Quarterly Investment View

Lotos
Asset Management

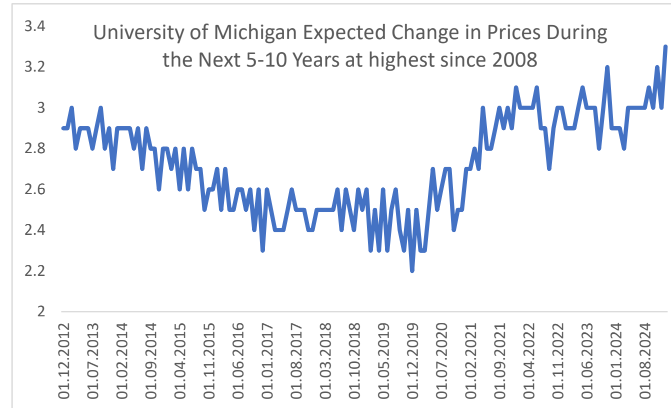
How dangerous will increased borrowing costs be in 2025?

2024 was a successful investment year for us thanks to our overweight in the US stock market and the strong USD allocation.

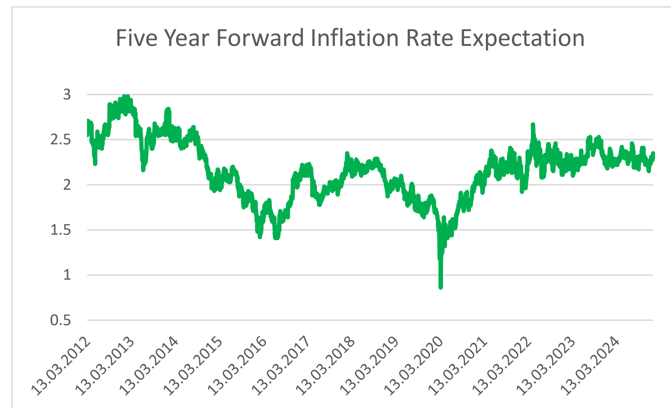
The year 2025 has commenced amid considerable volatility, with uncertainties reaching exceptionally high levels. Following the election of Donald Trump, markets initially focused on the prospects of economic growth and deregulation. However, recent consumer surveys in the United States are beginning to expose underlying concerns, particularly regarding inflation. Many respondents now express apprehension about the inflationary pressures that could accompany certain proposed policy changes. According to the latest survey by the University of Michigan, consumers anticipate a significant increase in both short-term and long-term inflation expectations. The projected 1-year inflation rate has risen from 2.8% to 3.3%, while the 5-to-10-year inflation expectation has increased from 3.0% to 3.3%. These are substantial upward revisions. More troubling is the fact that the long-term level was not even reached during the inflationary concerns that followed the COVID-19 pandemic (see graph at the top left).

The influence of politics seems to dominate at present, as can be seen in the vastly different perceptions of Republicans and Democrats (see graph on the middle right; blue represents the median). Republicans broadly expect inflation to slow dramatically ahead while Democrats expect tariffs promised by the incoming Trump administration to push up prices.

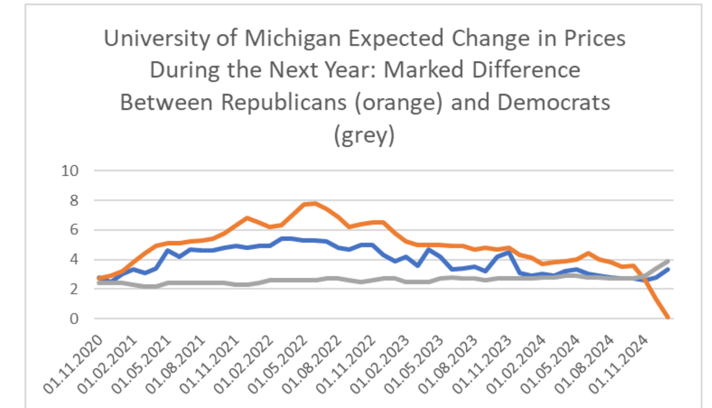
Most interestingly, according to professional market participants the longer-term inflation outlook – as indicated by the "Five Year Forward Inflation Rate Expectation" – remains firmly anchored (see graph at the bottom left). This relatively subdued level may be attributed to a heightened confidence in the efficacy of central bank policies, as well as the prevailing view that the sustained strength of the USD is contributing to a reduction in import costs.



