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*"We don't have inflation because the people are living too well.
We have inflation because the government is living too well."
Ronald Reagan*

*"All Government spending is taxation"'
Elon Musk*

*"We all know what we need to do as politicians, we just don't
know how to get elected after we have done it."
Jean Claude Juncker*

2024 saw the financial trends of 2023 extended. Equity markets produced strong returns, led by the US indices, with most of these returns generated by the giant technology companies. Performance was particularly strong after the victory of President Trump in the US Presidential election in early November. Most other markets in Europe and the Emerging world were more subdued. The US bond market suffered an unprecedented fourth year of decline. The US dollar remained strong against most of its international rivals, and gold had a strong return. Most remarkable was bitcoin which rose 120% during 2024.

The last quarter was dominated by the US election and Trump's comprehensive victory. Unusually for a Republican candidate, he won the popular vote, as well as making a clean sweep of Congress, giving him a strong mandate to implement his policy platform. The result was a vote for less Government, and markets celebrated the promise of deregulation and lower taxes. The expected boost to growth is supportive of equities. So far markets have been unconcerned by the less market-friendly protectionist threats of the incoming Administration, such as the promise to curb immigration and impose draconian tariffs on foreign goods, both of which could increase prices. It is hard to say the extent to which these measures will be implemented. Judging by his first term Trump is more fluid in his policy making than other Presidents, and he will start this Administration with a different set of circumstances to his previous one. For example, the fiscal deficit is 6% of GDP compared to 3% on his arrival in 2016, and the total debt has risen from $19 trillion to $36 trillion. This ballooning debt is accumulating in a strong economy, which begs the question of what it would be in a recession. Cutting taxes could also push the deficit higher, at least in the short term. Regarding immigration the US economy has operated for decades on cheap immigrant labour. Cutting off this supply would push up wages, which would be inflationary. Trump's own hotels are run with this sort of workforce. Likewise implementing tariffs is fraught with complication. Thirty-five years of globalisation has pushed manufacturing into lower cost countries, with the result that the West is dependent on them for supplying many key goods. Trump wants to reverse that, but tariffs are a blunt instrument, and a blanket application would be disruptive and inflationary. It seems unlikely, for example, that Apple's iPhones will have a 60% tariff slapped on them. If it did happen it would cause chaos, so the sequencing of these initiatives is likely to be more nuanced and careful than some of the hostile rhetoric in the electoral campaign.

In any case reversing America's industrial decline is a formidable task that will be a long process. The practical problem is the lack of skilled employees and necessary capital equipment after decades of US industry being hollowed out. There are no 45-year-old workers to train the 20-year-olds, and the recent construction of giant semi conductor factories has required bringing in specialists from Asia. If the US is really going to rebuild all these industries in the US, an enormous task, then establishing all the plant and equipment is inherently inflationary. Moreover, even when up and running American manufacturing will be competing with a super-competitive China. It is hard to see the US outcompeting China for most manufactured goods for many years, so it will be an expensive and upheaving adjustment.

The more intriguing side of Trump's agenda is to attack bloated Government spending, and the appointment of Elon Musk as Head of DOGE (Department of Government Efficiency). Trump has been fascinated by Javier Milei, the new President of Argentina, who was the first head of state to meet him after the election. Against all predictions Milei won a mandate on an austerity agenda and has survived a year after imposing drastic cuts to government spending. In the US Musk has targeted savings of $2 trillion out of a Federal Budget of $6.5 trillion, and Trump has said these measures must be in place by July 4th, 2026 (the 250th anniversary of Independence Day). It is unclear how these cuts will be achieved, but he has spoken of reducing the Federal bureaucracy from over 250 agencies to less than a 100. Defence, education, and climate change are all areas likely facing steep reductions in spending. If even $1 trillion of Federal spending was cut in the next two years that would be extremely painful in the short term as it represents about 3.5% of GDP but, given that these measures can be started almost immediately, they are likely to be a major focus of commentary next year. If Musk does manage to achieve significant cost cuts in Government expenditure, then it may represent the most significant reforms in western policy since the Reagan/Thatcher reforms of the early 1980's.

