Goldman Sachs | Portfolio Strategy Research

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Global Equity Strategy

2025 Outlook: The Year of the Alpha Bet

The Year of the Alpha Bet

- We are entering a benign part of the cycle; interest rate cuts that coincide with economic growth tend to be supportive for equities.
- Nevertheless, global equities have already risen 40% since October 2023 leaving them more vulnerable to any disappointments.
- Equity valuations have increased and leave little room for further valuation expansion. We expect index returns to be driven largely by earnings growth.
- We forecast total equity returns in US$ of 10% through to the end of 2025.
- Given high valuations and unusually high concentration in equity markets, we focus on diversification to improve risk adjusted returns.
- We prefer a more eclectic mix of sector and styles with an increase in focus on Alpha relative to Beta.
- We highlight 4 themes: market broadening opportunities, selective value, geographical diversification and enhanced capital market activity.

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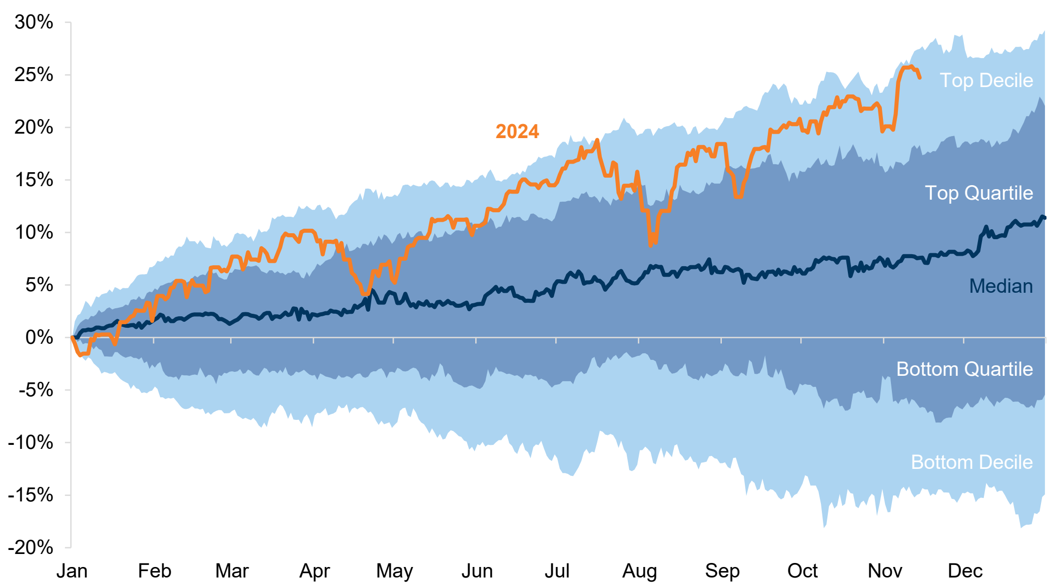
The Year of the Alpha Bet

It is tempting, as we approach a new year, to assume that the clock resets, and we start anew. While it is true that performance is typically measured in yearly increments, it is also important to recognize that context matters. Some years, like 2021 or 2023, follow periods of falling equity prices and low valuations, while others, like 2025, come after already strong rallies. As Exhibit 1 illustrates, the rise in the S&P 500 in 2024 has been one of the strongest since 1928. More strikingly, the current equity upswing began in October 2023, driven by optimism in peak inflation and the prospect of a 'Fed pivot'. Since then, the MSCI world index is up nearly 40% in price terms alone (and around 60% since the trough triggered by rising interest rates in 2022), the Nasdaq has climbed over 50% and the World's biggest company, Nvidia, has surged 264%.

