Market Outlook:

Top Ten Investment Themes for 2025

January 2025

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January 2025

Element Pointe's Top Ten Investment Themes for 2025

1. **The US Economy:** We believe strong consumer and corporate spending amid continual fiscal stimulus will lead to solid, but slowing, US economic growth in 2025. Recession remains a non-zero probability as geopolitical escalations, ballooning government deficits, and a potential reacceleration in inflation all pose risks to our forecast.
2. **The Federal Reserve Outlook:** We anticipate that the Federal Reserve will provide one or two more 25-basis-point ("bps") rate cuts in 2025. However, further rate cuts will likely prove stimulative and heighten the risk of reinflation in the back half of the year.
3. **US Policy Under Trump 2.0:** Anticipated aggressive immigration reforms, revised tariff strategies, and a bold efficiency agenda led by DOGE signal meaningful shifts in US policy.
4. **US Equities:** US equities are poised for another positive year, but gains will likely be muted, and therefore investors will have to endure through multiple drawdowns.
5. **Risks to US Equities:** We believe the key risks that could derail the US equity market include: 1) higher bond yields brought about by a resurgence in inflation and/or investor concerns for the long-term sustainability of US debt, 2) the high concentration of the S&P 500 Index and its leverage to the AI investment theme, and 3) escalating geopolitical conflicts.
6. **Artificial Intelligence:** Artificial Intelligence ("AI") will continue to be a dominant theme driving big tech, but gains are likely to be more broad-based as many companies show progress on AI initiatives.
7. **Europe:** Structural issues and political uncertainty lead us to maintain an underweight position to European equities; however, regional bright spots and low relative valuations could present targeted opportunities across the continent.
8. **China:** Is China a value trap or a generational buying opportunity for investors?
9. **Private Markets Outlook:** M&A and IPO activity should accelerate in 2025 due to lower interest rates and an easing regulatory environment. Increased capital markets activity should increase distributions from existing private equity and venture capital strategies. Private credit continues to provide attractive risk-adjusted yields in a higher rate environment.
10. **Democratization of Private Markets:** The wealth management channel will increasingly allocate towards alternative investments in 2025 as investors utilize the growing suite of evergreen investment vehicles. However, investors must weigh the unique risks and tradeoffs of evergreen investment structures.

ELEMENT POINTE'S TOP TEN INVESTMENT THEMES FOR 2025

1. The US Economy

The US economy had another year of surprisingly robust growth in 2024, with projected GDP growth of 2.7%, outpacing the consensus estimate of 1.2% before the start of the year.[1] Nearly three years since the Fed began raising interest rates, the US economy has remained resilient despite expectations for a slowdown amid restrictive monetary policy. We believe structural changes in the US credit environment have desensitized the economy to rising benchmark rates. At the same time, historic levels of federal spending have largely offset the effects of monetary tightening. Our base case for 2025 is another year of above-trend growth, albeit a deceleration from 2024's GDP growth. A continuation of strong consumer and corporate spending supported by their respectively healthy balance sheets should propagate economic growth, while further Fed rate cuts and fiscal stimulus should support the economy. Nonetheless, a 2025 recession remains possible as geopolitical tensions, expanding government deficits, and a reacceleration of inflation all present potential risks to our forecast.

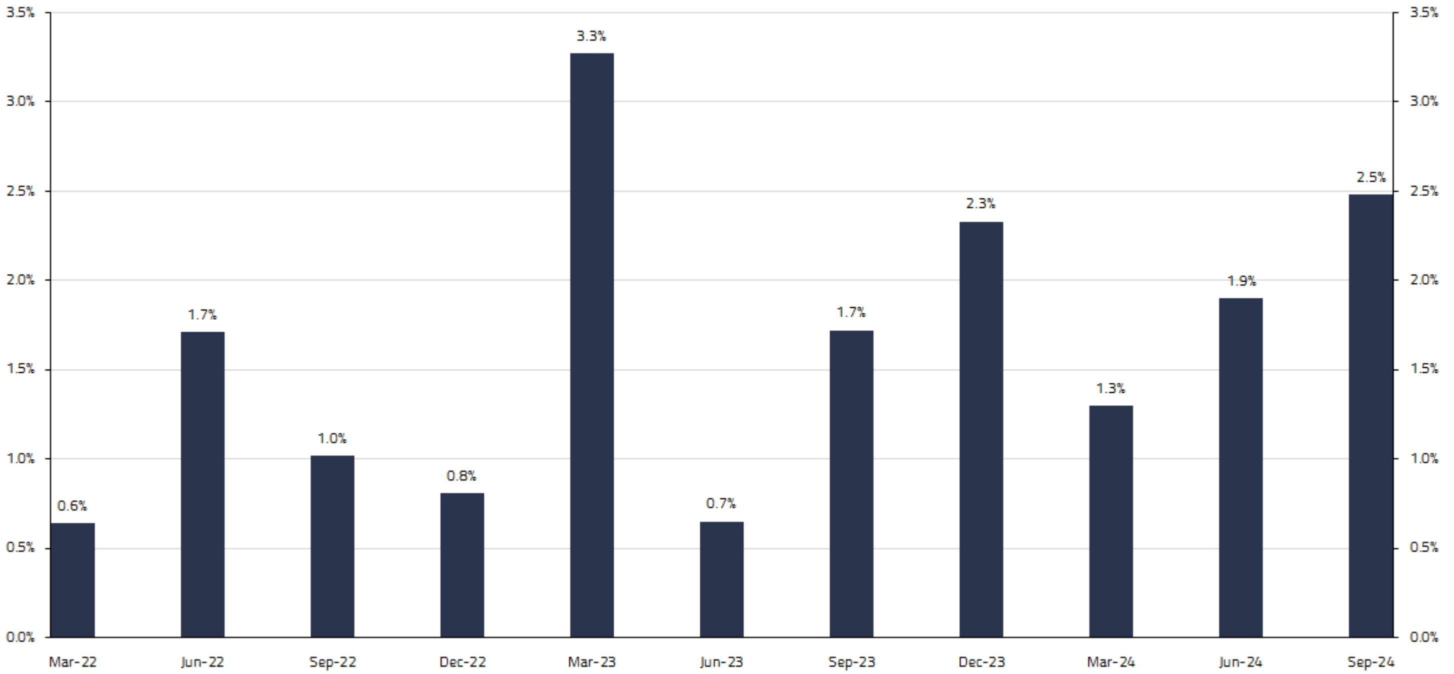
When the Fed began hiking interest rates in March 2022, the consensus expectation was that the heightened rate environment would lead to an economic slowdown and potentially send the US into a recession. Yet, nearly three years since the first hike, the economy continues to grow at an above-trend pace. One of the key reasons for the US's economic resiliency was the ability of consumers and corporations to lock in long-term, fixed-rate debt in a zero-rate environment during the pandemic.

Mortgages are the most significant liability on US consumer balance sheets, making up 70% of total household debt as of Q3 2024.[2] However, US mortgages are predominantly fixed-rate and long-dated, unlike other developed nations. In the US, 95% of mortgages have a 30-year fixed-rate[3], meaning rising interest rates did not affect debt servicing costs for most homeowners with an existing mortgage. Additionally, many US homeowners proved opportunistic during COVID by refinancing their existing mortgages at attractively low rates, leading to lower debt servicing costs and substantial savings. The effective rate on outstanding mortgage debt currently sits below 4%, well below the 30-year prime rate of around 7% for new mortgages.[4] US household debt to disposable income remains at healthy levels, sitting well below 2007 levels and below levels seen currently in other developed countries. All considered, the Fed rate-hiking cycle put a minimal strain upon the US consumer's balance sheet, which we believe partially contributed to high levels of spending.

In the aggregate, consumer spending has been robust, growing at an annualized 2.8% through the first three quarters of 2024.[5] The US economy is heavily reliant on the consumer, with personal consumption expenditures accounting for 68% of GDP.[6] Exhibit 1 shows that robust consumer spending was a main driver of recent economic growth, a trend that we anticipate will persist in 2025.

1. Bloomberg
2. "Household Debt and Credit Report." Household Debt and Credit Report - FEDERAL RESERVE BANK of NEW YORK, www.newyorkfed.org/microeconomics/hhdc. Accessed 6 Jan. 2025.
3. Slok, Torsten. "2025 Economic Outlook: Firing on All Cylinders." Apollo Academy, www.apollo.com/content/dam/apolloaem/documents/insights/apollo-global-2025-economic-outlook.pdf. Accessed 6 Jan. 2025.
4. Id.
5. "Gross Domestic Product (Third Estimate), Corporate Profits ..." Bureau of Economic Analysis, 19 Dec. 2024, www.bea.gov/sites/default/files/2024-12/gdp3q24-3rd.pdf.
6. Id.

Exhibit 1: Contribution of Personal Consumption Expenditures to GDP



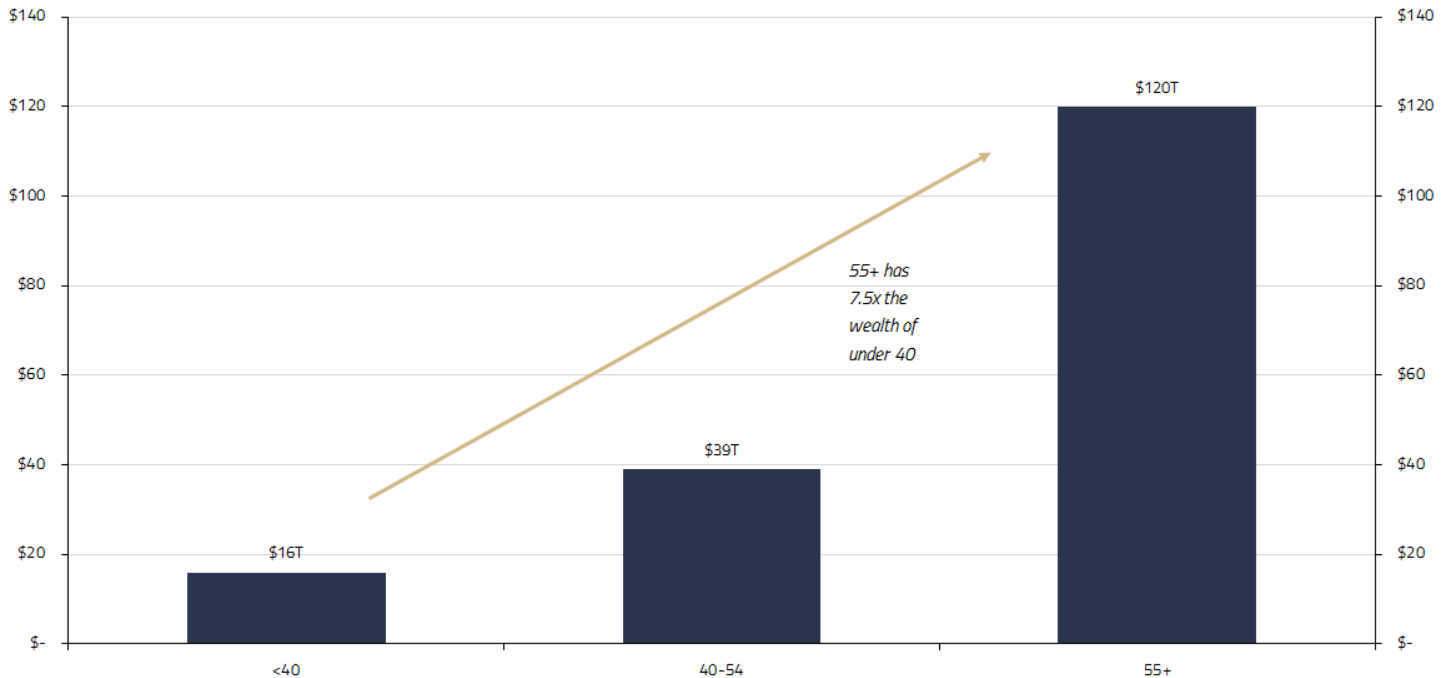
Source: Apollo, U.S. Bureau of Economic Analysis

Concerns around the health of the consumer have been mounting, especially when observing the feedback from voters during the election. NBC exit polls showed that 46% of voters believed their family was in a worse financial situation than four years ago, with 81% of Republican voters claiming their situation had deteriorated over the same time. [7] There has certainly been a notable bifurcation among US consumers, as younger and lower-income cohorts have borne the brunt of inflation. While overall inflation has notably decreased, heightened inflation levels still exist in essential categories such as food and shelter, whittling away discretionary spending for lower-income consumers. Home unaffordability and surging rent prices have also weighed on younger consumers, with a Bloomberg survey stating that nearly 45% of people aged 18 to 29 still live with their parents , an 80-year high.[8] Auto loan and credit card debt delinquencies have risen to recessionary levels for younger and lower-income borrowers, suggesting that these cohorts are under financial strain. The economic concern seen from voters does not surprise us, but we still maintain that, on aggregate, the US consumer will remain healthy in 2025.

It is important to note that high-earning consumers spend disproportionately more than lower earners. The top 20% of earners contribute to nearly 40% of total consumer spending, while the bottom 40% of earners only contribute around 20%.[9] This implies that aggregate consumer spending will largely be dictated by high-income consumers who also hold the lion's share of total household wealth. Record levels of household wealth should continue to support spending growth, especially for consumers in the upper echelons of the income spectrum. High-income households have experienced a tremendous increase in net worth as home prices and investment portfolio values have risen dramatically since the pandemic. The total value of owner-occupied real estate reached $48.2 trillion in Q2 2024, over twice the value it was a decade ago, causing homeowner's equity to reach its highest level since 1950.[10] Simultaneously, US households' stock portfolio values increased by nearly $8 trillion in 2024 alone.[11] As seen in Exhibit 2, the majority of household net worth is held by older consumers who tend to in-

7. McVey, Henry H. "Insights - Glass Still Half Full." KKR, www.kkr.com/content/dam/kkr/insights/pdf/2025-outlook-glass-still-half-full.pdf. Accessed 6 Jan. 2025.
8. Id.
9. U.S. Bureau of Labor Statistics, September, 2024
10. McVey, Henry H. "Insights - Glass Still Half Full." KKR, www.kkr.com/content/dam/kkr/insights/pdf/2025-outlook-glass-still-half-full.pdf. Accessed 6 Jan. 2025.
11. Id.

Exhibit 2: Household Net Worth by Age Group (Trillions)



Source: Federal Reserve Distributional Financial Accounts as of 6/30/2024

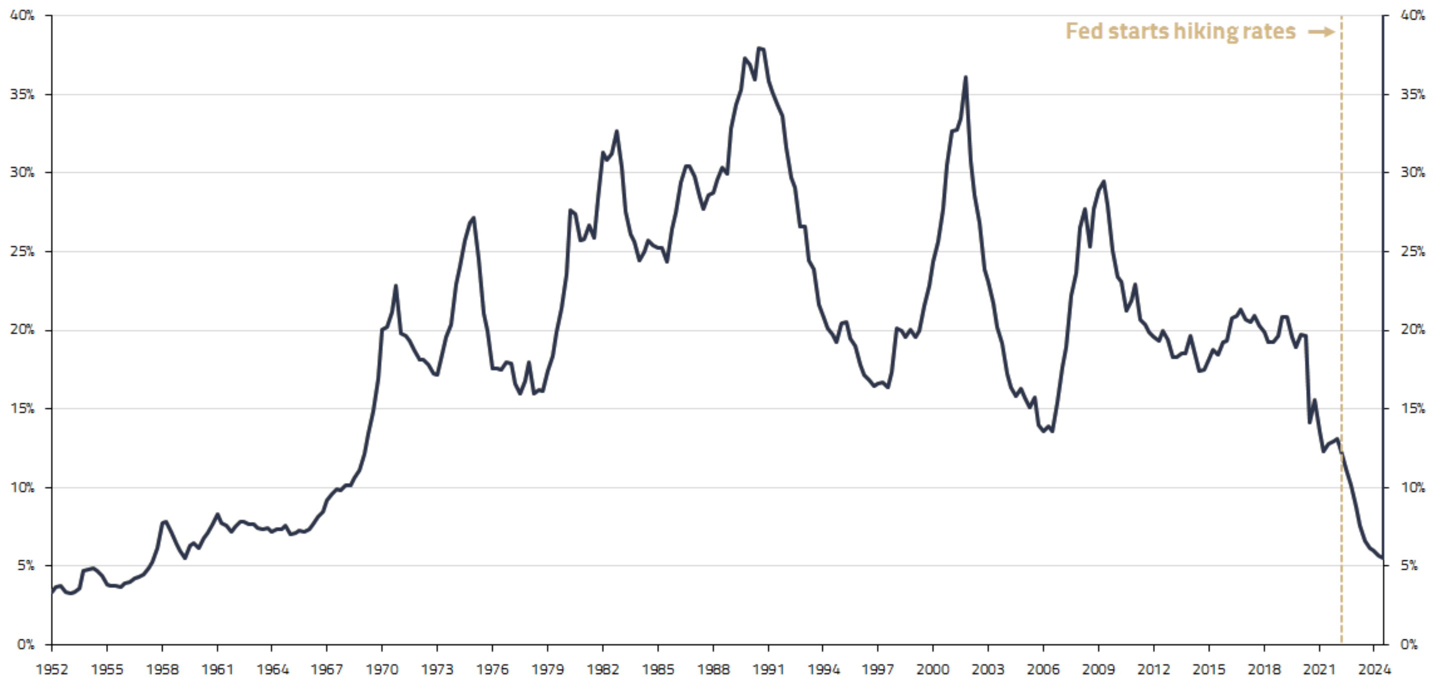
creasingly spend more than they earn in their latter years, as indicated by negative savings rates for households where the head of household is 65 or older. In turn, we believe the aging population explains the structural decline in the household savings rate, which we do not think should be a significant concern. Yet, we anticipate wealth creation in 2025 to be significantly less than what was experienced in 2023 and 2024. This will likely slow consumer spending growth, but strong consumer balance sheets should support a solid level of growth. We recognize that a significant correction in risk asset prices would likely erode consumer confidence and curtail spending, but we view this as a low-probability risk.

Alongside household wealth creation, we believe real income growth will drive spending growth throughout the year. A tight labor market led to strong levels of real income gains in 2024 that supported spending. We expect a softening job market to slow real income growth, but we anticipate it will remain at a constructive level. A greater risk to our outlook would be the reacceleration of inflation that weighs on purchasing power and changes consumer behavior. There is a confluence of factors that we believe could ignite a reacceleration in inflation, but that likely would not occur until later in the year.

Moderate risk asset returns, limited real wage gains, and sustained inflation will likely slow consumer spending growth from the robust levels seen in 2024. Nonetheless, strong consumer balance sheets should lead to solid levels of consumer spending this year, which will prove to be the main driver of above-trend GDP growth.

Like the consumer, the US corporate debt market has been desensitized to Fed rate hikes, as seen through the growth in the primarily fixed-rate investment-grade corporate bond market. The US investment grade bond market has grown to $9 trillion today from $3 trillion in 2015, and dwarfs the smaller leveraged loan market, valued at $1.4 trillion, which consists of primarily floating rate debt. Rising interest rates have had a minimal impact on the overall corporate credit market. Instead, US corporate net interest payments have decreased relative to operating surplus due to strong corporate profit growth (Exhibit 3).

