Goldman Sachs Exchanges

Keep on truckin': Will US equities keep outperforming?

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Allison Nathan: After another stellar year for US equities, how should investors position themselves for 2025? I'm Allison Nathan and this is Goldman Sachs Exchanges.

Today I have the pleasure of sitting down once again with Sharmin Mossavar-Rahmani. Sharmin is the Chief Investment Officer of Goldman Sachs Wealth Management and the head of the Investment Strategy Group. Sharmin and her team recently published their 17th annual outlook in which they share their investment themes and recommendations for clients.

Sharmin, welcome back to Exchanges.

Sharmin Mossavar-Rahmani: Thank you very much, Allison. And until you said 17th, it hadn't registered that there were that many of them. But yep, quite a few.

Allison Nathan: Time flies. So, let's start at the beginning as I always like to do and talk first about the cover of your piece and the title, in particular, which I know you and your team put tremendous thought in. I say this every year, but every year it's very true. This year's piece is entitled "Keep On Truckin'." So, talk to us about why you chose this title.

Sharmin Mossavar-Rahmani: As you know, and hopefully many of your listeners already know, US preeminence has been one of our key investment themes. So, we're always trying to convey the message that that investment theme is still valid. Maybe at some point it won't be. But we can't foresee any such change.

So, again here when we say, "Keep On Truckin'" and we have a big image of something very US oriented, we're trying to convey the message that US Preeminence is intact. And in fact, the US keeps on trucking ahead of everybody else. And the distance between the US and these other countries just continues to get longer and longer.

Allison Nathan: Absolutely. You could not have been more right on that theme that we discussed quite comprehensively last year at this time. But even in prior years. But 2024 was certainly a year of US dominance.

But we now had yet another year of phenomenal US stock performance. And valuations really by most measures are very, very stretched. So, even if you believe that companies in the US are going to continue to outperform, is that already fully priced in?

Sharmin Mossavar-Rahmani: That's an excellent question that a lot of our clients are asking. So, on the US side, clients are saying given how well the US has done, shouldn't we actually continue to be just invested in US equities? And why do we even have any other assets outside of US equities, whether it's public or private, but just the concept of non-US developed equities or emerging market equities? And the non-US clients are saying given how expensive US equities are, why not tactically shift towards non-US equities?

And our view is that while US equities are expensive, when we actually look at valuations in this environment, we're saying that valuations alone and the level of concentration in the S&P 500 index for example, alone, are actually not good indicators of the next year's returns. So, in fact, if you look at these valuation metrics and you look at the range of returns that we've had at different valuation metrics and you look at, let's say, a scatter chart, and we have some really good exhibits in the actual report, you see that there's no significance to either of these measures in terms of forecasting the next year's return. So, that is actually not a very relevant factor.

For us, the fact that US GDP is going to be well above trend, somewhere around 2.3 percent based on our numbers. We know that Goldman Sachs Research has a slightly higher number than we do. But generally, a very good economic backdrop that is more likely to generate really good earnings. And so, with good earnings, we think these valuations are manageable.

Now, longer term, it's a different picture. Are we going to get somewhat lower valuations over the next five years? Yes. But we also extensively discuss that it is a myth that equity valuations are mean reverting to a long term, let's say post World War II mean.

Allison Nathan: Interesting. So, where does that leave you, that valuation perspective, and your earnings expectations leave you for returns for US equities in 2025?

Sharmin Mossavar-Rahmani: So, when we look at the returns for US equities and look at returns outside the US, basically we're talking about returns somewhere depending on the country between 7, 8, 9 percent. So, for the US, our base case is an 8 percent return. This compares to a 6 percent from last year. But we don't want clients to think we're actually more bullish because this 8 percent would have been a lower number if we didn't have the down draft we had over the last several weeks of 2024. So, in fact, the number's a tad higher only because we had that big down draft.

So, our base case returns are somewhat similar. And then in terms of our upside, we actually have a reasonable probability that US equities will do better than that. That's why we look at the returns and we say stay invested. Between the base case returns and the upside, we think you're going to have pretty attractive returns.

Allison Nathan: But just to put that into perspective, that's down from high double digit returns in 2024.

Sharmin Mossavar-Rahmani: Yes. We've had two years in a row of returns over 20 percent. So, when we think about valuations, we totally agree that US equities are expensive. In fact, we have a series of metrics we look at, and based on these metrics, either we're in the ninth or tenth decile of valuation metrics. So, no doubt, very expensive.

But, for example, we were in the ninth decile in 2013, and equities were up several hundred percent over a long period of time. So, I don't think valuations alone tell you you can't continue to have good returns. And in a good economic environment, our base case is you're going to get good earnings growth. And so, hence, stay invested.

Allison Nathan: What about interest rates? I have to ask you this because, of course today again, we had a blockbuster payroll number in the US and we've seen interest rates, the 10 year, in the US, moving up close to 5 percent. Many investors now think they're going to be at 5 percent or above 5 percent in 2025. Does that pose any risk to your view?