Source: University of Michigan



Source: Bloomberg



Source: University of Michigan

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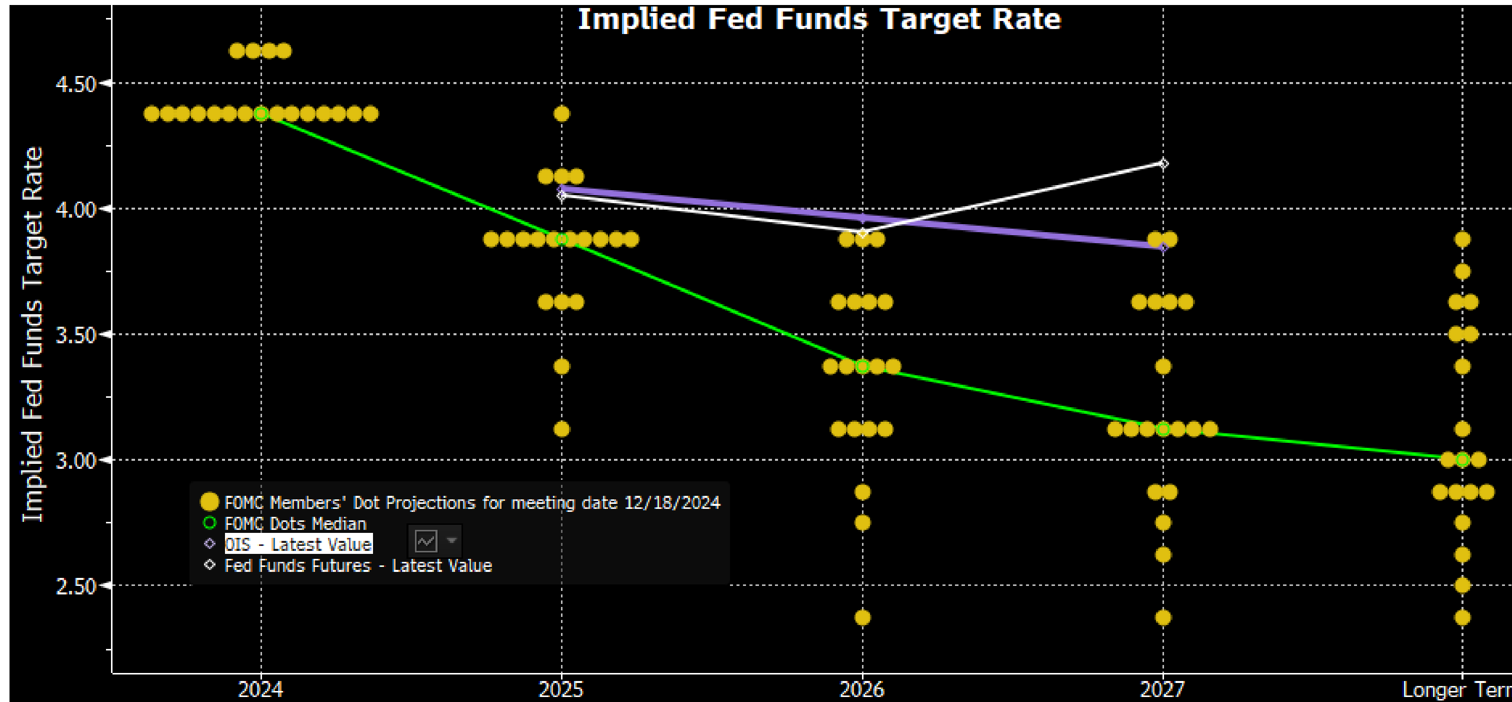
Also, the situation surrounding US monetary policy has grown increasingly complex. On one hand, the economy has demonstrated greater resilience than initially anticipated. Improving supply conditions have supported the strong performance of the economy. The labor force has expanded rapidly, and productivity has grown faster over the past five years than in the two decades before the pandemic, increasing the productive capacity of the economy and allowing rapid economic growth without overheating. Higher productivity helps to keep a lid on inflation and is key to long-term economic growth. On the other hand, the introduction of potential new tariffs may provoke retaliatory measures from US trading partners, thereby complicating the overall economic impact. The anticipated adverse effects on growth could potentially offset the positive contributions of fiscal policy. Fed Chair Powell declared: " I think we have time to make assessments about what the net effects of policy changes will be on the economy before we act." Several Fed policymakers signaled they supported keeping rates on hold for an extended period.

Swaps reflect a similar viewpoint, with the next-quarter point cut not fully priced in until the second half of the year. Some market participants even don't see the Fed easing at all this year.



