SHELTON
CAPITAL MANAGEMENT

Global Investment Outlook 2025

Global Investment Outlook 2025: What, Me Worry?

As 2025 dawns, global markets appear to be pricing in a benign macroeconomic future. The prevailing sentiment is one of cautious optimism, buoyed by expectations of moderating but stubborn inflation, stable growth, and accommodative monetary policies. Equity markets in advanced economies, particularly in the United States, remain elevated. Meanwhile, fixed income markets anticipate a varying pace of rate cuts from central banks.

A deeper look at 2024 reminds us that markets rarely unfold in straight lines and that the current macroeconomic environment is not necessarily benign, but binary. That in the post-COVID-19 era, the role of inflation has become paramount in determining the direction of markets in a way that we have yet to adjust for.

2024: Year in Review

The U.S. economy grew at a steady rate of about 2.6%[1] over the first three quarters of the year, supported by resilient consumer spending and robust private sector investment in AI and automation. Potential post-election policies, including tax cuts and deregulation, further bolstered sentiment and small-to-mid-cap businesses, though concerns about fiscal sustainability linger.

Inflation moderated slowly toward the Federal Reserve's 2% target. Core inflation also declined, but remained sticky at 3.3%[2], driven by persistent pressures in the services sector. Wage growth, although softening from 2023 levels, continued to support consumer spending while keeping inflation slightly elevated. When combined with concerns over inflationary policies of the incoming Republican administration, inflation remains a key concern.

Europe grew at a sluggish pace of 0.8%[3], constrained by weak external demand and structural challenges in key economies like Germany. Disinflation gained traction in the region, aided by declining energy costs, but persistent inflationary pressures in services sectors posed challenges to the European Central Bank's efforts to stimulate growth.

Japan's GDP fell slightly in 2024 driven by rising wages, moderating domestic demand, and corporate governance reforms. Inflation remains a concern, and as a result The Bank of Japan was the one central bank in the developed world to raise rates, even in the face of economic weakness.

Emerging market growth was uneven across regions. India stood out with GDP growth exceeding 6%[4], fueled by strong domestic demand and infrastructure investments. Mexico and Brazil, stalwarts in 2023, fell victim to trade concerns and political instability. China's growth slowed to 4.5%-5.0%[5], reflecting structural challenges in the property sector and weak external demand. Domestic fiscal stimulus helped mitigate some of these pressures but was insufficient to sustain higher growth rates and swing investor sentiment.

[1] Bureau of Economic Analysis | [2] Bureau of Labor Statistics | [3] Eurostat | [4] Central Statistics Office India | [5] National Bureau of Statistics of China

Show Me the Mo'

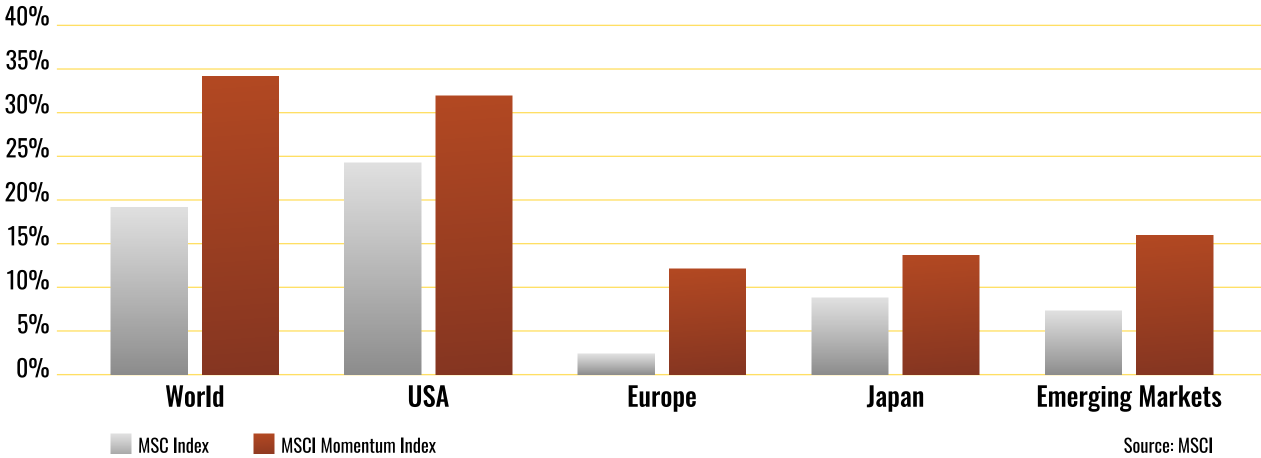
While equity markets have been up worldwide, the returns have been disproportionately concentrated in the United States. The S&P 500 index rose 25%[6] in 2024, while the MSCI All Country ex-US index only rose by 6.1%[7]. At the end of the year, the US equities constituted 66% of the market capitalization of the global equity market[7]. Ten years ago, it was less than half.

