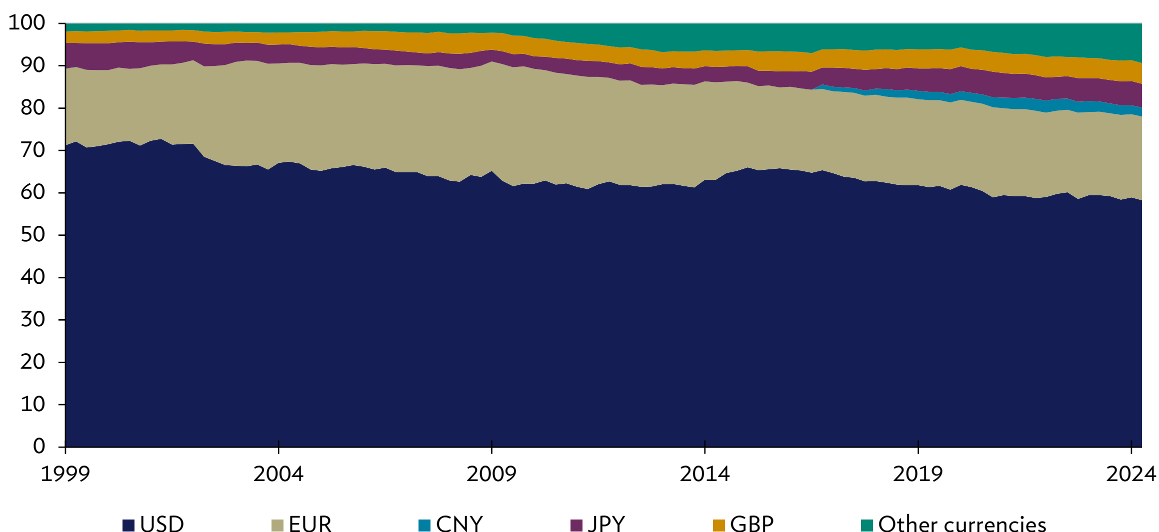
While we acknowledge the merits of diversifying portfolios beyond the traditional USD-based financial system, for the foreseeable future, no currency or alternative capital market appears poised to challenge the dominance of USD capital markets. As in the past, the current secular US bull market is underpinned by the strength of the US information technology sector, which boasts unrivalled growth and free cash flow generation.

Ever since President Nixon halted the USD's convertibility to gold in 1971, the greenback has experienced successive secular bear and bull cycles. It has been particularly important to understand the USD regime and its implications for asset allocation. During USD bull cycles (e.g. 1994–2001 and after the Global Financial Crisis), US equities have outperformed rest-of-the-world assets, including commodities, while during USD bear cycles (e.g. 2002–2008), rest-of-the-world assets have outperformed US equities. This sequence has been driven by the unique status enjoyed by the USD as the world's main reserve currency.

With the structural increase in demand for gold and other out-of-system assets, coupled with skyrocketing US government deficits, investors are wondering whether the current USD bull market is due for a reversal, or indeed, if this marks the beginning of the end of the dollar's reign as the world's reserve currency and, potentially, the fiat currency system at large.

While we see the merits of diversifying portfolios away from the traditional USD-based financial system, especially for investors based outside of the Organisation for Economic Co-operation and Development (OECD), for the time being, we do

Chart 10: The USD is still the world's preferred global reserve currency



Source: International Monetary Fund (IMF), Macrobond, Julius Baer
Note: Data as at Q2 2024.

not see any signs of a change in the dominance of the US. First of all, the USD still holds the status of the world's reserve currency. Most of the global trade in goods and services is conducted in USD, even if this trend is declining. Furthermore, the USD's dominance remains pronounced in global foreign exchange markets, where still more than 80% of all transactions are conducted using the greenback. There is only limited evidence that Western sanctions have had a generalised impact on central banks' reserve currency portfolios (see chart 10). Instead, in line with our view on out-of-system assets, we observe a divergence between central banks in developed markets and those in emerging markets and developing economies (EMDE), with the latter placing a much greater importance on mitigating political and sanction risks when considering diversification away from fiat currencies into gold.