Source: FOMC

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In addition to monetary policy, the issues of **debt and the deficit** are progressively taking center stage.

Despite robust economic growth and low unemployment, the **fiscal burden** remains substantial. The nonpartisan (impartial) Congressional Budget Office (CBO) estimated last year that the budget deficit is projected to reach 6.5% of GDP in 2025 and 6.9% of GDP by 2034, compared to an average of 3.7% over the past five decades. The introduction of potential new tariffs, coupled with tax cuts and deregulation, heightens the risk of further exacerbating these deficits.

Regarding the **debt burden**, the substantial stimulus measures implemented in the aftermath of the pandemic caused a sharp surge in debt levels (see graph below), aligning with a broader global trend. Although the debt situation may have been somewhat mitigated since then, Bloomberg Economics projects that the US debt-to-GDP ratio will once again reach 132% by 2034. This level is widely regarded as unsustainable by many market observers. While the United States benefits from a degree of insulation, as its debt is traditionally considered the world's safest asset and the US dollar dominates global markets and trade, there are emerging signs of a shift in sentiment. Notably, some of the largest holders of US Treasury securities, such as China, have reduced their holdings in response to escalating political tensions.

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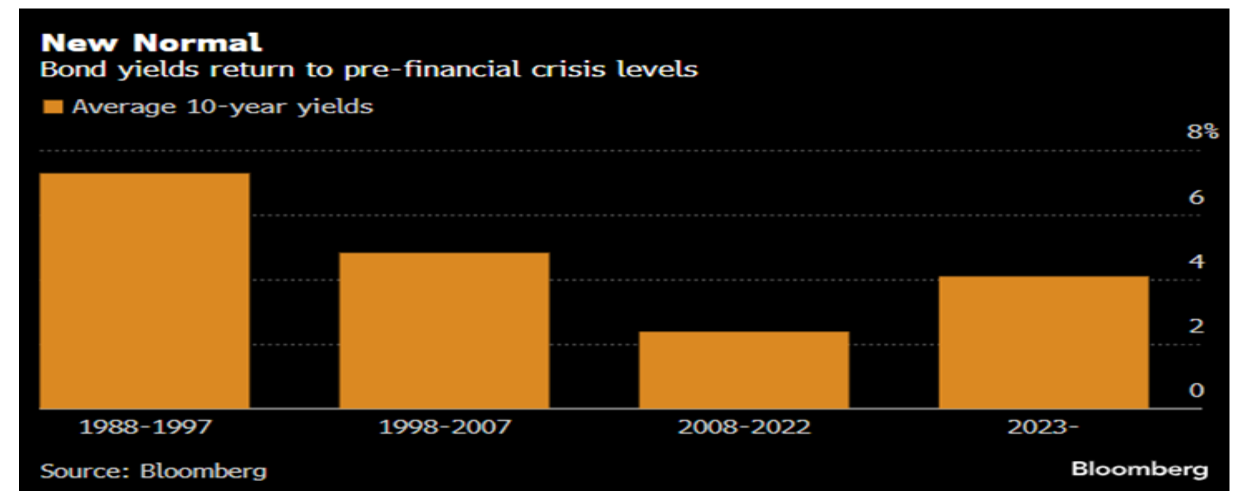
Some analysts point to the term premium as a signal of growing concern regarding the US fiscal trajectory. They argue that the steepening of the yield curve aligns with the historical pattern observed during periods of large and rising deficits. However, traditional market perspectives, or "Old School" views, regard a certain degree of steepness in the yield curve as normal, simply reflecting the compensation investors require for assuming the risk of lending over extended periods. This was the prevailing market dynamic prior to the financial crisis. The true anomaly was the post-2008 period, when interest rates hovered near zero, inflation remained exceptionally low, and central banks engaged in extensive bond purchases, thereby distorting the natural shape of the yield curve.

Interest rates near zero—essentially allowing borrowing at no cost—constitute a perilous phenomenon, as they incentivize market participants to invest in unproductive ventures, such as "zombie companies." In an environment of persistently low, or even declining, interest rates, the risk profiles of companies often become secondary concerns. With newer generations having grown accustomed to exceptionally low inflation and yields, a normalization of interest rates could fundamentally alter their perspectives. Companies with higher levels of debt would suddenly face significantly higher borrowing costs, and the concept of risk would once again take center stage in the markets. As a result, investors would demand substantially higher yields to compensate for the increased risks.

