A ‘3E’ Environment: Excess returns from Exceptionalism, Evolution, and Liquidity

Fullerton Investment Views – Quarterly Report

Q1 2025

Executive summary

Fullerton is bullish on global risk assets and Developed Market (DM) equities, with a positive outlook for Asia (ex-Japan) equities and fixed income.

- We remain bullish on DM equities, led by the US and then Japan, with Europe lagging. High US equity returns can be sustained as earnings growth benefits from strong productivity, consumer spending, and supportive liquidity. The prospect of positive equity returns from Japan reflects rising economy-wide profitability and robust exports.
- Asia ex-Japan expected earnings growth has slowed significantly, but underpinned by favourable performance across Taiwan, India, China and Singapore, returns should remain positive in 2025.
- Asia should benefit from improving competitiveness, strong demand from DM, and rising intra-Asia trade. Headwinds can stem from the possibility that China’s stimulus disappoints with limited traction against deflation or from adverse spillovers from US trade tariffs.
- Our positive view for returns from global sovereign bonds reflects the possibility that yields may settle at levels that provide a favourable income-stream and give some protection if equities fall sharply. The risk of the latter is mostly underpinned by geopolitical concerns given push-backs against globalisation, tension in the Middle-East, and the Russia-Ukraine War.
- We also maintain our positive outlook for Asia investment grade corporate credit as default rates can remain modest with a ‘soft-landing’ for global growth (around its trend) while returns could be supported by robust profitability.

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01

Investment Environment and Risk-Asset Outlook

Fullerton believes that the rewarding investment environment of 2024 can continue in 2025

Summary of Fullerton's Views (12 months ahead)

	Bearish	Negative	Positive	Bullish
Risk Assets (overall)				√
Developed Market Equity				√
Asia ex-Japan Equity			√	
Global Sovereign Bonds			√	
Asia IG Credit			√	

Source: Fullerton Fund Management, Jan 2025. Views may be subject to change without prior notice.

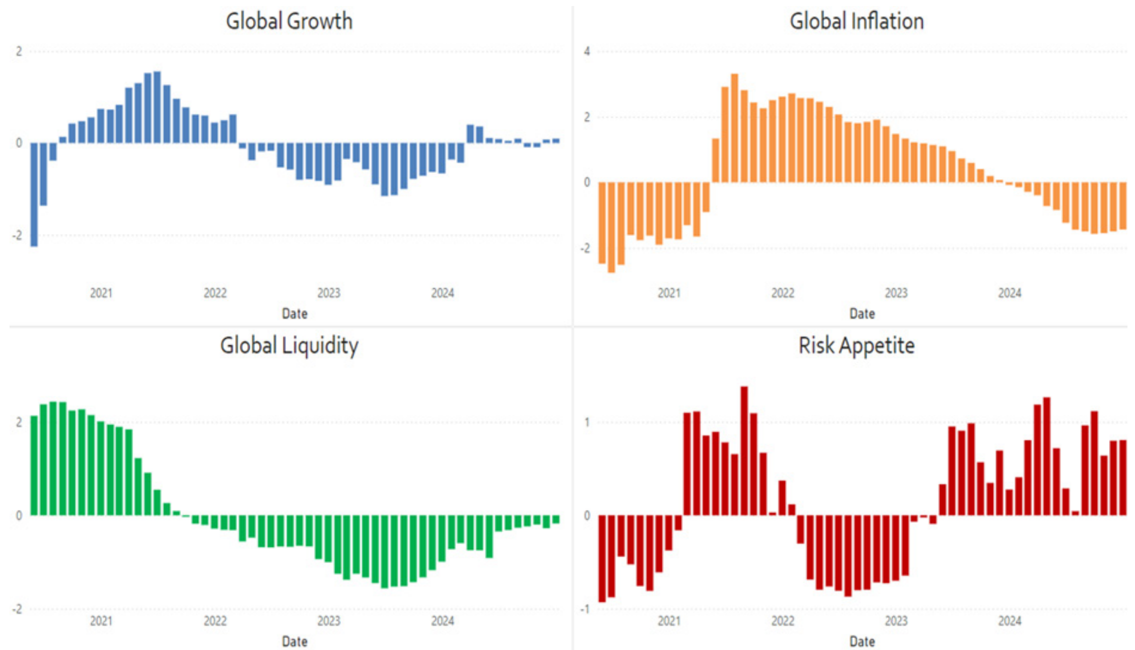
Global growth is expected to remain around its trend this year (i.e 3.5% p.a, since 1990[1]) facilitating double-digit earnings growth, but with significant variation across countries. The US is the only region where its earnings growth expectations are not slowing down. Across Asia there have been wide gaps in performance between Japan, China (i.e China-MSCI, China-H and -A), and Europe the laggard. We believe this 'Great Decoupling' will continue, where China can (again) achieve its policy-target GDP growth (of around 5%) in 2025, while the US can sustain above trend performance[2].

Fullerton's Investment Environment Indicator remains in 'Goldilocks' which means strong returns can be achieved

With global growth around trend, inflation low, and liquidity improving along with risk appetite, the core fundamentals into 2025 remain very supportive for risk asset returns (see Figure 1). The resulting 'Goldilocks' signal (see Figure 2) means that there is still significant scope for fundamentals to continue to drive robust returns.

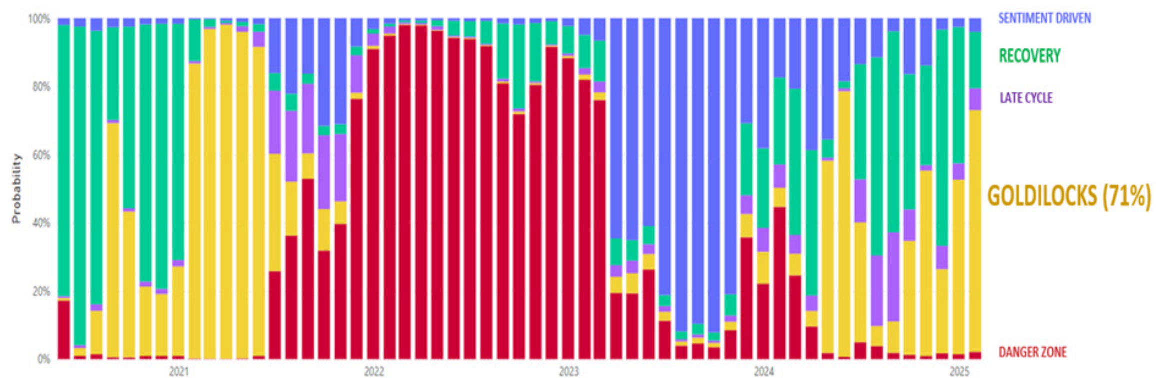
1. Source: LSEG Datastream, January 2025.
2. Japan and Europe are likely to continue to lag, and their respective growth rates may not shift too much in 2025 from last year i.e Japan's growth averaged 1.8% (SAAR over Q224 and Q324), while Europe lagged DM with 1.2% growth (on average SAAR over Q224 and Q324).

Figure 1: Fullerton's key global factors that drive investment returns



Source: Fullerton, Jan 2025. These global macro factors of growth, inflation, liquidity, and risk appetite, are constructed by Fullerton and expressed as standardised z-score deviations from trend (or average). In turn, they impact the signal from our Investment Regime Model. The information presented in the chart above is calculated based on Fullerton's internal methodology and is subject to change. Past performance may not necessarily be indicative of future performance.

Figure 2: Fullerton's Investment Environment Indicator: Goldilocks continues



Source: Fullerton, Jan 2025. The Investment Regime Model is calculated based on Fullerton's internal methodology and is subject to change. Past performance may not necessarily be indicative of future performance.

