CLOUGH CAPITAL

THE MACRO COMPASS

In 2024, global capital markets experienced a year of resilience and growth, despite ongoing economic uncertainties and geopolitical tensions. The year was characterized by strong performance in equity markets, particularly in the United States, while fixed income markets showed mixed results as central banks navigated the delicate balance between controlling inflation and supporting economic growth.

Equity Markets

The U.S. stock market led the way in 2024, with the S&P 500 Index delivering an impressive return of 25.0%. This marked the second consecutive year of gains exceeding 20%, a feat not seen since the late 1990s. The NASDAQ Composite Index surged even higher, rallying 30% over the year. The strong performance was driven by robust corporate earnings, moderating inflation, and the continued adoption and growth of artificial intelligence ("AI"). The "Magnificent Seven" tech stocks (Apple Inc, Microsoft Corp, Alphabet Inc, Amazon.com Inc, NVIDIA Corp, Meta Platforms Inc, and Tesla Inc) continued to play a significant role in market performance, although their dominance moderated in the latter half of the year. These stocks accounted for over 30% of the S&P 500 Index and collectively returned over 60% in 2024. International markets, while positive, lagged behind the U.S. The MSCI ACWI Index gained 18.0%, with the MSCI Emerging Markets Index up 8.0%.

Fixed Income Markets

The bond market experienced a volatile year as central banks began to ease monetary policy. The Federal Reserve initiated its first rate cut in nearly four years, lowering rates by a total of 100 basis points over the course of 2024. This shift in policy contributed to a rally in fixed income assets, particularly in the latter part of the year. High yield bonds were the top-performing fixed income sector for the fourth consecutive year, delivering returns of over 8%. Investment-grade corporate bonds also performed well, benefiting from high all-in yields and tightening spreads. Government bonds faced challenges, with global government bonds returning -3.6% over 2024. However, the high starting yield partially cushioned U.S. Treasuries, which still delivered positive returns of 0.6% for the year.

Economic Landscape

The U.S. economy demonstrated remarkable resilience in 2024, with gross domestic product ("GDP") growth increasing at an annual rate of 3.1% as of Q3 2024. Inflation continued to moderate, with Core PCE prices rising 2.7% in 2024, down from 3.2% in 2023. Global economic growth remained steady, with the IMF forecasting a 3.3% expansion for both 2025 and 2026. However, growth prospects varied across regions, with the U.S. outperforming other major economies.

Market Trends and Themes

1. AI and Technology: The artificial intelligence boom continued to drive substantial gains across the technology sector, contributing to the outperformance of growth stocks.
2. Market Broadening: The latter half of 2024 saw a broadening of market participation, with returns extending beyond the dominant tech stocks.
3. Commodities: The broad Bloomberg Commodity Index delivered a modest return of 5.4%, while gold stood out with an impressive 26.6% gain, as measured by the Bloomberg Gold Subindex.
4. Geopolitical Factors: The U.S. presidential election and ongoing global tensions influenced market sentiment throughout the year.

In summary, 2024 proved to be a year of strong returns for risk assets, particularly in the U.S. equity market. The shift in monetary policy, coupled with resilient economic growth and moderating inflation, created a favorable environment for investors. However, the divergence in performance between U.S. and international markets, as well as the continued dominance of large tech stocks, we believe highlighted the importance of diversification and active management in navigating the complex global market lansdscape.

Market Outlook For 2025

We believe fixed income and equity markets will reflect strength in 2025. Slowing demand and declining inflation should continue as demographics as well as business and household leverage cause spending to slow, and supply lines to improve. We also believe the economy can avoid a recession. It is worth noting the so-called "Trump Rally" in November, in which financial, industrial, and smaller capitalization stocks rose sharply, lasted only five weeks before meeting resistance. That is about the time the first "Trump Rally" lasted back in 2016. In general, the investment strategies we manage at Clough Capital have skewed more underweight those sectors. While concerns over tariff policies and large fiscal deficits raise concerns, we think their potential negative effects on inflation and interest rates will be minimal, and they could turn out to be constructive.