The key question at present is whether the recent shift in interest rates reflects underlying structural factors, or if it simply marks a reversion to more conventional, pre-crisis economic conditions.

Additionally, one must consider the possibility of a yield reversal, predicated on the assumption that the tightening of financial conditions and rising bond yields will ultimately result in an economic slowdown or contraction, thereby prompting the Federal Reserve to adopt a more accommodative stance once again.



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The rise in yields is not confined to the United States; similar concerns regarding fiscal sustainability are manifesting across the globe. At the close of last year, both France and Brazil experienced significant market pressure, while more recently, UK gilt yields surged, driven by the nascent Labor government's fiscal strategies. At one point, the 30-year gilt yield reached its highest level since 1998, prompting comparisons to the market turmoil observed during Liz Truss's brief tenure as Prime Minister in 2022.

Moreover, threats of tariffs are already exerting upward pressure on long-term borrowing costs globally. The uncertainty surrounding the trade policies of the incoming administration is further compounding global economic challenges, with its effects becoming evident through rising long-term interest rates. This occurs even as short-term rates have declined—an anomalous dynamic that underscores the complexity of the current economic environment.

As governments have increasingly resorted to extensive fiscal spending in response to recent crises, the bond market appears to be the sole mechanism capable of compelling a reevaluation of the unchecked accumulation of debt. In this regard, the recent market reactions may, with any luck, serve a corrective function, prompting a more prudent and disciplined approach to fiscal policy.

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	USGG10YR Index	USD	21.04%	21.04%	-7.22%	20.79%
2)	GFRN10 Index	EUR	28.26%	28.26%	--	27.91%
3)	GUKG10 Index		26.70%	26.70%	-1.56%	26.38%
4)						
5)						
6)						

Source: Bloomberg

Sharply rising yields in the mentioned countries with extensive fiscal spending / plans or other government measures, based on comparable data starting January 2024.

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Conclusion:

- The Trump administration is poised to exert a profound influence on inflation, interest rates, and fiscal policy.
- Markets, businesses, and consumers have already begun factoring in potential repercussions, adjusting their expectations accordingly.
- These initial reactions and anticipations are likely to reverberate back to the new administration (some rumors on gradual tariff hikes, for example, underscore this dynamic).
- We expect inflation to remain relatively anchored as the labor market shows signs of normalization and continued productivity gains are anticipated.
- The Federal Reserve has already indicated a more cautious approach to rate cuts in the near term. We foresee the Fed taking swift and decisive action in response to the new government's policies.
- Bond markets are increasingly assuming a pivotal role in correcting the unchecked accumulation of national debt, with rising yields serving as a disciplinary mechanism.
- The U.S. economy remains fundamentally robust, and there are emerging signs of accelerating growth.
- We believe that solid economic expansion, de-globalization trends, the imperative to invest in combating climate change, and a degree of normalization in interest rate curves will keep the 10-year Treasury yield above 4%.
- While corporations have reaped significant benefits from refinancing their debt at historically low interest rates in recent years, they will soon face the necessity of funding at higher costs.
- Households, too, will encounter higher borrowing costs, with U.S. mortgage rates having already rebounded to approximately 7%.
- We expect fixed-income markets to become more sensitive to risk, a development that may particularly affect the high-yield segment.
- Similarly, equity markets will increasingly focus on balance sheets. It is worth noting that growth companies typically maintain lower levels of debt, and the combination of favorable economic trends and productivity improvements should provide ongoing support for corporate earnings.
- As is customary, we will remain vigilant in monitoring unfolding developments and will take the requisite actions to adjust our investment strategy accordingly.

Please refer to the section "How are we invested and why" for further details.