Within the US market, the focus is on a select set of large cap growth stocks, collectively known as the Magnificent Seven, but really includes about ten stocks[8]. These ten stocks in the US add up to 35.2%[6] of the S&P 500 index, and of the 25.2%[6] return the S&P generated this year, 15.5% came from these ten stocks.

Emerging Markets saw some of the same behavior – the top ten represents 25%[7] of the market, and out of the 8.7%[7] return of the MSCI Emerging Markets index, 6.0%[7] came from the top ten – in fact, 6.5% came from the top 2: Taiwan Semiconductor and Tencent

Underlying these concentrated returns has been a common foundation: **momentum**.

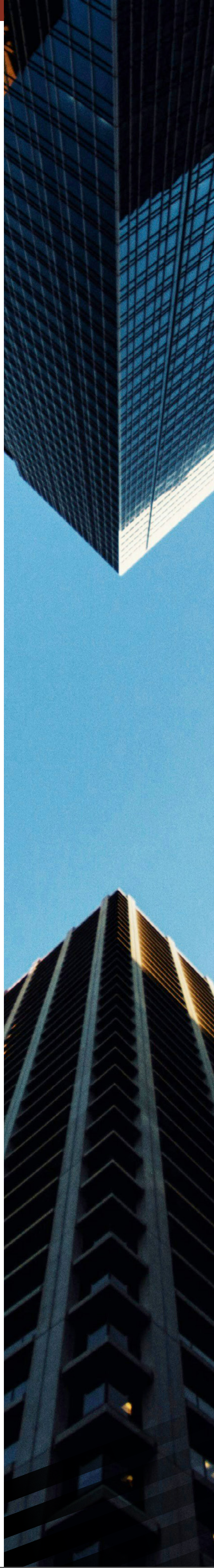
TOTAL RETURN - 2024



Momentum[9] as an investment style was the strongest driver of performance worldwide in 2024. The big names have garnered all the attention, but behind the scenes many stocks that had delivered for investors in the past continued to deliver in 2024.

Can it go on? What could derail the momentum train?

To be clear, momentum is a symptom, not a cause. There is always a theme behind it. The momentum market of the late 90s was driven by the Internet boom and associated growth stocks. The momentum market of 2008 was driven by the flight to quality in fear of the impending Global



[6] S&P

[7] MSCI

[8] The extra three stocks are Broadcom (AVGO), J.P. Morgan (JPM) and Eli Lilly (LLY).

[9] Momentum can be defined many different ways, but in all cases it is the strategy of selecting stocks that have performed well in the recent past. For the MSCI indices in the table below, MSCI uses 6 and 12 month returns, as well as some short-term return measures, and includes the highest returning 20-30% in the momentum index. It is rebalanced semi-annually

Show Me the Mo' (Continued)

Financial Crisis. The momentum market of 2020 was driven by the response to COVID-19 and excessive exuberance towards stocks focused on home-bound consumers.