Exhibit 3: Nonfinancial Corporate Business Net Interest Payments as a Percentage of Net Operating Surplus



Source: Federal Reserve Board as of 12/31/2024

Strong corporate balance sheets and sustained profit growth have shielded corporations from the levels of defaults and bankruptcies commonly seen in a rate hiking cycle. Companies with weak fundamentals and floating rate debt were certainly challenged when the Fed began raising rates, as reflected by a pickup in weekly bankruptcies starting in 2022. However, weekly bankruptcies remain below levels typically seen during a recession and have been trending downwards in recent weeks. Leveraged loan defaults remain at pre-pandemic levels despite their floating interest rate structures, as strong profit growth has largely offset increasing debt service costs. The maturity wall for corporate credit provides di minimis concerns since most companies refinanced in 2020 or 2021 and will not need to refinance soon. On the other hand, a significant amount of commercial real estate debt that was issued in a zero-rate environment will need to be refinanced in 2025 and 2026 at substantially higher rates. Commercial real estate debt is one area of the credit market that poses a potential risk and an area that we are watching closely.

The US economy should also continue to be catalyzed by investment in AI-related capital expenditures throughout the year. The AI boom has led US companies to invest huge sums in equipment, R&D, software IP, data centers, and energy transition. The accretive effects of AI investment spending can already be seen in recent GDP prints, with areas such as equipment capex growing notably quarter to quarter. We believe this spending will endure, as effective AI adoption will likely define the success of major US tech companies in the years to come.

Many argue that the productivity increase from AI will also promote economic growth. We are hopeful that AI adoption will boost productivity in the near term, but we are realistic that it typically takes many years for companies to integrate new technologies into their business processes. Nonetheless, productivity has increased over the past few years, especially compared to the last decade's low-productivity era. We attribute recent increases in productivity to increased workplace digitization during COVID, which should continue to support productivity growth and economic activity. One potential short-term catalyst for productivity growth may come from deregulation, which could reduce administrative costs and labor hours.

Unprecedented fiscal stimulus, as reflected by expanding budget deficits, is a massive contributor to US economic strength during this cycle. Policies such as the CHIPS Act, Inflation Reduction Act, and Infrastructure Act have led to a boom in construction that significantly boosts the economy. While spending from these programs has slowed, we still believe they will promote net growth as companies will now need to spend on equipment to outfit these new facilities. We expect the new administration to continue fiscal stimulus by extending the 2017 Tax & Jobs Act with additional tax cuts while potentially increasing spending in areas like defense. Overall, fiscal stimulus should support growth but to a lesser degree than what was observed in the past four years.

On the other hand, expanding fiscal deficits are a cause of concern with the debt-to-GDP ratio at levels unseen outside of a recession. Rising rates have made debt servicing costly for the government with interest expense now outpacing both Medicare and defense spending. With a large portion of the debt set to mature in the next few years, the Treasury will have to refinance debt at higher rates, exacerbating the issue. Furthermore, demand for Treasury issuance appears to be weakening as yield-agnostic sovereigns have reduced their Treasury purchases leaving yield-sensitive households and institutions to pick up the slack. We believe expanded fiscal deficits will be a primary contributor to a higher-for-longer interest rate environment and bias yields to the upside, especially at the long end of the curve.

Healthy consumer spending, continued business investment, and accommodative fiscal policy should promote 2025 GDP growth above 2%, while a benign credit environment and a solid job market mitigate the chances of a recession. Still, risks to our outlook exist as geopolitical tensions and ballooning federal debt prove more onerous. However, the most significant risk to our outlook would be a rapid reversal in inflation trends that forces the Fed to change course, crushing consumer sentiment and hampering corporate profitability.

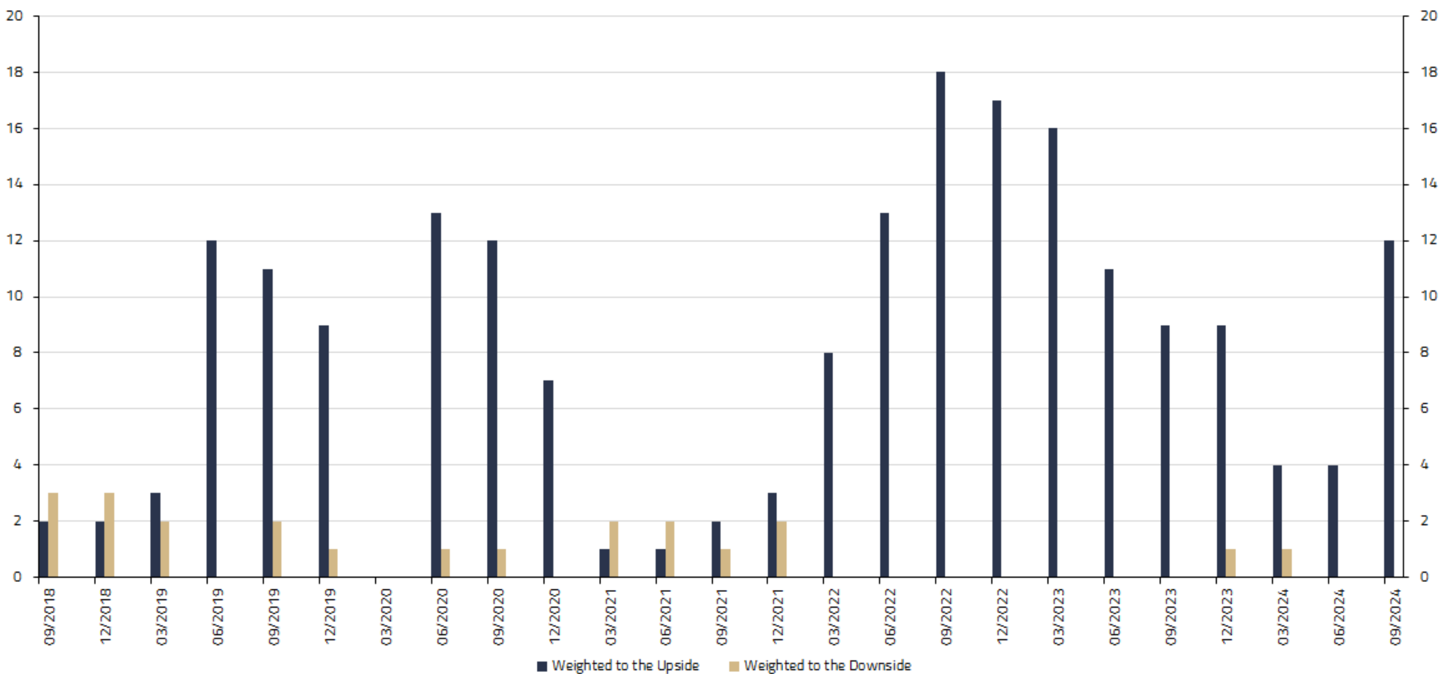
ELEMENT POINTE'S TOP TEN INVESTMENT THEMES FOR 2025

2. The Federal Reserve Outlook

The Federal Reserve closed out the year by providing a 25-basis-point cut at its December meeting, bringing the Fed funds rate down to a range between 4.25% and 4.50%. The December meeting marked the Fed's third rate cut of the year, bringing down the benchmark rate by a total of 100 basis points since September. While the market expected the 25-bps cut in December, investors appeared surprised by a hawkish dot plot that showed a median projection of two cuts in 2025 rather than the three that consensus expected. Equity markets sold off sharply on the news, while the bond market lowered its expectations for 2025 rate cuts from 50 bps to 32 bps.[12] The FOMC has signaled its plan to slow rate cuts; however, Chairman Powell's press conference provided a slightly more dovish tone by stating that labor market cooling merits attention. Our belief is that the Fed funds rate is at an appropriate level given that the last mile of inflation reduction remains challenging, and our view that the labor market will remain firm through 2025 despite the recent softening. Nonetheless, we believe the Fed is eager to cut rates further as its priorities change from price normalization to labor market stability. That said, we forecast 25 to 50 bps of easing in 2025 but fear that policy error becomes a notable risk as inflation trends skew to the upside.

Inflation has meaningfully decelerated from the peak levels seen in June 2022 when the Consumer Price Index reached 9.1%.[13] The November 2024 core PCE reading, the Fed's preferred inflation index, came in at an annualized rate of 2.8%,[14] representing a meaningful slowdown in inflation but still above the Fed's stated target of 2%. However, the Fed appears comfortable with the current disinflation trajectory and has shifted its priority to the labor market. Exhibit 4 showcases the general concern from FOMC members that the unemployment rate will rise further than their forecast. Taken together, we deduce that the Fed believes the risk of a rapid increase in unemployment is greater than the

Exhibit 4: FOMC Members Worried About Rising or Falling Unemployment



Note: Survey asked FOMC Members whether they think the risk to their unemployment rate forecast is weighted to the up or downside. No survey conducted in March 2020 Source: Apollo, Federal Reserve

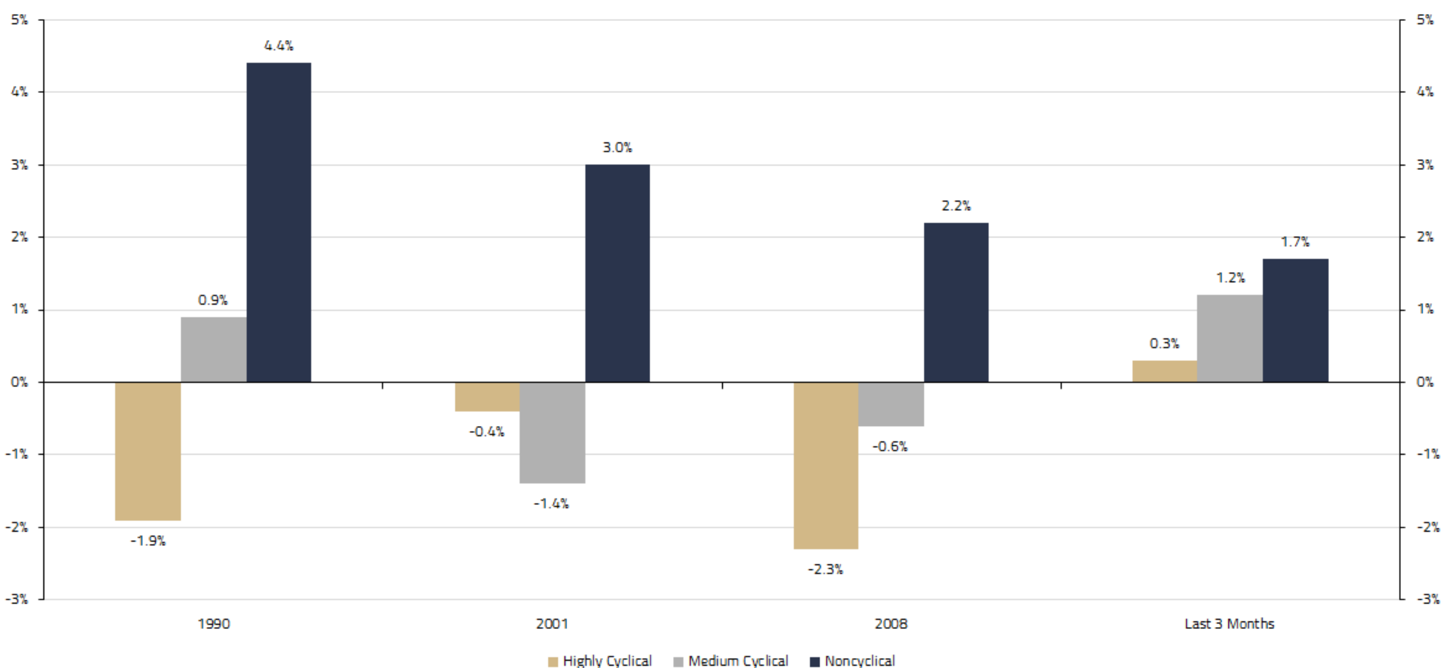
12. Mericle, David. "US Daily: December FOMC Recap: More Risk to Rate Cuts in 2025." Goldman Sachs, 18 Dec. 2024, publishing.gs.com/content/research/en/reports/2024/12/19/0c20b42e-f860-4bff-97f6-f69b1d7958c7.html.
13. Bloomberg
14. Id.

risk of a reacceleration of inflation. We take the opposite stance. We believe the softening labor market will remain on solid footing through the year, and that there is significant risk of another inflation surge, especially if the Fed cuts faster than necessary.

Labor market concerns increased in the summer of 2024 as an uptick in the unemployment rate triggered the Sahm rule. The Sahm rule is an economic indicator used by the Federal Reserve that signals the start of a recession when the three-month average unemployment rate increases by 50 bps or more relative to the previous twelve months. Historically, even moderate increases in the unemployment rate have eventually grown into large increases accompanied by recession. However, we are not overly concerned about the pickup in the unemployment rate for a few crucial reasons. First, the increase in the unemployment rate during the summer of 2024 was not caused by an increase in layoffs. An increase in layoffs often creates a snowball effect where laid-off workers reduce their spending, which detriments corporate revenues and leads to further layoffs. There was no material increase in the layoff rate in 2024, and the latest reading indicates a historically low level of 1%.[15] Second, a meaningful contributor to the increase in the unemployment rate has been a surge in labor supply driven by immigration.

The US Census Bureau estimates that a net of 2.8 million people migrated to the US between 2023 and 2024.[16] Unsurprisingly, the unemployment rate for recent immigrants is higher than that of other workers for their first few years in the country. Goldman Sachs cites that 13 bps of the 46 bps increase in the unemployment rate this summer can be attributable to recent immigration.[17] Looking forward, we anticipate immigration will have an insignificant effect on the labor supply and unemployment rate during the Trump administration.

Exhibit 5: Last Three Month Job Growth Prior to Recession by Industry Type



Note: Highly Cyclical includes construction, manufacturing, and tech/publishing. Medium Cyclical includes finance, education/healthcare, leisure/hospitality, and government. Source: KKR, Bloomberg

15. Federal Reserve Bank of St. Louis
16. Gross, Mark. "Census Bureau Improves Methodology to Better Estimate Increase in Net International Migration." Census.Gov, 19 Dec. 2024, www.census.gov/newsroom/blogs/random-samplings/2024/12/international-migration-population-estimates.html#:~:text=Today%2C%20the%20U.S.%20Census%20Bureau,fluctuations%20in%20net%20international%20migration.
17. Abecasis, Manuel, et al. "Why We're Less Worried About the Rise in the Unemployment Rate." Goldman Sachs, 28 July 2024, publishing.gs.com/content/research/en/reports/2024/07/28/4d8dfabb-4842-4079-b289-0d1907b150a7.html.

Job growth has been solid in 2024, with the November 2024 non-farm payrolls measure indicating that the economy added 227,000 jobs after a weak October print affected by labor strikes and hurricanes.[18] Job openings are declining, which suggests that labor demand is softening. Thus, we expect non-farm payrolls to trend below the breakeven rate in 2025. While this will likely lead to a small increase in the unemployment rate, there will need to be a significant increase in layoffs to see material deterioration in the labor market. With that in mind, KKR notes that fully 81% of respondents in its latest Americas Chief Human Resource Officer survey indicated that headcount in 2025 should grow or remain the same.[19] Further, Exhibit 5 shows that job growth in highly cyclical industries remains positive. We consider negative job growth in highly cyclical industries to be a harbinger for a broader layoff cycle, but this is unlikely given our constructive outlook on US growth for the year.

On the other hand, we are more concerned about the upside risks to inflation during the year, especially if the Fed cuts rates too quickly. The Trump administration's policies could lead to increases in inflation, but we do not believe it will be significant. Goods inflation could increase drastically due to tariff policy; however, this would likely result in a one-time price shock that would normalize by 2026. We expect Trump to increase tariff rates on Chinese goods, focusing on non-consumer goods, with the potential for additional tariffs on auto imports from Mexico and Europe. The impact of tariffs on inflation could be significant. Yet, the Trump administration is incentivized to limit increases in consumer price inflation following an election where the elevated cost of living was a central issue. As he did in his first term, we believe Trump will target tariff categories where an easy substitution exists, mitigating their impact on inflation. Trump's proposal of a universal tariff on all imports poses a serious risk but is unlikely to be implemented. Trump is likely using tariff threats as a negotiation tool to help push through his trade and national security agendas. All in all, tariffs may lead to a slight increase in goods inflation, but it will likely be less than what the consensus fears.

Similarly, deportation policies could lead to upward pressure on wage inflation, but it is unlikely that we will revert to levels experienced during 2022. From 2020 to 2021 , 2.5 million workers left the economy, creating a tight labor market where there were almost two job openings for every unemployed worker.[20] In order to reach those levels in 2025, nearly seven million people would need to exit the labor force. For perspective, about 271,000 people were deported between October 1, 2023, and September 30, 2024, a 90.4% increase from the year before.[21] It appears virtually impossible for the administration to deport enough people to accelerate wage inflation akin to what was observed in 2022. Certain industries more reliant on undocumented workers may experience near-term labor supply strain, but a broad-based increase in labor inflation looks unlikely.

Shelter inflation has proven hard to tame and looks to be an area that may reaccelerate in the coming year. Low levels of inventory have sheltered home prices from elevated mortgage rates and declining levels of transactions. Home affordability remains low, and house price-to-rent ratios are significantly above 2006 levels, driving rental demand. Rent inflation in large cities has begun to increase, and we anticipate it will expand. The S&P Case-Shiller Home Price Index, a leading indicator of housing inflation, has already started to trend upwards. We believe home prices are poised to rise nationally in 2025 as low inventory and low unemployment offset high mortgage rates. Home price growth could accelerate if the Fed cuts interest rates too quickly and mortgage rates fall in tandem.

Our most considerable concern regarding a reacceleration of inflation in 2025 centers around the Fed's rate cut trajectory. The Fed appears committed to normalizing the Fed funds rate to the perceived neutral rate of 3%, where policy is neither stimulative nor restrictive, albeit at a slowing pace. The neutral rate is likely higher than 3%, and the Fed should consider pausing future rate cuts until inflation comes down more meaningfully. If the neutral rate were indeed 3%, the current policy rate would be significantly restrictive. Yet, consumer and corporate spending has been robust for the past few quarters, indicating that policy is less constraining than perceived. The Bloomberg SHOK model

18. Bloomberg
19. McVey, Henry H. "Insights - Glass Still Half Full." KKR, www.kkr.com/content/dam/kkr/insights/pdf/2025-outlook-glass-still-half-full.pdf. Accessed 6 Jan. 2025.
20. Id.
21. Habeshian, Sareen. "U.S. Deportations Hit Highest Number in a Decade in 2024." Axios, 19 Dec. 2024, www.axios.com/2024/12/20/deportations-immigration-record-2024-ice.

suggests that further normalizing Fed policy to 3% through a 150 bps decrease in forward guidance and a 100 bps decrease in policy rate could increase inflation by 100 bps over the next few quarters.[22] While far away from the run-away inflation witnessed in 2022, a 100-bps increase is nonetheless significant and moves the Fed further from its inflation target of 2%. Taken together, the actual neutral policy rate is likely around current levels, and any additional rate cuts will likely prove stimulative and potentially reaccelerate inflation.

