LGT Wealth Management

Outlook 2025

Navigating transformation, trade and technology

Forward-looking for generations

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A message from our CIO

Dear Reader,

Welcome to our annual Outlook publication, where we explore the key macroeconomic trends shaping markets both today and in the future.

As technology and geopolitics continue to redefine the world around us, we are focused on identifying opportunities that reinforce our investment philosophy and align with our long-term approach. Our Outlook offers a forward-looking perspective that discusses these developments, as well as other economic indicators that guide and shape our investment discussions.

This time last year, we discussed themes such as regional policy and growth divergence, easing price pressures and declining energy prices. With half of the world's population heading to the polls, we expected that 2024 would be a pivotal year for global politics, leading to more growth-oriented policies. We also highlighted the key themes shaping capital markets, such as interest rates, private markets, sustainability, geopolitics and Asia's potential.

Over the past year, we have seen varying degrees of progress across these themes.

- Interest rates and post-election fiscal policies have remained significant market drivers.
- China's ongoing difficulties have somewhat affected Asia's potential. However, with Xi Jinping signalling that he would implement more proactive policies to promote Chinese growth, we see this region as a powerful driver of markets.
- Early 2024 saw a shift in market focus from inflation to growth, though inflation's resurgence remains an important factor influencing economic conditions.
- We anticipated a focus on high-quality businesses in 2024, but the dominance of artificial intelligence (AI) related tech giants limited a broader market rally. However, we feel optimistic that 2025 will witness a broadening of earnings, reinforcing the resilience of a long-term, diversified investment approach.

Looking ahead to this year's Outlook, no discussion of 2025 would be complete without examining the shifting geopolitical landscape. The return of President-elect Donald Trump to the White House is set to significantly shape global power dynamics and international relations for years to come. We also consider the implications of increasingly concentrated indices dominated by the Magnificent 7. Finally, we delve into the transformative role of emerging technologies, such as AI, and their profound impact on industries like healthcare.

We hope you find this Outlook insightful and look forward to working with you in the new year, and for many years to come.

Wishing you a prosperous 2025.

Sanjay

Over the past five years, few would have predicted a global pandemic, surging inflation, aggressive interest rate hiking and a recession that actually never happened.

Global economic outlook 2025

Predicting markets is notoriously difficult and can often prove futile during periods of transformative change. Over the past five years, few would have foreseen a global pandemic, rising geopolitical aggression, surging inflation, an aggressive interest rate hiking cycle and a widely anticipated recession that never actually materialised. Expand that timeframe to ten years and you can include the UK taking the unprecedented decision to leave the European Union (EU). Predicting the events of 2025 will not be any easier. The European political landscape remains volatile, AI continues to disrupt the status quo and Donald Trump's second term will likely be unpredictable. But in these uncertain times, performing in-depth research and forecasting various scenarios is more important than ever.

Transformation, trade and technology

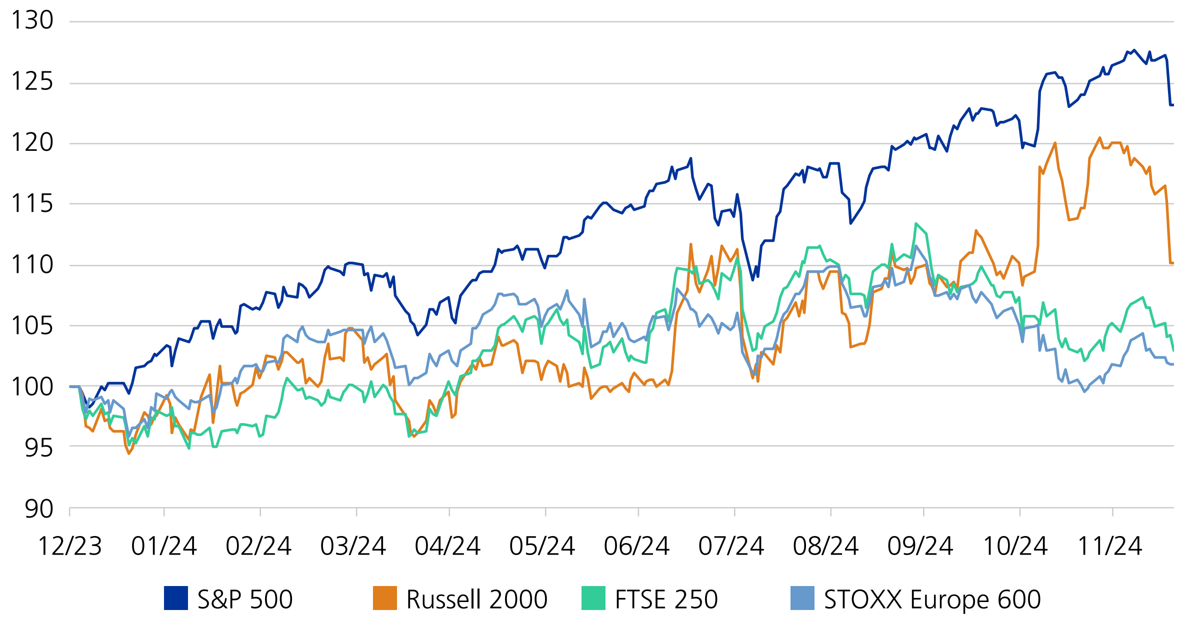
We expect Trump's policies on tariffs, taxation and deregulation to become clearer in the first quarter, providing a pathway for markets for the remainder of 2025. During the past year, many expected that the performance of equity markets would broaden beyond the technology behemoths to include companies from a variety of sectors. But yet again, the Magnificent 7 led the way in 2024.

Magnificent 7 companies:

Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, Tesla

Despite ongoing geopolitical uncertainty and high interest rates driven by persistent inflation, US economic growth gained momentum as the Federal Reserve (Fed) successfully orchestrated a soft landing. This created a backdrop where robust corporate earnings and renewed confidence buoyed both equity and credit markets. The S&P 500, fuelled by the Magnificent 7, gained some 25% over the year. US equities led the way globally, with much more muted performance for UK and European equities.

Equity Returns 2024



Source: Bloomberg

Diverging economies and shifting politics

After roughly half of the global population went to the polls in 2024, we will likely witness a divergence of global economies over the next 12 months.

Across the pond

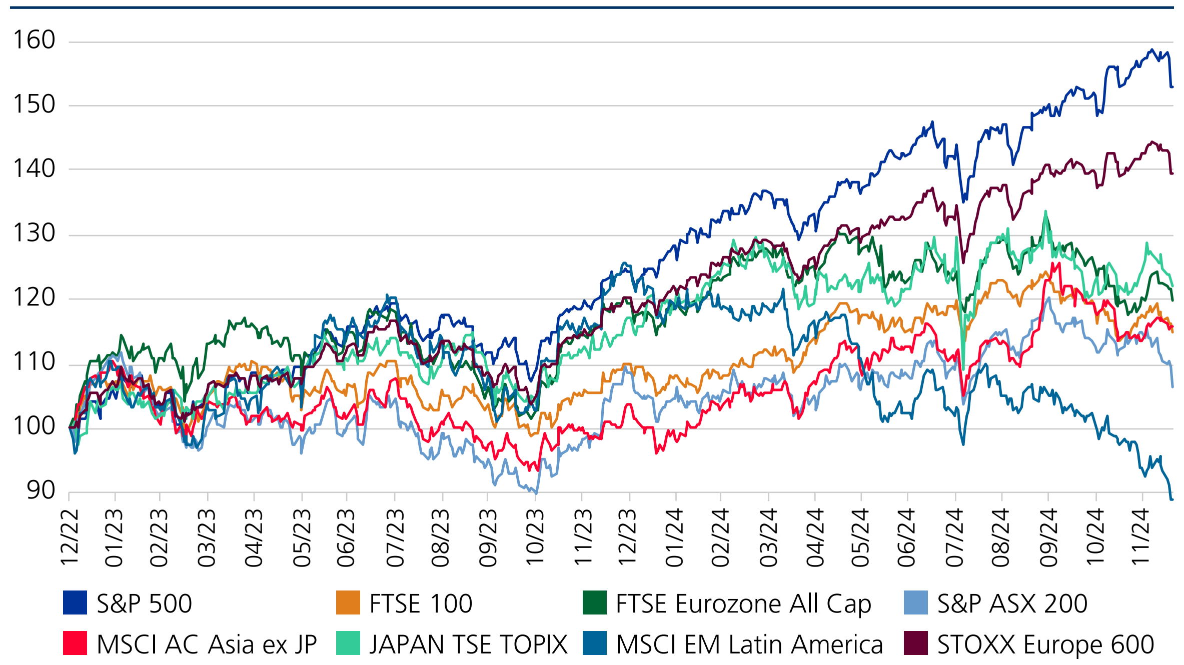
Governments that implement pro-business policies tend to lay the groundwork for stronger economic growth. Trump's recent victory, along with his 'America First' agenda, could well result in the US furthering its dominance and equity outperformance, relative to the rest of the world. The Republicans secured the trifecta of the House, Senate and presidency, making the President-elect well-positioned to enact his proposed agenda. However, the Republicans' narrow House majority, the smallest since the 1930s[1], may pose challenges in securing unanimous support for key policies. While Trump's policies, including tax cuts, deregulation and trade protectionism are positive for risk assets short term, it is important to be aware that these policies carry risks, including higher inflation and expanding national debt.

In all this, one must not lose sight of the fact that US equities have rallied strongly since October 2023 under the outgoing Biden administration.