The driving force behind the momentum stocks of 2024 is inflation in the US.

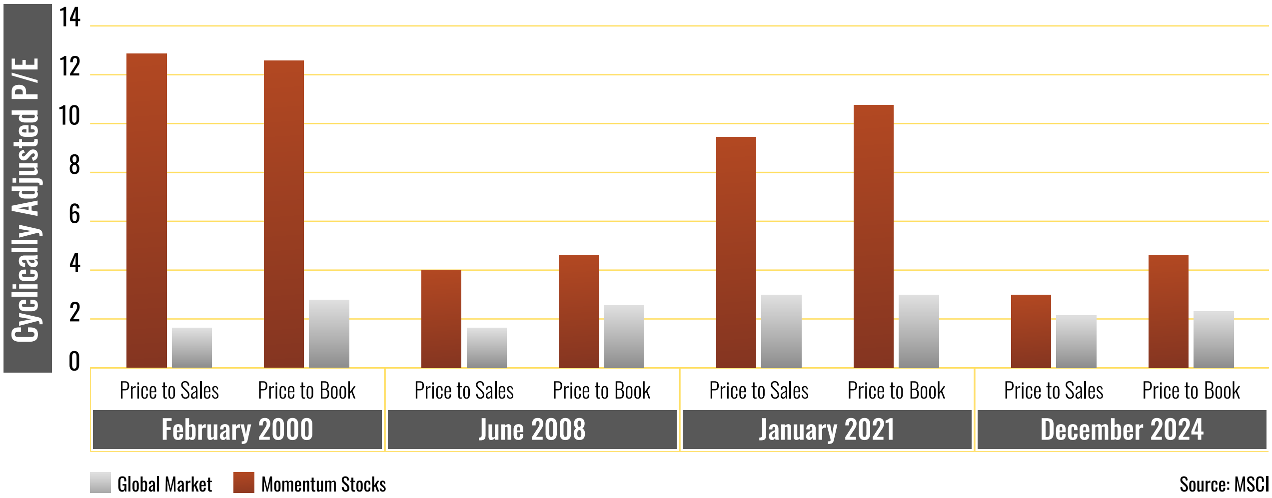
Inflation has a host of effects:

- Higher interest rates
- Higher capital costs
- Higher volatility
- Stronger dollar

Inflation has driven investors into the firms most insulated from its effects: US large cap growth stocks. With their high profitability, cash-filled balance sheets, dominant industry positions and solid pricing power, they have become the safety stocks of the post-COVID-19 market. Financials have recently jumped on the momentum train as the recent steepening of the yield curve favors their prospects.

Identifying the source and participants of a momentum cycle helps determine how long the cycle might last. Momentum cycles often result in valuation distortions that if they reach extreme levels, leave little room to run. This cycle is not there yet. Thanks to the considerable cash flow and profitability of the Magnificent Seven, this momentum cycle looks middle aged when compared to the stratospheric Internet stocks of the 1990s, or the post-COVID-19 stay-at-home stocks of 2020[10].

MOMENTUM STOCK VALUATIONS AT DIFFERENT MOMENTUM CYCLE PEAKS



Show Me the Mo' (Continued)

If valuation says there is room left to run, investors should look at macroeconomic forces for signs of change. Further momentum leadership depends on inflation remaining stubbornly persistent, or even increasing. Recent events provide reason to believe that could be true. Headline CPI figures have ticked up in the last few months. More detailed measures of sticky inflation remain resilient as well. Potential policies put forth by the incoming Republican administration such as tariffs and extension of tax cuts are all on the margin, inflationary. All this adds up to a core inflation rate currently at 3.3%[10].