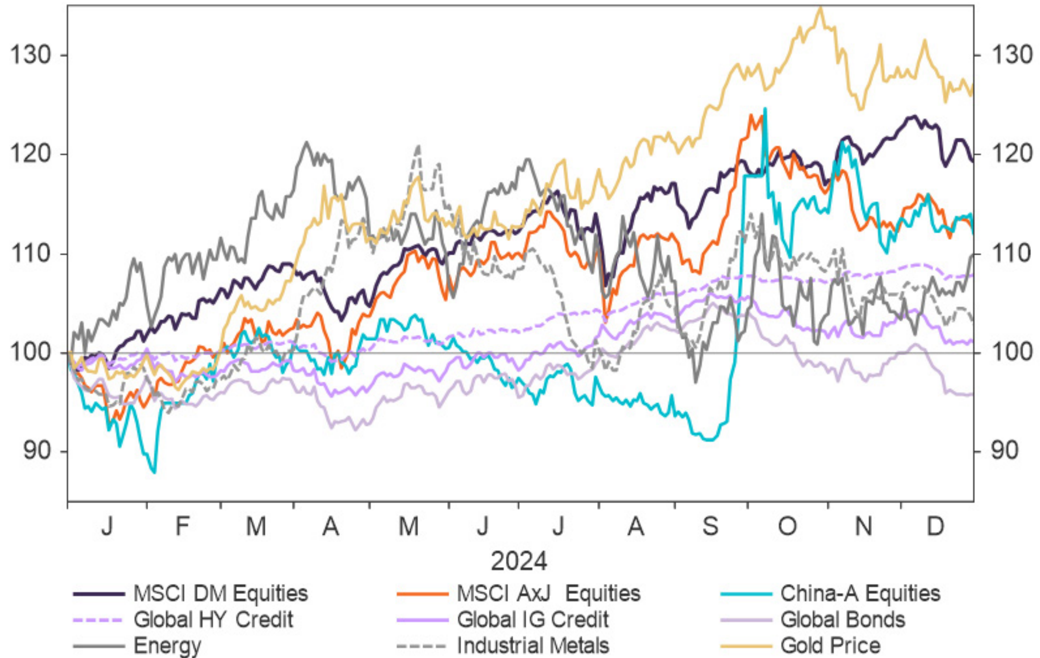
We maintain our bullish outlook for global risk assets, dominated by DM equities

With DM equities having achieved around a 25% (USD) return in 2023 and around 20% in 2024 (see Figure 3), gains for investors in 2025 may ease further but should remain very positive.

Figure 3: Risk asset performance: very strong returns for 2024

Global Risk Asset Returns

USD Total Return Index for 2024



Source: LSEG Datastream, January 2025.

Our investment themes, outlined in our Q3 Fullerton Investment Views[3], of Industry 5.0 and Innovation are shaping into a '3E environment' – where 2025 can be a year of excess returns driven by exceptionalism ('winners take all' type situation - the US is the poster-child for this), evolution (AI/Metaverse-related changes, plus China's changing policy response), and liquidity.

Exceptionalism = winners take all

Exceptionalism is not a new buzz word nor recent development – for the US, it is a well-established 15 year trend[4] where strong productivity performance has kept real unit production costs down. This resulted in robust earnings growth (averaging 10% p.a), with some re-rating adding to equity returns of 15% p.a. With the highest productivity levels in the world, and its productivity growth still outpacing DM this cycle[5], the US has averaged real growth (2.4% p.a) above typical trend assumptions (i.e 2% p.a). US households are the largest consumer market in the world by spending ($21tn p.a) and are the most affluent (i.e with the highest wealth as a percentage of GDP). Most importantly, such strong growth over the last 15 years did not create significant price pressures as US PCE inflation averaged around the Fed's target. That is very important for investors because inflation did not significantly erode the purchasing power of returns over time. See Figure 4 that pictorially illustrates and summarises all these points.

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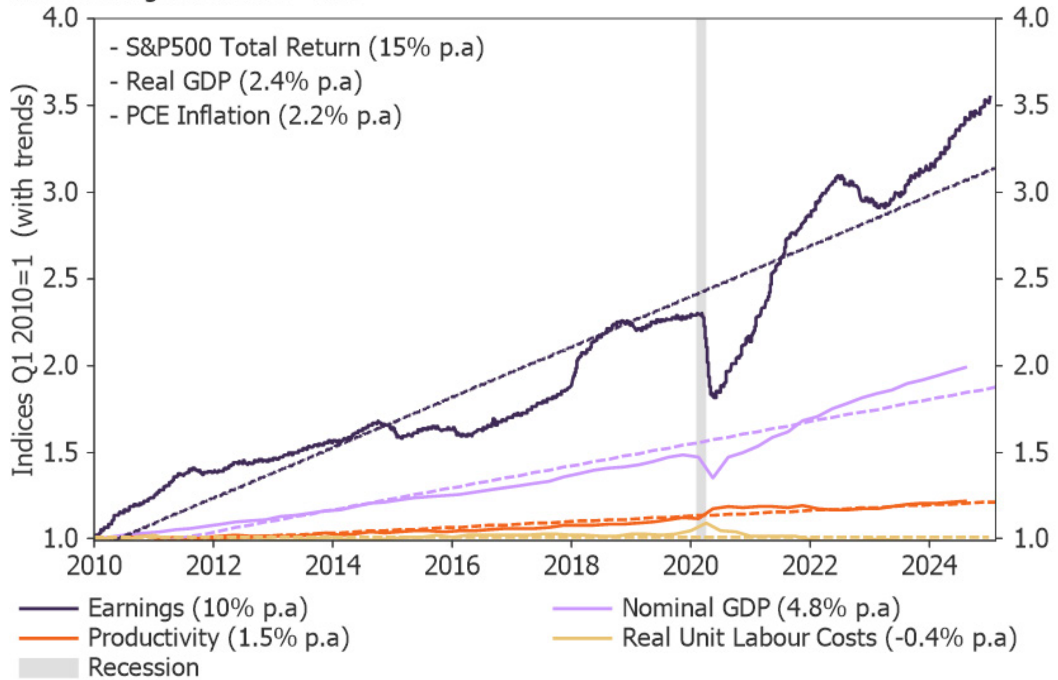
3. See FIV-Q3-2024_Final-C.pdf. In this Q3 FIV we also emphasised that AI and the Metaverse is an evolving process with different investment opportunities at different times along the stages of its lifecycle.
4. That is since 2010 and after the private sector debt deleveraging driven by Global Financial Crisis (GFC) 2008-09. To many such strong US performance was inconceivable (ex-ante) because after the GFC many believed the US consumer and economy were broken, trend growth would plunge, and investment returns would be extremely poor.
5. See 'Investing in Productivity Growth' by McKinsey (March 2024).

Figure 4: US exceptionalism is a 15 year trend



Source: LSEG Datastream, January 2025.

With such favourable trend fundamentals the US equity market has been a top performer for 11 years out of the last 15 (i.e where S&P500 returns were at least 12% p.a, see Figure 5). Today, and driven by both Main and Wall Street firms, US corporate economy-wide profit is sustaining at highs not seen since the 1950s (i.e at around 13% of GDP[6]).

Exceptionalism is not solely about the US

Exceptionalism is not exclusively about the US – 'winners take all' are driven by productivity-enhanced earnings, rising investment, and sustained demand. Such 'creative monopolies' can be found across any market/sector. That is why it is vital for investors to harmonise their top-down strategy with active management and stock selection.

6. Source: LSEG Datastream, January 2025.

Figure 5: Asset class performance by year since 2010

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Gold 29.2%	US Treasuries 9.8%	REITS 23.8%	S&P 500 32.4%	S&P 500 13.7%	S&P 500 1.4%	Commodities 17.5%	MSCI EM 37.8%	Cash 1.8%	S&P 500 31.5%	Gold 24.8%	Commodities 46.3%	Commodities 31.1%	S&P 500 26.3%	Gold 26.7%
MSCI EM 19.2%	Gold 8.9%	Global HY 19.3%	MSCI EAFE 23.3%	REITS 11.7%	US Treasuries 0.8%	Global HY 14.8%	MSCI EAFE 25.9%	US Treasuries 0.8%	REITS 27.4%	MSCI EM 18.8%	REITS 37.1%	Cash 1.5%	MSCI EAFE 18.9%	S&P 500 25.0%
REITS 15.9%	Global IG 4.5%	MSCI EM 18.6%	Global HY 8.0%	US Treasuries 6.0%	Cash 0.1%	S&P 500 12.0%	S&P 500 22.0%	Gold -1.9%	MSCI EAFE 22.8%	S&P 500 18.4%	S&P 500 28.7%	Gold -0.8%	Global HY 13.4%	MSCI EM 8.0%
S&P 500 15.1%	Global HY 2.6%	MSCI EAFE 17.9%	REITS 0.7%	Global IG 3.2%	MSCI EAFE -0.8%	MSCI EM 11.2%	Gold 12.9%	Global HY -3.3%	Commodities 20.1%	Global IG 10.3%	MSCI EAFE 11.9%	US Treasuries -12.9%	Gold 12.7%	Global HY 7.5%
Global HY 13.9%	S&P 500 2.1%	S&P 500 16.0%	Global IG 0.1%	Gold 0.1%	REITS -3.4%	Gold 8.6%	REITS 11.5%	Global IG -3.4%	MSCI EM 18.6%	MSCI EAFE 8.4%	Global HY 1.4%	Global HY -13.2%	REITS 11.3%	Commodities 5.5%
Commodities 13.3%	Cash 0.1%	Global IG 11.1%	Cash 0.1%	Cash 0.0%	Global IG -3.8%	Global IG 4.3%	Global HY 10.2%	REITS -3.9%	Gold 17.9%	US Treasuries 8.2%	Cash 0.0%	MSCI EAFE -13.9%	MSCI EM 10.1%	Cash 5.3%
MSCI EAFE 8.2%	Commodities -2.6%	Gold 8.3%	Commodities -2.1%	Global HY -0.1%	Global HY -4.2%	REITS 1.3%	Global IG 9.3%	S&P 500 -4.3%	Global HY 13.7%	Global HY 8.0%	MSCI EM -2.3%	Global IG -16.7%	Global IG 9.5%	MSCI EAFE 4.4%
Global IG 6.0%	REITS -9.4%	US Treasuries 2.2%	MSCI EM -2.3%	MSCI EM -1.8%	Gold -10.4%	US Treasuries 1.1%	Commodities 7.6%	Commodities -13.1%	Global IG 11.4%	Cash 0.5%	US Treasuries -2.4%	S&P 500 -18.1%	Cash 5.1%	REITS 3.2%
US Treasuries 5.9%	MSCI EAFE -11.7%	Cash 0.1%	US Treasuries -3.3%	MSCI EAFE -4.5%	MSCI EM -14.9%	MSCI EAFE 1.0%	US Treasuries 2.4%	MSCI EAFE -13.2%	US Treasuries 7.0%	REITS -4.4%	Global IG -3.0%	MSCI EM -19.8%	US Treasuries 3.9%	Global IG 1.2%
Cash 0.1%	MSCI EM -18.2%	Commodities -0.3%	Gold -27.3%	Commodities -29.3%	Commodities -29.4%	Cash 0.3%	Cash 0.8%	MSCI EM -14.3%	Cash 2.2%	Commodities -15.0%	Gold -4.1%	REITS -25.2%	Commodities -3.5%	US Treasuries 0.5%