UK budget blues

In the UK, the tone is very different. Not only have UK equities struggled, but the much-anticipated Labour budget has done little to reassure investors. The so-called pro-growth budget, that included an increase in employer national insurance contributions, could prove inflationary as businesses pass these hikes on to consumers. This will make the Bank of England's (BoE) job much harder in 2025. The UK has one of the cheapest major stock markets in the world. But sticky inflation, a stock

Regional equity performance since 2023



Source: Bloomberg

market primarily constituting of 'old economy' companies and uncertainty over future interest rate cuts will continue to deter investors for the foreseeable future.

Eurozone shake up

Europe's political landscape is marked by uncertainty as we enter the new year. French President Emmanuel Macron's decision to hold a snap election backfired, and his centrist party lost ground to both right- and left-wing parties. Germany's Chancellor, Olaf Scholz, lost a vote of confidence in Parliament, paving the way for elections in February 2025. Low investment, weak exports and the threat of US tariffs has resulted in European stocks underperforming US markets in 2024. The weak euro has also discouraged foreign investors. Looking to the future however, Europe has the potential to surprise. The European Central Bank (ECB) has greater potential for monetary easing, the weak euro should benefit exports, and the upcoming elections in Germany may well result in looser fiscal policy, which would boost both economic growth and corporate earnings. Recent corporate results in the region show signs of improving prospects.

A tale of two giants: India's rise, China's revamp

Asian markets continue to be dominated by India and China, but since the pandemic, sentiment and market performance in these two regions could not be more different. Under Prime Minister Narendra Modi, India has seen strong economic growth driven by robust domestic demand, favourable demographics and structural reforms. This, along with India's largely domestically focused economy being less exposed to American trade and fiscal policies, has resulted in optimism surrounding India's long-term growth story and highlighted the nation as an alternative to China.

In contrast, China has faced challenges, but 2024 saw a material shift as President Xi Jinping introduced stimulatory policies to boost domestic consumption and revive their property market. These measures to support all areas of the Chinese economy have led to a recent stock market rally, albeit from a low base. Sustained growth will be dependent on the successful implementation of Xi's new policies, coupled with the potential impact of Trump's proposed tariffs on the region. China must also continue to mitigate the country's debt levels.

Roughly half of the global population went to the polls in 2024.

[1]Barrons: https://www.barrons.com/articles/house-majority-election-results-trump-599c16f9

A turning point

A pivotal shift in global interest rate cycles:
2024 marked a significant turning point as many major central banks, excluding Japan, began lowering rates. While inflation remained persistent and economic growth resilient, which limited the extent of the cuts, markets welcomed these reductions as a positive signal, as they occurred amid declining inflation and strong growth rather than as a defensive measure to prevent recession.

Divergence ahead for central bank policies:
In 2025, central bank strategies are expected to vary significantly.

- **The Fed's uncertain path:**
  The Fed faces an uncertain trajectory due to potential inflationary pressures driven by Trump's tariff threats and pro-growth policies. Markets currently anticipate no change in US rates during the first half of 2025, though this outlook could shift depending on growth and inflation data.
- **The ECB's steady easing approach:**
  The ECB appears to have a clearer path. With weaker economic prospects across the eurozone and limited price shocks, markets expect the ECB to cut rates at every meeting until mid-2025. This has already weakened the euro, potentially offering some support to the region's economy.
- **The BoE's cautious response amid domestic pressures:**
  The BoE faces a more complex backdrop. The impact of the October 2024 budget on inflation is still unclear, but recent data shows that inflation is more persistent in the UK than in the US or Europe. Combined with the UK's weaker growth dynamics, this adds to the challenge. At its final meeting of 2024, the BoE held rates steady but indicated plans to continue with its gradual rate-cutting cycle in 2025.

Central bank decisions set to shape 2025's economic landscape:
As we move through 2025, the actions of key central banks will continue to influence both economic and market trends, with diverging strategies reflecting the varied challenges and opportunities facing different regions.

Trump's election victory may well result in a continuation of 'US exceptionalism', especially as his policies prioritise domestic economic and profit growth.

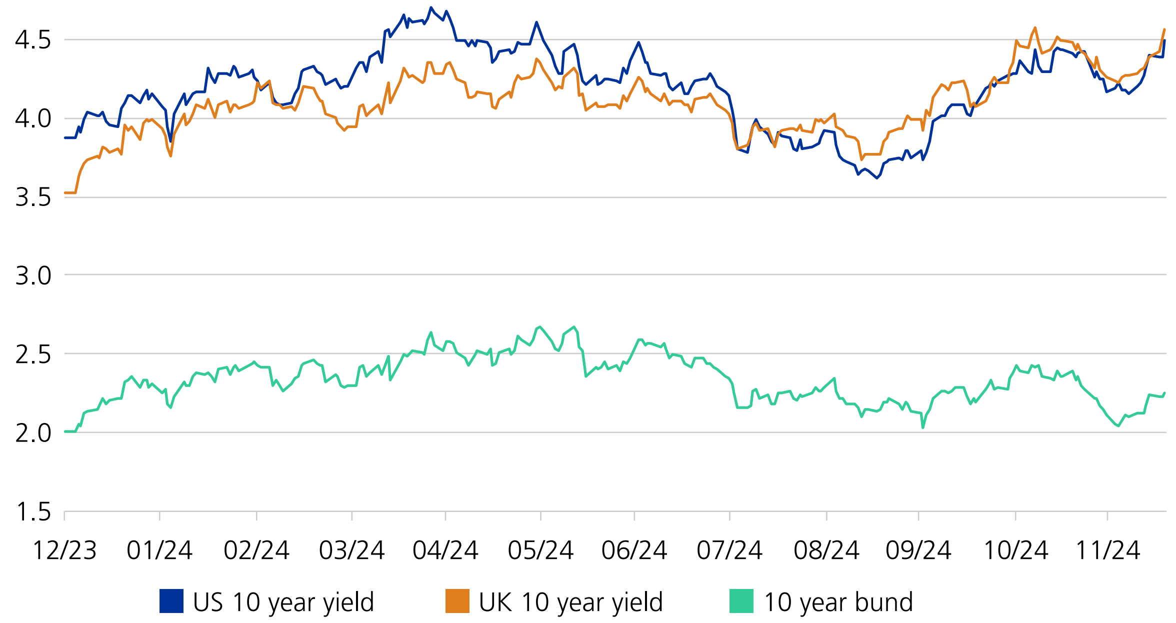
Opportunities in bond markets

Ongoing geopolitical uncertainties, and the subsequent divergence in monetary policy is reflected in the bond market. Spreads between UK gilts and German bunds have widened to levels last seen during Liz Truss' mini-budget fallout in 2022.

Meanwhile, the US Treasury market has been range-bound since the start of 2024, with two- and ten-year Treasury yields trading in between a range of circa 3.7% and 4.7%. Strong economic growth has led the Fed to adopt a more cautious pace in reducing interest rates, reinforcing the divergence in global policy approaches. This dynamic presents an opportunity to review our fixed income allocation to capitalise on attractive medium-term bond yields. At the same time, varying central bank policies are likely to result in heightened currency volatility. This means we can expect continued volatility across the yield curve as central banks manoeuvre and manage rates in a world where inflation is expected to be stickier and above the 2% target. This underscores the need for careful portfolio management to mitigate potential impacts on returns throughout 2025. We aim to be nimble with our allocations and ready to capitalise when opportunities present themselves.

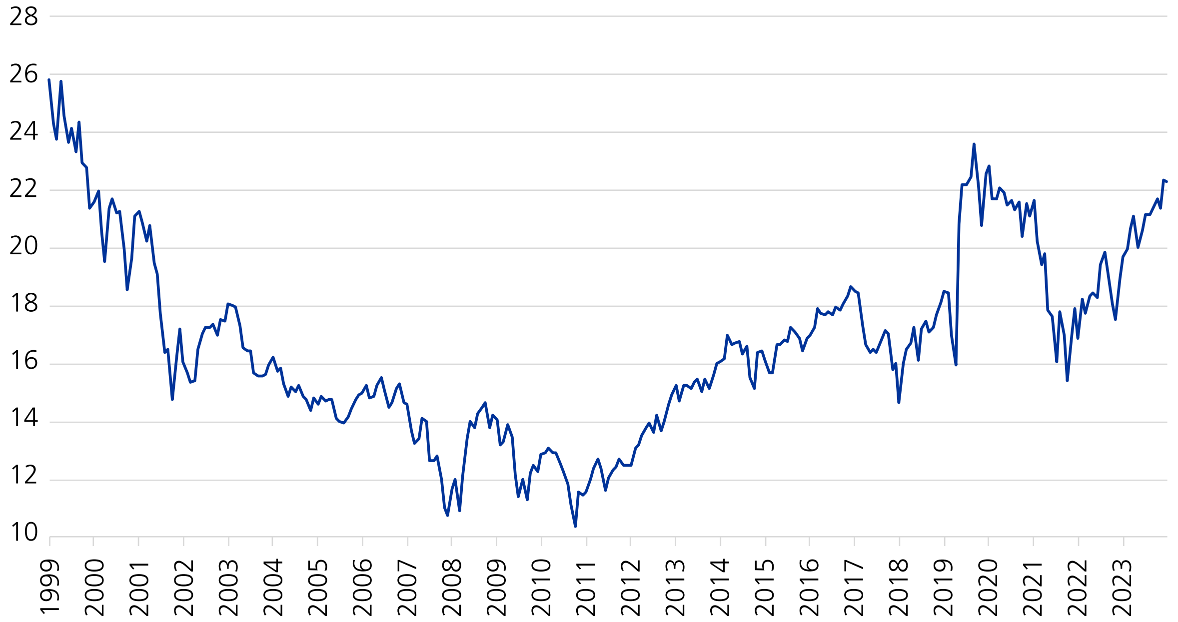
Trump's election victory may well result in a continuation of so-called 'US exceptionalism', especially as his policies prioritise domestic economic and profit growth. Despite certain predictions of renewed opportunities, US equity valuations are not cheap, and Trump's stance on tariffs may pose the risk of potential trade wars as well as higher inflation. We therefore must tread with caution. We will keep a close watch on valuations and earnings, as over the medium-to-long term these are the primary drivers for equity markets.