In combatting inflation, the Federal Reserve is at a crossroads. They have a dual mandate of controlling inflation and promoting employment (through economic growth) but can only concentrate on one goal at a time. The level of inflation, specifically core inflation, influences the direction of this focus. When core inflation in the US remains below 3%, the Fed can prioritize growth and will lower the Fed Funds rate when necessary to mitigate recessions and the risk of deflation. But when the core rate rises above 3%, the Fed prioritizes inflation and will raise rates aggressively even at the risk of pushing the economy into recession. With the Core CPI rate at 3.3%, the Fed has to choose which dragon to slay: inflation or economic weakness[11].

And there are signs of economic weakness. Leading indicators have been calling for economic weakness for a good two years. Employment has bottomed out, and risen through medium term trendlines, a signal that has foretold nearly every recession since World War II. Fiscal stimulus is likely to wane now that the election is over. Trade Tensions and geopolitical risks abound. China is embroiled in growth challenges of their own and can no longer be counted upon to pull the global economy forward. If economic weakness does show itself in 2025…

— Inflation fears likely abate

— Short term rates fall in anticipation of accelerated Fed rate cuts

— The dollar strengthens

…and the momentum cycle comes to end.

[10] Bureau of Economic Analysis

[11] The Federal Reserve actually focuses on the PCE – Personal Consumption Expenditure Price level index, which draws data from a broader range of sources, but for purposes of this perspective, is generally in tune with Core CPI.

Fixed Income –
The Dog is Tired of Being Wagged by its Tail

After being whipped around in 2024 by higher inflation expectations (1st half 2024), then slowing growth, declining inflation expectations and the onset of rate cuts (Summer 2024) to the return of inflation fears (Q4 2024), the long end of the bond market made a statement. The 10-year Treasury rose nearly 100bp after bottoming in mid-September, indicating one way or the other, the future direction of rates is up.

This move finally brought the Treasury yield curve out of inversion, but instead of a "bull steepener" the curve shifted through a "bear steepener"[12]. The bond market is telling us to expect:

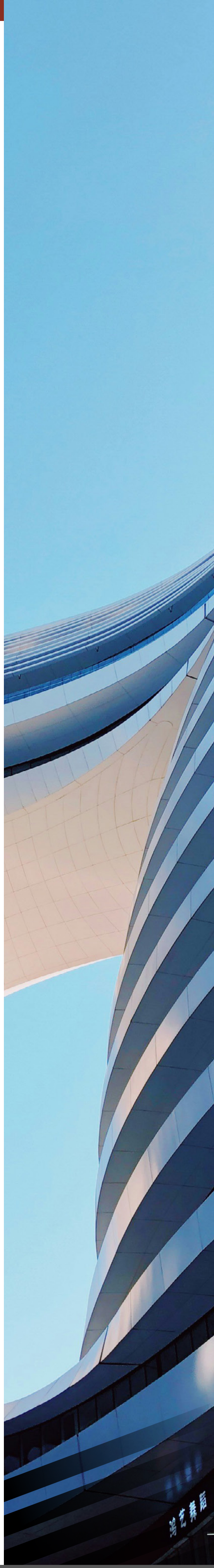
- Stronger economic growth
- Higher Inflation
- Higher risk appetite

The continuation of these trends would keep credit spreads narrow and stable and moderate bond returns overall.

Economic weakness would put pressure on short term rates, and return the curve to a "bull steepener", indicating:

- Weaker economic growth
- Lower inflation
- Lower risk appetite

Credit would come under pressure – economic weakness puts pressure on credit spreads, and if there is one asset class that has benefitted in the momentum cycle other than large cap growth, it has been high yield credit.