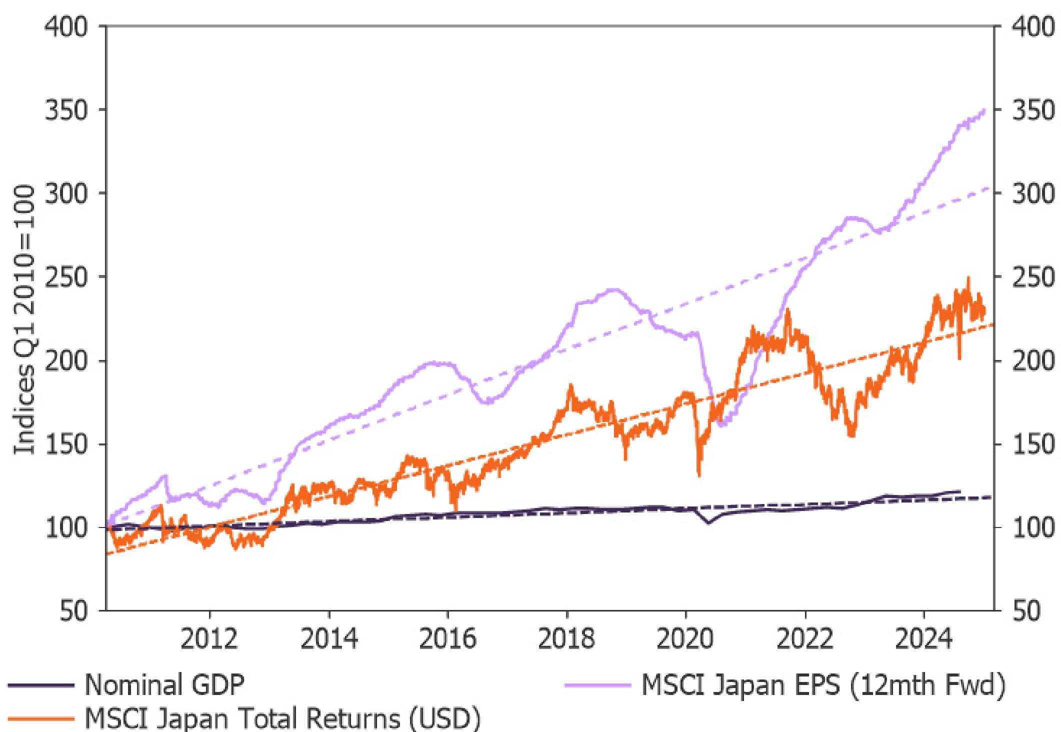
Source: BoA 'The Flow Show' and Bloomberg, January 2025.

DM equity returns in 2025 should also remain supported by Japan's performance (MSCI-Japan achieved almost a 10%[7] USD return in 2024), given its robust productivity growth (second only to the US), strong exports, and investment. As we have emphasised before, investors should not worry that Japan's low GDP growth on average can be a headwind to equity returns. What is much more important is Japan's productivity and earnings performance which has followed very favourable trends even with weak GDP (see Figure 6). In harmony with the US, Japan's economy-wide level of corporate profit has also reached record highs. At the same time, Japan is extremely competitive (almost 15% more so than Europe on a real exchange rate basis[8]) which helps boost equity returns from Japan's companies selling in global markets.

7. Source: LSEG Datastream, January 2025.
8. FX rate calculations derived from LSEG Datastream and JP Morgan, as of January 2025.

Figure 6: Japan's robust trends in earnings and returns are productivity driven (even with flat GDP)

Japan GDP, MSCI Equity Returns and Earnings



Source: LSEG Datastream, January 2025.

Europe is likely to remain the laggard of DM equities, as it ended 2024 with almost zero return (MSCI-USD basis). We maintain our 2025 outlook that any contribution to DM equity returns from Europe may only be a small positive as earnings growth expectations try to bottom. As activity slowly improves, especially with the benefit of Europe's high trade share to the US, then profitability may be able to slowly grind higher. Furthermore, Europe equity valuations are below average and as the ECB continues to cut rates it may give an added boost to investor sentiment.

Evolution in China

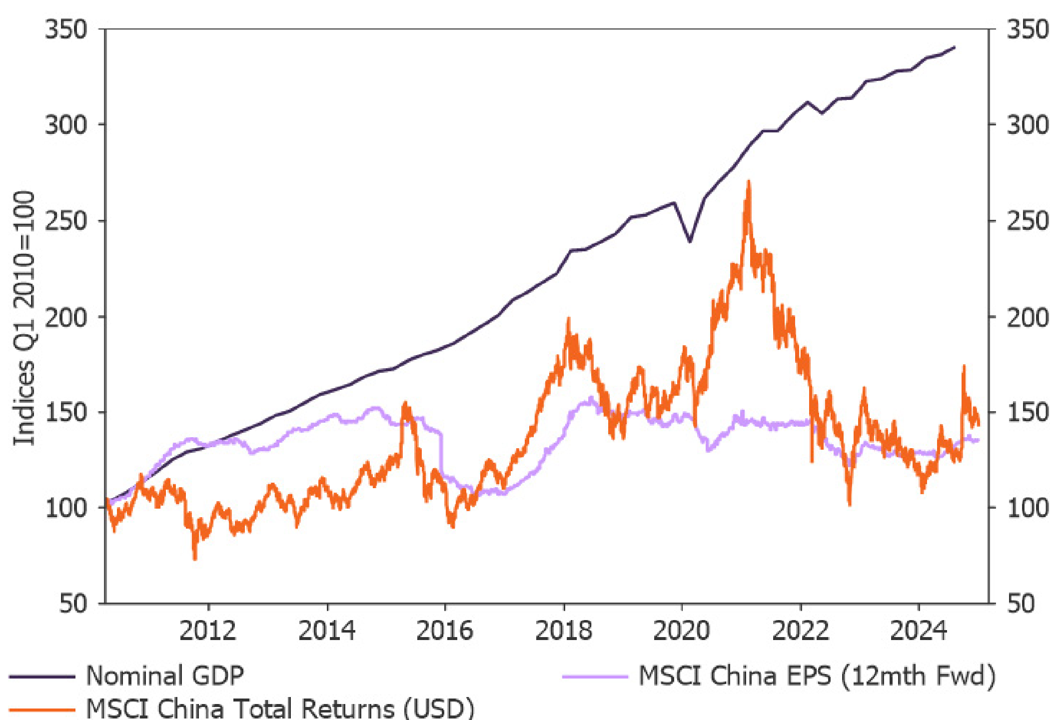
On the one hand, as we discussed in Q4 Fullerton Investment Views[9], China's Q424 announced stimulus may prove to be a 'whatever it takes moment' to ultimately resolve deflation because there may now be too much political credibility at risk to fail.

9. See Fullerton-Investment-Views-Q4-2024_FINAL.pdf.

However, it will take several years of significant stimulus to end deflation and key support initiatives still have to move via the local government bureaucracy[10]. It remains unclear if China can break-away from being a range-bound market with counter-cyclical measures and structural reforms happening over time (see Figure 7). Most of the fiscal spending may not start flowing until after the March NPC, and so far investors seem to be giving China's policymakers 'the benefit of the doubt' - as China's equity returns ended 2024 much stronger than many expected i.e China-A almost 15%, MSCI China 20% and China-H over 30%[11].