Yields 2024



Source: Bloomberg

S&P 500 next 12 months forward P/E



Source: Bloomberg

The impact and benefits of AI on equity markets and the wider economy should become clearer in 2025.

Conclusion

The year ahead presents a complex landscape, with diverging central bank policies, geopolitical turbulence and technological disruption. The US may continue to lead global markets owing to pro-growth strategies, but inflation remains high and valuations are elevated. Europe is plagued by political uncertainty, although monetary easing may support exports, which may give the continent's growth a much-needed boost. Meanwhile in the UK, persistent inflation, weak growth and subdued investor confidence have led economists to revise growth forecasts down. In Asia, India looks to be a bright spot, as the country has a strong domestic growth story. In China, investors will be looking for more detail around the new stimulus measures, and how the country handles its substantial debt. In fixed income, there are many opportunities in bonds (both sovereign and corporate) as uncertainty surrounding interest rate policies will continue to impact the shape of the yield curve.

While the Magnificent 7 companies have directly benefited from the rapid growth in AI, the impact and benefits of AI on equity markets and the wider economy should become clearer in 2025. AI is expected to increase productivity, expand revenues and enhance profitability in broader markets. This should further strengthen our case that in 2025, market dynamics will depend on the entire S&P 500 index stocks, rather than just the Magnificent 7.

Uncertainty will likely persist whilst global powers realign and settle under new leaders. Therefore, rigorous research analysis will be key to navigating 2025's risks and opportunities. Having the flexibility and agility to adapt to the changing macro environment, whether through our equity exposure, adjusting portfolio duration or increasing investment in alternative assets, will be paramount.

Sanjay Rijhsinghani
CIO

Sanjay

Themes for 2025

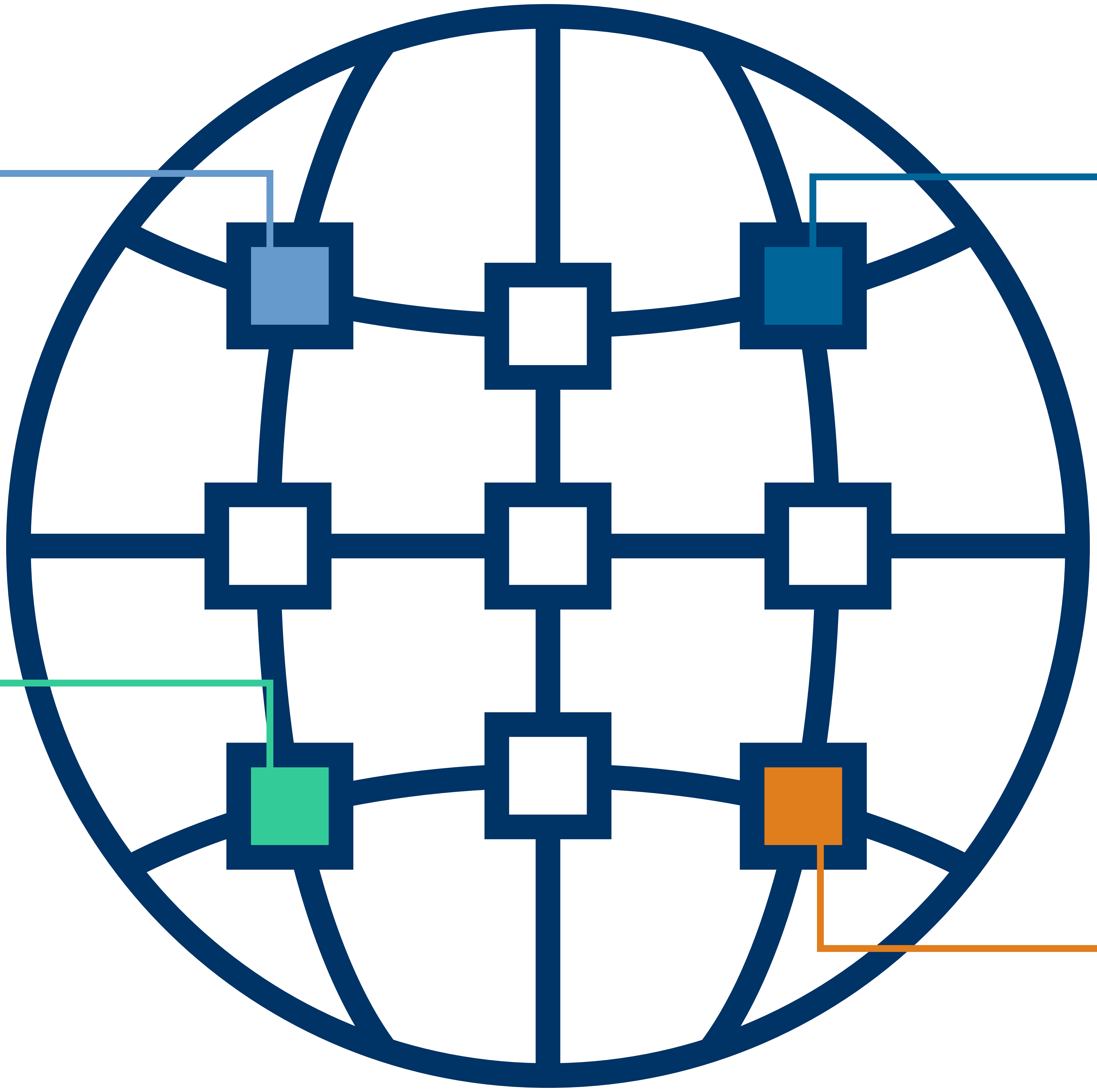
Key investment trends that we expect will shape markets both now and for years to come

Geopolitical tensions

Investment opportunities in an uncertain world

The AI revolution

Who will be the cars and who will be the horses?



Broadening markets

The Magnificent 7 effect: what it means for active vs passive investing

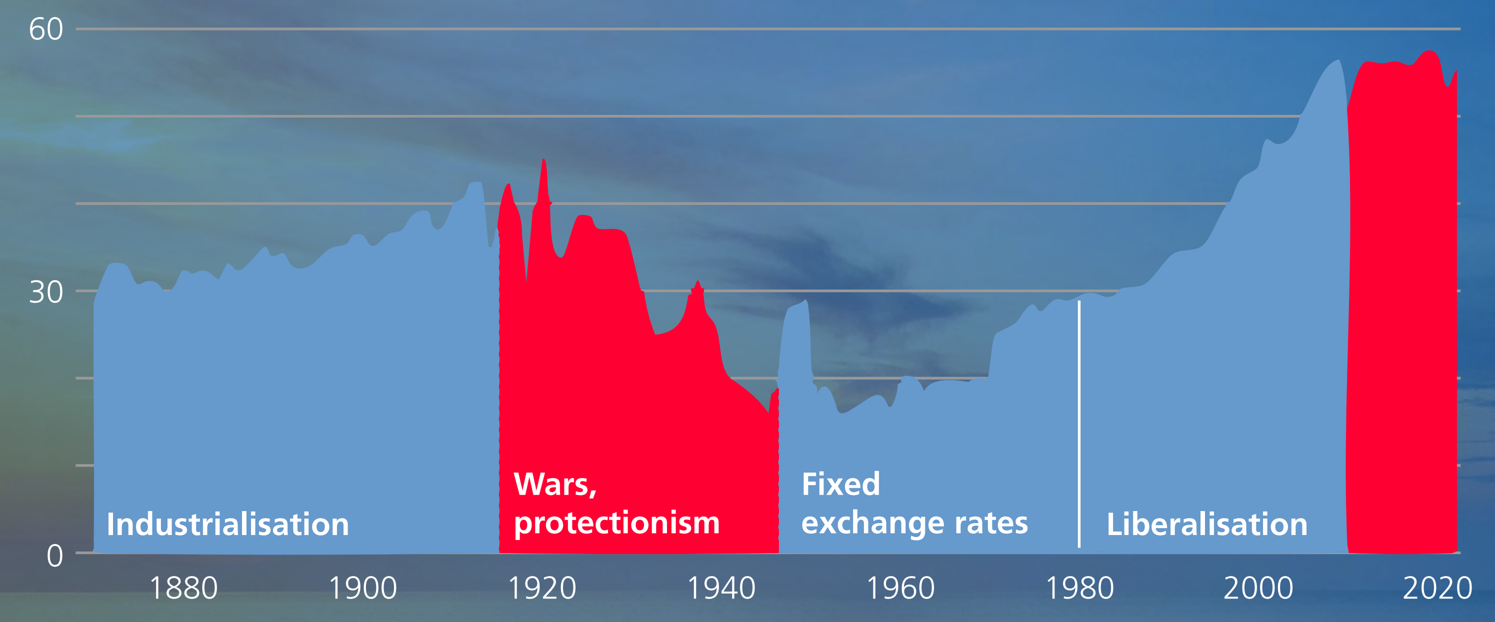
Stewardship interview

In conversation with our CIO and Global Stewardship Lead

Eras of globalisation

Trade openness slowed following the global financial crisis

(sum of exports and imports as a % of GDP) [2]



Sources: PIIE, Jorda-Schularick-Taylor Macrohistory Database, Penn World Data (10.0), World Bank, and IMF staff calculations.
Note: Sample's composition changes over time

It shows how dramatically things have changed that markets had minimal reaction to the ongoing conflict in the Middle East, Vladimir Putin's nuclear rhetoric or mounting concerns that China may invade Taiwan.