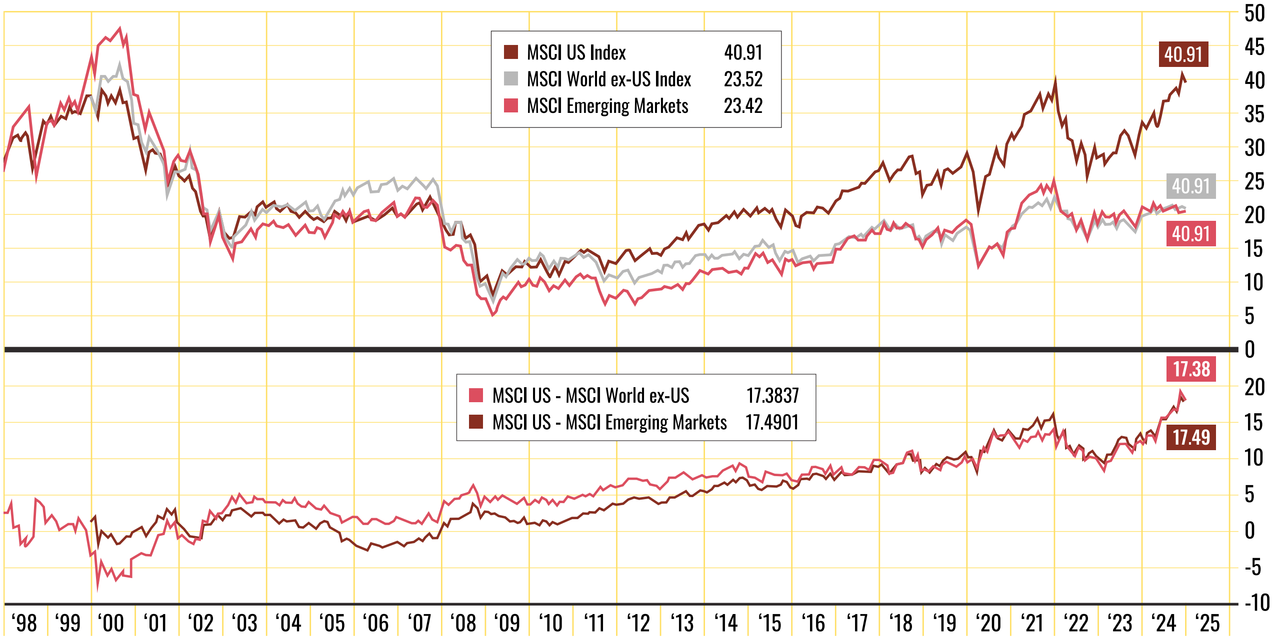


[12] A "bull steepener" is when short term rates fall more than long term. A "bear steepener" is when long-term rates go up more than short term. Note that bull and bear in this context refers to the bond market, not the equity market.

International and Emerging Markets

International and Emerging Markets are intrinsically tied to the momentum trade…on the short end. In this case however, the valuation gap IS extreme.

CYCLICALLY ADJUSTED P/E RATIO: MSCI US v. DEVELOPED v. EMERGING MARKETS



MXUS Index (MSCI USA Price Return USD Index) US Relval v. Intl' & EM Montlhy 31DEC1997-20DEC2024 Copyright©2025 Bloomberg Finance L.P. Source: MSCI

This chart shows the relative valuation of the US versus Developed and Emerging equity markets using the "Shiller P/E", which averages earnings over 10 years to smooth out cycles. While international markets have always traded at a discount to US markets, these markets are as cheap as they have been since the late 90s. There are several good reasons:

— International markets, especially developed markets, have a lower weight in higher growth sectors such as technology. (Less true in Emerging markets, which are led by Taiwan Semiconductor. But semiconductors are the cart, not the horse – they enable technology, not lead it)

— Geopolitical risks in close proximity – Ukraine, Taiwan and the South China Sea, and the Middle East.

— The dollar has been strong for 15 years.