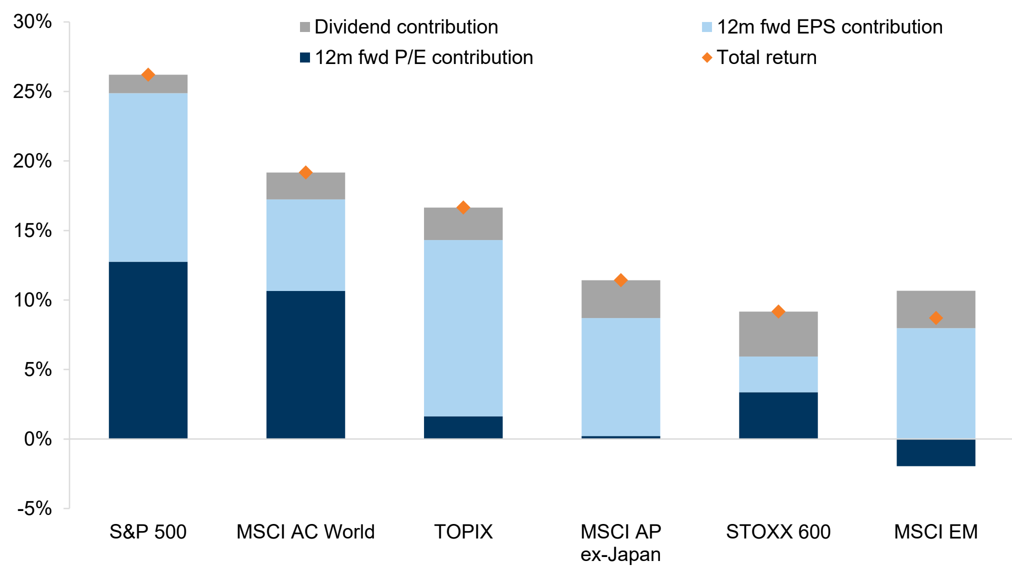
Exhibit 1: The rise in the S&P in 2024 has been one of the strongest since 1928
Calendarized S&P 500 performance since 1928



Source: Bloomberg, Datastream, Goldman Sachs Global Investment Research

This spectacular return has, in part, been driven by profit growth. But around half of the equity return globally in 2024 has come from valuation expansion, driven by growing optimism in lower inflation and interest rates (Exhibit 2).

Exhibit 2: Half of the equity return globally in 2024 has come from valuation expansion reflecting growing optimism in lower interest rates
Global indices YTD return contribution in local currency

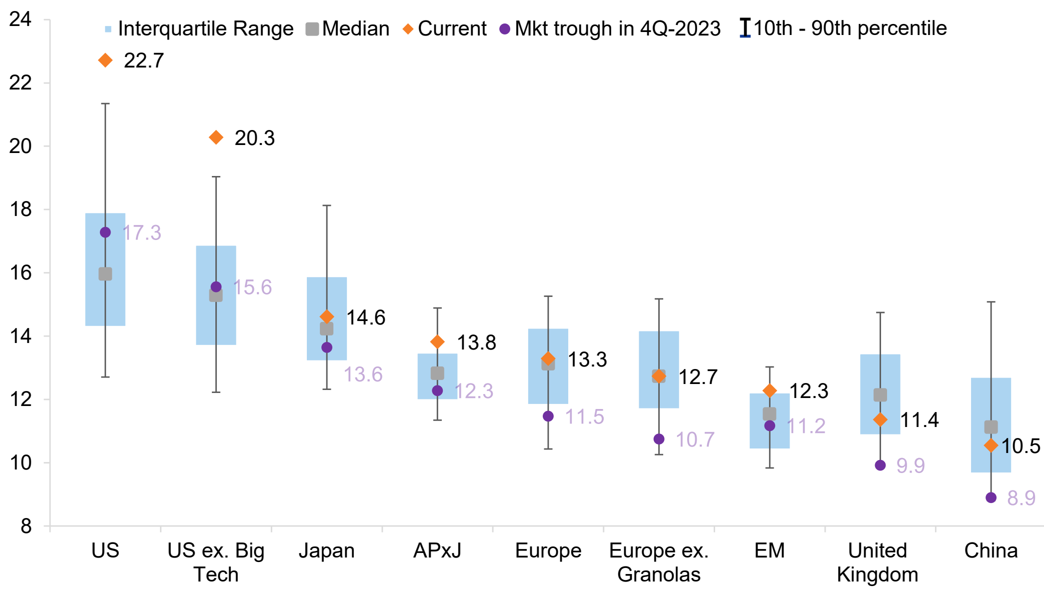


Source: Datastream, Goldman Sachs Global Investment Research

Valuation validation

The expansion of P/E ratios in the current bull market has pushed valuations of equities (as well as credit) to historically high levels, particularly in the US. Outside of the US, while absolute valuations are lower, valuations have increased throughout 2024 (in Exhibit 3 the purple measures the minimum PE ratio in 4Q-2023). Even the weaker economies facing greater structural headwinds (like Europe and China) have seen their stock markets enjoying a sharp re-rating since the Q4 2023 trough, leaving them broadly in line with long-run averages - they are no longer cheap.