Figure 7: The challenge for China is to boost trend earnings and returns by ending deflation

China GDP, MSCI China Equity Returns and Earnings



Source: LSEG Datastream, January 2025.

10. As monies raised from local government (LG) bonds create new financial resources and allow them to launch targeted spending programs. The fiscal package is significant (i.e 6tnCNY to be distributed in 2024/25 of a multi-year 12tnCNY/9% of GDP total package). The objectives are optimal: boost household spending and consumer credit, while stabilising corporate loan growth, resolving unprofitable investment and deflation. As Figure 7 shows, China is not a typical 'Japanification' risk because GDP is trending. GDP growth is not the problem, it is weak earnings, excess investment and deflation. See Fullerton-Investment-Views-Q4-2024_FINAL.pdf for further discussion.
11. Source: LSEG Datastream, January 2025.

We have a positive outlook for Asia (ex-Japan) equities and fixed income

We have revised our 2025 bullish outlook back to positive largely because earnings growth expectations across the region have slowed sharply and are past the peak. Headwinds also stem from the possibility that China's stimulus disappoints with limited traction against deflation or from adverse spillovers from US trade tariffs[12]. That said, equity returns in 2025 should remain positive as Asia (ex-Japan) earnings growth remains above average, supported by export competitiveness, a larger share of global trade, and improving supply-chain demand from China.

Our positive view for returns from global sovereign bonds reflects the possibility that yields settle at levels that provide a favourable income-stream and give some protection if equities fall sharply. The risk of the latter is mostly underpinned by geopolitical concerns given push-backs against globalisation, tension in the Middle-East, and the Russia-Ukraine War.

Gold has also proved a very useful hedge against geopolitical fears, gaining around 25% in 2024 (see Figure 3) and rising further into 2025. The best defence for investors is to always remain well diversified beyond equities, and to note that against a backdrop of strong fundamentals, any adverse reactions to geopolitical shocks can 'wash-out' and risk assets can eventually return to positive trends[13].

We also maintain our positive outlook for Asia investment grade corporate credit as default rates can remain modest with global growth set to achieve a 'beautiful-landing' around trend, while returns should also be supported by robust profitability.

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12. The degree of this potential headwind is not clear as China's experience with high US tariffs (since 2018) has been to maintain its global export share (i.e with gains to Asia and to Europe mitigating the large fall in export market share to the US). See 2024 US election outcome: It's Trump! With a red sweep - Fullerton Fund Management for more detail.
13. See Fullerton Investment Views Q4 2023 "Speedbumps in a Goldilocks environment" for background discussion https://www.fullertonfund.com/wp-content/uploads/2023/11/FIV-Q4-2023_FINAL.pdf

02

Equities

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The US is expected to remain the dominant driver of our bullish outlook for DM equity returns

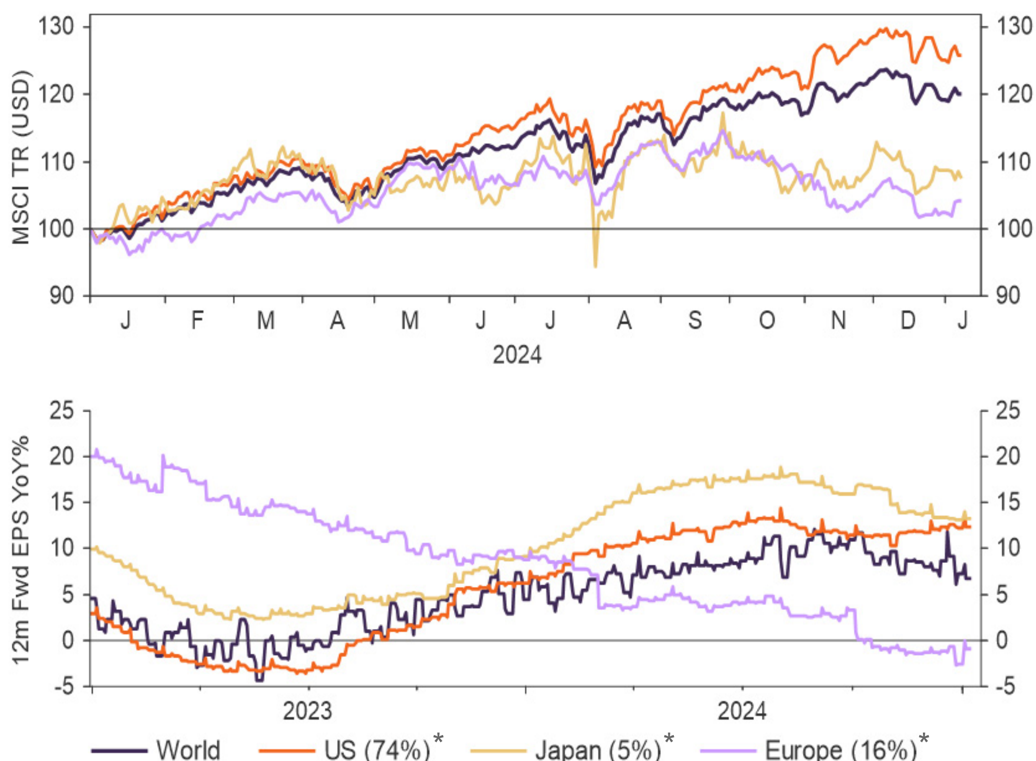
With DM equities having achieved two consecutive years of exceptionally high returns[14], gains for investors in 2025 may ease further but is likely to remain positive. US activity indicators in 2024 surprised some investors on the upside, but it is what we expected and we believe the US can hold above (2%) trend growth this year.

Earnings performance can remain strong, driven by solid revenues from consumerism and robust productivity growth keeping unit labour costs low. In addition, money growth and liquidity conditions should remain supportive. Employment growth and high levels of US household financial wealth can continue to drive spending, while corporate investment (financed from record-high economy-wide profit) can reinforce payoffs from technology and innovation. As we have emphasised before, AI technologies and metaverse demands are an evolving process with different investment opportunities unfolding over the lifecycle.

14. As reflected in the returns of the MSCI US, Japan, and Europe equity indices. Source: LSEG Datastream, January 2025.

Figure 8: MSCI World – DM equity performance

MSCI World Equity Returns and Earnings



Source: LSEG Datastream, January 2025.

* percent in brackets is the weight in the aggregate MSCI World Index

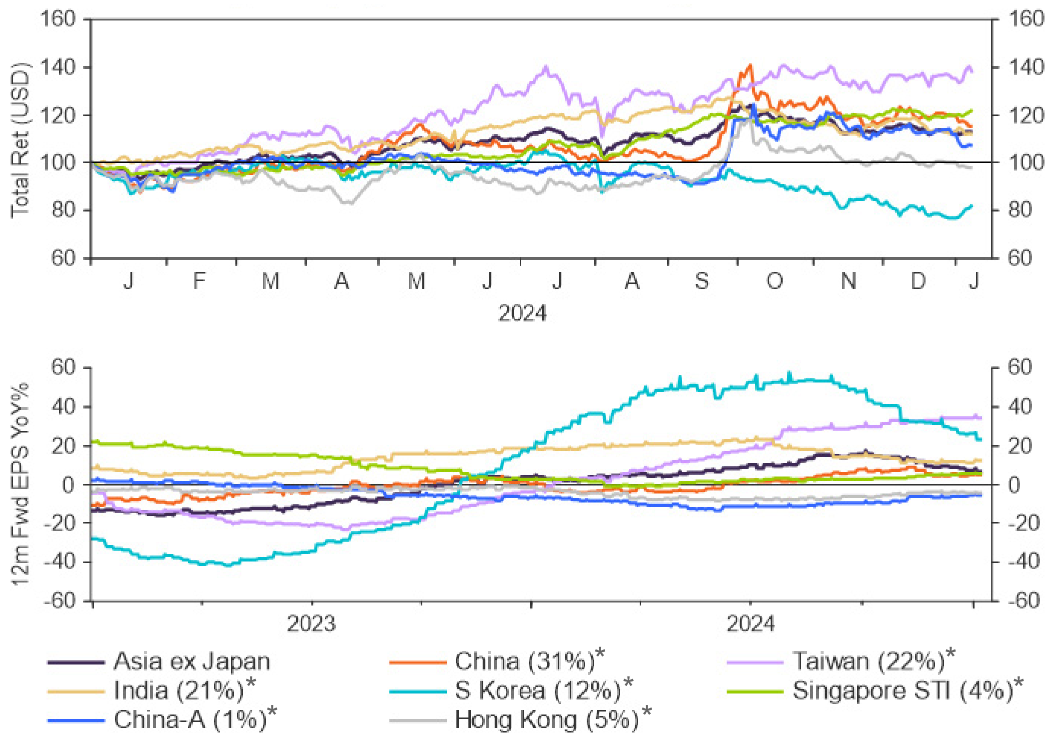
We explained in our Q4 Fullerton Investment Views[15] that if US policy shifts toward more intense protectionism it could ultimately prove positive for US stocks (especially those with domestic centric supply-chains and revenues) and negative for foreign equities (especially for firms that rely on US demand). We do not foresee our bullish outlook on US equities being derailed, by the actions of politicians, because the core fundamentals driving earnings are very supportive (i.e above trend growth, robust productivity, very low real production costs, and sustained consumer spending).