Sharmin Mossavar-Rahmani: Our base case is that interest rates will come down. Now, the market is very jittery because they're worried about tariffs. They're worried about do we have a trade war. Could that create inflation? But our base case is that we will have some tariffs. It's not going to be anywhere immediately to the full level that was discussed during the campaign. And so, if they're incremental and there's going to be going back and forth, you'll have a lot of market volatility.

But the key driver of inflation will be other factors. And we'll continue to have a steady lowering of inflation. Nothing too dramatic. But slowly, slowly going down. And that will actually lower interest rates.

So, we expect fixed income rates to actually be a little bit lower. But what's really interesting is the vast majority of corporate debt in the US is fixed. So, in terms of affecting companies and having a negative impact, it's actually negligible. The interest burden of US companies right now is so low because we had interest rates at such a low level.

So, that’s not going to be a major factor. The question is, are we going to use a totally different discount rate for forward earnings? So, obviously, if rates were to go to 5 percent or higher, that would be a factor. But that’s not our base case.

In addition, people are saying rates could go higher because of the debt trajectory of the US. And we’ve done a lot of work, as have your colleagues in the economics research team that it is not an immediate concern. It’s really a much more long-term concern. And there’s enough time to actually change that debt trajectory. So, we’re not concerned that in the next year or two we have to do something about the budget deficit.

Allison Nathan: So, you’re at, as you said, 7 to 8 percent for US equity returns and returns of some of the major other indices in developed markets. Where does that leave you in terms of your overall asset allocation strategy recommendations for ’25 in the context of what you’ve just mentioned about rates as well?

Sharmin Mossavar-Rahmani: We have been overweight US equities for quite some time. So, if we go back to 2009 during the global financial crisis, the overweight that we had in our strategic asset allocation recommendation for clients was about 23 percent. So, we were looking at the overall benchmark, let's say the MSCI All Country World Index, where were US equities? And we were significantly overweight.

But as US equities have continued to outperform, the weight in the index has gone up and now we're only overweight by 7 percent. So, we said, well, that's too little given our view of US preeminence. So, either we could shift out of non-US equities, both developed and emerging markets and go into US equities. Or we actually made a decision to say we will lower that allocation to non-US equities by a marginal amount. It's not a huge amount. And we'll actually put that in private assets, specifically in buy out and growth equity.

Our view is over the next 10 years, for example, buy out and growth equity, most of which tends to be US oriented, will outperform non-US developed and emerging market equities. And so, we made that shift. And that's, again, a long-term strategic shift.

Allison Nathan: Interesting. And when we think about these allocations though and just bringing up the question, I believe you said your clients outside the US are most asking though, yes you might see US companies continuing to outperform, but everything else looks so cheap in other major developed economies and beyond. So, to what extent though should that be considered a buying opportunity for some markets outside the US? Should there be some increase in allocations at all to some of these places?

Sharmin Mossavar-Rahmani: Our response to that question for clients is that, yes, when you look at the numbers at a very superficial level, it looks like they're extremely cheap. By any measure, the discount is, let's say in non-US developed economies, at historic lows. We actually have never seen them be so low, the discounts relative to the US.

However, our view is you need to actually dig a little bit deeper to understand what is the true level of cheapness. What do we mean by that? If you look at US equities, 30 percent of the earnings of the S&P 500 for example comes from the broad technology sector. If you look at the UK equity market, which is one of the cheapest out there, only

1 percent comes from the technology sector.

So, if you have a bigger weight to a sector that trades at a higher valuation because the earnings growth is much faster, then you're not really comparing apples to apples. So, if you look at the UK, it looks cheaper partly because it has so little technology.

Another sector to look at is the energy sector. The energy sector is a mid single digit in the S&P 500. It's double digits in the UK market. And so, again, that's a much cheaper sector. So, the UK has less a more expensive sector. And a lot more of a cheaper sector. And so, you need to make that adjustment. And suddenly, these markets do not appear as cheap.

And so, our view is, yes, they are cheap. They're not as cheap as it appears initially. And then when we make this sector adjustment, one of the questions we're asking ourselves is what is the right discount for these various countries? What is the discount they should have relative to the US given it is a faster economically growing country, it has a very diverse economy, and it is not exposed meaningfully to a slowdown in China's economy? A lot of these other markets are going to be severely impacted as China's economy continues to steadily, really steadily slow down.

Allison Nathan: So, does it go without saying given your views on China in the past that have been very pessimistic and very, very right, honestly, that China is not a buy here, even though we are seeing more stimulus moving into the economy? And some investors seem to want to try to take advantage of the very low valuations there.

Sharmin Mossavar-Rahmani: One of our views about China is that China, at best, will follow the path of Japan. They will have a Japanese slow down. It's inevitable from our perspective. Not just because of demographics, but because of all kinds of headwinds that they're facing.