Geopolitical tensions

Investment opportunities in an uncertain world

The period following the end of the Cold War in 1989 was a relatively stable time when conflict and intimidation between global powers was rare. A rules-based system was built upon the Washington Consensus, which fostered mutual co-operation and led to a transformational collapse in trade barriers as countries embraced globalisation, the EU expanded and China joined the WTO.

It shows how dramatically things have changed that markets had minimal reaction to the ongoing conflict in the Middle East, Vladimir Putin's nuclear rhetoric, or mounting concerns that China may invade Taiwan. Likewise, large-scale civilian deaths or major retaliatory incursions by Ukrainians into Russia are largely unreported. Sadly, we have become accustomed to a world in which aggression, sanctions and trade barriers are the norm. In this article, we explore the reasons for rising geopolitical uncertainty and explain our approach to investing in an uncertain world.

End of the Cold War
Marks the beginning of global coorperation

China joins the WTO
China becomes a major player in global trade

Global Financial Crisis
Affects global markets and power dynamics

US-China Trade tensions escalate
Introduction of tariffs and trade barriers

Russia-Ukraine conflict
Increases energy insecurity in Europe

Increased US-China tensions over Taiwan
Intensifies strategic decoupling efforts

[2]IMF: www.imf.org/en/Blogs/Articles/2023/02/08/charting-globalizations-turn-to-slowbalization-after-global-financial-crisis

Strategic decoupling, trade barriers and building reserves

After multiple decades when the US and China peacefully respected one another from a distance, China's emergence as a geostrategic player and an increasingly dominant economic competitor has forced the US, EU and UK to reconsider their positions. The notion of "strategic decoupling"[3] has gained traction, particularly as US-China tensions heightened during Covid and the Russia-Ukraine war. Sanctions, tariffs and trade barriers are increasing, heightened by Trump's re-election.

As the West re-evaluates their relationship with China, they can also take lessons from the nation too. Former ECB President Mario Draghi discussed this topic in an EU report on competitiveness, arguing that nations must learn more from China which retains its natural resources for its own industries, with its long-term plans and prosperity in mind. The global focus on strategic reserves of natural resources, including rare metals and semiconductors essential for technology and military hardware, has forced leaders to reconsider their stance on China, the dominant producer of these materials. As countries seek to boost reserves, this will have significant implications on global supply chains and investment strategies.

Europe has faced its own set of unique challenges. Russia's invasion of Ukraine sent energy prices in Europe soaring. Car manufacturers have also been hit by China's growing influence in the electric vehicle (EV) space, where cars sell for as little as $10,000. On top of this, China's dominance in rare earths puts it in an enviable position when it comes to energy security, as rare earths are an important component in batteries, solar panels and wind turbines. The EU needs to secure their energy supply and protect their markets, but they are behind the curve, and they are not unified so this could prove challenging. A forward-looking, highly selective approach aligned with key trends will be critical. Identifying emerging Asian EV innovators like BYD, rather than relying on VW's past successes, is likely the best way forward.

Sanctions, tariffs and trade barriers are increasing, heightened by Trump's re-election.

Diversifying supply chains and the semiconductor arms race

Many businesses are moving manufacturing closer to home for security and economic purposes. This recalibration is especially relevant as Taiwan tensions escalate and the semiconductor arms race prompts firms and countries to re-assess their operational risks. TSMC, the world's largest manufacturer of semiconductors, has all but completed building its first plant in the US, at great expense and following political pressure and financial incentives from the US government.[4] TSMC has subsequently committed to building two more plants on the site over the next decade.[5] The US has banned exporting high-end semiconductors[6] to China, demonstrating once again the political nature of the industry.

The implications of decoupling extend beyond immediate economic impacts; they signal a broader shift in global power dynamics. As companies adapt, the reconfiguration of trade relationships will likely create new opportunities and challenges for investors. India, Mexico and Thailand have all been immediate beneficiaries of supply chains shifting away from China, but whether this continues under a Trump administration, which is keen to prioritise the US domestic economy, remains uncertain.

A company specific example is HSBC which announced plans to restructure its operations into four distinct units, notably splitting into 'East' and 'West' divisions, set to take effect from 2025. One unit will align with China's alternative to the SWIFT payment system, a significant pivot in global banking practices.[7] George Soros teaches the principle that for every big top-down idea, one should look for a bottom-up expression. HSBC's move exemplifies this, signalling how financial institutions are approaching geopolitical realities.[8] A one-size-fits-all approach is no longer suitable, therefore the businesses which are adaptable will be best placed to benefit.

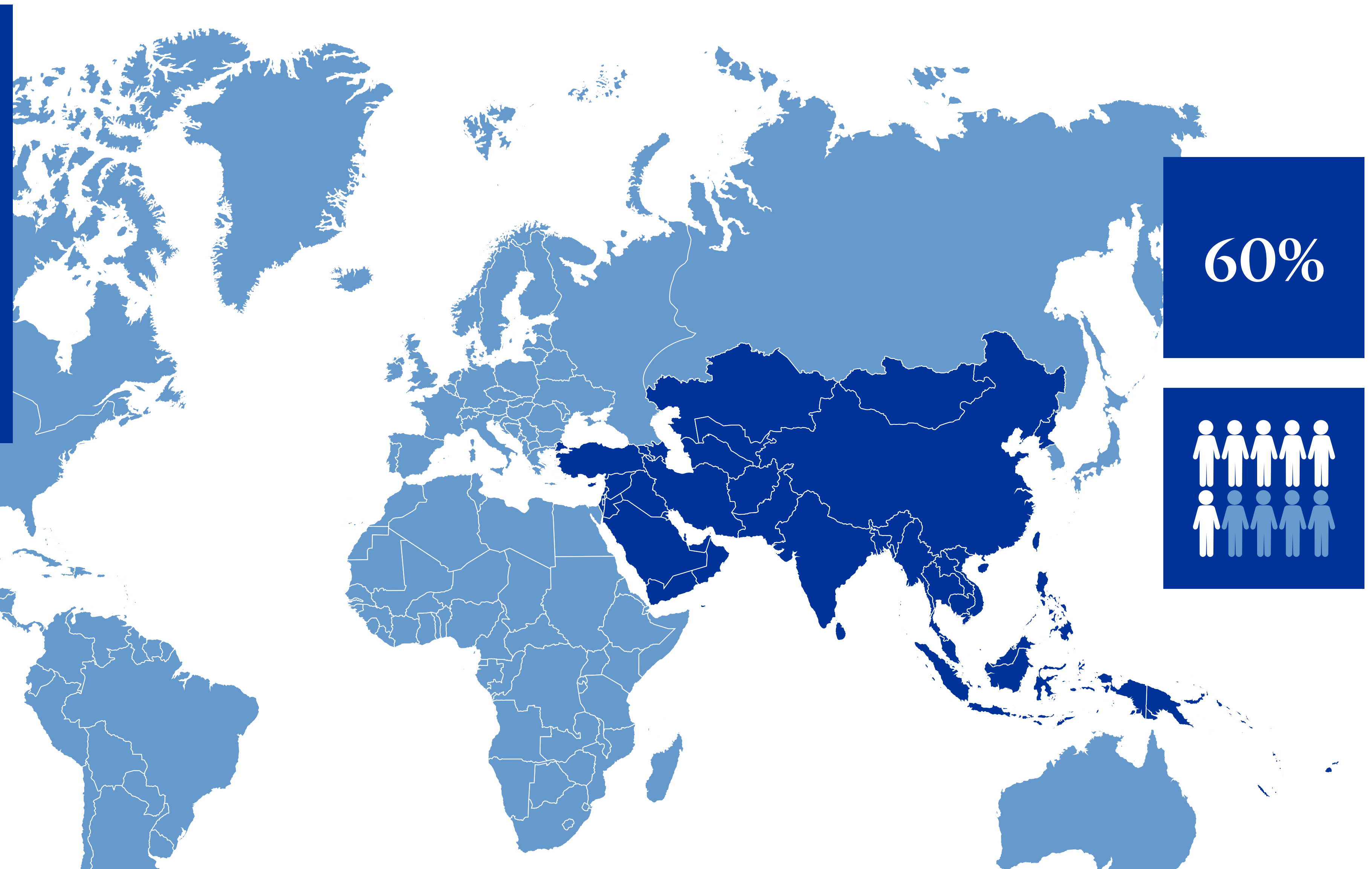
[3]The Diplomat: www.thediplomat.com/2024/10/de-risking-vs-strategic-decoupling-understanding-harris-and-trumps-approaches-to-economic-security/
[4]TSMC Arizona: www.tsmc.com/static/abouttsmcaz/index.htm
[5]CNBC: www.cnbc.com/2024/12/13/inside-tsmcs-new-chip-fab-where-apple-will-make-chips-in-the-us-.html
[6]CNBC: www.cnbc.com/2024/09/06/us-china-quantum-chip-related-export-controls.html
[7]HSBC: www.hsbc.com/news-and-views/news/hsbc-news-archive/we-are-simplifying-to-accelerate-our-strategy
[8]Reuters: www.reuters.com/business/finance/hsbc-appoints-pam-kaur-first-female-cfo-2024-10-22/

The Global South, BRICS and payment networks

A significant development in this shifting landscape has been the emergence of the Global South, which broadly consists of Africa, Latin America, the Caribbean, Asia (excluding Japan and South Korea) and Oceania (excluding Australia and New Zealand). This ambitious and cohesive economic bloc, exemplified by the recent BRICS* summit in October 2024 which was headed up by de-facto leaders Xi Jinping, Vladimir Putin and Narendra Modi, admitted another 13 partner states. The summit's declaration was widely seen as posturing, with few clear plans or commitments for implementation. For investors, the long-term investment significance of BRICS will depend on its ability to challenge existing paradigms but also its members' commitment to meaningful cooperation.