Asia equity returns should remain positive in 2025 as long as earnings growth holds above average

Earnings growth expectations for 2025 across the region have slowed sharply and are past the peak. In our view, headwinds from the possibility that China's stimulus disappoints with limited traction against deflation is a key risk to favourable performance. That said, Asia (ex-Japan) returns should be supported by export competitiveness, a larger share of global trade, and improving supply-chain demand from China.

15. See Fullerton-Investment-Views-Q4-2024_FINAL.pdf. We also showed in our research note on the US elections that there is strong evidence that the fundamentals of risk asset returns can trump the impacts of US politics. See https://www.fullertonfund.com/fullerton-insights/2024-us-elections-and-potential-investment-implications/

Figure 9: MSCI Asia ex Japan equity performance



Source: LSEG Datastream, January 2025.

* percent in brackets is the weight in the aggregate MSCI Asia ex Japan index

Earnings growth expectations for Taiwan and China (on an MSCI basis) are robust and continue to benefit from stronger global demand, particularly in IT and industrials. India's earnings are also tracking above trend, reflecting strong US demand, contained inflation, and the slide in yields. Singapore equities can gain from increased global demand for higher-end capital goods, as well as from the favourable environment for financials. South Korea is likely to remain the laggard in the region as its earnings growth has corrected sharply with the slippage in its global IT-related (export) market share. In addition, political uncertainties, as the country navigates the process toward new presidential elections, have added headwinds.

We continue to like IT, consumerism, and new industrials

The global equity sectors we like have not changed materially from what we discussed in detail in our Q3 Fullerton Investment Views[16]. We generally prefer growth over value, and sectors linked to consumerism, IT, new industrials, (select) healthcare names, financials, and ESG-leaders. These sectors are favoured as overall they are experiencing rising market share coupled with productivity gains containing costs.

16. See https://www.fullertonfund.com/wp-content/uploads/2024/08/FIV-Q3-2024_Final-C.pdf

Potential rotations are likely to remain on the radar as earnings growth expectations continue to converge between some of the strongest (slowing down) sectors and the laggards (rising). That said, relative performance orderings may not change dramatically i.e IT and Communications will likely maintain the strongest earnings growth expectations, while the Energy sector may hold the lowest ranking.

Figure 10: Some of Fullerton's investment themes

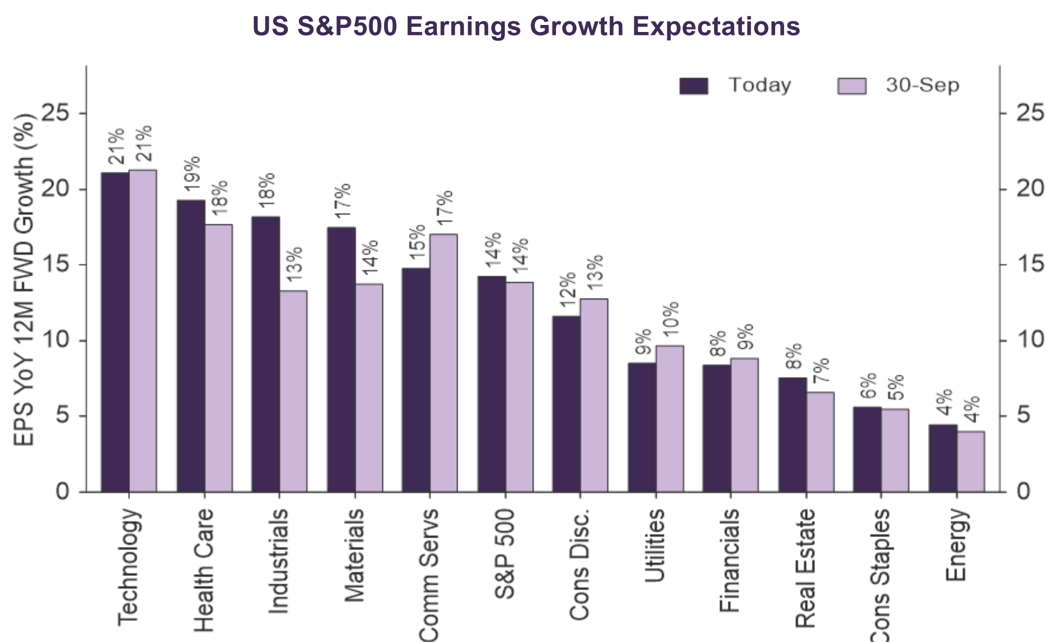
Source: Fullerton Fund Management, January 2025.

US equity market performance remains broad, with positive earnings growth expectations for 2025 across all sectors

Understandably, US IT sector expected performance remains very high, and has not shifted since Q3 earnings realisations and the election of POTUS Trump. The sectors that have seen the largest upward revisions to earnings growth expectations are Industrials, Materials, and Healthcare. The latter should benefit from AI and metaverse shifts over time, yet Healthcare is not a typical 'Trump trade' like industrials. Financials may also perform stronger as the yield curve is expected to steepen and as the investment/deal environment becomes more favourable (boosting non-interest income). Nevertheless, these sectors are still unlikely to outperform IT in 2025[17].

17. As the US rally continues to broaden there could be some 'catch-up' for returns from small-caps (i.e Russell 2000). Small-cap returns jumped to 20% YTD post the POTUS election, only to fall back and end 2024 at 12%. It is very hard to make the case that US larger caps will not continue to beat smaller caps in 2025 - just as returns from IT will likely beat Energy. On the latter, some proponents of 'Trump trades' saw Energy as a possible strong performer given POTUS' views on fossil-fuel exploration but the sector still struggles as a whole from weak global oil demand.

Figure 11: US S&P500 1y-ahead earnings growth expectations (as at end-Q3 vs end-2024)

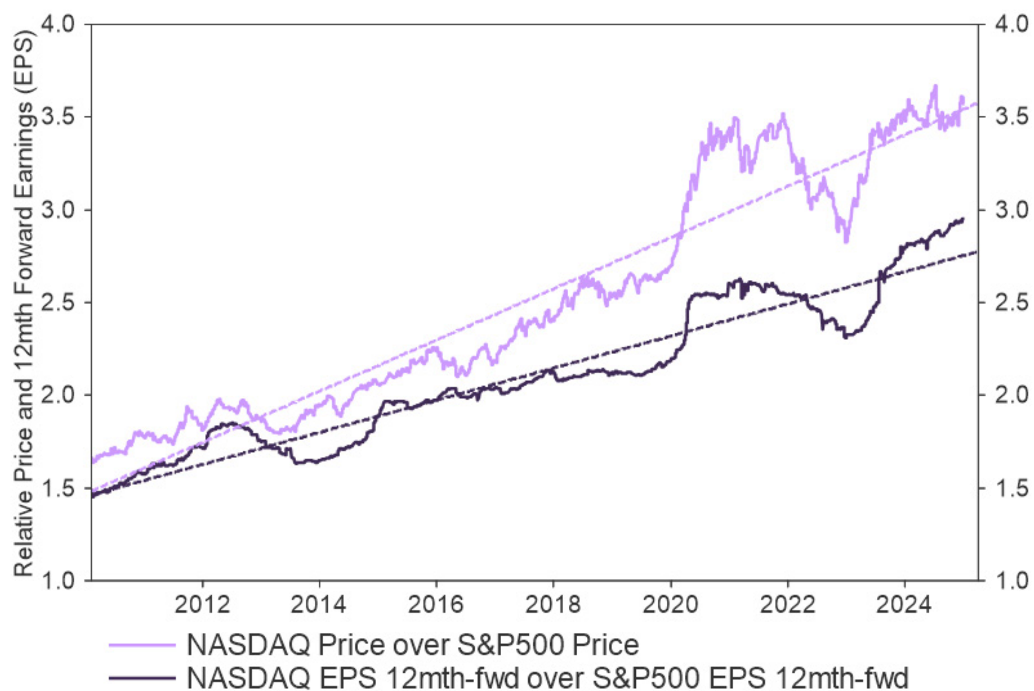


Source: LSEG Datastream, January 2025.

