Brewin Dolphin

2025 Market Outlook

At this time of year, it is traditional for investment firms to opine on their outlook for the next 12 months, speculating on what will happen to equity markets, currencies and interest rates.

Of course, the inescapable reality is that nobody knows and as John Kenneth Galbraith said many years ago: "*the only function of economic forecasting is to make astrology look respectable*".

I appreciate this isn't especially satisfactory, as investors would like their financial advisers to offer at least some view of the future. Indeed, several years ago, I was taken to task at an event for not offering a prediction for where the S&P 500 would finish at the end of year. My explanation that it was pure folly to guess where the index would be after 12 months wasn't appreciated.

If we can't know the future, how should we invest our capital? Whilst we must embrace a degree of uncertainty, we can learn a lot from history and past economic cycles. We can also endeavour to see the present more clearly and try not to fall victim to behavioural biases.

Our analysis of past economic and market cycles certainly supported our positive stance last year, with evidence of growing corporate earnings and moderating inflation supporting our thesis during the year.

As we enter 2025, not too much has changed in this view. Whilst inflation is still a concern, it's not at a level that has proved problematic for equity market valuation in the past, and corporate earnings continue to grow.

The greater challenge this year though is valuation, as markets became more expensive last year, with the forward earnings yield for the world equity market declining from circa 6% to 5.5%.

While there may be a debate over the sustainability of the corporate margins that underpin these earnings, the earnings yield is a reasonable way to think about potential after-inflation returns from the equity market, over the long term.

With government bond yields now between 2.5% and 5% across the developed world, there's a valid debate as to whether we are getting paid a sufficient premium to invest in equities today. Of course, we should subtract inflation from these bond yields to draw a true comparison, but for the first time in many years it seems possible to deliver acceptable returns from a bond portfolio.

Whilst we have little doubt that a well-constructed equity portfolio will deliver significantly superior long-term returns, investors who wish to minimise portfolio volatility certainly have more options today.

Despite this, our guidance is to remain overweight equities in portfolios relative to a neutral position. This may change as the year progresses but the indicators we use as part of our investment process continue to support this position.

This implies a positive view on the economy, as we need to see earnings growth to support equity market gains.

In the absence of earnings growth, higher markets would require higher valuations, which may push the market to an unsustainably high level. This, of course, could happen, and it has certainly happened in the past, with the late 1990s being the most extreme example.

The late 1990s is an interesting period to reflect on now, as the market at the time was driven by a speculative fervour over new technology, which draws certain parallels to today's excitement over artificial intelligence (AI).

Indeed, if we look at market returns last year, it's evident that 2024 was a very momentum-driven market, and we should be wary when investors are investing in assets based on momentum. However, last year's winners were supported by strong earnings growth and, thus, while valuations have increased it looks reasonably rational to us.

The 1990s analogy does make us wonder whether it could all get silly at some point. To give you a sense of this, an index that tracks some of today's perceived AI winners trades on approximately 1.3 times the market's valuation multiple, whereas in the late 1990s, the perceived winners traded on nearly five times the market's multiple – now that was crazy.

Thus far, aside from pockets of madness in certain in 'things' like memecoins, market valuations look rational, but if narratives truly take hold that could change, presenting challenges to conservative firms like us. How we might respond if this should happen is something we're debating.

We're also very open to the idea that corporate earnings could be very strong for a period, should the benefits of AI flow through company revenue and margins, which we've discussed before when extoling the virtues of companies with data advantages. Such a scenario would go some way to overcoming today's valuation challenge.

All this really is to say that we can see, and are open to, several outcomes over the coming years.

Indeed, within the last week, we've seen the market swing from being very positive on the capital expenditure plans of big tech to worrying whether they're spending too much and that AI models will be commoditised. This follows the release of a new potentially more efficient AI model from the Chinese company DeepSeek.

Geopolitical risk has also come to the fore in recent days, following the imposition and subsequent pausing of tariffs by the U.S. administration. No doubt trade relations will be an ongoing source of volatility throughout the year.

These wild swings remind us of the value of diversification and the hubris of prediction.

Looking forward, it's certainly the case that equity valuations are higher today and we've more alternatives when building portfolios. This would suggest more caution and diversification. However, we can also envisage better-than-expected outcomes that result in a continuation of equity market outperformance.

Either way, we look forward to another interesting year and we thank you for the continued trust you place in us.

As ever, if you would like to discuss our views further, please do not hesitate to contact us.

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