Second, the US Treasury market remains the go-to place for investing foreign exchange reserves. It offers unparalleled access to high-quality, highly liquid debt in substantial quantities, backed by a stable regulatory environment and free from capital controls. For those concerned about the exponential rise in US government debt, it is worth noting that even if deficits remain in an upward trajectory, the US government cannot default unwillingly. As a sovereign issuer of its own currency, it can print the money needed to service its debt, eliminating the risk of default due to artificial constraints like debt-to-GDP ratios. In reality, the true constraints on government spending are a potential depreciation of its currency and spiralling inflation. Whether the latter poses a significant risk depends on how efficiently public funds are allocated and the strength of the country's institutional framework – both of which remain solid in the US.

Third, just as there is no alternative to the US dollar or US safe-haven bonds, there is seldom a substitute for US equity markets, which are clearly among the default destinations for Western investors looking to deploy capital in exponential growth opportunities at scale. Secular US equity bull markets have been underpinned by major technological innovation cycles. In fact, the outperformance of US equities is entirely attributable to its technology sector and its unparalleled growth and free cash flow generation. Looking at the equally weighted S&P 500, US equity performance aligns more closely with other developed markets like Europe.

For the foreseeable future, no currency or alternative capital market appears poised to challenge the status quo of USD capital market outperformance.

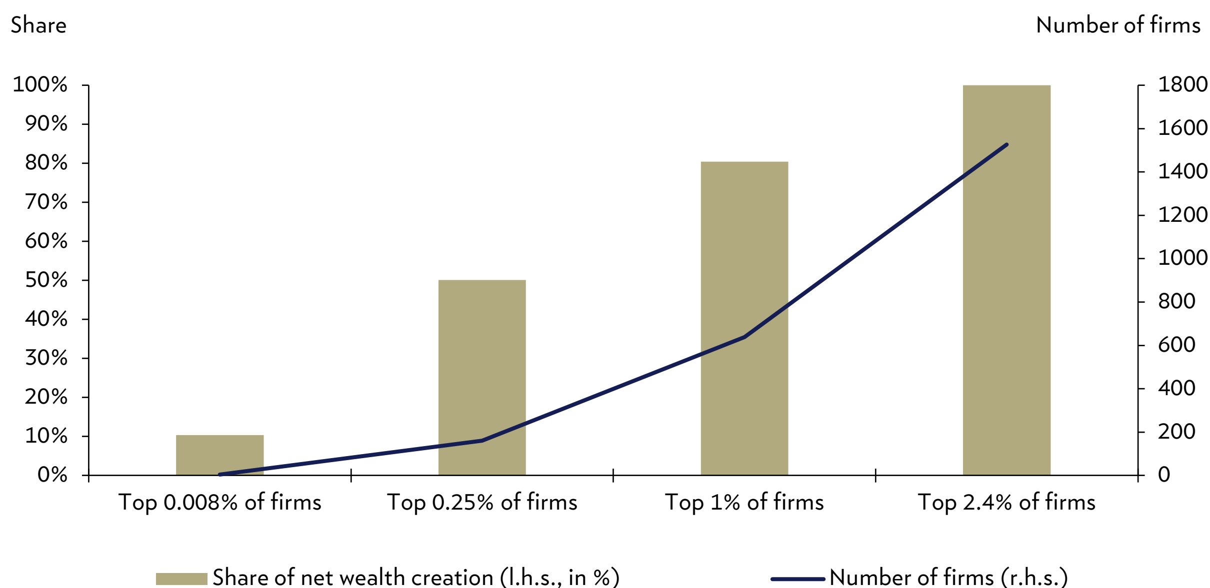
Nasdaq+

The innovation super cycle has important implications for asset allocation. Historically, accelerated innovation has always led to significant shareholder value creation among leading companies. The big question is where this new market leadership will emerge. Looking at the current situation, the answer is likely to be the same as before: within the US IT sector.