The US IT sector can remain a leading performer, and we do not believe it is a bubble

Since 2010 with the huge productivity-driven positive trend shift in the US economy, the IT sector has been a key enabler and benefactor. The Nasdaq 100 has enjoyed its earnings rising relative to aggregate market earnings (and is still above trend), along with its returns rising relative to the market (which is back around trend. See Figure 12). Because IT sector relative earnings expectations are well-above trend, and yet relative returns are at trend, the environment is not symptomatic of a bubble yet.

Figure 12: the US IT sector performance relative to the US equity market



Source: LSEG Datastream, January 2025.

03 Fixed Income

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Head of Fixed Income
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We remain positive on global sovereign bonds and IG corporate credit

Our positive view for returns from global sovereign bonds reflects the possibility that yields can settle at levels that provide a favourable income-stream and give some protection if equities fall sharply. The risk of the latter is mostly underpinned by geopolitical concerns given push-backs against globalisation, which may become more intense with the election of POTUS Trump. Certainly fears of trade tensions have negatively impacted currencies across Asia, while the US dollar has surged, especially against DM.

We maintain our positive outlook for Asia investment grade corporate credit as default rates can remain modest with a 'soft-landing' for global growth (around trend) while returns should be supported by robust profitability and liquidity. Our constructive view also reflects the bias toward easier policy across Asia's central banks.

In November we published a deeper-dive into alpha opportunities across the Singapore (SGD) credit market for global investors. Historical returns have been competitive, with relatively stable credit spreads, and have provided valuable portfolio diversification[18].

A strong US dollar can be a headwind for Asia local currency investors

What has made the investment environment more challenging into 2025 has been the rapid appreciation of the US dollar. Much of the gains have been against DM currencies, and if the strong US dollar can avoid overshooting too much against currencies across Asia, then that would boost investors' confidence. The US dollar (DXY Index) is not at the extreme highs we have seen over the last few years (as it re-rated higher on the US becoming a net oil exporter) and if it can stabilise, there may be scope for Asia's central banks to ease faster. In particular, countries like South Korea, Indonesia, and Singapore, as inflation is well-contained.

18. See The 5 Myths of the SGD credit markets de-bunked - Fullerton Fund Management

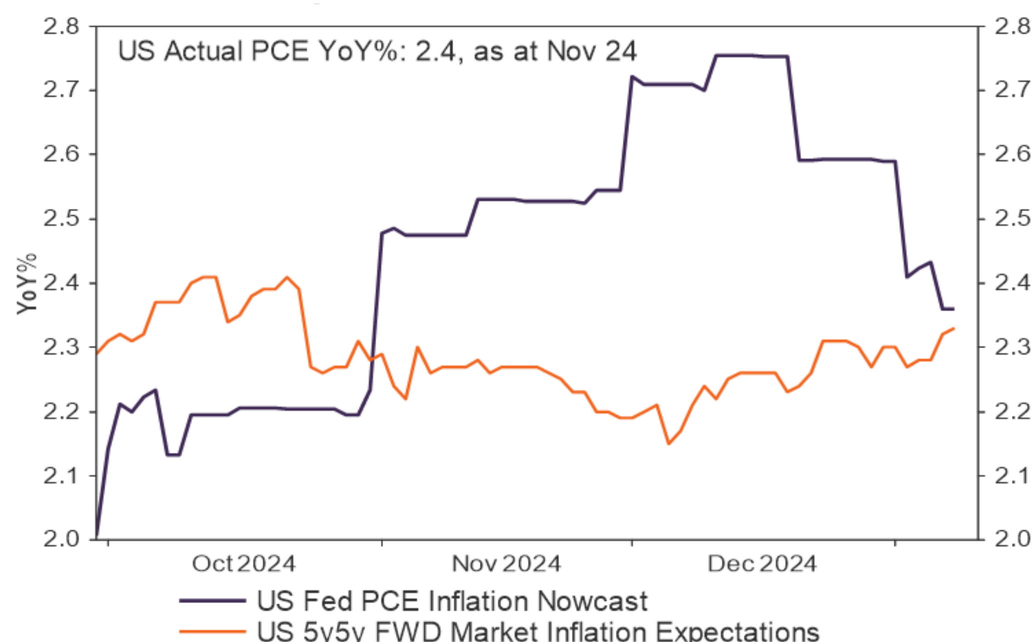
With China unveiling its monetary and fiscal stimulus packages it still faces the significant challenge of trying to boost household demand for credit (to encourage more consumption) and government bond yields. Investors are still in a 'wait-and-see' mode whether China's policy actions can push bond yields sustainably higher over time. The key balancing act for China's policymakers to navigate is how much currency weakness to allow at the same time (to avoid tighter aggregate monetary conditions that higher yields may imply).

We continue to believe that investors may consider adjusting exposures toward sectors that are linked to consumerism and select industrials. This is because they may benefit the most from improved earnings and from the China's stimulus to come. There is also likely to be select opportunities over time across Emerging Market (EM) credits, where technicals are less crowded, but we remain cautious on regions with geopolitical sensitivities.

The Fed and the market have the same outlook for the policy rate: 4% by end 2025

With its December Statement, the Fed became more sensitive to inflation risk, and perhaps understandably, as its PCE inflation nowcast hit 2.8% (i.e back at Q2 2024 highs) which could take much of 2025 to come back down. That said, the Fed still cut its policy rate by 25bps to end 2024 at 4.5%, and since the Fed's Statement its PCE inflation nowcast has fallen back to 2.4%. It is also encouraging that forward-market inflation expectations have not increased much (holding at 2.3%) which may suggest any sustained surge in PCE inflation is still not on the radar for 2025 (see Figure 13).

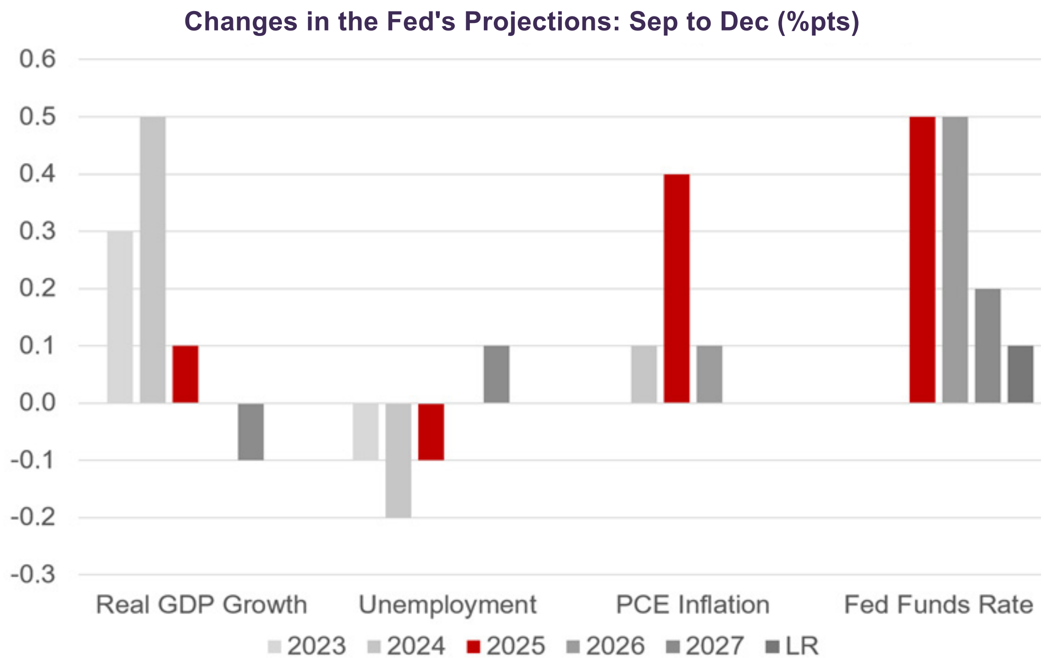
Figure 13: US PCE inflation and forward-market inflation expectations

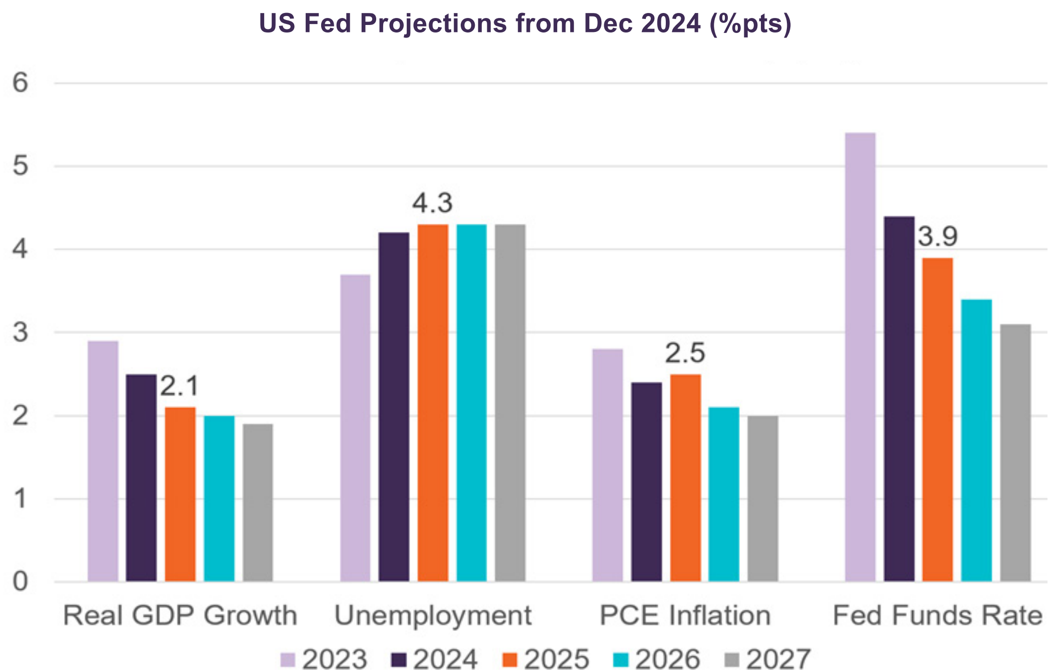


Source: LSEG Datastream, January 2025.