Exhibit 3: All regions have experienced a rise in valuations through 2024
12m fwd P/E, MSCI regions; data since 2003



Source: FactSet, Goldman Sachs Global Investment Research

For the US equity market, the 12-month forward PE is well above its previous 20-year high and mean. While this is partly explained by the higher valuation of mega cap technology companies, the US equity market is still trading at close to record valuations even if we exclude these companies. Furthermore, the stretched valuation in the US equity market is reflected across most standard valuation metrics (Exhibit 4), with the median 'absolute valuation metric' in the 97th percentile compared with history.

Exhibit 4: The stretched valuation in the US equity market is reflected across most standard valuation metrics
Data since 1976, unless noted otherwise

	Aggregate index		Median stock	
Metrics	**Current**	**Historical %ile**	**Current**	**Historical %ile**
EV / sales	3.4	100 %	3.5	97 %
Cash flow yield (CFO)*	5.1 %	100 %	5.8 %	95 %
Price / book*	5.3	99 %	3.7	98 %
EV / EBITDA*	16.5	97 %	13.8	94 %
Forward P/E	22.3	95 %	19.2	95 %
Cyclically adjusted P/E (CAPE)	34.3	96 %	NA	NA
Free cash flow yield*	2.9 %	77 %	3.6 %	63 %
Median absolute metric		**97 %**		**95 %**
Yield gap vs. real 10-year UST	240 bp	91 %	310 bp	90 %
Yield gap vs. 10-year UST	6 bp	89 %	76 bp	71 %
Yield gap vs. IG**	-76 bp	88 %	-5 bp	84 %
Median relative metric		**89 %**		**84 %**

**data since 1987*
***data since 1999*

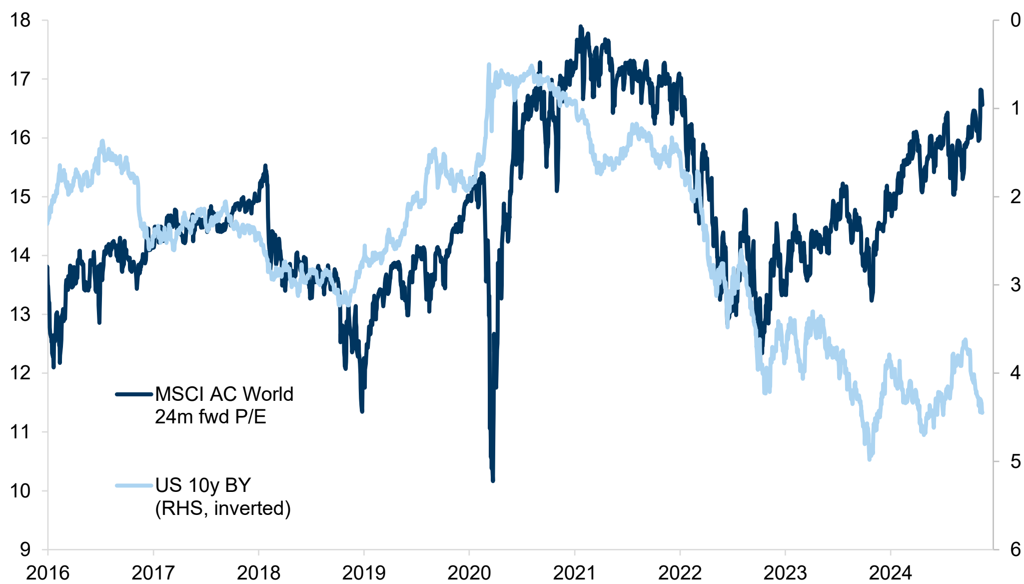
Source: Compustat, Goldman Sachs Global Investment Research

The growth and interest rate mix - priced for perfection

This rise in valuation has, to some extent, been driven and justified by interest rate cuts. Nevertheless, longer-term interest rates have been more sticky, driving a wedge between the 'typical' relationship between bond yields and PE ratios (Exhibit 5).