Although we believe policy rates should remain at current levels, the Fed is inclined to bring rates down further, and we anticipate one or two more 25-bps rate cuts in the first half of the year. Forecasting the Fed funds rate is often a futile task with market expectations typically failing to predict the correct path of Fed policy. Nonetheless, we predict that the Fed will cut rates one to two more times in 2025, as weakening labor data in the first half of the year may be used as justification to ease policy. However, policy rates will likely move into stimulative territory, and we view it unlikely that we will see any rate cuts in the second half of the year, barring a recession. In fact, with areas of inflation proving sticky and further rate cuts potentially creating upward price pressure, the Fed may be forced to hike rates in the second half of 2025.

22. Slok, Torsten. "2025 Economic Outlook: Firing on All Cylinders." Apollo Academy, www.apollo.com/content/dam/apolloaem/documents/insights/apollo-global-2025-economic-outlook.pdf. Accessed 6 Jan. 2025.

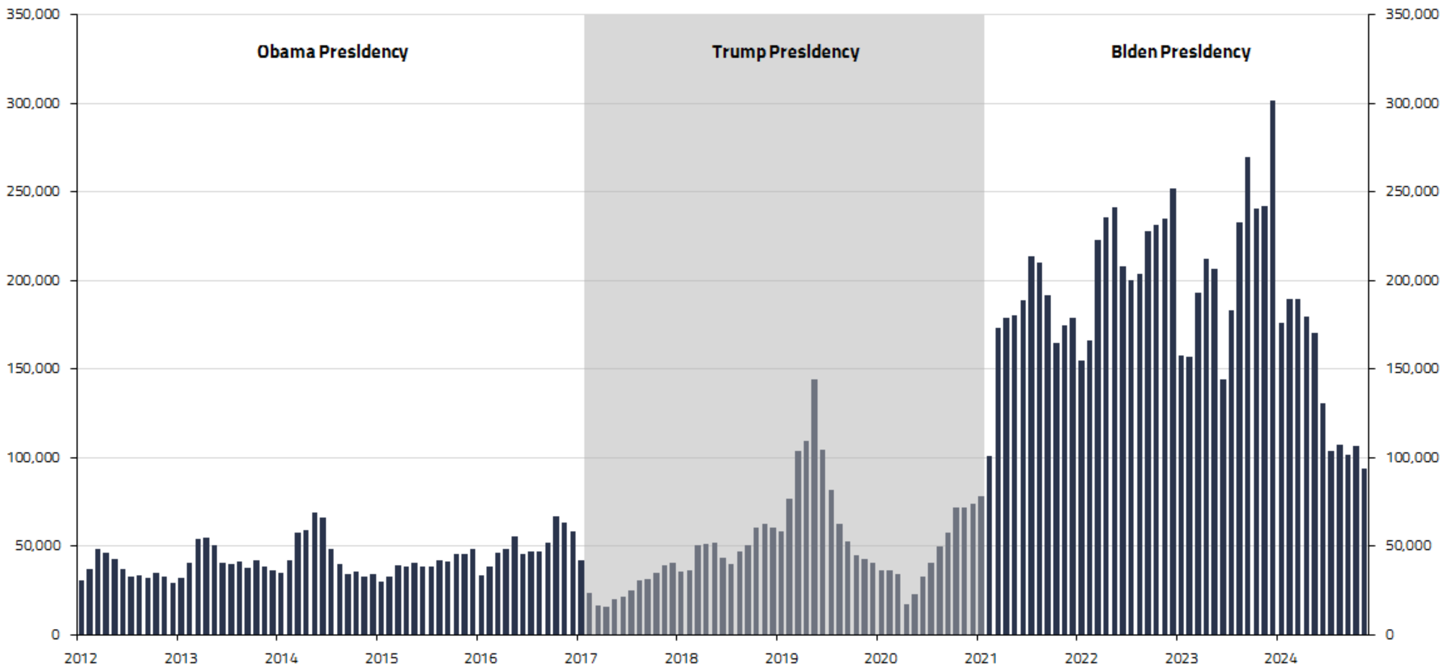
ELEMENT POINTE'S TOP TEN INVESTMENT THEMES FOR 2025

3. US Policy Under Trump 2.0

The 2024 US presidential election was marked by a series of dramatic events. The Republicans battled President-Elect Donald Trump's legal conviction and multiple assassination attempts. At the same time, the Democrats experienced a historically late candidate swap, putting Vice President Kamala Harris as their nominee after President Joe Biden's unconventional withdrawal. In the days leading up to the election, both polling data and betting markets pointed to a toss-up contest. Ultimately, Trump secured all seven key swing states and achieved the highest electoral college vote count for a Republican candidate since 1988. As long-term investors, we look beyond short-term policy changes in Washington and focus on broader secular trends that drive the US economy. Nonetheless, some of the incoming administration's key policy priorities warrant close attention.

Immigration, tariffs, and criticism of the previous administration's economic record were key tenets of Trump's campaign platform. Immigration, a signature issue for Trump since 2016, emerged as a winning strategy, garnering support not only from his traditional base but also from centrist and undecided voters. A June 2024 Gallup poll reflects voters' shifting sentiment by showing that 55% of respondents favored reducing immigration levels, while the same poll before the 2020 election showed that only 28% of responders supported reduced immigration.[23] The significant shift in public opinion is widely attributed to mounting concerns over illegal border crossings under the Biden administration. Encounters at the southern border accelerated to an average of over 155,000 per month during the past four years.[24] This figure is more than three times higher than during Trump's first term and nearly quadruples the levels seen during President Obama's second term (Exhibit 6). Given this backdrop, Trump is expected to take swift executive action to curb immigration levels upon assuming office in January.

Exhibit 6: Southwest Border Total Monthly Encounters



Source: Strategas, US Customs & Border Protection as of 11/30/2024

23. "Immigration." Gallup.Com, Gallup, 16 Oct. 2024, news.gallup.com/poll/1660/immigration.aspx.
24. Bohnsack, Nicholas. "In Extremis." Investment Strategy, Strategas, 12 Dec. 2024.

Likely measures include declaring a national emergency to unlock funds for resuming border wall construction and deploying military personnel to assist in border enforcement and deportation proceedings. Additionally, Trump may move to terminate Biden's parole programs, which have allowed migrants to enter the US on humanitarian grounds at a faster pace than traditional visa programs.

Certain aspects of the administration's immigration agenda may prove challenging to implement effectively. For instance, Trump's pledge to end birthright citizenship for children of undocumented immigrants would likely require a constitutional amendment, an exceedingly unlikely scenario. While Trump has also promised the "largest deportation program in American history," we view such a large-scale effort as logistically difficult and politically challenging. Instead, we expect the administration to focus on preventing future illegal immigration, an area over which it has more direct control. While Trump's team will likely be aggressive in pursuing their immigration agenda, they will need to be mindful of the economic consequences. Most economists anticipate that anti-immigration policies could exacerbate inflationary pressures. The Center for Migration Studies estimates that 8.3 million undocumented immigrants currently work in the US.[25] Comprising approximately 5% of the country's workforce[26], a mass deportation of undocumented workers would severely disrupt the labor market and drive-up inflation. Given the practical constraints, we believe deportations will be targeted and only mildly impact top line inflation.

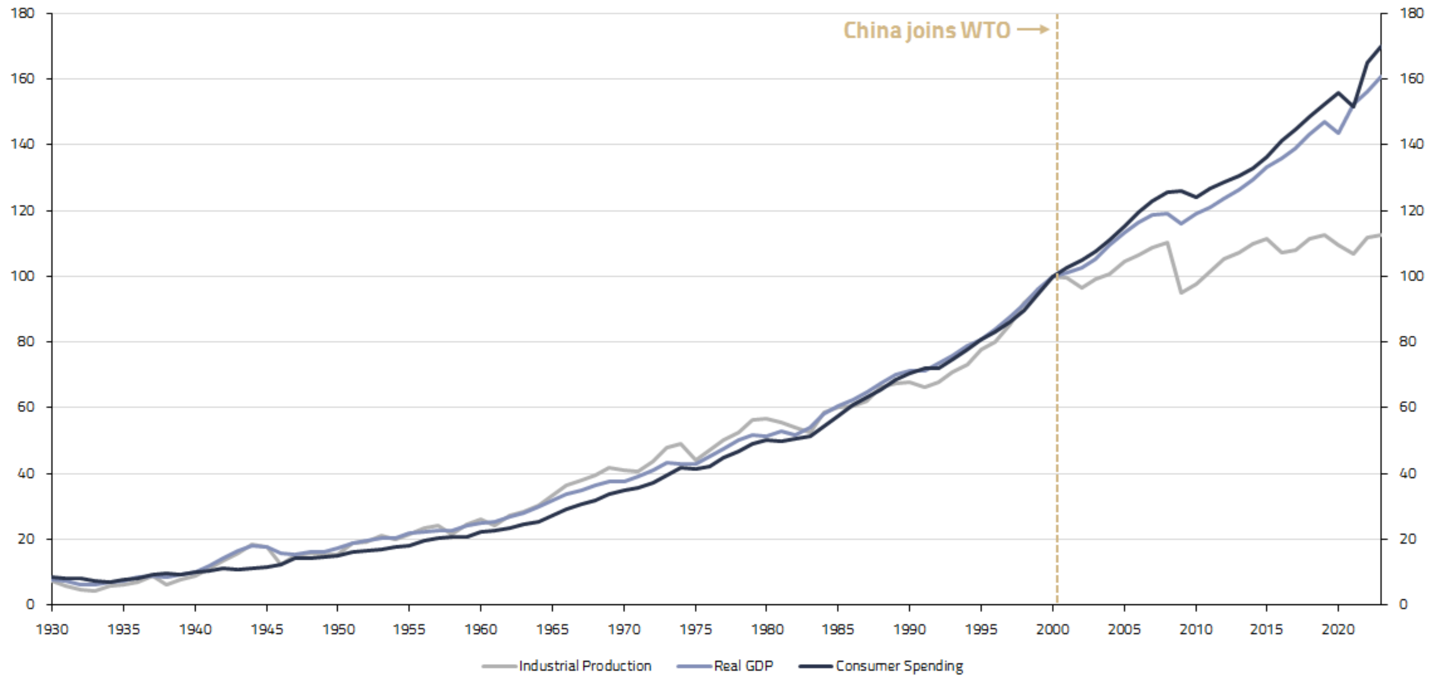
Tariff policy has been another focal point of media attention following Trump's victory, with particular interest in his proposed 10% global tariff. While this figure has captured headlines, we do not believe such a sweeping measure will be implemented. Instead, we expect a more targeted approach, with tariff policy sorted into three groups: China, Mexico and Canada, and the rest of the world.

China will likely remain the primary target of Trump's tariff agenda. We anticipate a renewed focus on tiered tariffs, particularly on non-consumer goods (List 1, 2, and 3 items), which are less likely to impact US consumer prices directly. Consumer goods (List 4B items), largely exempt during the previous trade war, may again face more limited tariffs to avoid harming American consumers. The Trump administration views China's inclusion in the World Trade Organization as a critical negative catalyst that has undermined domestic manufacturing over the past quarter-century. Evidence for the claim is apparent when looking at the relationship between US industrial production, real GDP, and consumer spending (Exhibit 7). To counteract these effects, the administration believes tariffs are essential for leveling the playing field by creating a more competitive environment for US manufacturers. Our base case is a significant increase in the effective tariff rate for China from the current 10% to at least 20%. This increase could lead to higher costs for US manufacturers relying on Chinese components, potentially raising prices for end consumers. Conversely, it will likely encourage some companies to shift production to other low-cost regions or domestically, aligning with the administration's broader goal of revitalizing US manufacturing and creating supply chain resiliency.

Unlike the aggressive approach toward China, Trump's tariff strategy for Mexico and Canada will be more nuanced. The more focused strategy intends to pressure these countries to support his immigration policies and narrow trade imbalances. In 2019, after border encounters peaked at 144,000 in May, the administration threatened a broad 5% tariff on Mexican imports. This tactic contributed to a subsequent decline in monthly border crossings by an average of 16,000 through the end of Trump's term.[27] Trump has already signaled a willingness to revive this approach, threatening 25% tariffs on Mexico and Canada unless they enhance border security efforts. While we believe these tariffs are unlikely to be enacted, they will serve as a key negotiation tool to reduce immigration flows. One area where we foresee tariffs being implemented is on automobiles manufactured in Mexico. Trump has suggested that such tariffs could be as high as 100%, emphasizing his ongoing criticism of US auto manufacturers relocating production south of the border as well as Chinese subsidiaries assembling cars in Mexico to circumvent existing tariffs.

25. Appleby, Kevin. The Importance of Immigrant Labor to the US Economy, The Center for Migration Studies of New York (CMS), 2 Sept. 2024, cmsny.org/importance-of-immigrant-labor-to-us-economy/.
26. Id.
27. De Senna Trennert, Jason. "WHEN IT COMES TO INFLATION, IMMIGRATION COULD BE A GREATER RISK THAN TARIFFS." Investment Strategy, Strategas, 25 Nove. 2024.

Exhibit 7: US Industrial Production, Real GDP, and Consumer Spending



Note: Indexed to 100 on 1/1/2000. Source: JP Morgan Asset Management, Bureau of Economic Analysis, Federal Reserve

As for the rest of the world, we do not expect the administration to enact the proposed 10% across-the-board tariff. Such a sweeping measure would risk significant economic disruption, creating a headwind to growth and reigniting inflation. Our view is that Trump will use the 10% figure as a negotiation starting point, with the end goal of "reciprocal tariff" policy. Currently, US goods face an average tariff of 6.5% abroad, compared to the average 3% tariff imposed on imported foreign goods.[28] In regions like Europe, the administration wants more access for US automakers to sell their products. New US automobiles are functionally extinct in Europe due to differing and stricter regulations. If the European Union ("EU") is not willing to work with the Trump administration by relaxing existing regulations, the US will likely increase import tariffs for European automobiles. The same dynamic is likely to play out on a market-by-market basis, where the Trump administration will push for specific concessions or targeted tariffs. While this shift toward reciprocal tariffs should raise the global effective rate closer to 6%, existing trade agreements will likely prevent an overnight change, making it a gradual, multi-year process.

Managing tariffs will require carefully balancing Trump's goals of protecting US industries and supply chains with the risk of reigniting inflation. Increased tariffs are generally seen as inflationary. KKR estimates that Trump's proposed tariffs could add 60 basis points to inflation,[29] while Goldman Sachs projects a more modest impact of 35 basis points.[30] While inflation remained tame during the first batch of Trump's tariffs in 2018, the current landscape presents a more complex challenge, with core PCE inflation currently above the Federal Reserve's 2% target.[31] Additionally, since inflation often occurs in multiple waves, the administration must be prepared for recurring inflationary pressures. Careful monitoring and assessment of their tariff policies will be necessary to prevent unintended spikes in consumer prices.

28. Nathan, Allison. "Post-Election Economic Policies." Top of Mind, Goldman Sachs Research, 21 Oct. 2024.
29. McVey, Henry, "2025 Outlook: Glass Still Half Full", Insights, KKR, Dec. 2024
30. Hatzius, Jan, "Macro Outlook 2025: Tailwinds (Probably) Trump Tariffs", Goldman Sachs Research, 14 Nov 2024
31. Bloomberg

Perhaps the most ambitious aspect of Trump's agenda comes from the Department of Government Efficiency (DOGE), led by Elon Musk and Vivek Ramaswamy. On the campaign trail, Musk and Ramaswamy promised to deliver "the most aggressive regulatory reduction in US history" and proposed cutting $2 trillion in government spending.[32] A primary target for DOGE's cost-cutting initiatives will be the federal workforce. Musk has a track record of cutting what he considers "bloated workforces". After acquiring X (formerly Twitter), he reduced the headcount by over 80%, describing the move as crucial for the company's survival, a rhetoric he has since repeated about the federal government. DOGE plans to reduce the broad government workforce by relocating functions from Washington to states where services are delivered. They also intend to eliminate hybrid and remote work agreements, aiming to compel voluntary resignations from employees unwilling to return to the office. The most aggressive proposal so far involves the complete elimination of certain departments, such as the Department of Education, which has faced repeated criticism from both Trump and DOGE. Musk and Ramaswamy are likely to face more bureaucratic hurdles than they are accustomed to in the private sector, and it remains uncertain how much they can realistically reduce the federal workforce, which currently stands at about three million.[33]

Musk and Ramaswamy have broader goals beyond workforce reduction, with a key focus on modernizing government operations to enhance productivity and reduce waste. High-profile supporters of this initiative include venture capitalist Marc Andreessen, hedge fund manager Bill Ackman, Palantir co-founder Joe Lonsdale, and tech entrepreneur Peter Thiel. DOGE plans to involve these Wall Street and Silicon Valley leaders, leveraging their proven expertise in streamlining operations to improve government efficiency. These leaders have achieved tremendous success in the private sector, and we are hopeful their strategies will translate effectively to the complexities of government. An early focus for the group is expected to be improper payments. These represent payments made by the government erroneously, which totaled $236 billion in 2023. While modern technology can prevent many of these mistakes, implementing the necessary system upgrades will require considerable upfront costs, posing a direct conflict with DOGE's immediate cost-cutting mandate.

Despite DOGE's ambitious goals, there will be significant roadblocks. DOGE itself is not a formal government department but rather a consultancy-like entity established to advise the administration. To pass new legislation proposed by DOGE, near-unanimous party support or bipartisan cooperation will be necessary, both of which have been recently elusive. While Republicans will control both chambers of Congress, their margins are razor-thin, with only a 220-seat majority in the House, the smallest in modern history.[34] Furthermore, with two strong-willed and eccentric personalities like Trump and Musk leading the charge, there is a real possibility that conflicting visions or impulsive decision-making could derail progress. Musk and other Silicon Valley leaders are known for their "move fast and break things" approach, prioritizing innovation over caution. While this philosophy has driven significant breakthroughs in the tech sector, applying it to the federal government could introduce significant risks and unintended consequences.

Although the $2 trillion savings goal appears overly optimistic in the short run, we view the administration's focus on government efficiency as a refreshing challenge to the status quo. Better oversight of government spending and bureaucracy is sorely needed. This is evident from the DoD's seven consecutive failed audits, the over $100 billion in improper payments amassed by government healthcare programs, and a tax code so bloated that, when including federal regulations and guidance, exceeds 75,000 pages.[35] Whether the administration can deliver meaningful results remains uncertain, but the conversation around greater accountability is long overdue.

32. Picket, Kerry. "Musk Estimates $2 Trillion of Waste Could Be Eliminated from Federal Budget." The Washington Times, 27 Oct. 2024, www.washingtontimes.com/news/2024/oct/27/elon-musk-msg-rally-says-2-trillion-waste-could-el/.
33. Cembalest, Michael, "Outlook 2025: The Alchemists", Eye on The Market, J.P Morgan Asset Management, 01 Jan. 2025.
34. Id.
35. Id.