Nevertheless, from a 'risk management' perspective, the Fed's December projections of less rate cuts in 2025 (than signalled in September) can be appreciated (see Figure 14). If US inflation starts 2025 higher than expected then the Fed's forecast of it taking time to slip back again to the 2% target is defendable. From an economic perspective there is still a lack of definitive evidence that US PCE inflation will be too high in 2025. The Fed's forward-looking growth/excess demand pressure assessment is unchanged, but they are now saying PCE inflation will not resettle at 2% until 2026.

Figure 14: The Fed's latest projections – revisions from Sep and the Dec 2024 outlook





Source: FOMC Dec 2024.

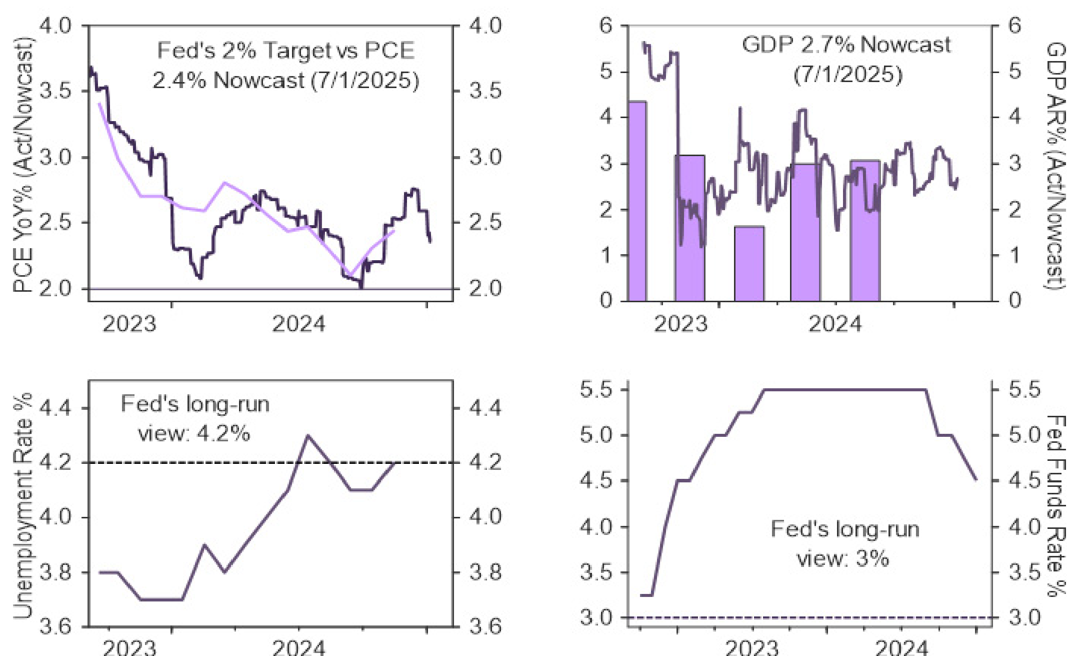
Some investors fear that fiscal policy under President Trump will be inflationary but that can be mitigated by his plans to cut government spending and the deficit. The potential impact of tariffs on US inflation is also fiercely debated. As we highlighted in Q4 Fullerton Investment Views[19], US consumer expenditure switching, and a strong dollar, can offset any inflation pressures.

The risk that US unemployment proves higher than expected may be more tangible. At 4.2%[20] it is already at the Fed's assumed minimum (consistent with its full employment mandate) so there is limited tolerance for overshooting (see Figure 15). The latter could occur with tighter immigration policies that POTUS Trump has signalled (if lower-skilled wages rise firms will retrench) and because the real cost of capital is now significantly cheaper than labour.

Some economists maintain the Fed will stop rate cuts when the Fed Funds rate is back around 4% which is much higher than the Fed's 3% longer-run assumption. Fed Chairman Powell repeated at his December press conference that policy is "meaningfully restrictive" suggesting that the 4.5% policy rate is still far above neutral. Further, if the neutral policy rate was much higher than what the Fed assumed, then the disinflation we have just experienced, (i.e US PCE inflation falling from a peak of 7% back to 2.1% by Sep 2024), would never have occurred with growth being above trend.

Figure 15: Key US indicators that the Fed is watching

US PCE Inflation, Growth, Unemployment, and Fed Policy Rate



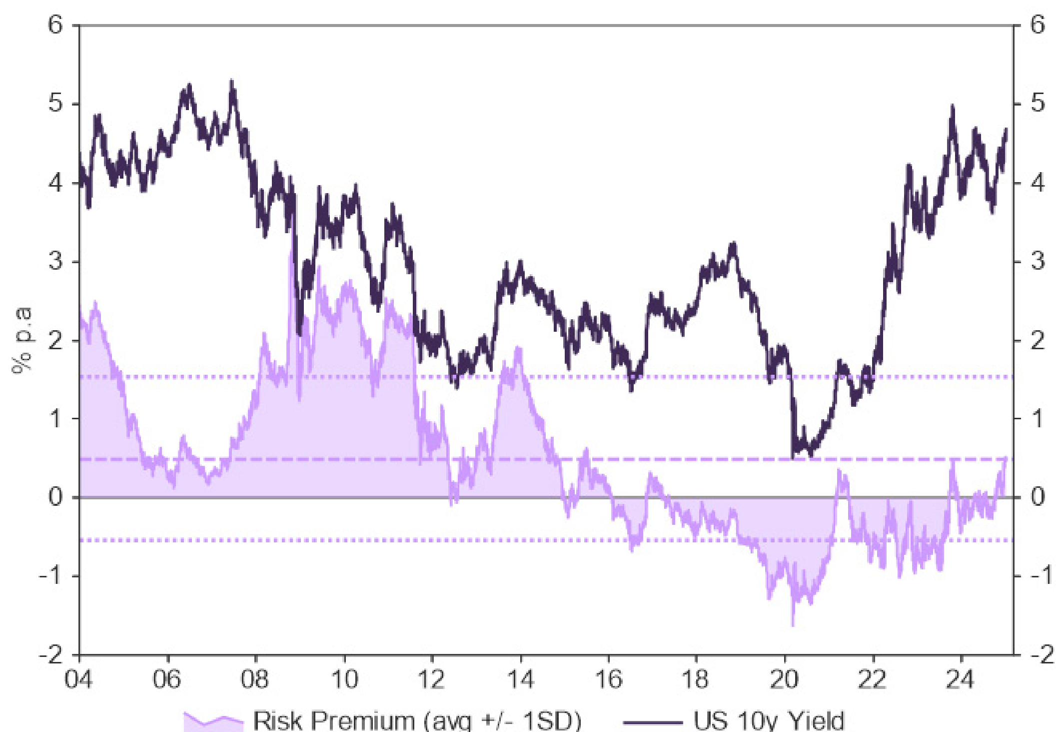
Source: LSEG Datastream, January 2025.

19. See Fullerton-Investment-Views-Q4-2024_FINAL.pdf. Expenditure switching by US consumers is a powerful force and it was the basis for Scott Bessent's (POTUS Trump's nominee for US Treasury Secretary) comment that "tariffs can't be inflationary" (25 Nov 2024, CNN).
20. Source: FOMC Dec projections.

But the US bond market does seem to be stressing about fiscal uncertainties and inflation – POTUS Trump will be pressured to keep his promises!

As we noted in our Q4 Fullerton Investment Views[21] if the Fed's estimate of the US bond risk premium reached 50bps then US 10y nominal yields could hit around 4.7% p.a - which is exactly what has happened.