The convergence of several disruptive technologies has led us to conclude that we are in the middle of an innovation super cycle in the current decade. The question that arises now is whether the major US technology companies will be able to extend their market leadership as we enter the new innovation era. Since the 1980s, every major iteration of technological progress has been driven by US-based companies. Whether it was the proliferation of the personal computer, the dawn of the internet, the advent of the smartphone, the rise of the cloud, or the emergence of generative AI, all technological breakthroughs have been characterised by the dominant, or even exclusive, leadership of US technology giants.

There are good reasons why the US has consistently produced some of the world's most disruptive companies. The country's combination of a strong innovation ecosystem (including top universities and technology hubs), ample access to venture capital, a skilled workforce, a supportive regulatory environment, and a culture of entrepreneurship is hard to match. Historically, the Nasdaq has been at the forefront of value creation during major iterations of US-led technological progress. While dominated by the US mega-cap IT names, the stock exchange

Chart 11: Shareholder value creation is extremely concentrated



Source: Bessembinder et al. (2020), Julius Baer
Note: Net wealth accounts for the cumulative shareholder value created above the performance of one-month US Treasury bills during the period 1990–2020.

also attracts growth-oriented, technology-driven companies outside the US. Beyond the Nasdaq, disruptive innovators can also be found selectively in other domiciles. However, in China, which we previously believed was the only market outside the US that offers exposure to exponential business models, the domestic leadership has decided to steer its civil society towards the goal of 'common prosperity' and not allow its digital champions to build a dominant competitive position similar to that of the US. In Europe, structural disadvantages stand in the way of its companies competing with their US counterparts. Not only does the Old Continent face an ageing infrastructure, weak productivity growth, and deteriorating demographics, but the tendency of its policymakers to favour regulation over innovation is particularly worrisome. Considering these challenges, we continue to focus our European equity exposure on a few selected large caps with global revenue footprints.

As you know, we believe that most active managers underperform, not because they own bad companies or overpriced stocks, but because they think linearly and miss the few remarkable companies that grow exponentially. In the past, shareholder value creation has been extremely concentrated in a few exceptional companies (see chart 11). One of our mantras is therefore to 'keep your winners and sell your losers'. One of the difficulties of long-term investing, however, is finding the right time to exit successful investments. In recent years, the major US technology companies created unprecedented shareholder value thanks to their ability to generate free cash flow despite their strong growth. They were fundamentally undervalued for more than ten years. However, this is no longer the case. Today, their free cash flow yield is slightly below that of the S&P 500, and their valuations fairly reflect their growth prospects and free cash flow generation. As such, investors like us, who have a fundamental growth DNA, are in a difficult position right now. China does not allow their digital behemoths to build a dominant competitive position, Europe is facing structural and ideological issues, and the leading US technology companies are no longer structurally undervalued. In this context, we believe it is too early to underweight the major US technology stocks, especially given their profitability and the strength of their franchises. We therefore expect the continued leadership of the Nasdaq+[4] companies to be the most likely scenario, while acknowledging that their contribution to the outperformance of the US market is likely to be more challenging in the future.

[4] 'Nasdaq+' refers to the technology-heavy Nasdaq Composite Index, as well as to selected companies listed elsewhere that are driving the next iteration of global technological progress.

Key risk factors

Climate risk

The physical risks of climate change are becoming more evident by the day. From rising sea levels to desertification the consequences are substantial, including the destruction of productive assets, forced migration, and a slowdown in economic growth.

Cyber risk

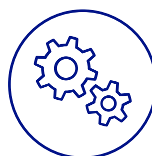
In an increasingly digitalised and connected world, cybercriminality and ransomware are likely to continue to pose a growing threat to businesses and individuals, as well as to governments and the economy.

Dormant systemic risk

Key systemic risk indicators have to be continuously monitored to assess whether any systemic issues, i.e. ones that threaten the stability of the economic and financial systems, pose a threat to the economic cycle and the overall outlook.

Geopolitical risk

As evidenced by the current wars in Ukraine and the Middle East, geopolitical rivalries have returned with a vengeance in the last few years, extending well beyond a strategic confrontation between the US and China. The new geopolitical landscape is complex and fragile, as countries driven by national interests tend to deviate opportunistically from seemingly strong alliances.