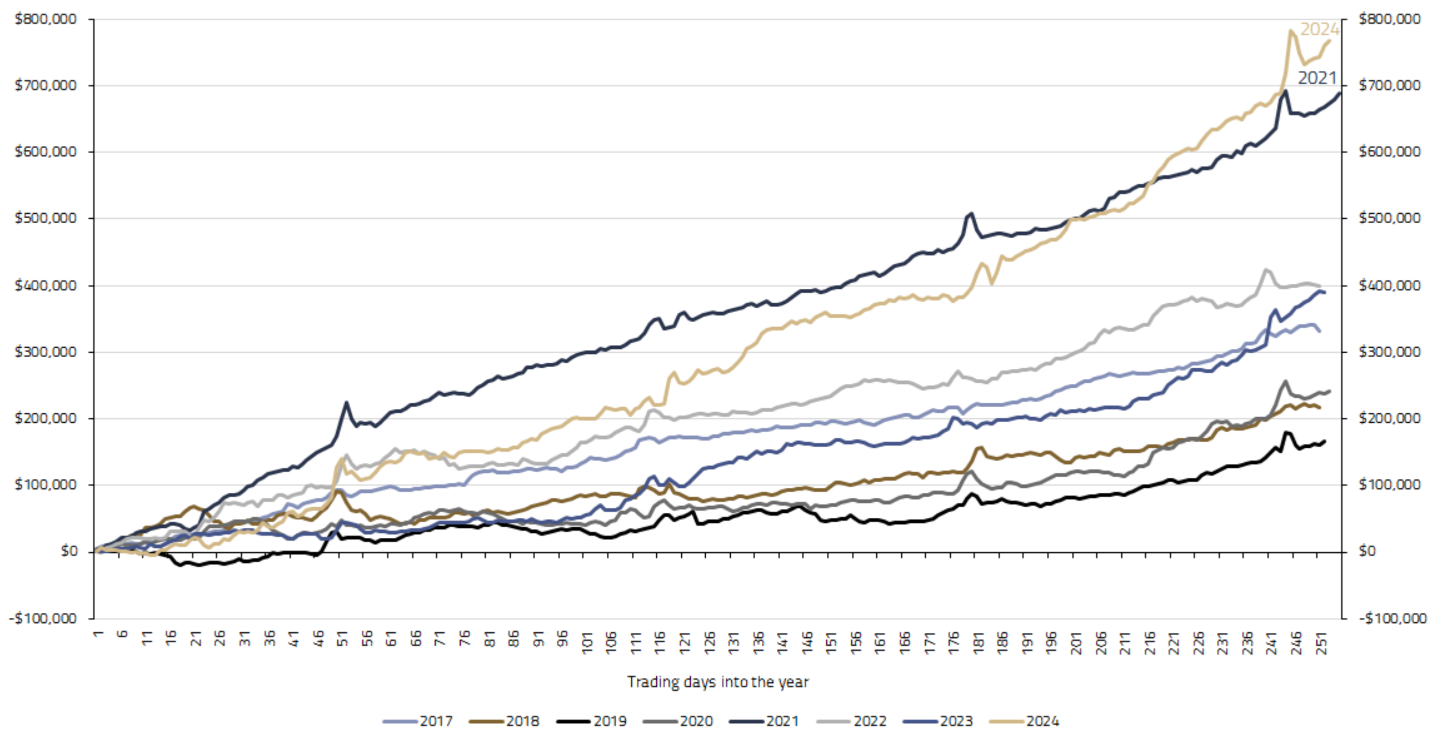
ELEMENT POINTE'S TOP TEN INVESTMENT THEMES FOR 2025

4. US Equities

The S&P 500 had another banner year in 2024, gaining 23.3% and delivering its second consecutive year of greater than 20% performance for the first time since 1998.[36] S&P 500 returns continued to be led by the Magnificent Seven, which returned 48% as a group and accounted for 55% of the S&P's return.[37] Although market breadth improved in 2024 relative to 2023, both the S&P 500 equal-weight index and the Russell 2000 small-cap index significantly underperformed the S&P 500 with price gains of 10.9% and 10%, respectively.[38]

As we look towards 2025, we see a favorable backdrop for US equities. We believe the US economy will continue its above-trend growth, and we see reduced odds of a recession. The likelihood of a recession appears minimal due to resilient consumer spending supported by a firm labor market, robust capital spending supported by strong corporate profits and generous fiscal policies, and historically tight credit spreads that reflect abundant liquidity in the system. As a result, consumer and corporate balance sheets are predominantly healthy, and impending debt maturities are only a concern in pockets of the commercial real estate market. Additionally, despite above-trend growth and inflation that is still running above two percent, the Fed will likely ease monetary policy further in 2025, providing an additional tailwind for the economy. Taken together, our base case is that the US economy will continue to outperform expectations and that US equities will have another positive year.

Exhibit 8: Cumulative Daily Equity ETF Flows (Millions)



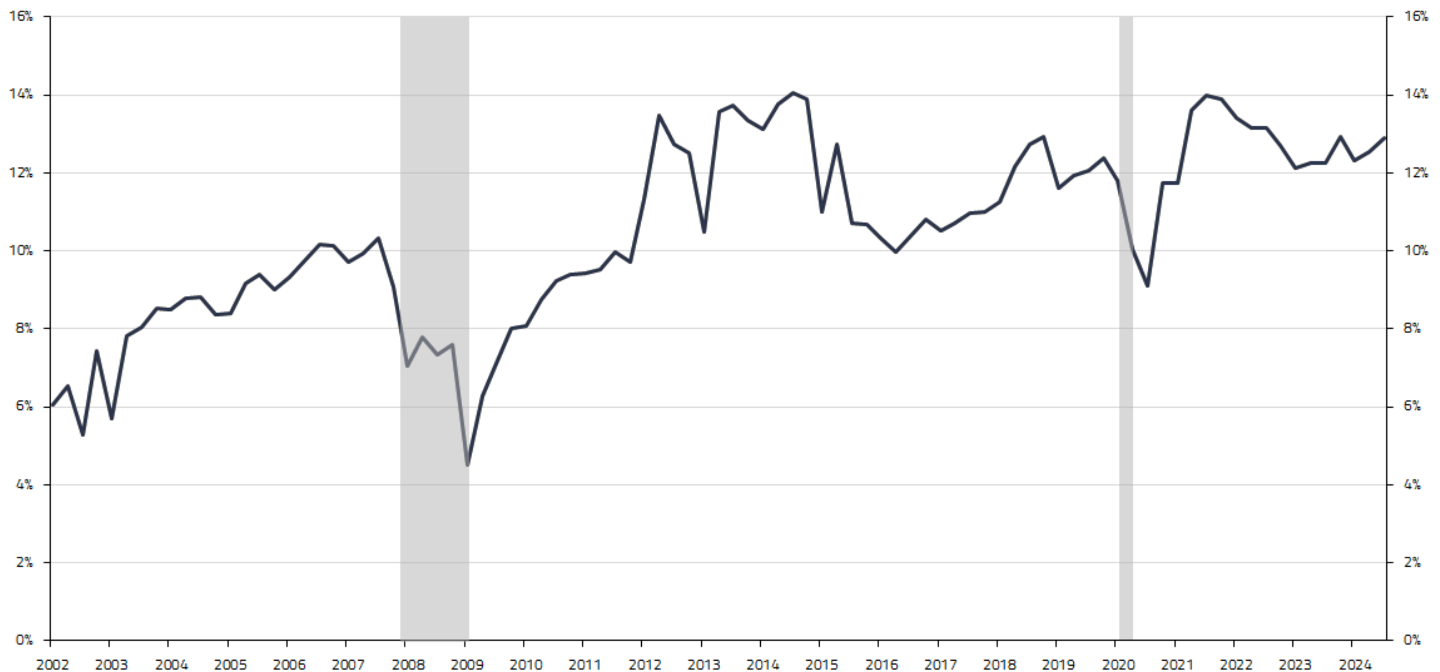
36. Bloomberg
37. Global Market Insights Strategy Team. Guide to the Markets U.S. | 1Q 2025, p.12, J.P. Morgan Asset Management, 1 Jan. 2025, am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/guide-to-the-markets/.
38. Bloomberg

While the run-up in US equities over the past two years has left positioning and valuations stretched, we believe these concerns are overblown. There is no doubt that markets got ahead of themselves after Trump and the Republican Party delivered a convincing victory on Election Day. Investors raced to add US equity exposure with election uncertainty in the rear-view mirror and a belief that a Republican-controlled government was positive for markets. At year-end, equity inflows in 2024 easily outpaced the previous record year of 2021, with roughly half of the inflows occurring over the last three months of the year (Exhibit 8). By early December, positioning and sentiment indicators were at extreme levels that warranted short-term caution.

Despite notching fifty-seven record closes throughout the year[39], the S&P 500 ended 2024 with a whimper. The S&P declined -2.5% in December, while the Russell 2000 experienced a more significant drawdown of -8.4%.[40] The S&P closed the year on a four-day losing streak that slammed the door on any hopes for a Santa Claus rally. On a positive note, we believe December's swoon was what the market needed to work off some of the sentiment and positioning excess that had developed post-election. While we would not be surprised to see modest selling pressure to start the year, we believe any sell-off will be short-lived.

With respect to valuation, the S&P 500 ended the year trading at 21.5x forward earnings versus a ten-year average of 18.5x.[41] We have cautioned in previous communications that valuation is a terrible timing tool. It does not have any predictive power over the short-term, despite correlating highly with longer-term returns. More importantly, we believe the S&P 500 is a higher-quality index than it has been in the past, arguing for a higher multiple. One example is how well the S&P 500 has traded despite the ISM Manufacturing index being in contraction territory for a record twenty-five consecutive months.[42] Extended periods of manufacturing contraction have historically been highly correlated with periods of earnings and stock price declines, but that relationship has broken down over the past two years.

Exhibit 9: S&P 500 Profit Margins



Note: Quarterly earnings/sales. Source: Bloomberg as of 1/02/2025

39. FactSet
40. Bloomberg
41. FactSet
42. Strategas

Furthermore, the S&P 500 Index currently has more exposure to technology and other high-margin businesses than it has in the past. As such, index earnings are less cyclical, and profit margins are higher than they have been in the past (Exhibit 9). The combination of the two calls for the S&P to trade at a higher multiple than in years past; thus, we are not as concerned as others about today's seemingly elevated multiples.

Small-cap stocks are one area of the market that we expect better relative returns from in 2025. Relative to their large-cap peers, small-cap companies tend to be more domestically focused and interest-rate sensitive. Trump's deregulation and lower tax agenda should boost margins and earnings for the group. Trump's tariffs should make domestic goods more competitive with imports, and Trump may also propose new tax incentives that favor domestic producers. Small-cap companies tend to finance themselves with floating-rate debt, so they will have an outsized benefit from recent Fed interest rate cuts and easing monetary policy. Finally, the Trump agenda should be a tailwind for increasing mergers and acquisitions ("M&A") activity, a trend that should benefit small caps since many are considered acquisition targets.

It is important to note that many small-cap companies are unprofitable or highly speculative, making most small-cap indices unattractive. Thus, we prefer active managers over index ETFs or funds when seeking exposure to small caps in client portfolios. We prefer well-established managers with compelling track records who perform deep fundamental analysis and can identify the best small-cap companies to invest in.

Despite our moderately bullish view for 2025, we recognize that Trump's presidency and agenda bring elevated uncertainty. As we think about the range of equity-market outcomes for 2025, we settled on the following framework:

- We see a 30% probability that continued advancements and adoption of AI will lead to a productivity and growth surge, fueling further AI euphoria and resulting in another stellar year for the S&P 500. This scenario results in the S&P gaining 15% to 25% and resembles the late 1990s internet boom when the S&P experienced four consecutive years of 20%+ gains and narrowly missed a fifth in 1999. In this scenario, we would expect mega-cap tech and the AI complex to lead the market, but with broader participation and better performance from small caps.
- We see a 50% probability that the S&P will rise 5% to 10%. In this scenario, the S&P rises in line with our expected S&P earnings growth forecast for 2025, but multiples stay the same or contract modestly. Market breadth improves as more companies experience earnings growth, small caps outperform large caps, and the Magnificent Seven experiences mixed performance with several notable underperformers. We also envision increased volatility in the AI complex, which results in multiple S&P drawdowns of at least 7%.
- We see a 20% probability that the S&P 500 will decline by -10% to -20% as progress on AI initiatives disappoints, the Trump agenda fails to live up to investor expectations, and the economy experiences stagflation. In this scenario, the market is dragged down by the performance of big tech while defensive sectors like energy, healthcare, and consumer staples shift to leadership. We also believe that non-US stocks would outperform in this scenario, as discounted multiples and low expectations offer better downside protection.

Taken together, we see a probability-adjusted return for the S&P 500 in 2025 of 7% - 8%. While we think market returns will become less dependent on the performance of the Magnificent Seven, we think technology will continue to lead the market, although uncertainty around the return on investment for massive AI capital expenditure spending will lead to more volatility and several sharp corrections throughout the year.

ELEMENT POINTE'S TOP TEN INVESTMENT THEMES FOR 2025

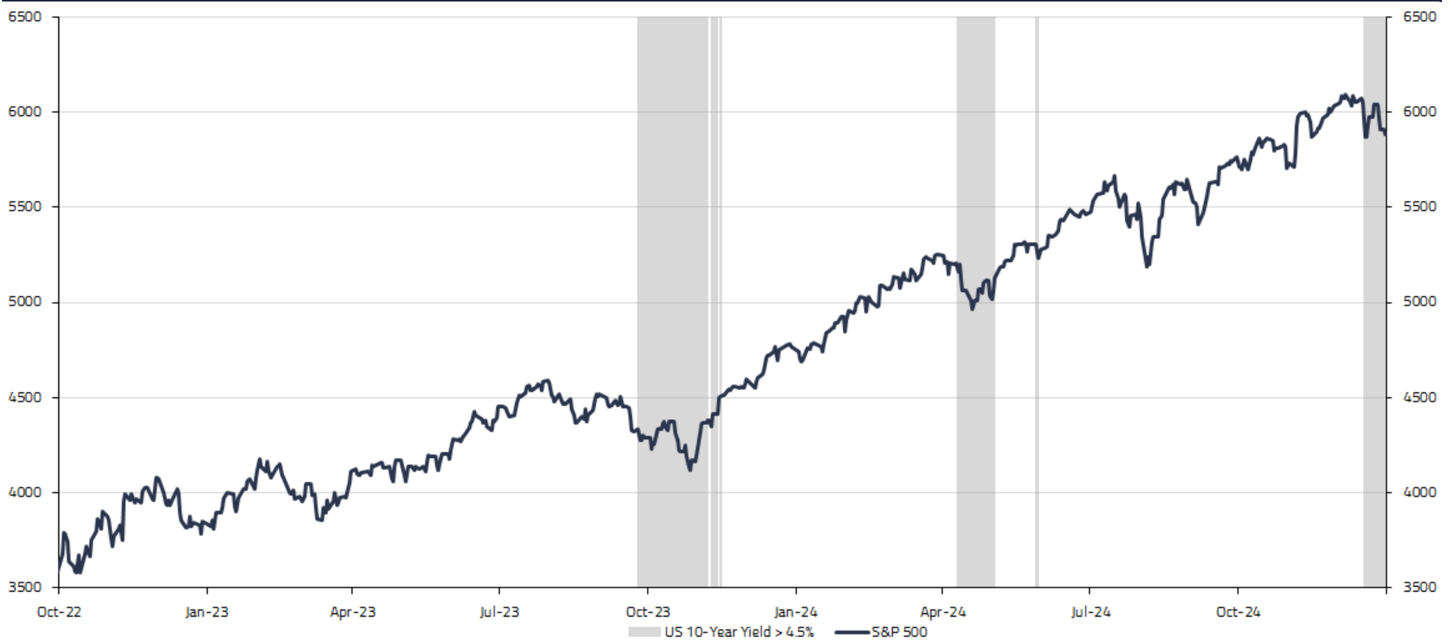
5. Risks To US Equities

As we indicate in our framework for equity-market outcomes in 2025, we see a 20% chance that US equities may be down as much as 20% for the year. It is essential to understand the risks that could crystalize such an outcome so that we can closely monitor developments on these fronts and recalibrate our expectations as needed. With President Trump set to take office, investors must consider a series of policy changes that are likely to take effect, which include deportations and restrictions on immigration, an extension of the 2017 tax cuts with potential new tax cuts added, more aggressive tariff policy, a lighter regulatory regime, and cuts to some areas of government spending.

While investors are currently bullish about Trump's overall agenda, we would be remiss not to recognize three key risks that could derail the US equity market. We believe the three key risks are as follows: 1) higher bond yields brought about by a resurgence in inflation and/or investor concerns for the long-term sustainability of the US debt, 2) the high concentration of the S&P 500 Index and its leverage to the AI investment theme, and 3) escalating geopolitical conflicts that have made the US more vulnerable in the event of a direct conflict.

Higher Bond Yields: The first key risk to equities is higher bond yields that would weigh on economic growth, pressure equity valuation multiples, and potentially spark renewed solvency concerns for regional banks that are still overly exposed to long-duration assets on their balance sheets. In 2024,10-year US Treasury yields rose 69 bps to close the year at 4.57% despite the Fed cutting the Fed funds rate by 100 bps.[43] The move upward in 10-year yields suggests that the term premium is rising, meaning investors are demanding more compensation for holding riskier long-term bonds. As Trump is set to take office, "investors are pricing in higher government spending, annual operating deficits, greater volatility and a rising premium to hold US debt."[44] Importantly, the US equity market has repeatedly struggled over the past eighteen months when the 10-year yield rises above 4.5% (Exhibit 10). With the 10-year yield starting the year above that level, we think an upward move to 5% or higher would pressure economic growth and destabilize equity markets.

Exhibit 10: S&P 500 Index vs 10-Year Yield > 4.5%



Source: Bloomberg as of 12/31/2024

43. FactSet
44. Brusuelas, Joseph. "Morning Market Minute: US Term Premium and Higher Yields." The Real Economy Blog, 6 Jan. 2025, realeconomy.rsmus.com/morning-market-minute-us-term-premium-and-higher-yields/.

What could cause such a rise in yields from here? The first likely culprit is a resurgence in inflation. After coming down sharply from 9% over the past two years, several leading inflation measures have stabilized around the 3% area over the past quarter. History suggests that inflation comes in waves, and Trump's immigration and tariff policies have the potential to reignite a second inflationary spiral. Trump's intention to conduct mass deportations and severely restrict immigration may lead to higher wage inflation, especially in the industries most exposed to immigrant labor, like construction, agriculture, hospitality, and domestic services. With respect to tariffs, if Trump implemented all the proposed tariffs, the average tariff on imports would be the highest in over 100 years.[45] While we believe Trump will strategically limit tariffs to goods that have abundant domestic substitutes or a limited impact on inflation readings, he cannot control how other countries retaliate. Many leading economists warn that a global tariff war will substantially raise inflationary pressures in the US. If a new bout of inflation takes hold, investors are likely to push long-term yields above 5%, and the Fed will be forced to pivot once again. Instead of easing monetary policy further, the Fed would likely have to initiate another round of rate hikes to quell inflationary pressures, sparking renewed concerns of a hard landing for the economy.

While the timing is tricky to assess, the return of bond market vigilantes may pressure long-term yields above 5%. With the US currently running annual budget deficits exceeding 6% at a time of full employment and our debt-to-GDP ratio approaching an all-time high, bond investors are more frequently calling into question the fiscal sustainability of the US. One particularly alarming figure is the rapidly rising government interest expense that nears $1 trillion per year and now exceeds both national defense and Medicare spending (Exhibit 11). Neither political party seems to have any credible plan or a serious desire to meaningfully reduce the deficit. President Trump's Department of Government Efficiency ("DOGE") is a step in the right direction and holds promise, but DOGE is likely to meaningfully underperform its objectives unless a review of entitlements is brought into its purview.