Both interest rates and inflation declined during Donald Trump's first administration despite the tariffs he put in place. As it turned out, Trump's policy moves to reduce federal regulations had a positive effect. Supply chains opened and costs fell. In 2019, three years into his term, Fed Funds and ten-year Treasury yields averaged 1.6% and 1.8% respectively. The Personal Consumption deflator *declined* to 1.5%. If deregulation in the new administration is similarly successful, we think it will generate positive supply shocks and reduce regulatory costs. We think the FTC would challenge fewer mergers, allowing industries with excess capacity to combine and restructure. In short, markets could be allowed to work with less regulatory friction, which tends to foster more favorable outcomes for asset prices.

Meanwhile downward pressures on inflation will likely persist. Labor markets are weakening, hiring rates are slowing in the private sector (a significant amount of the growth in non-farm payrolls has come from government related sectors), laid off workers in the office sector are having difficulty finding work, and virtually every leading indicator of inflation points

down. The Bloomberg Commodity Index has been relatively flat for years. Supply issues, not excessive demand, were responsible for the few commodities which have been rallying recently. Drought affected coffee supplies and avian flu reduced the hen flock, so coffee and eggs rose in price. As supplies are rebuilt, those prices should fall. The recent decline in pork prices reflects how the shortage of two years ago turned into glut once herds were rebuilt. The most powerful illustration of supply side recovery was the collapse in the price of natural gas which soared after Russia invaded Ukraine. A global price war is breaking out in electric vehicles. Consumers are moving toward cheaper substitutes and are seeking discounts. The staples companies could not sustain their COVID price increases. Potential price declines for commodities, insurance, rents and durables could be combined to bring the Fed-favored Personal Consumption deflator below their 2% target.

Looking toward the rest of the decade, productivity is the potential wildcard in the financial market outlook. Strong productivity means higher profits and that often leads to higher stock prices. Productivity has bounced around in the postwar years, averaging roughly 2.7% per year in the twenty-five years following WWII. This gauge fell to 1.5% between 1974 and 1994 even as the use of personal computers expanded tremendously. By the mid-2000s productivity rose 3% per year as the Internet emerged but then fell to 1.5% in the years afterward. This productivity paradox perplexed economists. In 1987, the late Nobel Laureate Robert Solow famously observed in the New York Times: *"you can see the computer age everywhere but in the productivity statistics."* Then, in the first three quarters of 2024, it suddenly rose just shy of 4%, a postwar record.

The results of a series of studies on the outlook for productivity improvement were recently presented in an article by Niel Weinberg in the University of Chicago Booth Business Review. They indicate that great technological innovations do not quickly generate high productivity gains because of "innovation bottlenecks." In other words, the infrastructure needed for the technology to work takes time to build because the uneven growth of suppliers creates bottlenecks. Once those bottlenecks are resolved, a productivity explosion can occur. "When lagging industries ultimately increase their innovation and growth rates, a rapid takeoff in aggregate productivity should ensue."

The authors also point out productivity numbers may be understated because companies are making intangible investments such as worker training and software development, which are necessary to utilize an emerging technology but whose payouts lay in the future. Major productivity enhancing technologies advance in fits and starts. For example, AI can only work when both employees and customers are trained to use it. Finally, the pandemic era saw a surge in new business formations, particularly in technology, and entrepreneurship is a powerful force for technological advances and the productivity growth that comes from them. It takes a while for these new businesses to develop.

If we are correct and savings in the private economy are rising faster than those savings can be invested, whatever shortages are making inflation appear "sticky" should disappear over time. This savings glut is starting to appear in the Federal Reserve statistics. The non-financial sector saw debt/equity ratio fall to 18.5% from 23.5% a year ago.

In conclusion, the outlook for capital markets in 2025 appears promising, with both fixed income and equity markets poised for strength. The combination of declining inflation, improving supply chains, and potential productivity gains driven by technological advancements creates a favorable environment for asset prices. As regulatory friction potentially eases and markets are allowed to work more efficiently, investors can look forward to potentially positive outcomes across various sectors, setting the stage for a bullish sentiment in the coming year.

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