Exhibit 5: Long-term interest rates have been rising, driving a wedge between the 'typical' relationship between bond yields and PE ratios

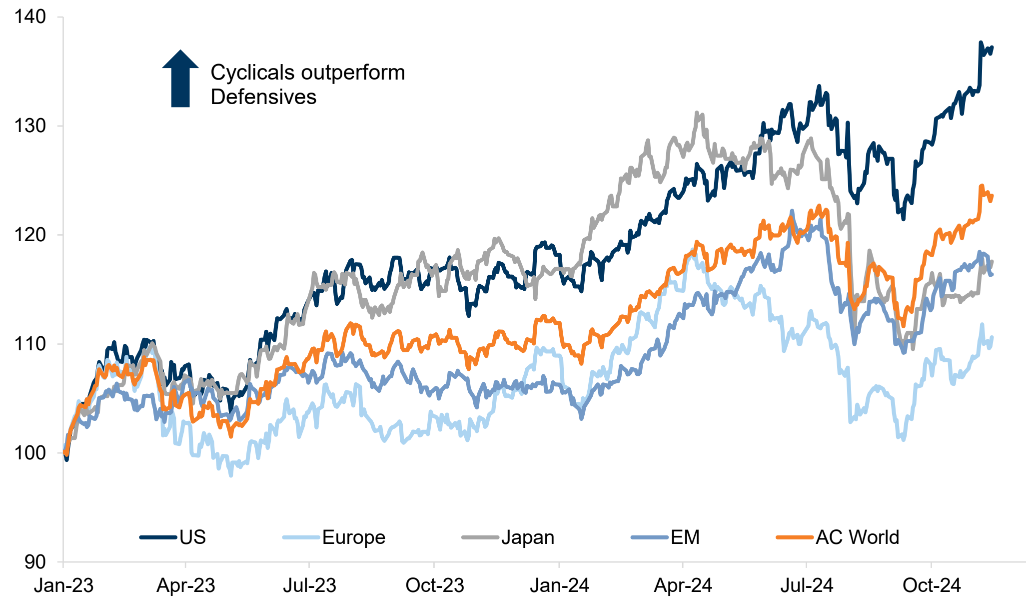
MSCI AC World 24 fwd P/E and US 10y BY (RHS, inverted)



Source: Datastream, Goldman Sachs Global Investment Research

The de-coupling of bond yields and equity valuations implies a fall in the equity risk premium (ERP) which can only be explained by increased confidence in future growth. From a cyclical perspective, this has been reflected in the outperformance of cyclical versus defensive sectors in most regions in recent months, and particularly so in the US (Exhibit 6).

Exhibit 6: The outperformance of cyclical versus defensive sectors in most regions in recent months, and particularly so in the US, suggests greater confidence in the trajectory of future growth
Cyclicals vs. defensives price performance. Indexed to 100 on 01-Jan 2023