As these nations seek to assert their influence, the investment implications could be profound, especially for the US dollar as the world's primary currency. These disenfranchised nations may seek to displace the dollar as the reserve currency, a trend fuelled by the perception that the US has weaponised the currency through its continued control, although this displacement is unlikely to happen in the near future. However, as those who have spent time in Asia can testify, companies such as Alipay** or WeChat are growing in influence in Asia, a region which has 60% of the world's population, and a growing middle class with significant spending power. This means the US and its companies may face increasing competition.

The US may face increasing competition from companies which are growing in influence in Asia, a region where 60% of the world's population resides.



*BRICS is an acronym for an association of five major emerging economies: Brazil, Russia, India, China, and South Africa

**Founded by Alibaba in 2004, Alipay is a third-party mobile and online payment platform. Alipay overtook PayPal as the world's largest mobile (digital) payment platform in 2013. As of June 2020, Alipay serves over 1.3 billion users and 80 million merchants. According to the statistics of the fourth quarter of 2018, Alipay has a 55.32% share of the third-party payment market in mainland China, and it continues to grow.

Leadership change

Following the US presidential election, we are at an inflection point. US foreign policy will change, which will impact both domestic and global economic policies. Despite all the threats around tariff implementation, this shift could signal a re-engagement with multilateralism, potentially altering the trajectory of current geopolitical tensions. The US leadership change could be critical for the Middle East, China, the EU and Russia. Do not assume Trump's second term will be the same as his first. Trump's new and younger team in JD Vance, Tucker Carlson, Elon Musk, RKJ and Vivek Ramaswamy may throw in some curveballs. If there is anything we know about Trump, it is that money talks and if he believes that closer relations with China will help 'Make America Great Again', then nothing should be discounted.

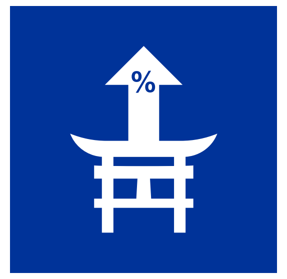
A greater emphasis on regional allocations will become essential.

Emphasising regional and sectorial splits within investment portfolios

Investing in global, quality businesses is still a key component of our investment framework. However, as the world continues to fracture geo-strategically into distinct spheres of influence, a globally-oriented portfolio built solely upon a collection of blue-chip businesses with global earnings but with no consideration for geopolitical trends, will no longer suffice. To simply invest in the whole basket of 'Emerging Markets' will be too generic. There are too many different countries with different return drivers, demographics and loyalties to put them all in the same basket. Instead, a greater emphasis on regional allocations will become essential. Diversifying across various geographies, with some exposure in Asia or emerging markets, some in the US and a handful of European companies is vital.

Within fixed income, we anticipate there will be opportunities to arbitrage the different interest rate regimes within regions. For example, while the US is cutting interest rates, Japan has started to raise rates. China is beginning fiscal expansion, while the UK is heading towards fiscal discipline. These differences will provide opportunities for nimble investors.

US cutting interest rates



Japan raising interest rates

Preparing for the future

As geopolitical tensions continue to evolve, understanding their financial implications will be crucial for investors. Rising uncertainty, coupled with strategic decoupling and emerging power dynamics in the Global South, presents both challenges and opportunities. By embracing a diversified investment strategy that accounts for regional and sectoral distinctions, investors can better navigate this complex landscape and position themselves for success in an uncertain world. We believe that by being nimble, active and highly selective within our regional allocations, keeping focused on the long term and investing alongside a collection of the best-in-class regional fund managers, we are well placed to benefit from dispersions in returns between different companies, regions or sectors despite geopolitical uncertainty.

Henry Wilson
Partner and Senior Portfolio Manager

Enhancing supply chain resiliencies

Amid geopolitical tensions and global economic shifts, resilient supply chains have become essential. Companies are increasingly adopting strategies like onshoring, friendshoring and nearshoring to reduce reliance on high-risk regions. Onshoring and nearshoring grew during the pandemic, whilst friendshoring focuses on trade with political and economic allies. These strategies not only enhance supply chain security but also promote sustainability. LGT has been exploring these themes through direct company engagements this year.

A compelling example is NextEra Energy, the largest utility provider in the US, serving over 4.6 million customers. NextEra produces 24 GW of clean energy, enough to power 18 million homes. The company has restructured its solar supply chain by investing in domestic production and collaborating with allied nations, prompted by the Uyghur Forced Labour Prevention Act. This shift helps mitigate risks from rising tariffs and geopolitical uncertainties. LGT actively engages with portfolio companies like NextEra to enhance supply chain resilience, support domestic economies and promote sustainability, ensuring long-term value creation despite higher upfront costs.

Siobhan Archer
Global Stewardship Lead

Companies are increasingly adopting strategies like onshoring, friendshoring and nearshoring to reduce reliance on high-risk regions.

The AI revolution

Who will be the cars and who will be the horses?

It has become clear that AI is here to stay and will be completely transformational to the world as we know it. Its impact is being felt in all areas of society and in almost every industry. Only time will tell which sectors are able to nimbly adapt and ride the wave of this revolution and which will get left behind.

In June 2023, Nature magazine tested OpenAI's ChatGPT against a Turing Test, specifically assessing its ability to generate human-like text.[9] The Turing Test, originally proposed by Alan Turing in 1950, is designed to determine whether a machine can exhibit intelligent behaviour indistinguishable from that of a human. ChatGPT subsequently received an honourable mention on Nature Magazine's Scientists of the Year list (alongside 10 human scientists) denoting that AI systems were a force that cannot be ignored.[10] There are of course flaws in AI's current functionality. Regardless, it is momentous that something that was just a few years ago perceived to be a long way into the future is already here and making an impact. The discussion has quickly moved on to Artificial General Intelligence (AGI), or colloquially 'gen AI', and the point at which its intelligence overtakes humans.[11] For now, AI is present and becoming more intelligent daily.

AI leaders pulling ahead

The current winner in the AI revolution is the manufacturer of the chips used for AI processing, a company called Nvidia. It was quickly discovered that the Nvidia chips favoured for both gaming and crypto mining are also optimal for processing AI algorithms. Whether this will continue to be the case over the coming years will depend on whether competitors can quickly and effectively fund their own development projects and compete. Nvidia already had a high operating profit margin and has still doubled it in three years. This shows that it can name the price for its chips, so desperate are customers to get their hands on them. Despite a slowdown in revenue growth in the final quarter of the year following supply chain constraints, demand remains immense.[12] It is worth noting that some 50% of Nvidia's sales come from just three undisclosed companies[13], with Microsoft alone purchasing 485,000 of its chips this year, so we really are talking about a few very (very) deep-pocketed tech companies.[14]

NVIDIA.

AI

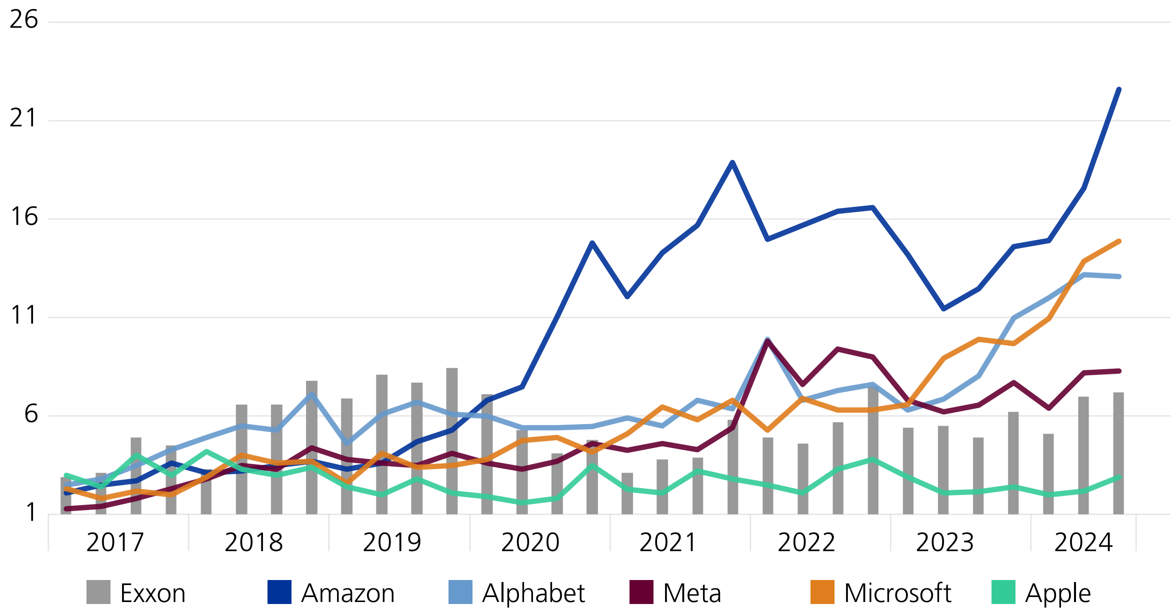
50%
sales from just 3 companies

[9]Nature: www.nature.com/articles/d41586-023-02361-7
[10]Medium: www.medium.com/@jenn_mc/chatgpt-named-as-a-special-mention-in-nature-magazines-2023-scientists-of-the-year-9dac882eeb3d
[11]McKinsey: www.mckinsey.com/featured-insights/mckinsey-explainers/what-is-artificial-general-intelligence-agi
[12]Reuters: www.reuters.com/technology/ai-chip-leader-nvidia-forecasts-fourth-quarter-revenue-above-estimates-2024-11-20/
[13]Business Insider: www.businessinsider.com/nvidia-stock-mystery-customer-microsoft-ubs-revenue-h100-gpu-chips-2024-5
[14]FT: https: www.ft.com/content/668883d6-f5ad-4512-874e-2741807caf49

Staggering sums

It is often said that data is the new oil, and the chart below exemplifies this. Amazon, Meta (Facebook) and Alphabet (Google) have each spent more than Exxon (one of the largest oil and gas companies in the world) on capital expenditure since at least 2021. Exxon's objectively huge $7 billion in Q3 2024 capex looks paltry compared to Amazon's $23 billion, Microsoft's $15 billion and Alphabet's $13 billion. Meta's $8 billion looks more sedate, although it is now forecasting $12 billion per quarter in 2025.These are staggering numbers and for each firm, a significant chunk has been attributed to their spending on AI, namely chips, servers and data centres. The sheer scale of the spending looks to be expanding their already impressive market shares, as so few other companies can spend these amounts on emerging technologies, such as AI. It is likely these powerful firms will continue to get stronger, but as initial adoption costs diminish, markets might well shift from favouring heavy spending to wanting the companies to focus on profitability once again.