Generally, politics has become much more unstable over the past year. Within just a few days in December there was a coup in South Korea, the French and German governments collapsed, there was chaos in Georgia, the Assad dictatorship in Syria imploded, and the CEO of United Healthcare was assassinated in New York, while the Ukraine conflict and Middle East battles continue. Markets have been remarkably sanguine about all these events, but governments will have to be more careful about how bond markets react going forward. While there is no set level of debt that is deemed unsustainable, western governments' borrowings have reached a size where questions over the ability to support such a debt load are being asked. If inflation rises Central Banks will be forced to raise interest rates and the concurrent rise in the interest burden could spook the bond market further. Inflation and the attendant higher costs of living destroyed the Democrats recent election campaigns. Several European countries face an even more problematic outlook. For example, the UK 's Government debt is about 100% of GDP, with much of it held by foreigners. At this level any sign of fiscal irresponsibility can lead to the cost of the debt rising if overseas investors withdraw because they set the price. The recent UK budget which raised taxes to meet day to day departmental spending, instead of investing for growth, exacerbates the situation. Many other countries

in Europe confront similar challenges. European budgets are stretched by welfare, their defence budgets need to rise, and large industries such as autos and machinery are losing competitiveness against a super-competitive China, and Japan's whose currency has fallen from 120 to 160 against the euro. This has even affected tourism as Asian tourists have redirected themselves to cheap and clean Japan rather than expensive and dirty Europe. Making matters worse has been Europe's highly regulated energy market, which has resulted in energy costs being much higher than the rest of the world. The resultant low growth puts more pressure on governments' finances. Ultimately highly indebted governments have become slaves of the interest rates on their own debt. However, there is no sign of any government addressing these issues, and recent voting patterns show that electorates are rewarding even more government spending, so nothing will change until the markets make it an issue.

Since the crisis in 2008 US equity market returns have trounced everywhere else, compounding at 14% for fifteen years. A good deal of this is due to the astonishing performance of the largest technology stocks, and the rest is due to the US market being re-rated, while everywhere else has been de-rated. In 2023 and 2024 much of the returns in the US have come from re-rating. There are clear signs of frothiness. Tesla rose 85% in a month or so following the election, even though its earnings have fallen this year. Apple sells at 35 times earnings and 10 times sales, even though it doesn't grow much. It's particularly odd that assets like tech and bitcoin have run up so strongly in the face of rising bond yields. Buying the S&P500 today an investor pays 25 times earnings for companies enjoying record margins. This high starting point suggests a reduction in the expected forward returns, and high expectations point to a bad outcome for any highly rated company that disappoints. Better opportunities lie in the ignored areas of the market. It may also be that the next phase of the market will benefit those companies that find ways of using the technology that has dominated returns recently, rather than the providers of that technology. As the big US companies have 50% of their sales outside the US these benefits will be spread widely, and generally investors can access these beneficiaries at much lower prices outside the US. There is an almost complete consensus that European markets are no longer interesting, and given the poor backdrop of European economies it comes as a surprise that the European bank sector has outperformed the S&P500 over the past four years, courtesy of these banks being operated much more efficiently. Financials are major beneficiaries of AI due to its ability to cut costs. Another sector that looks attractive is energy where many companies enjoy high cashflow yields and pay high dividends. Elsewhere Japan remains a compelling investment. According to the CEO of KKR 'Japan is a must own market', a view echoed by the CEO of Blackstone, citing the rapid growth of M&A activity and greater focus on shareholder rights and corporate governance. Excess capital is being returned to shareholders in the form of rising share buybacks and dividends. These improvements have not been accompanied by higher ratings, the Japanese market is rated at a similar level to ten to fifteen years ago, a marked contrast to the US, but if these strong returns continue to be delivered it will be hard for international investors to ignore them.

The world feels uncertain. The current economic expansion has extended further than most commentators anticipated and given how large the debt burden is it is remarkable that it has endured through an interest rate cycle that saw interest rates rise from near zero to over 5%. The Trump Administration promises significant upheaval, and their policies may cause considerable friction. China's economy remains mired in a slump despite the extraordinary performance of their manufacturing sector which produces a trade surplus of almost $100 billion a month. The recent ebullience in the US market suggests there is a lot more leverage being deployed than is commonly understood. For example, crypto ETFs have been launched in the US which are double, or triple leveraged. But reading the runes is only useful up to a certain point. Outcomes can be vastly different to expectations. In 2017 President Trump initiated the trade war against China, yet over the course of his Presidency to 2021 the China index outperformed the S&P. Likewise President Biden gave considerable policy and financial support to the renewable energy industry, yet the Clean Tech index underperformed the fossil fuel index during his administration. Nonetheless it seems prudent to reduce exposure to the frothier areas – crypto and the top end of the US index – and diversify into the less crowded names. These include mid and small cap US companies, Japan, and select areas in Europe and the Emerging Markets. In an uncertain world it is safest to own a portfolio of companies where that uncertainty is already priced in.

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