Figure 16: US 10y nominal yield and the bond risk premium



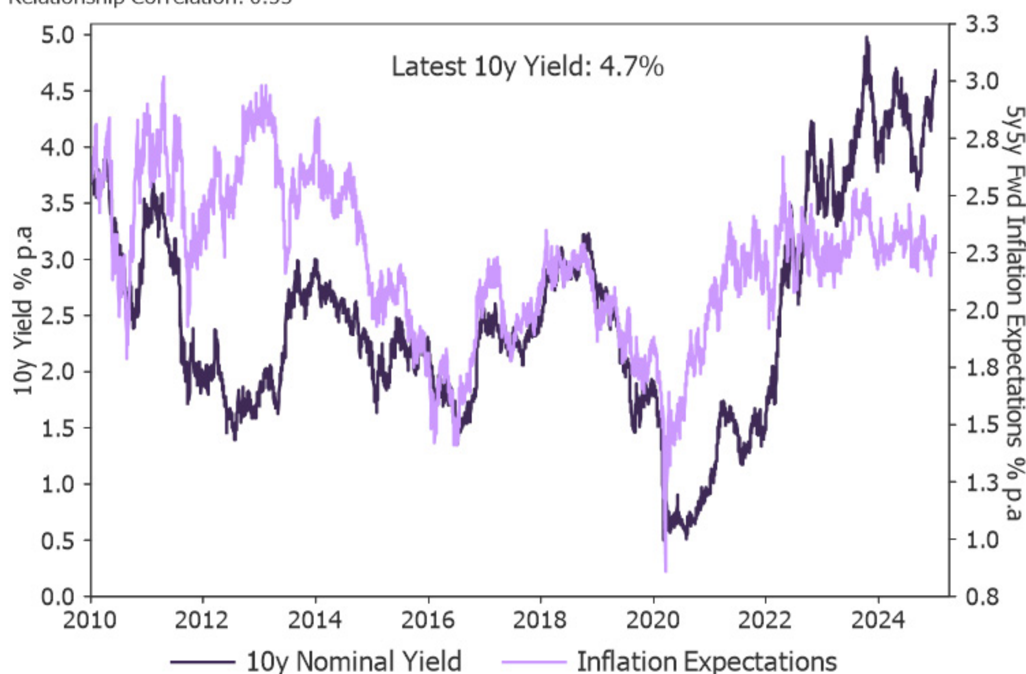
Source: LSEG Datastream, January 2025.

This is the third time this cycle that US 10y yield has threatened to hit 5%. The US bond risk premium has finally returned to around its historic average (+0.5%) which may reflect greater fiscal and inflation uncertainties (see Figure 16).

However, the US 10y yield may not sustain rates of 5% (or higher – which has not been seen in the last 15 years) because inflation expectations are well-anchored around 2.3% p.a (see Figure 17) and because the current risk premium would likely need to double (to +1%). Market pressure will likely rise on POTUS Trump to make sure he keeps his promise to cut government spending and the budget deficit.

21. See Fullerton-Investment-Views-Q4-2024_FINAL.pdf.

Figure 17: US 10y nominal yield and market inflation expectations



Source: LSEG Datastream, January 2025.

The US dollar is likely to remain strong, but range-bound

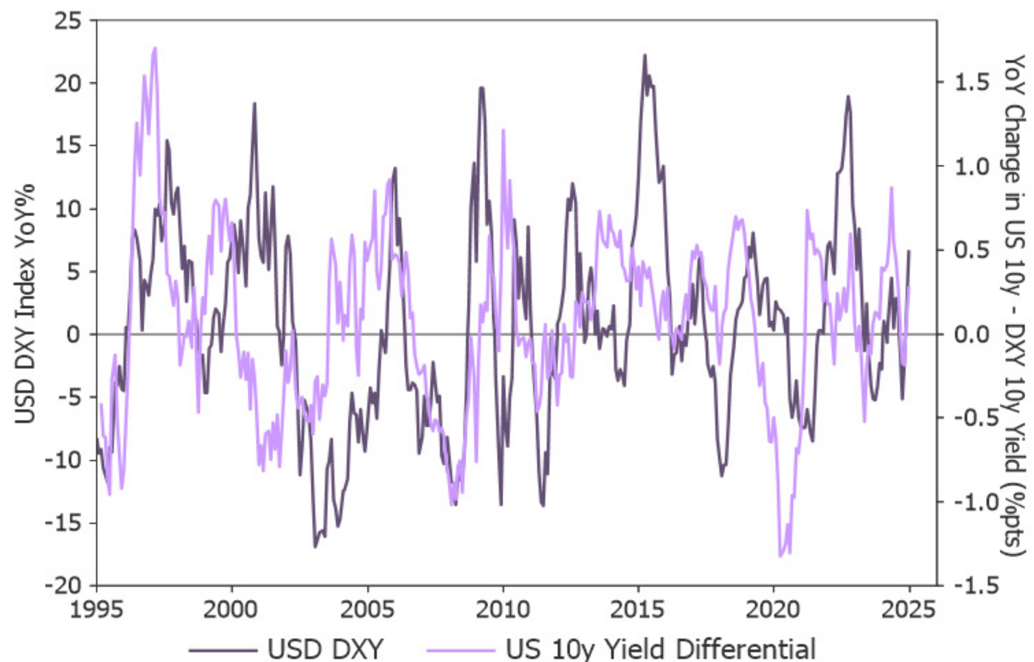
The US dollar defended its 1H gain against Asian currencies on average by rising 4% in 2024 (see Figure 18), while it appreciated by more versus DM currencies (i.e the USD-DXY index increased 7%) as the interest rate differential remained a key driver (see Figure 19).

Downside for the US dollar in 2025 should be limited by the interest rate differential remaining supportive, coupled with positive investor positioning and the strong US equity market attracting capital inflows. However, pressure for further significant appreciation may fade as the US dollar is stretched relative to measures of its real (inflation-adjusted) ‘fair-value’.

Figure 18: The US dollar appreciated against DM and Asia in 2024

Source: LSEG Datastream, January 2025.

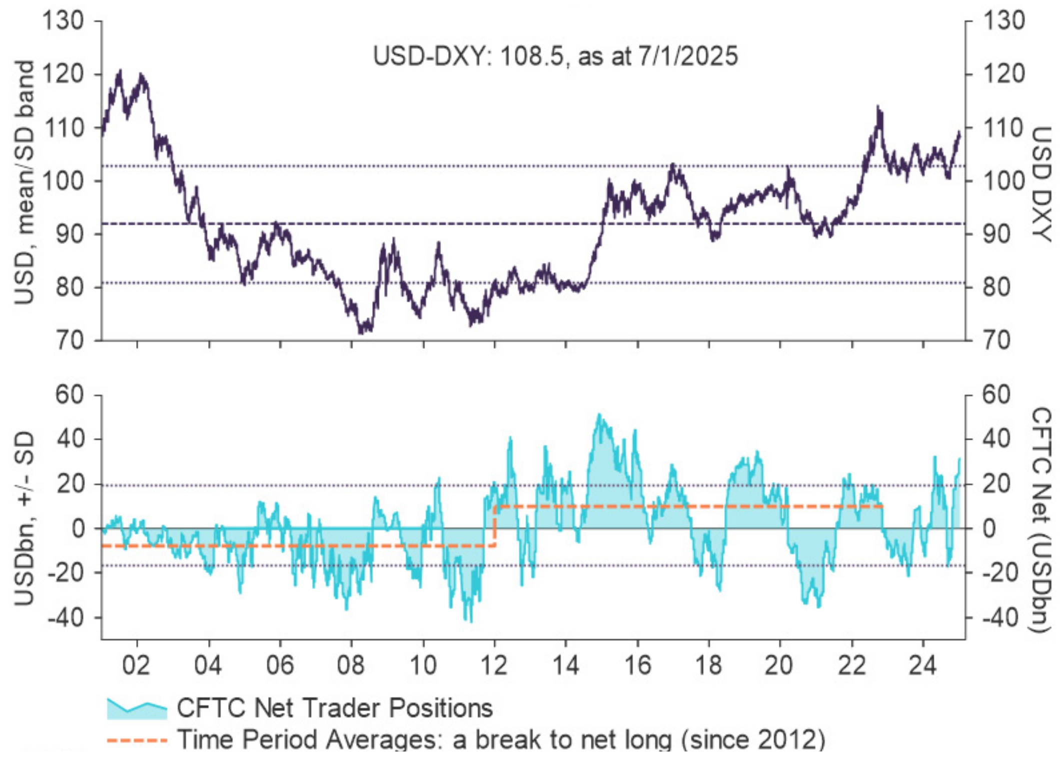
Figure 19: the strong US dollar reflected its attractive interest rate differential



Source: LSEG Datastream, January 2025.

Figure 20: the US dollar is supported by investor positioning

USD DXY and Investor Positioning



Source: LSEG Datastream, January 2025.

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