Magnificent 7 quarterly capital expenditure ($bn)



Source: Bloomberg, LGT Wealth Management

Long-term winners vs early adopters

Picking the AI winners long-term will be increasingly difficult, but the tool's ubiquity means that it is imperative companies embrace it in order to benefit from it. Never has Warren Buffet's suggestion that it would have been better to short horses rather than buy car companies when the car hit the road, seemed more pertinent.

The increasing role of AI can be felt in almost every industry. If a business relies on following complicated rules and regulations, AI can monitor, decode and simplify it better than humans and for near zero cost. For firms that provide outsourced customer services, low wages are unlikely to be enough to compete with 24/7 AI assistants. In the fields of education and training, AI can completely personalise the experience through learning a student's behaviours. Perhaps they are struggling with a particular maths problem, or their language learning progress is being tracked, then AI can present content personalised to their learning needs.[15]

The role of AI in healthcare is perhaps one of the most impactful of all, with the field of medicine an area where the pace and scale of technological breakthroughs are so far ahead of predictions, with the promise of never-before-seen developments in treatment and medication just over the horizon. AI is becoming increasingly embedded in the research, development and discovery of new medications and treatments. AI essentially won the Nobel Prize for Chemistry in 2024, though the founders of DeepMind, Sir Dennis Hassabis and Dr John Jumper took the cash. The Google DeepMind AlphaFold AI programme has enabled biochemists' predictions of 3D proteins to jump from a 50% success rate to an almost 100% success rate, with many of its predictions within atomic levels of accuracy. Previously, complex 3D protein predictions were essentially undeterminable despite decades of research.[16] This is a massive leap forward.

Pharmaceutical companies that do not adopt AI as part of their medication discovery and development process will be at a significant disadvantage in the innovation race. It seems that AI will dramatically accelerate and enhance this research and therefore, it is likely that the larger 'big pharma' firms such as Roche, Novartis, Astra Zeneca and Johnson & Johnson, amongst others, will continue to fund research and hopefully scale even greater heights in a new AI-driven society.

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[15]Forbes: www.forbes.com/councils/forbestechcouncil/2024/07/22/personalized-learning-and-ai-revolutionizing-education/

[16]BBC: www.bbc.com/news/articles/czrm0p2mxvyo

The issues

Unlike in the seemingly unlimited budget for AI integration in big tech, the key question that remains for the medical industries, however, is how these AI advancements can be funded? Particularly in nations like the UK where there is an already struggling national health service. As technology develops, and breakthroughs are made, coupled with the trend of ageing populations, governments and health providers must ensure that they too are far up the AI adoption curve.

Creative design software company Adobe was one of the big AI winners in 2023 because of its commitment to integrate AI solutions into its various products. But in 2024, its stock has fallen as ChatGPT and other AI chat's abilities to generate text and video content in an instant have offered an easy, often free solution to a gap that Adobe was previously meeting.[17]

As with the creation of video, text or image content like Adobe, AI also pushes the boundaries of copyright and legal infringement, which poses a risk to corporations and individuals alike. Implementing AI into an ecosystem that ensures copyright and legal protection not only addresses critical legal and ethical concerns but also builds trust, encourages innovation and provides a competitive edge in the market. This holistic approach is likely to resonate with most users and stakeholders, ultimately leading to broader adoption and success. Which is one of the reasons why, we ultimately think Adobe will come out the other side as an AI winner.

What does this mean for the future?

We see AI as a force for good and despite some valid scepticism, the potential for educational, medical and creative innovation seems limitless. AI will replace jobs, but it will also enhance others and we will all need to upskill to stay on top of this explosion of innovation.

The largest tech firms, already quick to adapt and drive innovations, are retaining their positions of power for now, largely due to their status as huge cash-generating machines and thus their capacity to invest in the hardware required for AI. In other industries, such as education and healthcare, AI presents a unique opportunity to solve issues, perhaps for the first time ever—provided firms are open to adoption. Only time will tell which players will come out on top, and will be holding the reins of AI, rather than in the knacker's yard.

As the wider world remain fraught with geopolitical divisiveness and conflict, it is easy to get lost in the negative headlines. However, technology and science have shown that there are many reasons to be optimistic about the future. The technological advances made in education and medicine alone in recent years are truly remarkable—and the issue around determining who will pay to cure diseases is a pretty good problem to have.

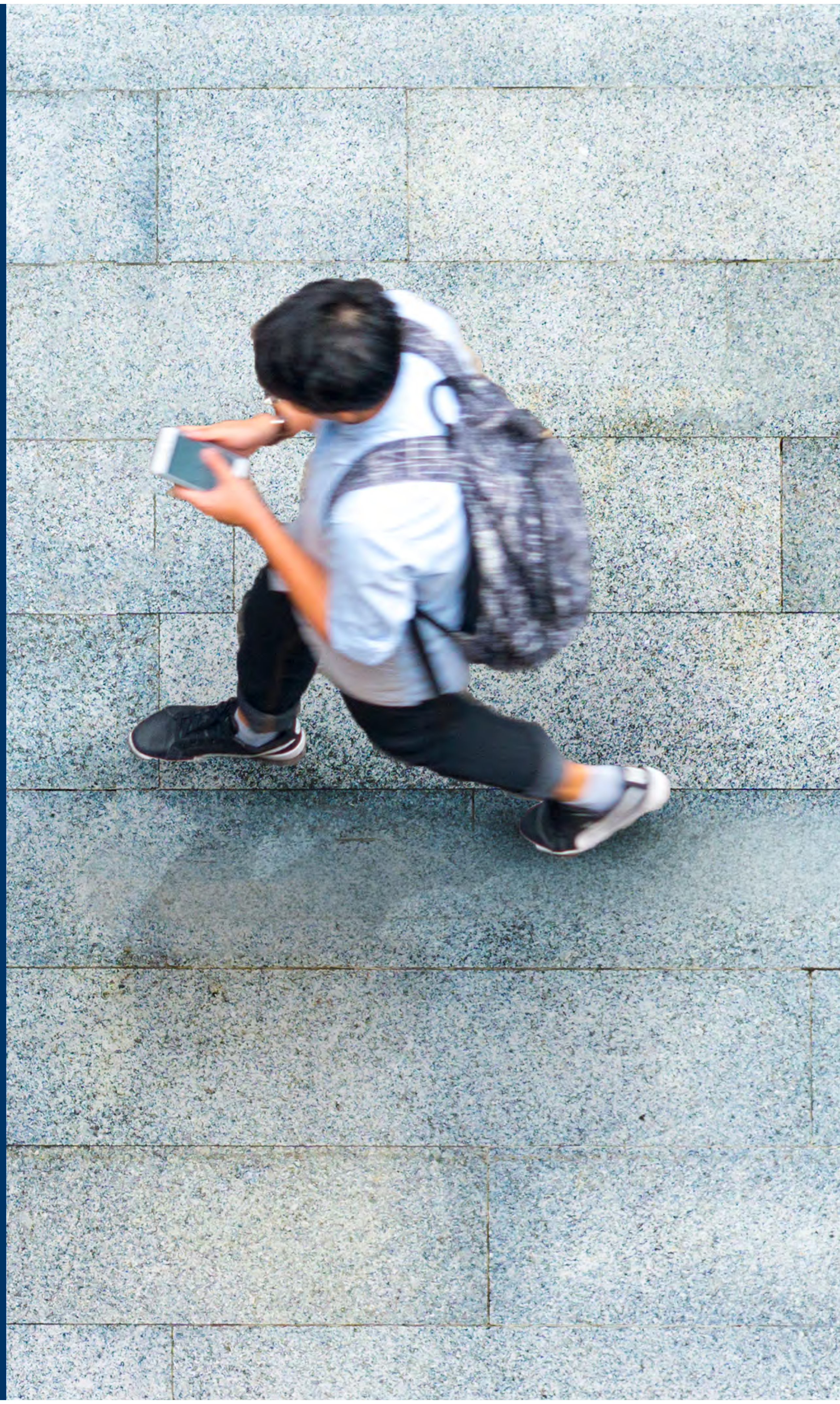
Russell Harrop
Head of Equities

AI on the ballot

The 2024 proxy season saw a rise in shareholder proposals focused on AI risks, as investors demand transparency and accountability on the ethical, environmental and financial implications of AI. Concerns include misinformation, disinformation and broader societal impacts. Shareholders are calling for stronger disclosure and due diligence, especially as AI becomes integral to business operations. Microsoft faced proposals for detailed reports on generative AI risks and alignment of AI practices with ethical principles.

Investors are pushing for AI development that will respect data privacy, uphold ethical standards and include safeguards against misuse. This focus aims to mitigate risks and protect long-term investment value. The increase in AI-sceptic proposals underscores the need for companies to manage AI's ethical and societal challenges. At LGT, we supported these proposals, emphasising the importance of transparency, responsible AI practices and long-term value creation whilst still fostering innovation.