Exhibit 11: Government Outlays

Government Outlays by Source	Amount (Billions)	% of Total
Social Security	$1,461	22%
Health	$912	14%
Net Interest	$882	13%
Medicare	$874	13%
National Defense	$874	13%
Income Security	$671	10%
Veterans Benefits and Services	$325	5%
Education, Training, Employment, and Social Services	$305	5%
Transportation	$137	2%
Community and Regional Development	$88	1%
Administration of Justice	$85	1%
International Affairs	$72	1%
Natural Resources and Environment	$57	1%
General Science, Space, and Technology	$42	1%
Commerce and Housing Credit	$36	1%
Agriculture	$35	1%
General Government	$30	0%
Energy	$14	0%
Undistributed Offsetting Receipts	($147)	-2%
Total	**$6,752**	

Note: Data is for FY24 ending 9/30/2024. Source: U.S. Department of the Treasury

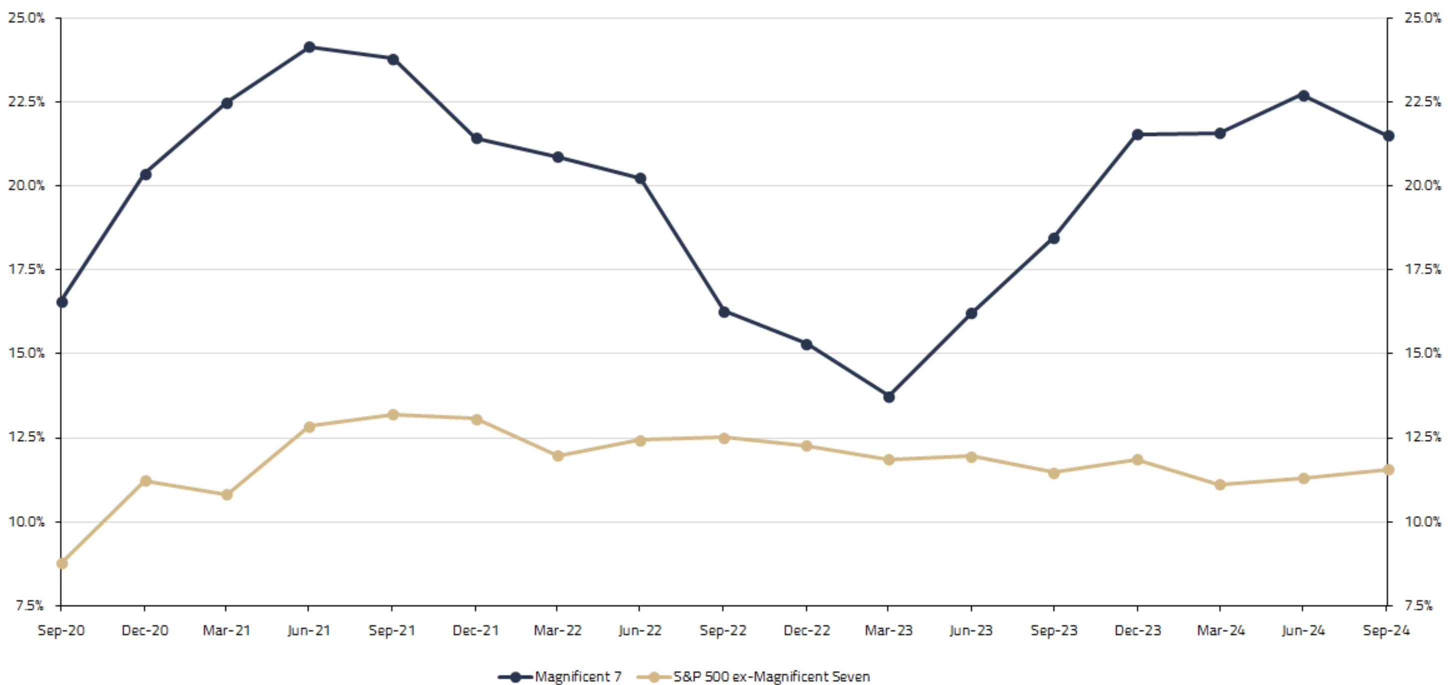
45. J.P. Morgan Asset Management, U.S. International Trade Commission.

As the US fiscal outlook deteriorates, demand for long-term US Treasuries has been waning, with the Fed and foreign governments reducing purchases. These price-insensitive buyers have been replaced by investors demanding higher yields. So far, the move up in yields has been orderly. Yet, a hypothetical retaliatory move by China to dump a large portion of its US Treasury holdings onto the market in a disorderly manner could be the catalyst that triggers a large bond and equity-market selloff.

High Concentration of the S&P 500 Index: After two consecutive years of stellar performance, the Magnificent Seven[46] constitutes 33% of the S&P 500 as of year-end 2024.[47] This level of concentration is unprecedented in modern history and raises legitimate concerns about market vulnerability, as the performance of the S&P 500 is increasingly tied to a handful of companies. Furthermore, these mega-cap tech companies have performed so well because they are considered leaders or beneficiaries of the AI investment boom. While the AI investment wave is still in its infancy, there will likely be many AI-led corrections, as investor expectations often get way ahead of reality when it comes to revolutionary technologies. As such, any tech or AI-specific challenges that emerge will likely disproportionately affect the Magnificent Seven, leading to a downturn in the S&P 500.

Valuation is another concern for the Magnificent Seven. While these companies have delivered consistent and outsized earnings growth as a group, their valuation multiples have expanded and they trade at a significant premium to the broader index. We believe that most of this valuation premium is justified since most of the S&P's earnings growth over the last two years can be attributed to the Magnificent Seven,[48] and the group has profit margins that vastly exceed the rest of the index (Exhibit 12). However, we believe that investors have unrealistic growth expectations for several of the Magnificent Seven companies, making them more vulnerable to any earnings disappointments. Additionally, high multiple stocks are more sensitive to moves up in long-term yields, as witnessed by the performance of the Magnificent Seven in 2022.

Exhibit 12: Magnificent Seven vs S&P 500 ex-Magnificent Seven Profit Margins



Source: JP Morgan Asset Management, Bloomberg as of 1/6/2025

46. The Magnificent Seven includes Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla
47. Bloomberg
48. Global Market Insights Strategy Team. Guide to the Markets U.S. | 1Q 2025, p.12, J.P. Morgan Asset Management, 1 Jan. 2025, am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/guide-to-the-markets/.

The final key concern of this unprecedented S&P concentration is regulatory risk. Most of the Magnificent Seven have come under the cross-hairs of global regulators, and several are facing antitrust lawsuits from the US Department of Justice. Any adverse rulings or remedies could hurt their growth and profitability prospects. Overly restrictive AI regulations could also be a catalyst for a selloff in the Magnificent Seven and the S&P 500 given their exposure to the AI investment boom.

Geopolitics: While geopolitical risks are always present and inherently difficult to predict, we believe geopolitical risks are higher today than at any time since the Cold War. The world is increasingly splitting into two camps, with the US and the "free world" on one side and four autocracies - China, Russia, Iran, and North Korea - leading the other side. These four autocracies are intent on dismantling the existing world order and are increasingly working together to achieve their objectives. Taking the Russia-Ukraine conflict as an example, Russia appears to be winning with the help of Iranian munitions, economic support and technological know-how from China, and manpower from North Korea, which has sent thousands of its troops to fight for Russia in Ukraine. The extent of this cooperation is underappreciated and has already put the US in a vulnerable position given our stretched industrial base. The US struggles to keep supplying weapons to allies like Ukraine and Israel, calling into question our country's military preparedness should a conflict arise that involves us directly. We believe that any sign that such a conflict is on the horizon could significantly destabilize equity markets.

ELEMENT POINTE'S TOP TEN INVESTMENT THEMES FOR 2025

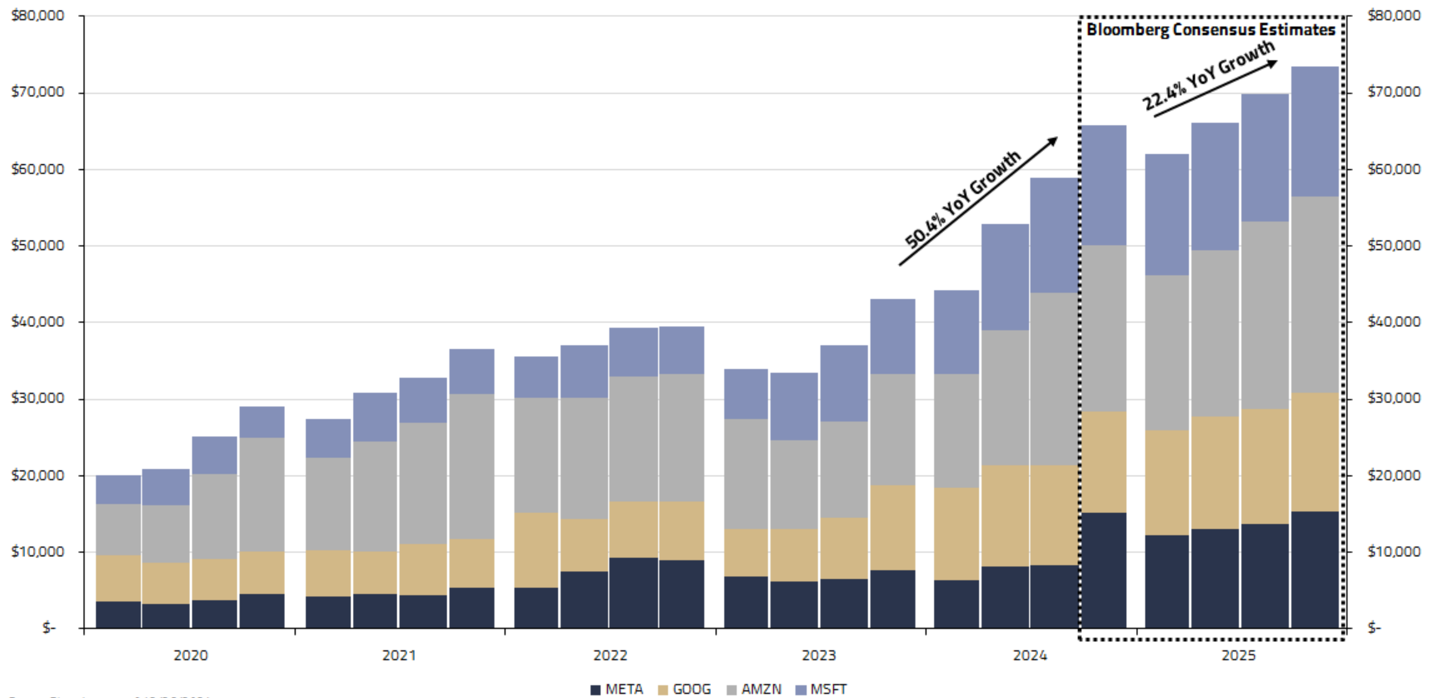
6. Artificial Intelligence

Ever since OpenAI released ChatGPT to the public in November 2022, investors have been enthralled by the potential of AI as a revolutionary technology. The application quickly won over users, reaching 100 million monthly active users just two months after launch and setting the record for the fastest-growing consumer application in history.[49] Not surprisingly, many companies quickly pivoted into AI investment and development mode while investors sought out the best ways to gain exposure to this powerful technology trend.

Over the past two years, AI has emerged as one of the most significant investment themes given its transformative potential to reshape industries and drive growth. Advancements in AI technology have progressed at astounding speed, and the technology's potential to revolutionize business is undeniable. Progress in the development of large language models ("LLMs") has continued apace, with several notable competitors to OpenAI emerging. To date, most of the value creation has accrued to the leading private companies that have developed LLMs, like OpenAI, Anthropic, and xAI, and the Magnificent Seven tech companies, which all have compelling AI investment narratives attached to them.

The poster child of this AI value-creation wave is Nvidia ("NVDA"). Over the past two years, NVDA's market cap has soared almost tenfold to above $3 trillion, and the company briefly became the most valuable company in the world in 2024.[50] NVDA, the leading provider of GPUs critical for AI processing, has experienced explosive growth, with revenue increasing approximately 500% and earnings increasing 900% over the past twenty-four months.[51] Analysts expect NVDA's stellar growth to continue in 2025 but at a reduced pace, with revenue and earnings expected to rise approximately 50%.[52]

Exhibit 13: Hyperscaler Capital Expenditure Growth (Millions)



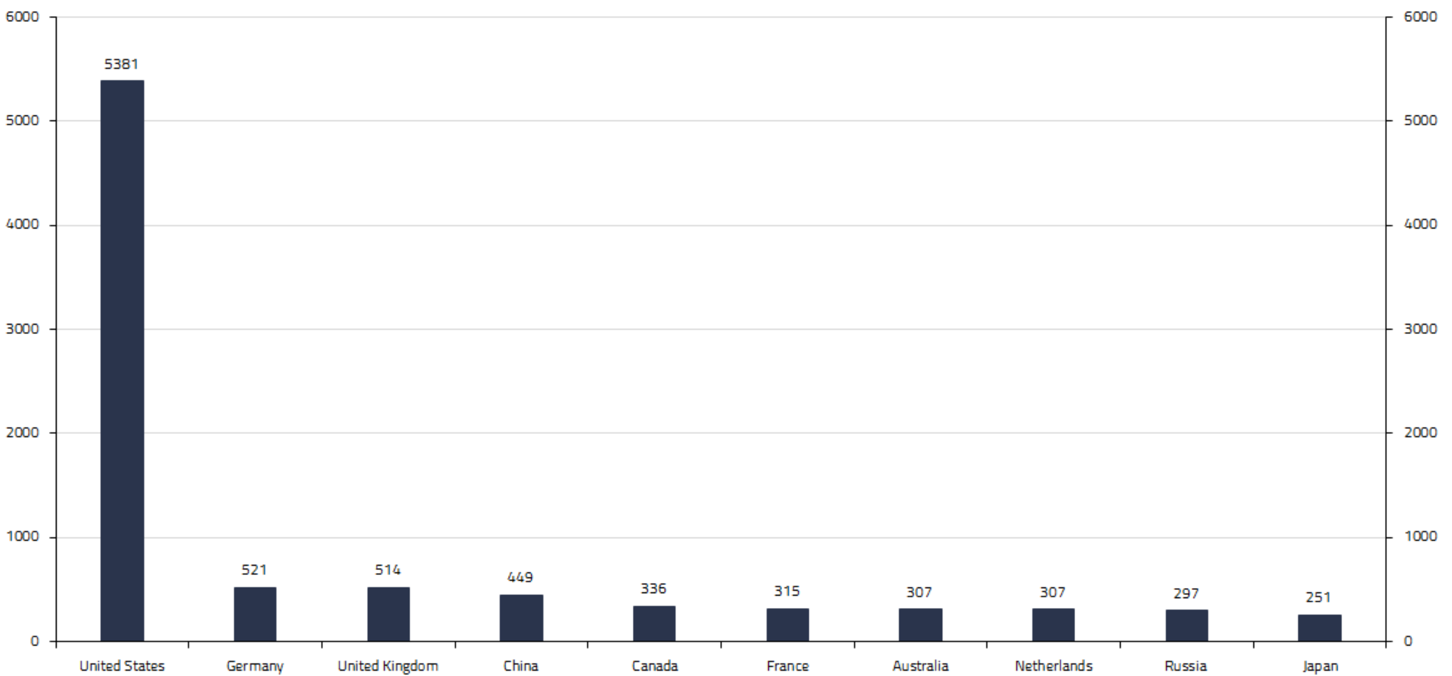
Source: Bloomberg, as of 12/26/2024

49. Hu, Krystal. "ChatGPT Sets Record for Fastest-Growing User Base ." Reuters, 2 Feb. 2023, www.reuters.com/technology/chatgpt-sets-record-fastest-growing-user-base-analyst-note-2023-02-01/.
50. FactSet
51. Bloomberg
52. FactSet

NVDA and other leading semiconductor companies, such as Taiwan Semiconductor ("TSM"), Broadcom ("AVGO"), and Marvell ("MRVL"), are directly benefitting from the surge in AI capital expenditure spending from companies developing LLMs and large cloud-computing companies (Exhibit 13). This growth in AI infrastructure spending has made these select semiconductor companies among the biggest winners to date. As we look forward to 2025, we believe the fundamentals will continue to support outperformance for the group, but the best returns will be found elsewhere.

The Magnificent Seven, many of which are responsible for this massive growth in spending, have also outperformed over the two-year period despite concerns about overspending. The leading cloud-computing companies, otherwise known as hyperscalers, are positioning themselves as the go-to providers for AI compute and services. AI requires immense computational resources, giving these mega-cap tech companies a competitive advantage. They are also adding innovative AI tools and integrations that should further cement their competitive advantage. After two years of outsized investment, we believe the hyperscalers are poised for an upward inflection in the growth of their cloud businesses as enterprise deployments increase significantly. This should lead to modest outperformance in 2025 for the leading cloud providers.

Exhibit 14: Data Centers per Country



Source: Apollo,, Statista

The last group of early winners includes data center operators, companies specializing in AI-optimized cooling systems, and companies developing more energy-efficient computing solutions. In the race for AI dominance, compute and data centers have become critical national infrastructures vital to maintaining the US's competitive edge in AI development. US government support and investment dollars have propelled an expansion in data center development, giving the US a huge lead and competitive advantage versus the rest of the world (Exhibit 14).

In summary, AI infrastructure stocks – semiconductors, cloud-computing, and data centers – have been the biggest beneficiaries of the AI investment wave thus far, much like we saw in the early days of the internet tech boom, when internet infrastructure stocks were the early winners. While we believe these leading infrastructure stocks are still poised to outperform over the next few years, the winners of the next wave of the AI investment cycle are likely to start emerging in 2025. We believe enterprise software companies and AI agents will lead this next wave of explosive growth and outperformance.

Enterprise software companies should begin to show monetization improvements with their industry-specific solutions. Companies developing AI tools, cyber companies specializing in AI security and monitoring, and businesses focusing on data preparation and management should all see meaningful upticks in their businesses. With enterprise software companies trading at valuation levels below pre-COVID, we see the potential for meaningful multiple expansion for the software companies that are successful in demonstrating new AI growth vectors.

Amid debate about whether progress on LLM advancements has begun to level off as the availability of high-quality training data is exhausted, researchers are shifting their AI training focus to logic and reasoning. This new phase of longer-duration inferencing should allow for multi-modal integration and enable autonomous agents that are capable of long-term planning and deliberation. As these advancements mimic human intelligence, AI agents will be able to drive efficiencies, enhance decision-making, and personalize experiences. Eventually, we envision a world where AI agents trained in industry and company data can make decisions and take action to meet specific company goals while adapting to changing circumstances. We believe that much of the value creation in AI agents will not accrue to incumbents, but to companies that are currently private or have yet to be formed.

Overall, we continue to believe in the transformational power of AI and that we are still in the early innings of a generational investment opportunity. We think 2025 will bring accelerating AI innovation, broader adoption, and increasing integration with other technologies and business processes. Like all major technology disruptions, the euphoria can sometimes lead to short-term mispricing and excessive volatility, and we would not be surprised to see a correction in AI-related stocks over the next few months. However, we encourage investors to stay invested and to use periods of doubt and disillusionment as opportunities to add exposure. As money managers, we subscribe to the adage that investors generally overestimate how much change can happen in one year but grossly underestimate the change that can occur over a period of ten years. Therefore, we will closely track developments in AI and invest with a long-term mindset. We aim to give our clients exposure not only to today's winners but also the leaders of tomorrow.