Infrastructure risk

Infrastructure risk lies at the crossroads between climate change and cyber risk. This prompts governments to accelerate their efforts against those threats and pushes infrastructure projects to increase their resilience to them.

Important legal information

Authors
Yves Bonzon, Group Chief Investment Officer,
yves.bonzon@juliusbaer.com[1]
Nicolas Jordan, CIO Strategy and Investment Analysis,
nicolas.jordan@juliusbaer.com[1]
Ronny Kaufmann, CIO Strategy and Investment Analysis,
ronny.kaufmann@juliusbaer.com[1]
Olga Mian, CIO Strategy and Investment Analysis,
olga.mian@juliusbaer.com[1]

[1] Employed by Bank Julius Baer & Co. Ltd., Zurich, which is authorised and regulated by the Swiss Financial Market Supervisory Authority (FINMA).

This content constitutes **marketing material** and is not the result of independent financial/investment research. The information and opinions expressed were produced by Bank Julius Baer & Co. Ltd., Zurich, ("Julius Baer"), which is authorised and regulated by the Swiss Financial Market Supervisory Authority FINMA. This content may contain information obtained from third parties. **The information and opinions expressed were valid at the date of writing, and may be based on numerous assumptions and, thus, subject to change without notice.** This content serves **for information purposes only and is not intended as a legal, accounting, or tax advice, or an offer,** or an invitation to buy or sell any financial instruments and/or products. Furthermore, it does not constitute a personal recommendation or take into account specific personal circumstances (e.g. investment objectives, financial situation, or investment strategies). Although the information is trusted to be accurate and complete and data has been obtained in good faith from sources believed to be reliable, no representation or warranty, expressed or implied, is made in this respect. **To the extent permitted by applicable laws and/or regulations, Julius Baer accepts no liability whatsoever for any claims for loss or damages of any kind arising directly or indirectly from this content** (including acts or omissions by third parties such as auxiliary persons and/or agents of Julius Baer).

General risks

The price and value of, and income from investments in, any asset class mentioned may fall, as well as rise, and **investors may not get back the amount invested.** Risks involved in any asset class mentioned may include, but are not necessarily limited to, market risks, credit risks, political risks, and economic risks. The investor may be exposed to **currency risk** when a financial instrument or underlyings of a financial instrument are denominated in currencies other than that of the country in which the investor is resident. The investment, as well as its performance, would therefore be exposed to currency fluctuations and may increase or decrease in value. Investments in emerging markets are speculative and may be considerably more volatile than investments in established markets. This content may include figures relating to simulated past performance. **Past performance, simulations, and performance forecasts are not reliable indicators of future results.**

Where the content is distributed into the United Kingdom by an offshore entity, it has been approved on the date shown on this content for distribution as a financial promotion in the United Kingdom by Julius Baer International Limited, which is authorised and regulated by the FCA (FRN 139179). If included, tax information is not based on individual circumstances and is subject to change. Clients should obtain independent tax advice before deciding to invest.

For further important legal information (e.g. regarding risks, sustainability, or third-party information) and country-specific disclaimers in connection with this content, please consult the following link or QR code:

Important legal information (click here)

Julius Bär

Founding Signatory of:

Signatory of:

JULIUS BAER GROUP

Head Office
Bahnhofstrasse 36
P. O. Box
8010 Zurich
Switzerland
Telephone +41 (0) 58 888 1111
Fax +41 (0) 58 888 1122
www.juliusbaer.com

The Julius Baer Group is present in around 60 locations worldwide, including Zurich (Head Office), Bangkok, Dubai, Dublin, Frankfurt, Geneva, Hong Kong, London, Luxembourg, Madrid, Mexico City, Milan, Monaco, Mumbai, Santiago de Chile, São Paulo, Shanghai, Singapore, Tel Aviv, and Tokyo.

11/2024 Publ. No. PU00960EN
© JULIUS BAER GROUP, 2024