Siobhan Archer
Global Stewardship Lead



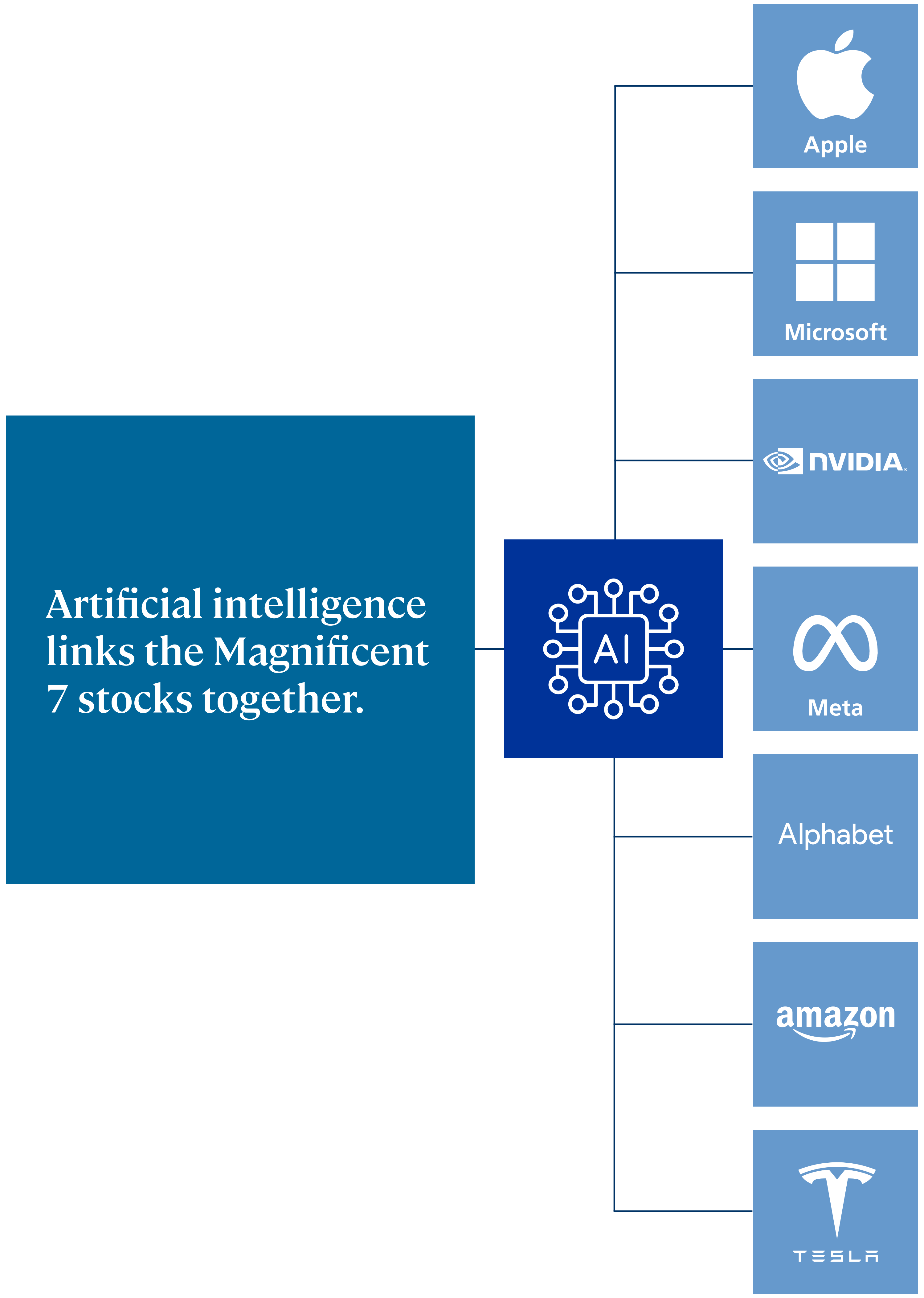
[17]Bloomberg: www.bloomberg.com/news/articles/2024-12-10/adobe-ai-video-rollout-lags-behind-openai-sora-launch

Broadening markets

The Magnificent 7 effect: what it means for active vs passive investing

Every year, new market phrases and jargon emerge to define trending economic phenomena. Recently, however, the rise of AI and the dominance of the Magnificent 7 have become more than just market buzzwords. Their astronomical earnings and performance have reshaped the conversation around active versus passive investing.

The Magnificent 7 has been the pre-eminent theme for the past 18 months, driven by their pivotal role in the rise of AI. The technology sector has delivered colossal earnings and stock performance across the period. In 2024, these seven companies accounted for over half of the S&P 500's total return. By mid-2024, Nvidia—which produces the chips required to process AI programmes—has contributed over 25% of global stock market returns, highlighting a level of market dependency rarely seen in recent history.



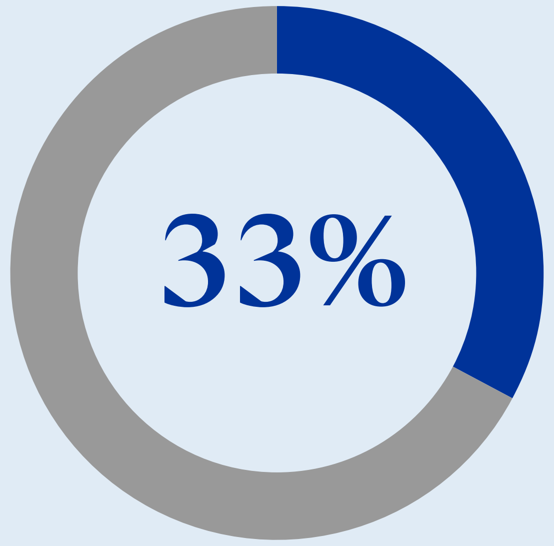
Sample companies are for illustrative purposes only and are not a recommendation for investment.

Active vs passive in the dawn of AI

This extreme market concentration has reignited the ongoing debate about active investment management—when a fund manager regularly buys and sells assets to outperform markets—versus passive investment management—which involves buying and holding investments such as index funds or ETFs that track indices like the S&P 500. Passive strategies have thrived during this period, benefiting disproportionately from the extraordinary performance of a small group of dominant stocks. In contrast, active management, which prioritises diversification and often seeks to avoid overexposure to the largest companies, has still delivered positive results but, by comparison, has lagged passive.

The Magnificent 7 stocks account for 33% of the S&P 500 as at year end. History offers a cautionary tale. A look back at Japan in the 1980s and 1990s shows a similar story, when Japanese banks made up an outsized portion of the Nikkei 225. This concentration ended abruptly, with a market crash leading to the 'lost decade' for investors in Japan, a period defined by economic stagnation, uncertainty and poor stock market returns. For active managers, this highlights a key strength: the ability to navigate market imbalances, manage risks, and uncover opportunities beyond the largest companies. As history has shown, extreme concentration rarely persists indefinitely, and active strategies remain well-positioned to benefit as markets rebalance over time.

Magnificent 7 stocks made up 33% of the S&P 500



AI has potential for educational, medical and creative innovation. It will replace jobs but enhance others, and we all need to upskill to stay on top.

The Magnificent 7 continues to dominate

Most of the outsized performance of the Magnificent 7 is for good reason. The seven or eight interest rate cuts expected from the Fed never fully materialised in 2024—with just three cuts being introduced in the US—and this created divergence among stocks. Magnificent 7 companies, which have very high cash on their balance sheets, benefited from higher interest rates. In addition, their earnings growth was driven by a structural growth story, a product of the emergence of AI. They were therefore less dependent on the stimulus of lower rates.

The rest of the stock market struggled to compete. The average US stock delivered a return of 13%, compared to the S&P 500's return of 25%. Clearly 'the rest' is a broad church but overall, they have a net debt position and are more subject to economic growth (expanding the economy's output), rather than structural growth (changing the underlying structure of the economy).

The broadening of market growth should improve the performance of average stocks compared to the largest companies, thereby supporting the case for active management. Firstly, the gap between the earnings growth of the Magnificent 7 and the rest of the market has narrowed significantly and is expected to continue to shrink into 2025. At its peak in the third quarter of 2024, Magnificent 7 earnings growth was over 60% year-on-year, compared to just 3% for the average stock. Things are expected to balance over the next 12 months, with Magnificent 7 earnings cooling to 22% and the average stock's earnings rising to 12% growth.

Valuations for the rest of the stock market appear far more attractive, with the average stock trading at 16.6 times 2025 earnings, compared to the Magnificent 7 trading at 31.2 times. Central banks' gradual dismantling of their restrictive monetary policy regime by cutting interest rates, can not only directly impact earnings as the cost of financing comes down, but it can also support valuations as the discount rate applied to forward earnings comes down. This can lead to much smoother economic adjustment and support economic growth, which will help stocks across various sectors.

No single investment strategy consistently outperforms. Historically, larger companies underperform smaller ones, a fact that seems hard to believe after the past two years. As the dominance of market-leading companies begins to level out, active managers are well-positioned to capitalise on broadening market growth. Markets have always corrected extremes and while structural themes continue to drive certain sectors, opportunities will ultimately extend across the broader economy, creating renewed prospects for active investors.

Tom Claridge
Senior Portfolio Manager

Remaining active in passive implementation

As passive investing grows in popularity due to its cost-effectiveness and performance, stewardship in this space has gained attention. At the end of 2024, LGT became the first European wealth manager to implement pass-through voting in passive investments, aiming to increase consistency and reflect client views in portfolios.

The rise of passive instruments has concentrated voting power among a few large asset managers, whose broad, centralised policies may not reflect individual client preferences. Our pass-through voting aims to represent client views in voting outcomes, including capital allocation and resolutions within pooled-fund investments, marking a shift towards more transparent, customised stewardship, especially concerning ESG (Environmental, Social, and Governance) issues.