ELEMENT POINTE'S TOP TEN INVESTMENT THEMES FOR 2025

7. Europe

The Eurozone's economic trajectory has remained underwhelming since the post-COVID recovery of 2021 and 2022. While the region has managed to avoid recession, growth has been hard to come by, with GDP having expanded by a below-trend 0.4% in 2023 and an expected 1.1% in 2024.[53] Meanwhile, US GDP growth significantly outpaced the Eurozone in every quarter of 2024. As we look to 2025, we anticipate the Eurozone will continue to struggle with sluggish growth despite some notable divergences at the regional level.

Germany and France, the Eurozone's two largest economies and historical leaders, now hinder the zone's economic growth. Germany's industrial sector faces persistent headwinds, including elevated energy costs and intensifying global competition. The constitutional Debt Brake remains in effect and is unlikely to be relaxed until the next German election in September 2025. The Debt Brake constrains fiscal flexibility during a period of economic uncertainty. Natural gas prices remain over five times higher than those in the US[54] even though they are down considerably from their 2022 peak. High energy prices undermine manufacturers' ability to maintain competitive production costs, resulting in reduced output and diminished profitability. Furthermore, the German auto industry contends with mounting external pressures, including potential retaliatory tariffs following the increased duties on Chinese electric vehicles. In addition, upcoming US tariffs may exacerbate existing challenges for the Eurozone, particularly Germany's export-driven economy. According to research from Goldman Sachs, Germany is expected to be the hardest hit among European countries, with tariffs creating an estimated economic drag of -0.6% on GDP growth, if implemented.[55]

Political instability adds to the existing uncertainty for Germany. Chancellor Olaf Scholz's coalition government collapsed in late 2024, prompting snap elections set for February 2025. Polling suggests the Christian Democratic Union ("CDU"), led by Friedrich Merz, will take control of the government.[56] If successful, the CDU will face the daunting task of revitalizing Germany's industrial complex while managing its lofty energy transition goals in an uncertain global trade environment. Improving consumer sentiment is critical to breaking the negative cycle of reduced spending and slow economic growth, given that consumer spending accounts for approximately 50% of Germany's GDP.[57] Without a meaningful recovery in sentiment, the risk of a prolonged economic drag increases as subdued spending perpetuates a vicious cycle of weak demand and reduced growth. Consumer sentiment, as measured by the Germany Consumer Climate Survey, has been persistently negative since early 2022. December's consumer sentiment reading of -23.1 is significantly lower than the long-term average of five.[58] Poor sentiment underscores the persistent consumer pessimism that has weighed on the German economy over the past three years. We believe Germany has too many issues to digest, and it is unlikely for growth to materially accelerate until at least 2026. Given these challenges, investors will need to be highly selective in their allocations to Germany, focusing on sectors or companies better positioned to navigate this difficult environment.

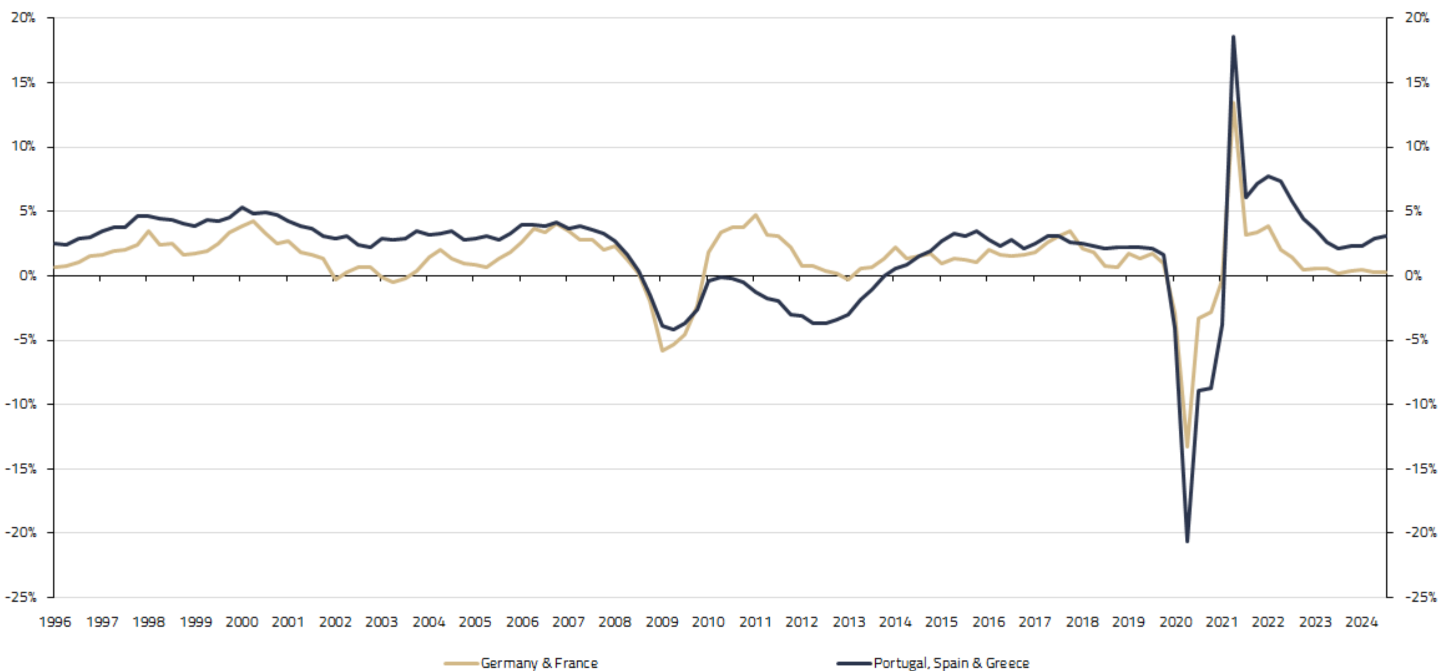
France, while less exposed to energy shocks than Germany, grapples with challenges of its own. Fiscal consolidation will be a key development to monitor as the government pursues rapid deficit reduction at a pace not seen since post-crisis normalization in 2011.[59] This ambitious fiscal strategy, aimed at stabilizing public finances and boosting investor confidence, will likely benefit the country in the long term, but may create a short-term drag on growth. The luxury goods sector, a cornerstone of French industry, also endured a lackluster 2024 as China's economic struggles continued to weigh on demand. Companies like Louis Vuitton Moët Hennessy, Hermès, and L'Oréal saw muted sales

53. Bloomberg
54. Jari Stehn, Sven. "Euro Area Outlook 2025: Under Pressure." Goldman Sachs Research, 14 Nov. 2024.
55. Id.
56. "German Election 2025: Who's Ahead in the Polls?" German Election, www.ft.com/german-election-2025. Accessed 2 Jan. 2025.
57. "Germany Private Consumption: % of GDP." CEIC, www.ceicdata.com/en/indicator/germany/private-consumption--of-nominal-gdp. Accessed 3 Jan. 2025.
58. "Germany Consumer Climate Survey: Gfk: Consumer Climate Indicator (CCI)." CEIC, www.ceicdata.com/en/germany/consumer-climate-survey-gfk-group/consumer-climate-survey-gfk-consumer-climate-indicator-cci. Accessed 3 Jan. 2025.
59. Stott, Alexandre. "European Daily: France—Budget Recap." Goldman Sachs Research, 11 Oct. 2024.

growth in 2024. Slowing revenue growth reflects the collapse of China's upper-middle class, a key consumer of the French luxury goods sector. Nonetheless, these businesses have strong margins, century-long track records of success, and a history of re-inventing themselves through changing macroeconomic conditions. Although we expect the French and European luxury economy to recover, it is likely to be a multi-year endeavor. Political discontent is another concern for France, with recent polls indicating significant public dissatisfaction with President Emmanuel Macron's administration. While calls for early elections in 2025 are unlikely to materialize, political instability could dampen consumer and business confidence, constraining France's economic momentum.

In contrast, southern European economies, such as Spain, Portugal, and Greece, have emerged as bright spots within the Eurozone. These countries are benefitting from robust tourism and service-sector growth in 2024. Additionally, household energy costs in these countries are now about 15% lower than the European Union's average.[60] Spain and Portugal's proximity to Africa provides access to alternate natural gas supplies, driving down costs. The lower energy burden helped boost household spending and economic competitiveness, further supporting growth. As a result, these economies outpaced their northern counterparts in 2024, resulting in an atypical dispersion in GDP growth, as shown in Exhibit 15. Immigration patterns and fiscal support from the EU Recovery Fund will further bolster these regions in the short run, suggesting continued, solid growth in 2025. However, without a resurgence from the German or French economy, these gains are unlikely to offset the broader Eurozone stagnation we anticipate in 2025.

Exhibit 15: European Real GDP Growth by Grouped Countries

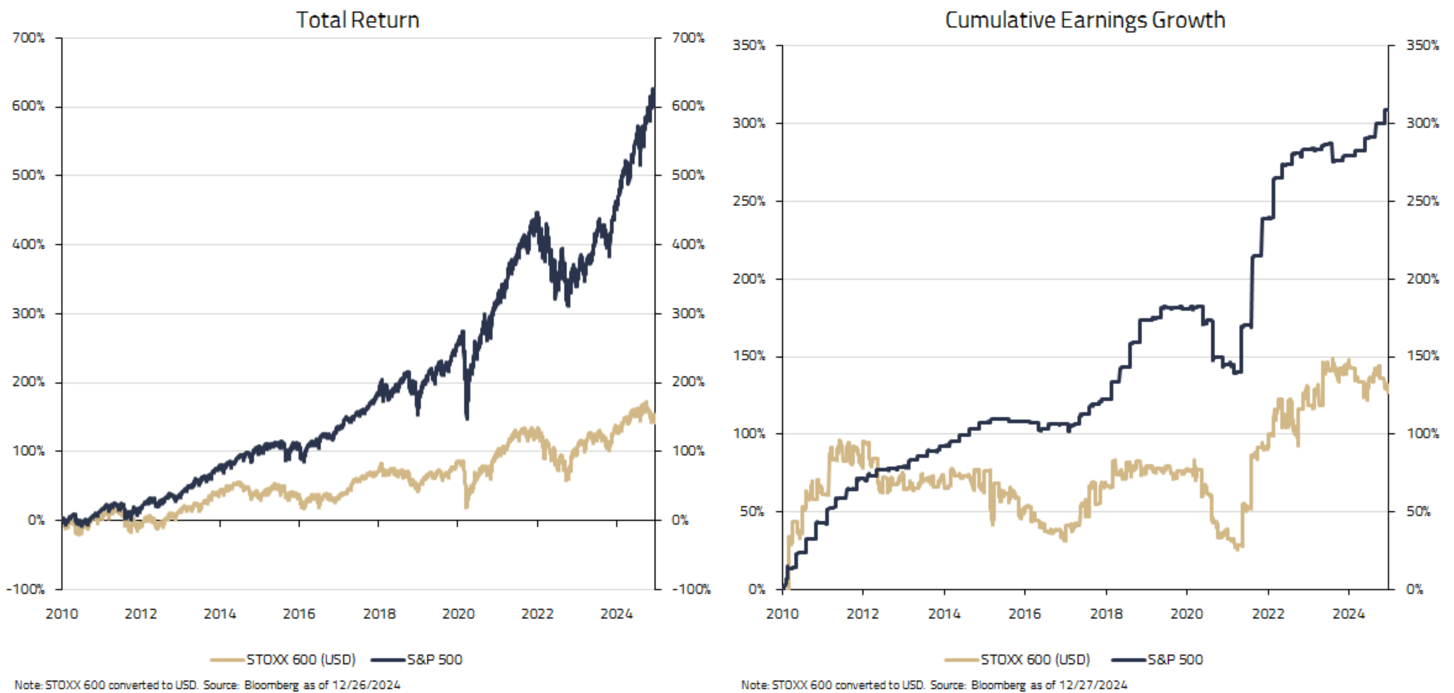


Note: Country groupings are nominal GDP weighted Source: Apollo, Bloomberg as of 1/2/2025

The uneven macroeconomic environment directly impacts investor sentiment and equity performance. US investors have experienced underwhelming returns from European investments over the past 15 years. Since 2010, the divergence in performance between US and European equities has been stark. A hypothetical $100 investment in the S&P 500 in 2010 would have grown by more than 600% by 2024. In contrast, a comparable investment in the STOXX 600 would have grown by approximately 130%.[61] The American market's outperformance has primarily been driven by differences in corporate earnings growth. S&P 500 earnings have significantly outpaced those of the STOXX 600 over the

60. Eurostat, ec.europa.eu/eurostat/databrowser/view/nrg_pc_204/default/bar?lang=en. Accessed 3 Jan. 2025.
61. Bloomberg

Exhibit 16: S&P 500 vs STOXX 600 (USD) Total Returns & Cumulative Earnings Growth



same period, as seen in Exhibit 16. These disparities are largely explained by sector composition. Technology, the dominant driver of global growth over the past decade, accounts for 32.6% of the S&P 500.[62] This figure rises to roughly 40% when including Amazon, Alphabet, and Tesla.[63] In contrast, the information technology sector represents only 7.7% of the STOXX 600, which remains heavily weighted towards financials and industrials.[64] The US market has been propelled by transformative innovations in areas such as social media, software-as-a-service, cloud computing, digital entertainment, and fintech. These are sectors in which Europe has played a minimal role. The next wave of technological innovation, led by artificial intelligence, seems to be following a similar pattern. US-based companies such as Google, Meta, Microsoft, OpenAI, Anthropic, and others, appear to be the early leaders.

Europe is not entirely absent from the AI landscape. Promising start-ups such as Mistral and Aleph Alpha have garnered interest from venture capitalists, raising $1.1 billion and $641 million, respectively.[65] Despite this, Europe's broader start-up ecosystem lags significantly behind the US due to a less favorable business environment, more aggressive regulations, and a smaller venture capital industry. Exacerbating these issues, 40 out of 141 European start-ups that achieved unicorn status between 2008 and 2022 have since relocated out of Europe, with most ending up in the US.[66] This drain of the continent's best technology talent only perpetuates the cycle of American dominance in the field. For European equities to regain competitiveness, a revitalization of innovation is imperative, though such a transformation appears unlikely in the near term. For these reasons, we maintain a bias toward US equity markets and an underweight position in Europe.

62. Bloomberg
63. Morningstar
64. Id.
65. Browne, Ryan. "The Best-Funded Generative AI Startups in Europe Have Something in Common: Big Tech Experience." CNBC, CNBC, 24 June 2024, www.cnbc.com/2024/06/20/europes-top-funded-genai-startups-founded-by-ex-big-tech-staff-accel.html.
66. Draghi, Mario. "The Future of European Competiveness." European Commission, Sept. 2024.

Despite the challenging outlook, we believe it is prudent to maintain some allocation to European equities, as several possible catalysts could provide potential upside. President-elect Trump's prioritization of a resolution to the war in Ukraine could stabilize energy markets and improve business sentiment, providing a much-needed boost to the region's economic prospects. Additionally, this past September, former European Central Bank President Mario Draghi released "The Future of European Competitiveness," a long-awaited report detailing the shortcomings and necessary reforms in European economic policy. Draghi, one of the most respected European economists, highlights the need for Europe to shift from pro-regulation to pro-growth, adopt a more pragmatic approach to energy transition plans, and prioritize supply chain and energy independence across the bloc. Implementing these structural changes would require a herculean effort, but their successful execution could lay the groundwork for sustainable, long-term competitiveness in the region.

Investor sentiment in Europe is currently at a low point. European equities remain historically cheap relative to the US, with the S&P 500 trading at a 1.8x price-to-earnings premium to the STOXX 600, well above the long-term average of 1.2x.[67] ETF flows are another noticeable indicator of investor pessimism. Despite 2024 being a record-breaking year for asset flows into broad equity funds, Europe-focused ETFs experienced a net outflow of $5.3 billion.[68] Both valuation and flows data point to the fact that investors have lost interest in Europe. This may make European equities more resilient in a period of negative returns, as lower valuations can provide a cushion by limiting downside risk during market declines. In other words, the bar for exceeding investors' expectations is already very low for Europe. The STOXX 600 demonstrated this dynamic in 2022. The index declined less than the S&P 500, resulting in relative outperformance, despite both indices closing the year with losses. While a global equity bear market is not our base case for 2025, it remains a plausible scenario. As such, we believe a strategically sized position in Europe, focused on resilient companies and sectors, not only enhances portfolio diversification but also ensures that investors are well-positioned to benefit if long-term reforms and economic stabilization take hold.

67. Bloomberg
68. Sohn, Todd. "Low Bar for Europe ETFs". Technical Research, Strategas, 10 Dec. 2024.

ELEMENT POINTE'S TOP TEN INVESTMENT THEMES FOR 2025

8. China

The Chinese economy continued to languish in 2024 amid a depressed property sector and weak consumer confidence. Meanwhile the leading benchmark for China-traded stocks, the CSI 300 Index, was heading for its fourth straight year of losses. In response, the Chinese government surprised markets by launching a series of stimulus measures in mid-September, to stabilize the economy and the country's stock market. The series of measures aimed to shore up sentiment by cutting policy rates, lowering mortgage rates, and providing financing facilities to support equity-market purchases. Equity markets responded favorably as the CSI 300 Index gained more than 25% over the ensuing five-day trading period.[69]

Despite September's sharp rally, the CSI 300 Index ended 2024 with a 5-year decline of -8.37% in US dollar terms.[70] With Chinese stocks trading at historically attractive valuations, especially versus the S&P 500, and most global investors underweight China, investors are asking themselves whether China represents a generational buying opportunity or simply a value trap (Exhibit 17). We believe it is the latter and that this rally will be short-lived, much like other rally attempts over the last three years. For the CSI 300 Index to make sustained gains, investors will need to see positive and consistent earnings growth from Chinese companies. We believe this is unlikely to happen given the ongoing challenges faced by the Chinese economy and the geopolitical climate that is likely to exacerbate China's problems.

The Chinese economy is mired in a slump, driven by an ongoing property market downturn, subdued consumer confidence and spending, and reduced trade flows from Western economies. The property market, once a pillar of economic growth, has been grappling with a monumental

Exhibit 17: Twelve Month Forward Price-to-Earnings of S&P 500 vs. CSI 300

Source: Bloomberg as of 12/31/2024

69. Bloomberg
70. Id.

debt overhang that has seen major developers and local governments face liquidity crises. Declining property prices have wiped out trillions of dollars of household wealth, weighing on consumer confidence and spending. A sagging labor market, especially for 16- to 24-year-olds for whom the unemployment rate is over 20%,[71] further pressures consumer confidence and highlights the need for a social safety net with better health and unemployment benefits. While lower mortgage rates will help on the margin, we believe China's property market faces a long, drawn-out recovery due to a large inventory overhang from years of overbuilding.

We believe China's recently announced monetary policy changes are insufficient to change the economy's trajectory. After a brief bump following September's policy changes, high-frequency data from China now shows fading economic momentum.[72] We believe the government needs to implement fiscal reforms aimed at supporting consumer spending to stimulate demand and reduce the economy's reliance on exports as a source of growth. With consumer price inflation hovering just above zero, there is the risk of a self-reinforcing deflationary spiral that could result in a long-term economic malaise, much like Japan experienced over the last thirty years after its property bubble burst in 1992. Of note, "China's gross domestic product deflator, a broader gauge of price levels across the economy, has been in negative territory for six consecutive quarters."[73] The global bond market is acutely aware of this risk, as evidenced by the fact that Chinese 30-year bond yields are now lower than those of Japan's (Exhibit 18).