And so, when we look at the Japanese equity market since it peaked, you have had opportunities in the general down draft for big rallies. And so, we look at that and say, well, maybe China could follow that. Because they could have stimulus programs. They could make statements. Investors could get all excited. And you could have a rally, just like we had last year. But it's not sustainable.

And to give you a good comparison to Japan, if you look at Japanese equities, where were they at the end of 1989/1990 when the Japanese equity market bubble burst? It didn't not exceed that peak level until the summer of 2024. So, it's actually incredible that there've been opportunities to buy Japanese equities in big rallies, but they've all lasted a limited amount of time. And then we've had a down draft.

And so, again, if at best China follows the path of Japan, that would be why it's a trading environment, not an investing environment.

Allison Nathan: The other asset I wanted to ask you about is gold. It had a very strong year in 2024. And it is historically thought of as an inflation hedge. And as we've been discussing, there are some concerns that inflation could resurge in 2025 off the back of Trump policies and, in general, the resilience of the US economy that we have been seeing. So, should gold be a bigger allocation in portfolios this year?

Sharmin Mossavar-Rahmani: We've done a lot of work on commodities in general and in gold and oil specifically. They're definitely not strategic asset classes. There are times where you want to be tactical. And over the life of the Investment Strategy Group, we have been tactical both on oil, on natural gas, on gold. And so, yes, there are opportunities to be tactical.

But right now, what is driving gold is not inflation. Because in fact, gold has shown not to be a good inflation hedge. In fact, US equities are the best inflation hedge. Gold and commodities are not a good hedge against inflation. And so, they're not a great store of value, nor short term a good inflation hedge.

So then, what is actually driving gold right now? It is significantly driven by central bank purchases. And then specifically, by Chinese purchases, both central banks and consumers. And so, how long will that last? Maybe China as a protection against any kinds of sanctions or freezing of assets if geopolitical tensions were to escalate. They want to diversify away from certain assets and own actually directly some gold for a while. That could continue and that could drive some upside. But that's, again, more of a trading issue and trying to figure out what China could be doing long term, which I think is very hard to predict.

And so, we're somewhat agnostic about the pricing. And we say we don't think we can predict it. And so, we don't think clients should tactically get engaged.

Allison Nathan: I think that's an interesting point because empirically you're saying gold has not shown to be a good inflation hedge, even though many investors think it is. So, interesting point there.

Should I even dare to ask you about bitcoin which is another asset that investors seem to be excited about in this type of environment in particular? And, ultimately, we have seen more institutional investors getting involved. We've seen a proliferation of instruments that allow them to do so. So, where do you stand on bitcoin today or crypto in general?

Sharmin Mossavar-Rahmani: So, when it comes to bitcoin or crypto in general, we have not changed our view. There's a great quote that we refer to from an information gathering firm. And they curate information and present it. And they had a great quote, and we refer to it in our outlook that price action creates its own investment thesis. So, just because prices have gone up, now everybody's coming up with reasons one should own bitcoin. And we're like, that is not a legitimate argument.

What is the underlying investment rationale to own or not own bitcoin? And we've had this view all along. We've said it is not an investment asset class. If you think about it, it doesn't generate cash flows. It doesn't generate earnings. It's not a portfolio diversifier. It doesn't dampen volatility. You could go through all the different reasons. So, it's still not an investment asset class, but it is a trading speculative asset. And so, if people want to speculate, then they should. But it's not something we recommend. Because there's no way of knowing if the current price is a good price. There's no way of actually assigning value to something.

And there's certainly no shortage of cryptocurrencies. A lot of the rally that came in bitcoin came after the election. And there's a view that a lot of people have that this administration will make a huge difference to it. But the actual value argument hasn't really changed.

Allison Nathan: So, given everything we've discussed, is this the kind of environment in which you want to be hedging your portfolio?

Sharmin Mossavar-Rahmani: The most important recommendation we make to clients so that they can withstand the unknown volatility is to make sure they have a strategic asset allocation that allows them to withstand the downside. Because hedging is expensive. If you buy a lot of put options to protect yourself against equity market downside or if you go out of equities whether it's US or non-US, you can be giving up a lot of upside. And if you're a US taxpayer, you'd certainly be paying a lot of taxes if you sell your current equities with a lot of gains.

And so, the best way to prepare for this volatility is to make sure you have the right strategic asset allocation that would have enough fixed income in it. High quality fixed income, long term, is the best hedge and gives clients the ability to withstand that interim volatility. Because, actually, hedging with derivatives is very expensive. You could be hedging against the downside. And need to buy options for a couple of years before anything happens. And so, that is not our recommendation.

Allison Nathan: Sharmin, always a pleasure to talk to you. Thanks so much for joining us today.

Sharmin Mossavar-Rahmani: Thank you very much.

Allison Nathan: If you want to learn more about the ISG Outlook, you can find a link to their report in the description.

This episode of Goldman Sachs Exchanges was recorded on Friday, January 10^{th}, 2025. I'm your host Allison Nathan. Thank you for listening.

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