A key motivation for this move is the misalignment of proxy voting approaches among large asset managers. In 2024, major passive managers like BlackRock and Vanguard supported only 4% and 0% of E&S shareholder proposals, respectively, showing a disconnect with many clients' values. LGT recognised the need to align voting outcomes with client values, ensuring consistent representation across both internally managed equities and passive equity funds.

This initiative also aligns with UK regulatory calls for wealth managers to take a more active role in stewardship rather than outsourcing to asset managers.

Siobhan Archer
Global Stewardship Lead

Stewardship interview

In conversation with our CIO and Global Stewardship Lead

In this interview, LGT Wealth Management's CIO, Sanjay Rijhsinghani, and Global Stewardship Lead, Siobhan Archer, discuss the vital role of investment stewardship, emerging trends in the stewardship industry and how LGT is responding to these developments with innovative strategies like pass-through voting for 2025.

Siobhan Archer: Sanjay, let's start with the big picture. Why is investment stewardship so critical to creating long-term value at LGT Wealth Management?

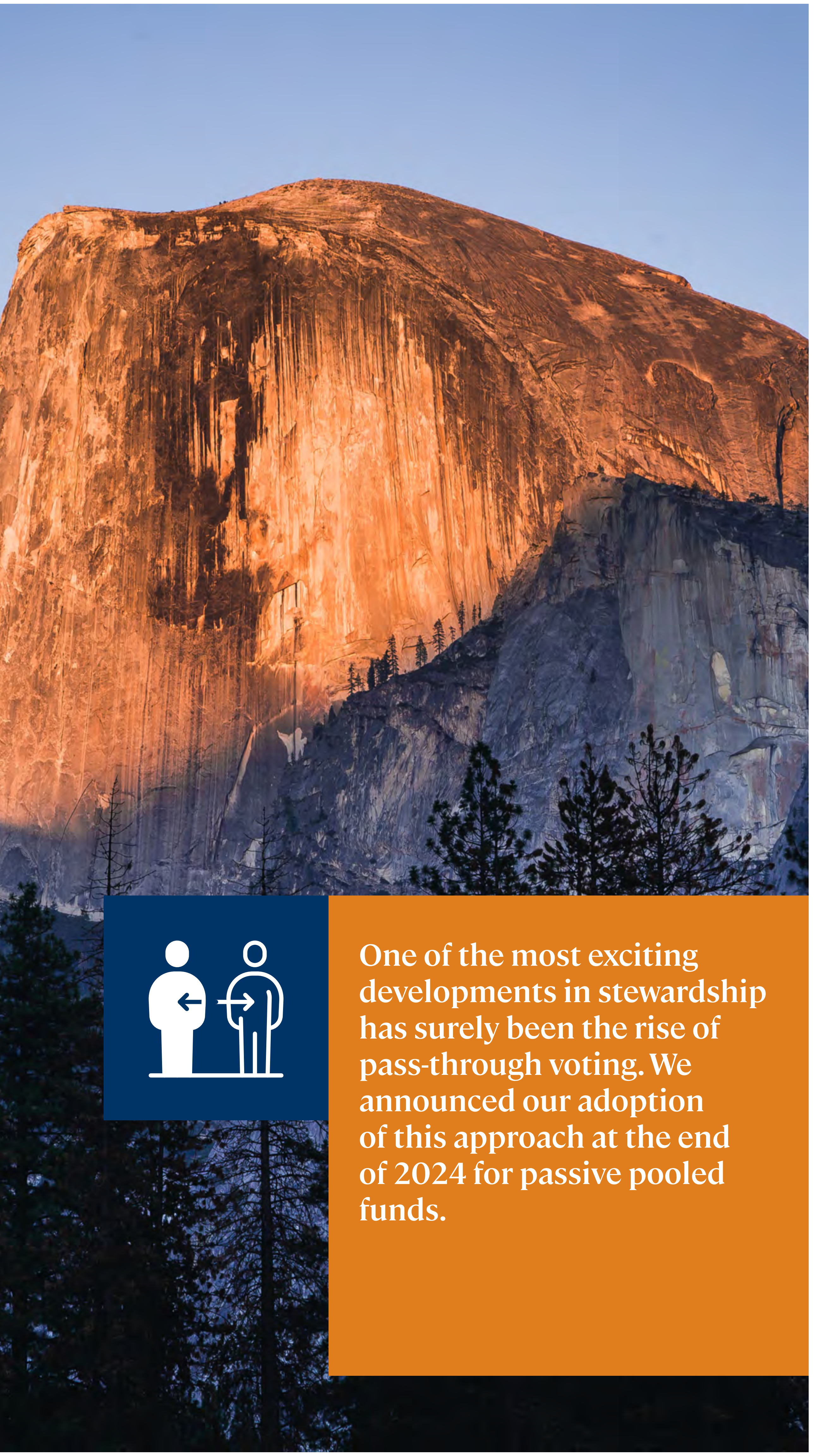
Sanjay Rijhsinghani: Fundamentally, our investment strategy centres on creating long-term value for our clients. That perspective not only drives how we build portfolios and allocate capital but also shapes how we engage as active investors and stewards of that capital.

The past few years have shown us just how volatile the world can be, with companies grappling with tumultuous geopolitics, and subsequent shifts in political leadership and policy changes, as well as ongoing international conflicts, supply chain disruptions, and extreme weather events – and the frenzied news cycles that follow each of these events. These pressures make open and sustained dialogue with portfolio companies essential. By engaging directly with our portfolio companies' leadership, we gain deeper insights into their operations and broader business activity and ambitions, enabling us to make more informed investment decisions.

But stewardship and engagement is more than just gathering information. It's a two-way street. Our engagements provide companies with valuable feedback and insights, fostering mutual understanding and encouraging positive change. We view stewardship as integral to supporting the transition to a low-carbon, resilient global economy. By addressing critical challenges—like global warming, biodiversity loss and human rights protection—through direct and collaborative engagements, we aim to address systemic risks to portfolios for our clients and for future generations.

Siobhan Archer: Thanks Sanjay. It is also worth highlighting that this long-term perspective you are referring to is very much echoed by our owner, the Princely Family of Liechtenstein. They view investing as a commitment to future generations. To them, the stewardship of our clients' assets goes hand in hand with the responsibility to support and influence the companies we invest in.

Sanjay Rijhsinghani: Absolutely. And there has been a lot of change in this space recently. From your perspective, what is shaping the world of stewardship?



One of the most exciting developments in stewardship has surely been the rise of pass-through voting. We announced our adoption of this approach at the end of 2024 for passive pooled funds.

Siobhan Archer: One of the most striking trends is the mainstreaming of stewardship. It has become front-page news. High-profile cases—like Elon Musk's controversial executive compensation package of $USD 56 billion, Nelson Peltz's campaign to join Disney's board and Exxon Mobil's carbon emissions lawsuit led by Arjuna Capital—have drawn unprecedented public attention, raising questions about the power dynamics between shareholders and company leadership. These cases highlight how stewardship can influence corporate governance, yet also reveal the complexity of driving meaningful change whilst navigating the needs of all stakeholders.

At the same time, shareholders are becoming more engaged, with clients increasingly being approached by brokers or the companies themselves to vote on key issues. Yet, despite this rising engagement, a shift in approach has been observed among some passive asset managers, with reduced support for Environmental and Social (E&S) proposals.

Sanjay Rijhsinghani: That shift is surprising. What do you think could be driving it?

Siobhan Archer: A few factors are at play. In the US, polarised politics have made consensus harder to achieve, even on seemingly universal issues like climate risk. At LGT, and in the UK and Europe more broadly, we believe that physical climate risk is financial risk. For example, 2024 has been the costliest year on record for insurance companies due to extreme weather events.

On the other hand, there's also been significant progress—in areas such as transparency and reporting standards—which has tempered the urgency around certain proposals we see on the ballot. This has made it more important to adopt a strategic approach and focus on areas of genuine financial materiality. Three years ago, supporting a climate transition plan often meant backing a leader in disclosure, now, it's essential to understand the details—what specific measures and targets mean in practice, and how they will be achieved.

Sanjay Rijhsinghani: That's a great point, and it underscores the importance of staying adaptive. This is where adopting proprietary research and analysis is critical to ensure proposals that are not only impactful but also aligned with financial materiality are prioritised. Basing decisions on robust data helps ensure a thoughtful and informed response to evolving trends and allows us to adapt our operations to these trends.

Siobhan Archer: Exactly. One of the most exciting developments in stewardship has surely been the rise of pass-through voting. We announced our adoption of this approach at the end of 2024 for passive pooled funds.

Sanjay Rijhsinghani: Indeed, pass-through voting represents a real evolution in how we think about shareholder rights, especially for passive investors. Siobhan, for those who don't know, what is pass through voting?

Siobhan Archer: Pass-through voting is a process that allows investors, like our clients, to directly influence how votes are cast in shareholder meetings for the companies in which they are invested, through funds. Normally, the fund manager decides how to vote on their behalf, but with pass-through voting, the voting power is "passed through" to the investor, giving them a say in important decisions like company policies, governance or sustainability issues.

What's particularly empowering about pass-through voting is how it is attempting to democratise stewardship. It allows clients in passive vehicles to directly influence voting decisions, ensuring their priorities are reflected.

It is not just about client representation—it's also about reclaiming our role as stewards of passive investments. As you often say, "passive doesn't mean inactive."

Sanjay Rijhsinghani: Very true, we see this as part of a broader strategy to deepen our engagement across markets. Pass-through voting is not just a tool; it's a signal of our dedication to active stewardship, regardless of the investment vehicle.

Siobhan Archer: It's a powerful example of innovation in stewardship and I'm excited about how we can leverage it to drive even greater impact.

Discover more at lgtwm.com

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