Exhibit 18: China vs Japan 30-Year Government Bond Yields

Source: Strategas, Bloomberg as of 1/2/2025

71. National Bureau of Statistics of China
72. Rissmiller, Donald. Economics Report, Dec. 23, 2024, p. 5. Strategas.
73. Wei, Lingling. "Xi Sticks to His Guns As Economy Teeters." The Wall Street Journal, 24 Dec. 2024, pp. A1, A8.

Despite rising deflationary risks and challenging demographics, President Xi remains defiant and recently asked a Communist Party advisory body, "What's so bad about deflation? Don't people like it when things are cheaper?"[74] Xi's comments suggest the government will double-down on making China an even bigger industrial power rather than rebalancing its economy towards consumption growth, as many economists believe necessary. Inherent in this strategy is Xi's "belief that the US is fading as the singular superpower. Xi still believes that the East is rising, and the West is in decline…Xi views American style consumption as wasteful, and fears providing too much state support to households could encourage 'welfarism.'"[75]

On a positive note, China's economy has made significant strides in certain areas over the last five years. China has become a global leader in electric vehicles ("EVs") and renewable energy. It has also made great progress in semiconductor manufacturing and is a real threat in the race to develop artificial intelligence ("AI") and quantum computing. The government's "Made in China 2025" initiative has accelerated technological self-sufficiency, while the "Belt and Road" initiative has been instrumental in increasing trade flows with Africa, Latin America, and other emerging market countries.

This progress gives Xi confidence that his approach is the right one. Rather than promoting consumption, Xi will continue to promote industrial policies that strengthen these new growth drivers for China's economy at the risk of creating overcapacity. A key risk is that these new growth drivers are squarely in the crosshairs of Trump's impending tariff war. Trump has already said that he will implement a 10% tariff on all Chinese imports on day one of his administration and 60% tariffs on some Chinese goods. Since the US competes directly with China in many of these high-tech areas, we believe the US will levy the highest tariffs on China's new growth drivers. Furthermore, the US will continue to restrict certain high-tech trade with China, impeding China's ability to keep up with US technology advancements.

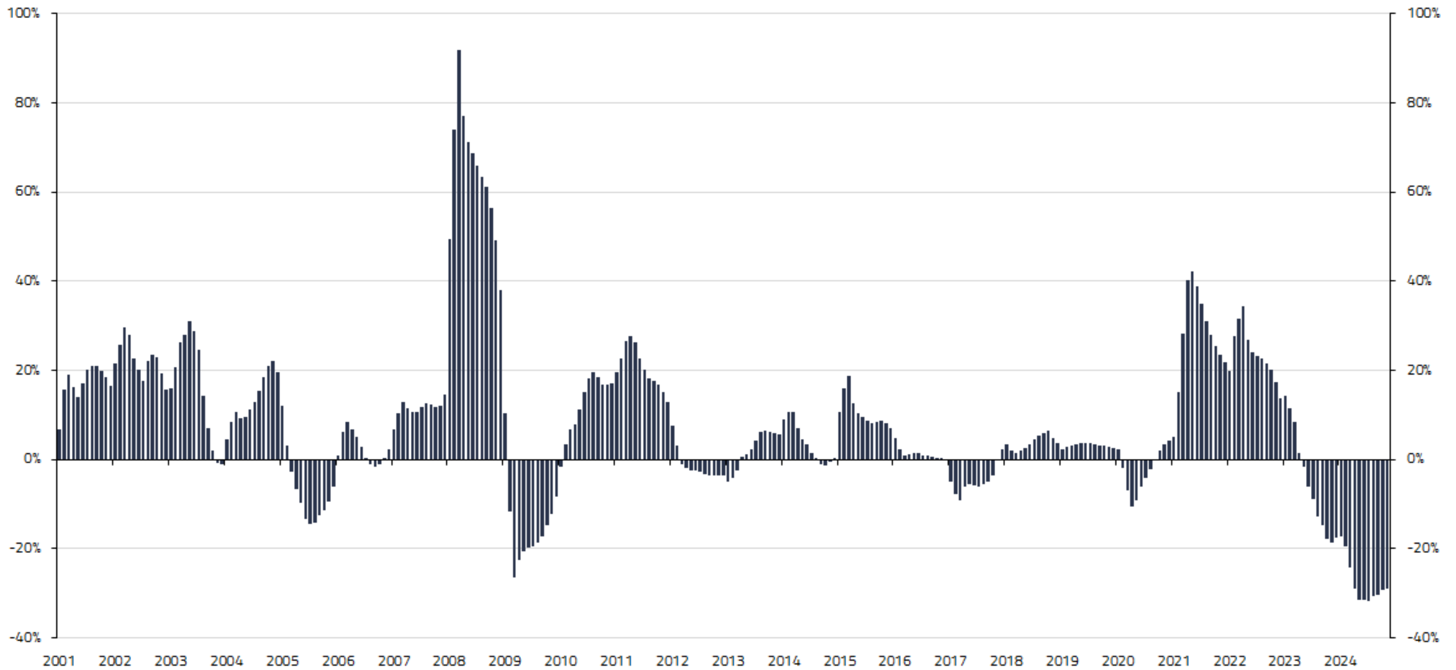
Although China, as a large net exporter, is vulnerable to a tariff war, the country will look to retaliate against US tariffs and trade restrictions with tariffs and trade restrictions of its own. China already tightened control of raw materials used in the production of high-tech electronics and batteries in December and will likely impose tariffs on agriculture and chemical imports while restricting the export of rare earth elements. China may also choose to crack down on US businesses operating in China or devalue its currency. Still, both options will likely accelerate the decline of foreign direct investment ("FDI") into China. The best leverage China has is the threat of dumping its large holding of US Treasuries in a manner that would destabilize US yields and capital markets.

With respect to China's equity market, global sentiment remains subdued despite September's epic rally. While valuation is at a historically attractive level, we believe China's current economic predicament, combined with rising geopolitical and tariff risks, justifies the current discount. Given the current economic backdrop, it is hard to forecast sustained corporate earnings growth absent more meaningful fiscal support that boosts demand.

We are also wary of the regulatory risks present in China. In 2021, the Chinese government's regulatory crackdown on the technology, education, and gaming sectors caused a significant decline in stock prices, which have yet to recover meaningfully. This episode highlights the unpredictability of Xi's actions and the Chinese government's disregard for the interests of investors. Not surprisingly, FDI into China has collapsed over the last three years (Exhibit 19).

74. Wei, Lingling. "Xi Sticks to His Guns As Economy Teeters." The Wall Street Journal, 24 Dec. 2024, pp. A1, A8.
75. Id.

Exhibit 19: China Foreign Direct Investment



Note: $USD YoY%, three month average. Source: Strategas, China Ministry of Commerce

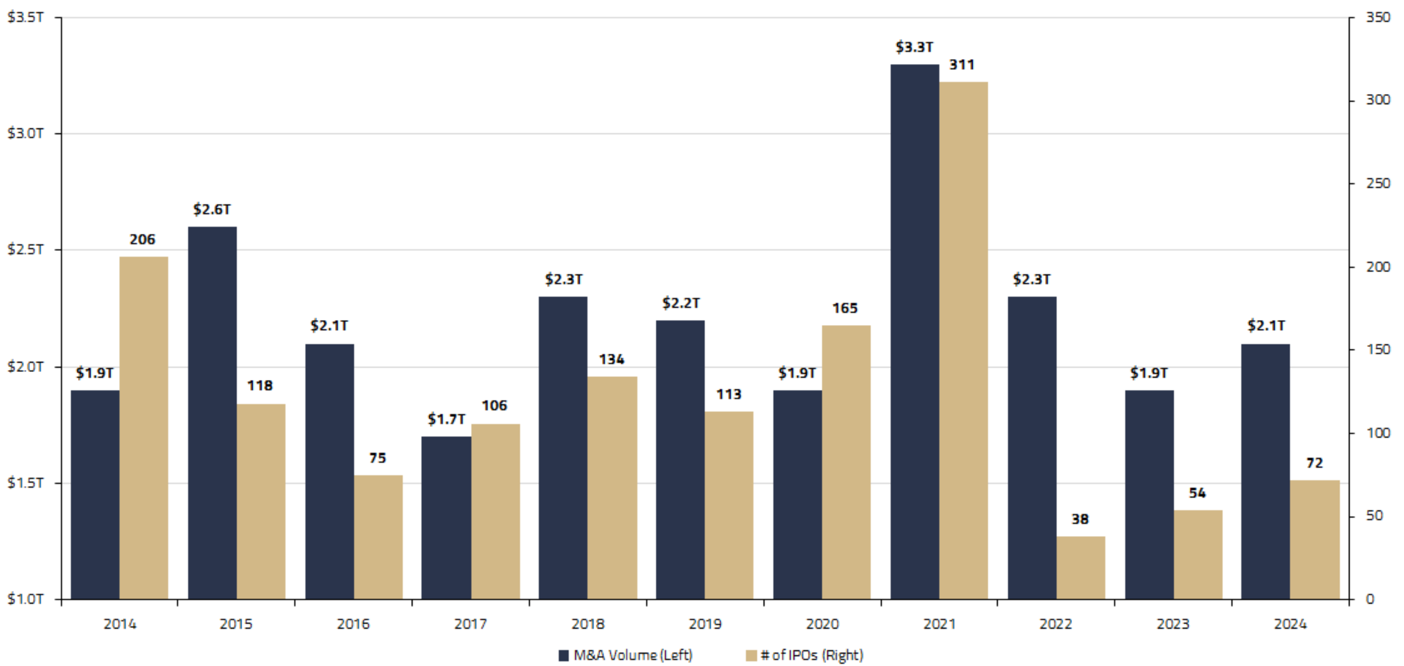
Finally, the issue of Taiwan hangs over any investment in China. President Xi has stated previously that reunification with Taiwan is "inevitable," and China has been ramping up its military exercises in the area. With the US committed to defending Taiwan's sovereignty, Taiwan will be a source of increased geopolitical tension, especially if the US and China engage in a protracted trade war. While we do not expect China to seek reunification over the next few years, we take the threat seriously, and we believe that Chinese investment assets require a sharp discount. Taken together, we view Chinese equities as a value trap at this time, and we will continue to remain underweight China in client portfolios.

ELEMENT POINTE'S TOP TEN INVESTMENT THEMES FOR 2025

9. Private Markets Outlook

Activity in the Merger & Acquisitions ("M&A") and Initial Public Offering ("IPO") markets declined significantly in 2022 from the euphoric levels seen in 2021, as the Fed sharply raised interest rates to combat runaway inflation. M&A activity has rebounded in the back half of 2024 as interest rates began trending lower and uncertainty diminished post-election. The momentum in the M&A market looks poised to continue, while a backlog of venture capital ("VC")-backed unicorns ready to go public in 2025 should promote a rebound in a sleepy IPO market. An increasingly constructive exit environment should benefit private equity ("PE") and venture capital returns in 2025, while a higher-for-longer rate environment will continue to support private credit yields.

Exhibit 20: Yearly M&A Volume and Initial Public Offerings



Source: Warrington College of Business, University of Florida, Bloomberg, as of 12/31/2024

iCapital estimates that M&A activity will rise 25% in 2025, as easing market conditions and financial deregulation spur a return to pre-pandemic levels.[76] An increase in capital market activity should lead to an increase in exit activity, resulting in distributions from PE sponsors to Limited Partners ("LPs"). Accordingly, we expect deployment to grow in tandem, as PE firms sitting on cash begin to take advantage of opportunities in the evolving environment. Activity should also increase for VC-backed companies, driven by an acute need for General Partners ("GPs") to provide LPs with liquidity. A weak exit environment has weighed on LP returns and has challenged capital recycling. Convergence on price expectations between buyers and sellers, as well as larger businesses looking towards acquisitions for inorganic growth, should promote an increase in VC-backed acquisitions this year.

76. Amarosa, Anastasia, et al. "2025 Market Outlook Solid Underpinnings and Plenty of Wild Cards." iCapital, Dec. 2024.

The Trump administration will likely promote less stringent, pro-business policies that will create a more favorable regulatory environment for M&A as compared to the Biden Administration. Biden-appointed Federal Trade Commission ("FTC") chair, Lina Khan, has earned the moniker "Trustbuster" by challenging M&A transactions to a historic degree and successfully blocking acquisitions from some of the largest US companies. Khan's hardline stance has spooked many investors and deal makers, possibly contributing to the muted transaction activity until recently. Under the Trump administration, the FTC and Department of Justice will likely adopt a lighter regulatory approach focusing on remedies to push transactions through rather than outright blocking them. While recent changes to the FTC antitrust disclosure rules will increase the workload for dealmakers before filing for merger approval, these changes should simultaneously provide clarity to the review process and prove constructive in the wake of a surge of new deals.

Like M&A activity, we expect IPOs to increase meaningfully in 2025, driven by a backlog of privately-held technology companies seeking to obtain liquidity through the public market. Pitchbook estimates that over 43% of US unicorns have been held in portfolios for at least nine years, accounting for nearly $1 trillion in value.[77] Unicorn IPOs should create relief for a strained venture capital fundraising environment, as high-value exits should lead to distributions that will then restart the fundraising cycle. Exhibit 21 shows a list of VC-backed unicorns that are set to go public in 2025. Even if only a portion of these companies go public, it should support broad venture exit values and increase distributions for existing funds. We also expect a healthy uptick in PE-backed IPOs, which should capture a greater market share of US IPO capital

Exhibit 21: Yearly M&A Volume and Initial Public Offerings

Company	IPO Probability	Most Recent Post-Money Valuation (Millions)	Company Age (Years)	Industry Sector
Chime	91%	$25,000	12	IT
CoreWeave	87%	$23,000	7	IT
Discord	93%	$14,700	12	IT
VAST Data	94%	$9,100	8	IT
Hinge Health	67%	$6,200	10	Healthcare
Lightmatter	93%	$4,400	7	IT
Arctic Wolf	95%	$4,300	12	IT
Patreon	93%	$4,255	11	B2B
Cerebras	96%	$4,250	8	IT
EquipmentShare	97%	$3,750	9	B2B
GrubMarket	97%	$3,600	10	B2B
Figure Technology Solutions	9%	$3,200	6	IT
Wellhub	93%	$2,400	12	B2B
MNTN	45%	$2,019	15	IT
Harry's	34%	$1,700	12	B2C
Turo	91%	$1,280	15	B2C
Kallyope	94%	$1,136	9	Healthcare
ShipBob	29%	$1,125	10	IT
Element Biosciences	94%	$1,044	7	Healthcare
Omada	95%	$1,032	13	Healthcare

Source: Pitchbook

77. Stanford, Kyle, et al. "2025 US Venture Capital Outook." Pitchbook, Dec. 2024.

than VC-backed IPOs. PE-backed IPOs represented approximately 34% of capital raised via IPOs in 2024, rebounding from a low point of 3% in 2022.[78] Market volatility in 2022 and 2023 has shifted public investor preferences towards more fundamentally sound PE-backed companies, and away from more speculative VC-backed companies. We believe that attractive returns for PE-backed IPOs are poised to persist in 2025.

Increased deal-making and cheaper borrowing costs should provide a tailwind to leveraged buyout activity in 2025. However, in a higher-for-longer rate environment, we continue to favor the middle market where deals are typically done at lower entry multiples and with less leverage than the upper market. Middle market entry valuations remain around 11.2x EV/EBITDA compared to the upper market, which stands at 12.7x.[79] Meanwhile, entry leverage ratios of 4.3x in the middle market are well below the 6.0x median seen in the upper market.[80] Furthermore, PE sponsors in the middle market have more runway to create value by improving operational efficiencies and processes than the upper market. This form of value creation will be paramount in generating excess returns over the public markets in a higher interest rate environment.

We continue to like private equity secondaries as a means of obtaining diversified private equity exposure while mitigating unfavorable aspects of primary private equity investing, such as the J-Curve effect[81] and blind pool risk.[82] Historically, secondary markets were dominated by LP-led transactions where institutional LPs sold their interests in a portfolio of private equity positions for either liquidity or rebalancing purposes. LP interests in these transactions are often purchased at discounts to NAV, and the discounts tend to increase during periods of public market drawdown or if the LP is distressed. In today's environment, GP-led secondaries, deals where general partners negotiate asset sales directly with secondary buyers, have rapidly-grown, accounting for around half of all secondary transactions in 2022 and 2023.[83] Private equity sponsors increasingly utilized GP-led deals to create liquidity in their funds as traditional exit avenues like IPOs and M&A ground to a standstill. Even with our view that both M&A and IPO markets will rebound this year, we expect GP-led deal volume to remain strong as it provides another means to generate liquidity. We believe that LP-led and GP-led secondaries can continue to provide attractive risk-adjusted returns to private investors.

We expect venture returns to improve broadly throughout the year; however, underneath the surface, we expect high levels of return dispersion as the venture ecosystem continues to reset after the euphoria of 2021. Venture valuations are currently depressed, with Pitchbook noting that trailing 12-month revenue multiples in 2024 are significantly lower than historical levels in industries like SaaS and FinTech.[84] As mentioned above, an increase in capital market activity should increase exit values for VC-backed companies, supporting multiple expansion. Still, we anticipate that the number of flat-to-down rounds will remain elevated as companies that raised at exorbitant valuations run out of cash and need to return to capital markets for additional funding. The increased time between fundraising rounds, combined with a valuation reset, creates a solid backdrop for venture capital strategies. Emerging technologies, like artificial intelligence, should create opportunities for shrewd venture capitalists to generate outsized returns going forward.

A pickup in leveraged buyout ("LBO") transaction volume benefits corporate direct-lending strategies whose yields have benefitted from a higher-for-longer interest rate environment. Corporate borrowers in the private debt market have shown resilience, with size-weighted covenant defaults declining to 2.6% over five consecutive quarters as of June 30, 2024.[85] However, smaller borrowers are showing increased signs of stress, as evidenced by the instance-weighted default rate, which has ticked up to 7.5% across the same period.[86] Notably, we are

78. Clarke, Tim, et al. "2025 US Private Equity Outlook." Pitchbook, Dec. 2024.
79. Amarosa, Anastasia, et al. "2025 Market Outlook Solid Underpinnings and Plenty of Wild Cards." iCapital, Dec. 2024.
80. Id.
81. The J-curve effect in private equity is the pattern of negative returns in the early years of an investment, followed by positive returns later on.
82. Blind pool risk in private equity is the risk that investors take when they commit capital to a portfolio without knowing the specific investments.
83. Slok, Torsten. "2025 Economic Outlook: Firing on All Cylinders." Apollo Academy, www.apollo.com/content/dam/apolloaem/documents/insights/apollo-global-2025-economic-outlook.pdf. Accessed 6 Jan. 2025.
84. Stanford, Kyle, et al. "2025 US Venture Capital Outook." Pitchbook, Dec. 2024.
85. Ogunlesi, Adebayo, et al. "2025 Private Markets Outlook - Institutional." BlackRock, Dec. 2024, www.blackrock.com/institutions/en-us/insights/private-markets-outlook.
86. Id.

seeing signs of trouble among smaller borrowers with less than $10mm of EBITDA. As of June 30, 2024, the default rate on this smaller cohort has exceeded 15%, implying that rate increases have proven more punitive for these borrowers.[87] An attractive yield premium over the public market still exists for private corporate lending strategies. Exhibit 22 compares the yields of the Vaneck BDC Income ETF, a reasonable proxy for direct middle market lending yields, and the broad high-yield market, showing that a healthy yield premium still exists. As LBO transactions increase, private loan volumes are expected to increase as well. At the same time, a large maturity wall in 2027 and 2028 will provide fresh refinancing opportunities down the line. We currently favor middle-market lending, as the lower market appears plagued by defaults. In contrast, the upper market looks crowded, with a surge of new entrants over the past few years, which has led to spread compression and looser covenants. Nonetheless, investors must focus on downside protection in corporate direct lending by allocating primarily to first-lien, senior secured loans. Loans that sit at the top of the capital structure with good covenants should protect capital if risks arise.