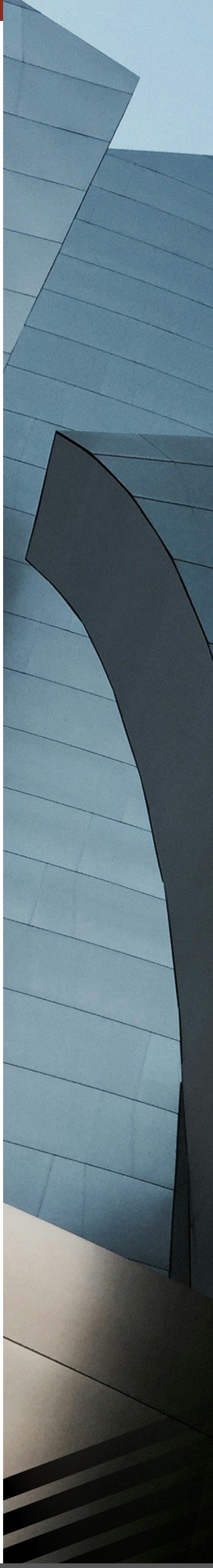
The argument for investing in international allocations is this is all priced in. While the geopolitical risks remain idiosyncratic and unpredictable, if the momentum cycle ends, international stocks stand to outperform. Their industry composition benefits from lower rates, and the dollar is likely to weaken. The last extended rally in international markets was from 2003 until 2008, coinciding with the last period of extended dollar weakness.

Small(er) Cap Stocks

Another market segment on the short end of the momentum trade has been small caps. The valuation gap is extreme as well, but for small caps, there is precedent – large caps carried this kind of premium back in the late 90s tech boom as well.

In the post COVID-19 world, small cap stocks have struggled to compete with larger firms. More than 40% of small cap stocks in the Russell 2000 index of small caps are losing money, including 6 of the largest 10 by market cap. In a universe where credit is limited, and profits are farther in the future, interest and discount rates have a profound effect on valuations.

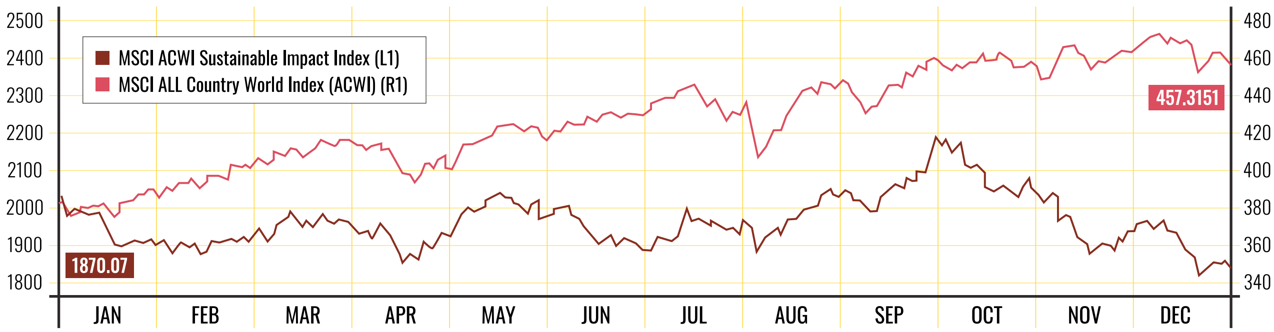
A shift in the momentum cycle would benefit small caps as well. While one could argue that economic weakness would hit smaller companies harder than larger ones, you can also argue that small cap stocks have already been through a bear market and don't have much more performance to give up. Evidence from past turns in momentum have shown that the stocks that went up the most in the cycle go down the most when it ends, and vice versa.



Sustainable Investing

Momentum markets are often defined by what is out of favor as much as what is in favor. There is no better poster child for this fact than the world of sustainable investing.