Performance major asset classes 2024 in local currencies

Category	Asset	Performance
Equities	Nasdaq	28,6
Equities	S&P 500	23,3
Equities	MSCI World (Local)	21,0
Equities	Nikkei 225	19,2
Equities	DAX	18,8
Equities	Hang Seng	17,7
Equities	MSCI China	15,7
Equities	MSCI EM (local)	13,1
Equities	RUSSEL 2000 ETF	10,1
Equities	Euro Stoxx 600	6,0
Equities	FTSE 100	5,7
Equities	SMI	4,2
Equities	Bovespa	-10,4
Fixed income	European High Yield	9,1
Fixed income	CS Leverage Loan Total Return	9,1
Fixed income	US High Yield	8,2
Fixed income	BBG Bclys Emerging Markets	6,6
Fixed income	Swiss Bond Index	5,3
Fixed income	Corporate credit (Gbl USD Hedged)	3,5
Fixed income	Bclys Gbl Aggregate	3,4
Fixed income	Bclys Euro Aggregate	2,6
Fixed income	Bclys US Aggregate	1,3
Fixed income	Floating Rate ETF	1,2
Fixed income	Ishares 1-5 yr US IG	0,8
Fixed income	Ishares Global Green Bond	-1,3
Fixed income	FTSE World Government Bonds	-7,0
FX	USD/JPY	11,5
FX	USD/CHF	7,8
FX	EUR/CHF	1,2
FX	EUR/USD	-6,2
Commodities	Gold	27,5
Commodities	Jefferies CRY	12,5
Commodities	Copper	3,5
Commodities	Brent Oil	-3,1
RE	NAREIT Gbl Dvlpd TR Net	4,5

Axis: 30,0; 20,0; 10,0; 0,0; -10,0; -20,0

Source: Bloomberg

Performance major asset classes Q4 2024 in local currencies

Category	Asset	Performance
Equities	Nasdaq	6,2
Equities	Nikkei 225	5,2
Equities	DAX	3,0
Equities	S&P 500	2,1
Equities	MSCI World (Local)	1,9
Equities	FTSE 100	-0,8
Equities	Euro Stoxx 600	-2,9
Equities	MSCI EM (local)	-4,4
Equities	SMI	-4,7
Equities	Hang Seng	-5,1
Equities	MSCI China	-7,8
Equities	Bovespa	-8,7
Fixed income	CS Leverage Loan Total Return	2,3
Fixed income	European High Yield	2,0
Fixed income	Swiss Bond Index	1,3
Fixed income	US High Yield	0,2
Fixed income	Bclys Euro Aggregate	0,1
Fixed income	Floating Rate ETF	-0,1
Fixed income	Bclys Gbl Aggregate	-0,9
Fixed income	BBG Bclys Emerging Markets	-1,5
Fixed income	Corporate credit (Gbl USD Hedged)	-1,5
Fixed income	Ishares 1-5 yr US IG	-1,8
Fixed income	Bclys US Aggregate	-3,1
Fixed income	Ishares Global Green Bond	-3,6
Fixed income	FTSE World Government Bonds	-8,1
FX	USD/JPY	9,4
FX	USD/CHF	7,3
FX	EUR/CHF	-0,2
FX	EUR/USD	-7,0
Commodities	Jefferies CRY	4,1
Commodities	Brent Oil	4,0
Commodities	Gold	0,2
Commodities	Copper	-11,6
RE	NAREIT Gbl Dvlpd TR Net	-3,3

Source: Bloomberg

Performance major asset classes Q4 2024

- **Equities:** 2024 was a year in which stocks outshone virtually all other asset classes. It was admittedly a concentrated rally, mainly focused on the US and some specific technology names. Despite some volatile sessions at the end of the year, the Nasdaq continued to be the star performer in 4Q. For the whole year, it advanced a stunning 28.6%. The S&P 500 gained 23% in 2024 and added to a terrific previous year performance. Since the start of 2023 it gained more than 50%, which is the best two-year increase since the late 1990. The new administration's potential goals to lift tariffs and reduce taxes as well as bureaucracy has led to a strong USD, impacting the performance of Emerging Markets. Additional stimulus measures proposed by China could not keep the positive 3Q momentum going.

- **Fixed Income:** Our benchmark, the Global Aggregate Total Return Index, concluded the year with a gain of 3.4%. In 4Q as well as for the full year, the best performers were concentrated in the more risk-sensitive segment of the market, notably high yield bonds and leveraged loans. Rising yields had a pronounced negative impact on government bonds and longer-duration assets. Conversely, floating rate fixed income securities remained relatively stable in the fourth quarter and posted a modest gain over the course of the year.

- **Commodities:** Copper – a proxy for global growth – sharply dropped in 4Q, primarily driven by concerns over potential trade tensions. Gold remained largely unchanged, reflecting expectations of fewer interest rate cuts by the Federal Reserve. For the year, however, it was one of the outstanding performers given sustained geopolitical risks and a wave of purchases by central banks.

- **Global Real Estate:** Worldwide increases in interest rates impacted real estate assets.

- **Currencies:** The U.S. dollar dominated the currency landscape, reinforcing its status as the world's preeminent reserve currency. As emphasized by the nominee for Treasury Secretary in the new administration, preserving the dollar's position is vital not only for the economic stability of the United States but also for its long-term financial future.

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