Private credit has grown to encompass more areas of the credit market that were traditionally financed through banking channels. One growing area in which we see opportunity for private credit investors is asset-backed lending. Asset-backed lending encompasses debt related to consumer spending, hard assets, commercial financing, and intellectual property, amongst other categories. More significant capital requirements and regulations have limited traditional bank lending in these areas, presenting an opportunity for private lenders to fill in the void. Asset-backed lending strategies can provide diversification benefits to investors with exposure to direct lending and public fixed-income strategies. Asset-backed lending strategies have limited correlation to the performance of corporations, tend to have shorter maturities, and are amortizing in nature. Historically, investors in the wealth management channel have lacked the ability to access these diversified return streams. However, with bank lending restricted, there are increasing opportunities for non-institutional investors to access the asset-backed lending markets.

Exhibit 22: Business Development Company Distribution Yields vs High Yield Bond Index Yields

Source: Apollo, Bloomberg as of 12/31/2024

87. Ogunlesi, Adebayo, et al. “2025 Private Markets Outlook - Institutional.” BlackRock, Dec. 2024, www.blackrock.com/institutions/en-us/insights/private-markets-outlook.

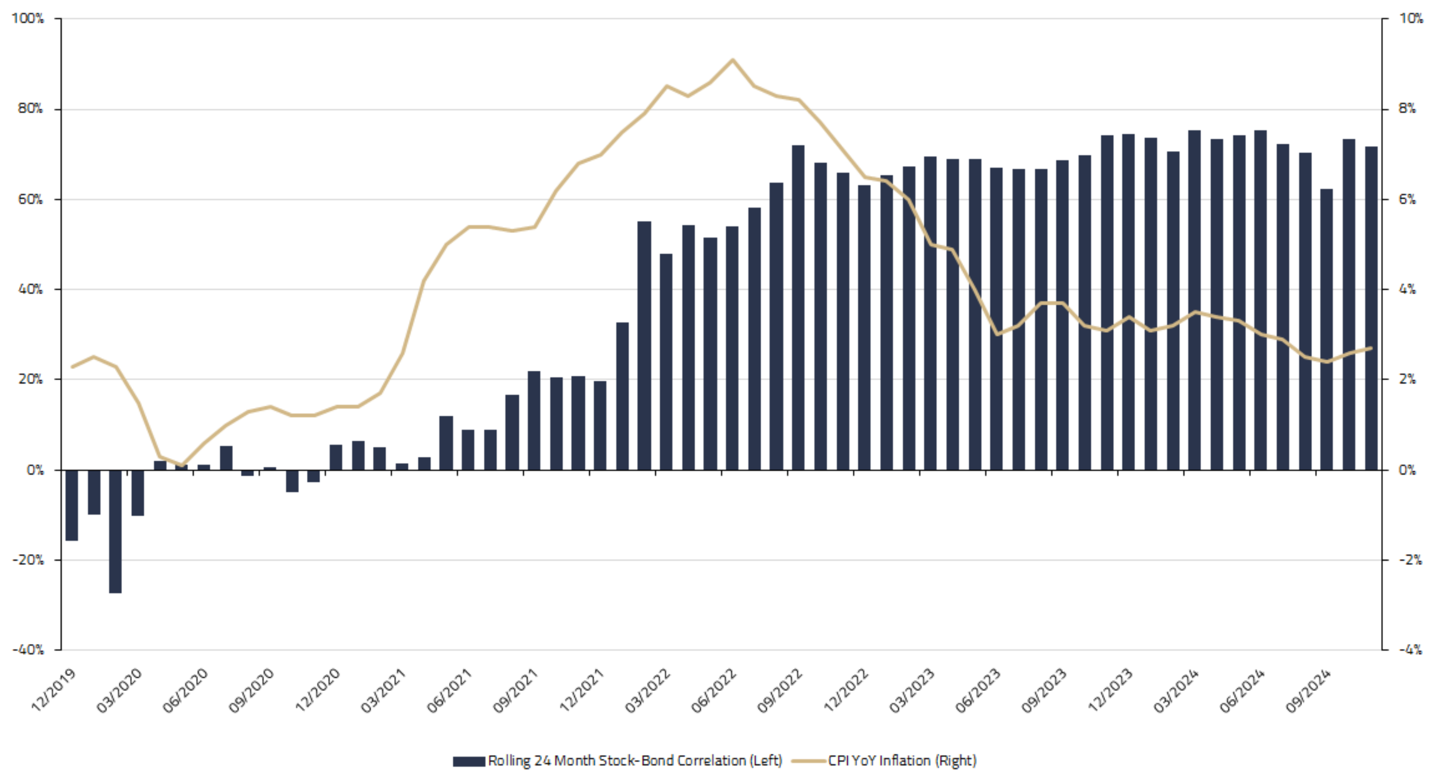
ELEMENT POINTE'S TOP TEN INVESTMENT THEMES FOR 2025

10. Democratization of Private Markets

The 60/40 portfolio[88] has been a staple of traditional portfolio management, predicated on the idea that a bond's low or negative correlation to stocks protects portfolios from stock market volatility. As shown in Exhibit 23, the correlation between stocks and bonds tends to trend positively in periods of high inflation, such as today's environment. Positive correlations between stocks and bonds make the 60/40 portfolio a poor protector of the downside in inflationary environments, as was observed in 2022 when the 60/40 portfolio fell about 16%.[89] As the structure of financial markets changes in a high inflationary environment, we believe that allocators will increasingly need to incorporate alternative investments into portfolios to properly diversify and optimize risk-adjusted returns.

Traditionally, alternative investments have been reserved for institutional investors given the sizeable minimum investment amounts, complicated structures, onerous tax reporting, and lack of liquidity, among other things. However, recent evolutions in the private markets have led to the creation of semi-liquid structures that have made alternative investments more viable for individuals. The opportunity in the retail wealth management channel is immense, with Cerulli Associates estimating over $24.5tn of investable assets across almost 17 million households in the US alone.[90] As expected, accessing the retail wealth management channel has become a strategic initiative for most prominent private equity firms that have already created structures to allow this channel to access their strategies. The further democratization of

Exhibit 23: Stock-Bond Correlation vs US Consumer Price Index (Year-Over-Year Change)



Note: Rolling 24 month correlations calculated using monthly returns from 1978 to 2022. Stocks modeled using the S&P 500 Index and bonds modeled using the Bloomberg U.S. Aggregate Index. Source: KKR, Bloomberg as of 12/31/2024

88. A "60/40 portfolio" refers to an investment strategy where 60% of the portfolio is allocated to stocks (equities) and 40% is allocated to bonds.
89. De Andrade, Charles, and Soren Godbersen. "The 60/40 Portfolio Needs an Alts Infusion." CFA Institute Enterprising Investor, 21 Dec. 2023, blogs.cfainstitute.org/investor/2023/12/21/the-60-40-portfolio-needs-an-alts-infusion/.
90. Sidgmore, Michael. "For Alts Managers, Is the Wealth Channel the New Institutional LP?" Citywire, Citywire, 30 Jan. 2024, citywire.com/ria/news/for-alts-managers-is-the-wealth-channel-the-new-institutional-lp/a2435158.

alternative investments should benefit retail investors as alternatives can provide increased diversification, excess return potential, and enhanced yields as compared to public market investments. However, it is imperative that investors thoroughly understand the risks and tradeoffs of investing in these asset classes through these new structures.

Private market investments can offer immense diversification benefits to investors, such as uncorrelated returns to public markets. For example, the Cliffwater Direct Lending Index[91] had a beta equal to 0.40 to the broadly syndicated loan market, as measured by the Morningstar LSTA US Leveraged Index, from September 2015 to September 2024.[92] A similar dynamic is observed when comparing public REITs to private REITs or publicly-traded infrastructure companies to privately-held infrastructure assets.

The number of publicly-listed companies is rapidly shrinking, with 7,810 publicly-listed companies at the beginning of 2000 and just 4,814 at the end of 2020.[93] In fact, 87% of US companies with revenues greater than $100 million are privately held, implying that companies are choosing to stay private longer and may never go public given the abundance of capital available to them.[94] Investors who only allocate to public markets will not only lack exposure to many large US companies, but will also miss out on the increased growth that is occurring in the private sector. Diversification away from public equity markets becomes increasingly important as markets become more concentrated, particularly in the US.

Exhibit 24: Private Market Returns vs Public Market Returns

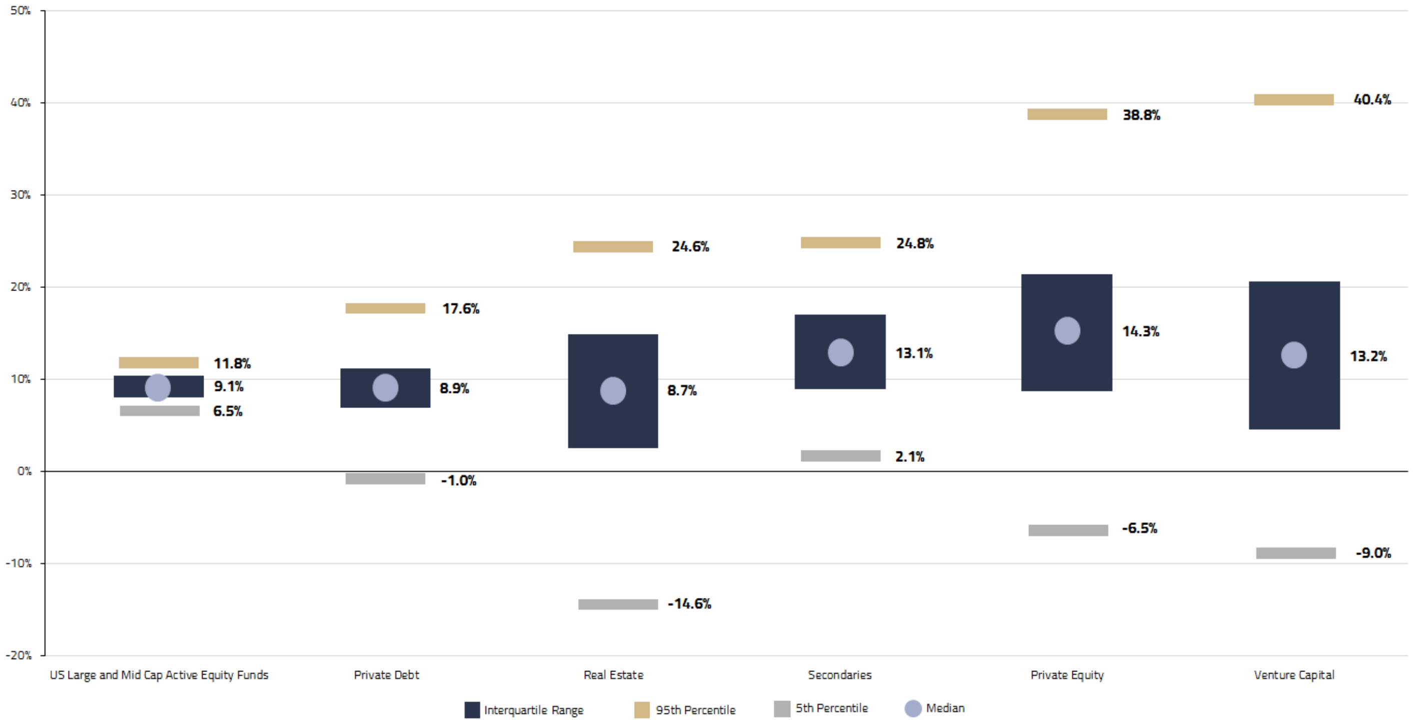
Strategy	1-year	3-year	5-year	10-year	15-year
Private Equity	4.90%	4.84%	16.42%	15.15%	15.90%
Private Credit	8.71%	6.73%	6.23%	5.96%	7.15%
Real Estate Equity	-9.99%	1.02%	2.27%	5.46%	6.62%
Real Estate Debt	8.21%	8.46%	8.37%	8.82%	6.77%
Global Secondaries-All Strategies	3.89%	8.01%	13.97%	12.44%	13.35%
Equity	18.26%	4.41%	9.70%	7.43%	9.34%
Fixed Income	0.49%	-5.91%	-2.45%	-0.85%	0.79%

Sources: MSCI Indexes, MSCI Private Capital Solutions, Cliffwater, NCREIF, Bloomberg, Macrobond, PitchBook, Franklin Templeton Institute as of 6/30/24

As seen in Exhibit 24, private market investments offer the potential to enhance returns over the public markets. Outside of recent public equity market strength, private market returns have outpaced their public counterparts across most historical periods, according to the table. While median returns for private markets have historically exceeded the returns for public markets, the return dispersion is extensive compared to public markets. The difference between the 95th and 5th percentile public equity manager is approximately 500 bps, while the difference between the 95th and 5th percentile private equity fund has been over 4,500 bps.[95] Dispersions become accentuated as you move further up the risk spectrum, with the dispersion between the 95th and 5th percentile venture capital funds reaching 5,000 bps.[96] These levels of return dispersion suggest that manager selection is paramount when allocating capital toward private markets (Exhibit 25).

91. The Cliffwater Direct Lending Index ("CDLI") seeks to measure the unlevered, gross of fees performance of U.S. middle market corporate loans, as represented by the underlying assets of Business Development Companies ("BDCs"), including both exchange-traded and unlisted BDCs, subject to certain eligibility criteria.
92. "Cliffwater Corporate Lending Fund." Cliffwater, Dec. 2024.
93. "Private Market Investing - Staying Private Longer." Hamilton Lane, 14 Apr. 2024, www.hamiltonlane.com/en-us/insight/staying-private-longer.
94. Id.
95. "2025 Private Markets Outlook ." Franklin Templeton, Dec. 2024.
96. Id.

Exhibit 25: Dispersion of Returns by Asset Class



Note: The returns for US Large and Mid Cap Active Equity Funds reflect the annualized returns for the period January 1, 2005 to June 30, 2024. The returns for Real Estate, Secondaries, Private Equity, Venture Capital (VC), and Private Debt are the Internal Rate of Return (IRR) of the funds with vintage years from 2005 to 2018, as of June 30, 2024. Source: MSCI Private Capital Solutions, Morningstar, Franklin Templeton as of 6/30/2024

Over the past few years, private equity firms have created evergreen structures like interval funds, private BDCs, private REITS, tender-offer funds, and operating companies to provide the retail wealth management channel access to their strategies. Evergreen structures can be sold to both accredited and non-accredited investors, while drawdown structures are typically only offered to qualified purchasers. Investors get immediate exposure to the strategy in an evergreen structure, eliminating the lengthy capital contribution period and J-Curve effect.[97] Evergreen structures also simplify tax reporting through inclusion on 1099s, rather than a manager issuing a separate K-1. Lastly, evergreens provide semi-liquidity, allowing investors to redeem holdings, sometimes as often as monthly, subject to certain restrictions.

On the other hand, evergreen structures come with unique drawbacks, and investors should be aware of the tradeoffs associated with using them. For example, evergreen structures can have stricter regulatory requirements that may limit the information the manager can provide to investors. For this reason, investors may find the diligence and monitoring processes more difficult for evergreens than traditional drawdown structures. Returns may be muted compared to similar strategies accessed through drawdown funds, due to performance drag from the "liquidity sleeve." Liquidity sleeves consist of cash or highly liquid securities that evergreen managers maintain in order to meet redemption requests. Evergreens may also be limited in the amount of leverage allowed, which can erode returns in certain strategies.

New investors often misconstrue the actual liquidity of evergreen structures. Many structures have a soft lock-up period where investors are subject to a financial penalty if they redeem before the end of the lock-up period. Although some types of structures, such as interval funds, are required to provide quarterly liquidity equal to 5% of net asset value ("NAV"), subject to restrictions, many structures do not include such provisions, and managers have discretion in providing liquidity at any given redemption window. The increased utilization of evergreen structures by less-sophisticated investors can create liquidity risks for other investors in the vehicle. In recent years, some managers of evergreen

97. The J-curve effect in private equity is the pattern of negative returns in the early years of an investment, followed by positive returns later on.

structures were forced to halt or limit redemptions during periods of market stress as investors sought liquidity. We believe investors should maintain a long-term view when using evergreen structures and rely on the liquidity function sparingly, as redemptions are not always possible.

Evergreen structures have been created to access a multitude of private asset classes, but certain asset classes are better suited for these structures than others. One primary consideration is the ability to set a clearing price, an agreed upon NAV where buyers and sellers can enter and exit. Many private credit strategies are well suited for evergreen structures given that the NAVs of the underlying loans move minimally, and most of the return comes from contractual cash flows. Private credit loans are short duration in nature, often three– to five-year maturities, so liquidity gets naturally created in the portfolio as loans turnover.

On the other hand, venture capital investments appear less suitable for evergreen structures. The valuation policies of many venture capital managers require that marks be adjusted after a new financing round is completed. The length of time between NAV adjustments causes venture valuations to move in step functions. This dynamic makes establishing a clearing price difficult for an evergreen structure that owns venture capital investments. Overall, we believe evergreen structures are most appropriate for short-duration private investments with limited price volatility and embedded liquidity mechanisms.

As the retail wealth management channel increasingly allocates towards private markets, investors should be aware of certain unique risks. Most private strategies utilize leverage in order to generate excess returns. Leverage can bolster returns to the upside but can also exacerbate losses in times of volatility. Investors should consider the amount of leverage managers use and how the loans are structured. Private investments are often subject to higher fees, including performance fees, rarely found in public investments. Private investment returns may be subject to smoothing bias[98] that may provide an inaccurate depiction of the actual risk of the underlying investment when using traditional risk metrics. We believe the most prudent way to incorporate private investments into portfolio construction is by replacing some portion of public market exposures with comparable private market exposures, depending on the objective of each individual investor. This strategy should help maintain intended risk targets as traditional measures of risk (i.e., standard deviation, Sharpe ratio, etc.) are often distorted when private investments are incorporated into portfolios.

We anticipate that the wealth management channel will continue to increase allocations to alternatives in 2025. On balance, increased exposure to alternatives benefits wealth management investors through increased return potential, diversification, and enhanced yields. However, given the deluge of asset managers seeking to capitalize on this channel opportunity, investors should proceed cautiously when evaluating the offerings available and the tradeoffs of using these products.

98. Smoothing bias refers to a tendency for reported returns on alternative investments, like private equity funds, to appear less volatile than their actual returns due to the practice of smoothing out short-term fluctuations by averaging them over time, which can lead to an underestimation of risk when evaluating investment performance.

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