SUSTAINABLE INVESTING IMPACT 2024

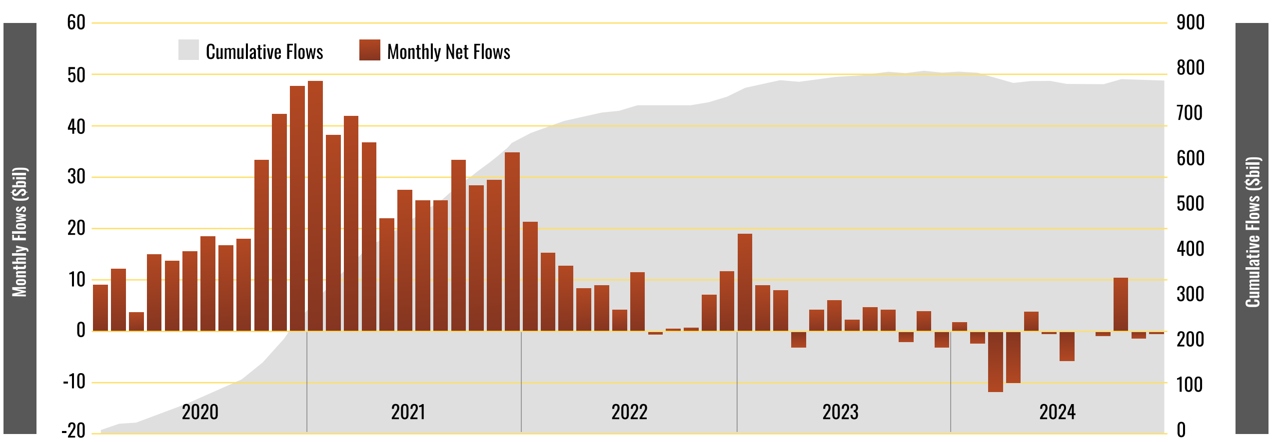


M1CXBLRV Index (MSCI ACWI Sustainable Impact Index USD Net Total Return) Sustainable Index v. ACWI Daily 31DEC2023-30DEC2024 Copyright©2025 Bloomberg Finance L.P. Source: MSCI

Equities in the sustainable space are vulnerable to the macroeconomic forces behind this current cycle. As many of these stocks are 'long-duration' with profits far in the future, like with small caps the rise in interest rates has de-rated significantly from their 2021 highs. Returns from the Inflation Reduction Act, which promised them billions of dollars in sustainable spending by the Federal government, have not yet shown up in firm returns, and concerns over "greenwashing" in some index-based ESG products turned sentiment against them.

These facts manifested themselves in dramatic investor outflows from sustainable investing, and subsequent dramatic underperformance. The outflows may have found a bottom in 2024, and if accompanied by a more supportive interest rate environment, we may see a resurgence in interest in these stocks in the near future. Rising power demand growth and an aging infrastructure coupled with growing need for reliability, efficiency and affordability, have made sustainability a key part of the global economy.

ESG MUTUAL FUND & EXCHANGE TRADED PRODUCT FLOWS



Source: Morningstar

Volatility

There is one winner no matter what the momentum cycle does – volatility. Given a choice between higher rates from inflation and lower rates from weaker growth, volatility will remain higher in either path. Consistent volatility levels (measured by the VIX) in the low teens requires a combination of stable growth and disinflation.

Conclusion

As we move through 2025, the outlook for global markets is inextricably linked to the trajectory of U.S. inflation. Inflation not only drives monetary policy but also acts as the linchpin for market momentum, asset class performance, and investor sentiment. With core inflation hovering around critical thresholds, markets are poised for binary outcomes: persistent inflation could sustain the dominance of large-cap growth stocks and momentum investing, while easing inflation would signal a rotation toward small caps, international equities, and fixed income.

This dichotomy highlights the precarious balance underlying the current market structure. On one side, stubborn inflation may force central banks to tighten again, sustaining volatility and concentrated leadership. On the other, emerging economic weakness could shift priorities toward growth, prompting policy easing and unleashing performance from undervalued segments. For investors, this dynamic calls for vigilance, adaptability, and a readiness to pivot as macroeconomic forces reveal their hand. In 2025, the investment landscape may well hinge on the answer to a singular question: which way will U.S. inflation break?

Important Information

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