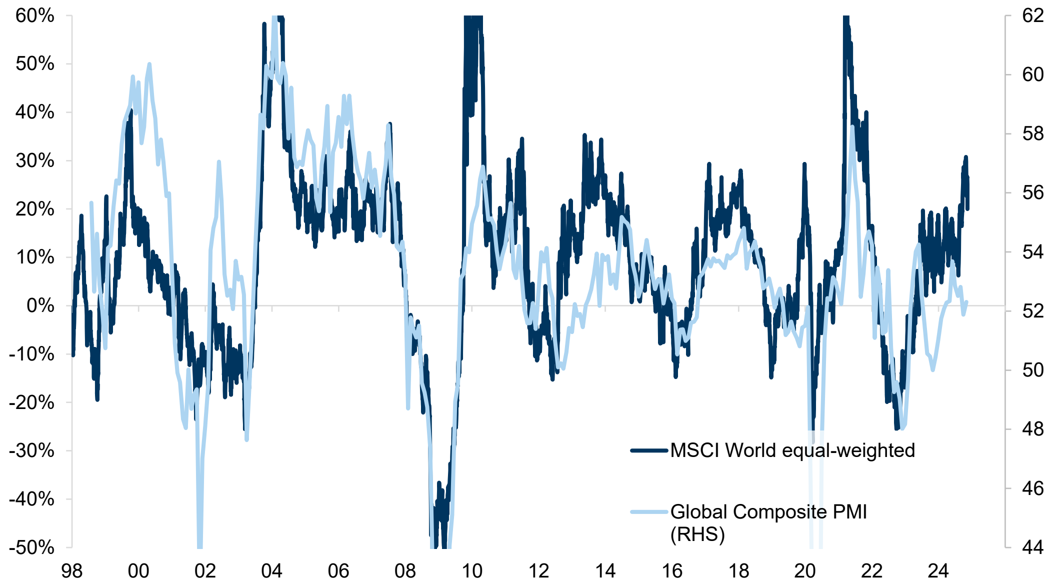


For details on the construction of the indices, please see: Cyclicals vs. Defensives: A global implementation

Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

For much of 2023 and 2024, this growth confidence was particularly elevated in the dominant technology stocks, while others were more subdued. More recently, however, growth optimism has spread beyond the mega cap AI beneficiaries and been reflected in the equal weighted global stock market index (Exhibit 7). Our economists remain confident about continued growth throughout 2025; for the US, they forecast 2.5% real GDP growth in 2025 compared with a consensus of 1.9%, although they are below consensus in Europe (0.8% compared with a consensus of 1.2%) and see relatively low recession probabilities, particularly in the US. That said, with growth expectations already elevated, there is less room for further optimism, while elevated valuations leave less upside potential for increases in valuation to be a meaningful driver of returns.

Exhibit 7: Stock markets have reflected a broad re-pricing of growth risks
MSCI World equal-weighted y/y returns

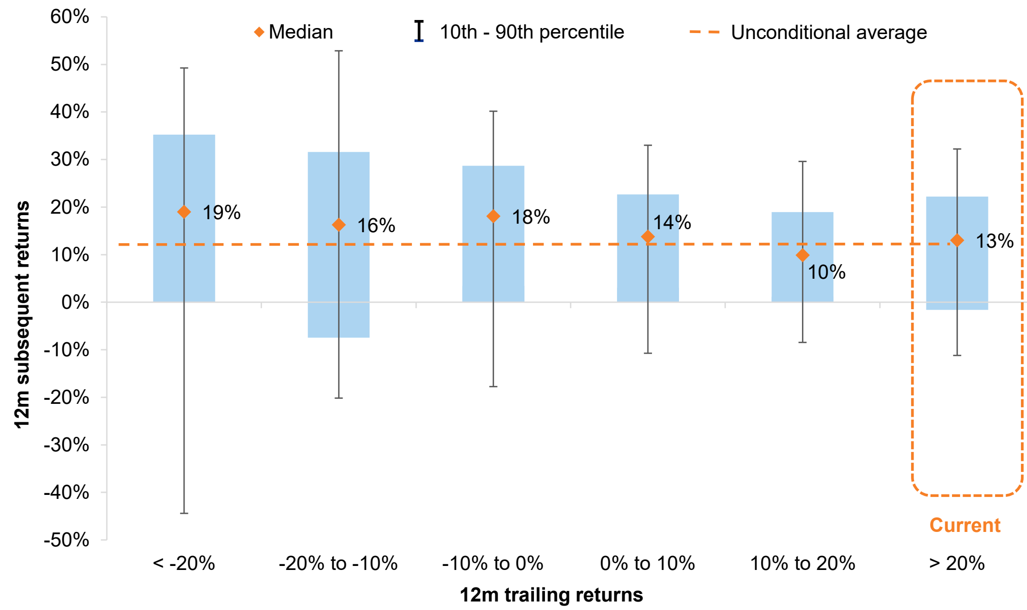


Source: Datastream, Haver Analytics, Goldman Sachs Global Investment Research

Do valuations determine future returns?

The fact that equities have gone up a great deal already does not, in itself, hamper the prospects for further gains from here. As Exhibit 8 shows, taking data back to 1929, the median 1-year forward return in the US equity market does not vary very much based on the past year's performance. That said, the high valuation may have more of an impact on dampening returns.

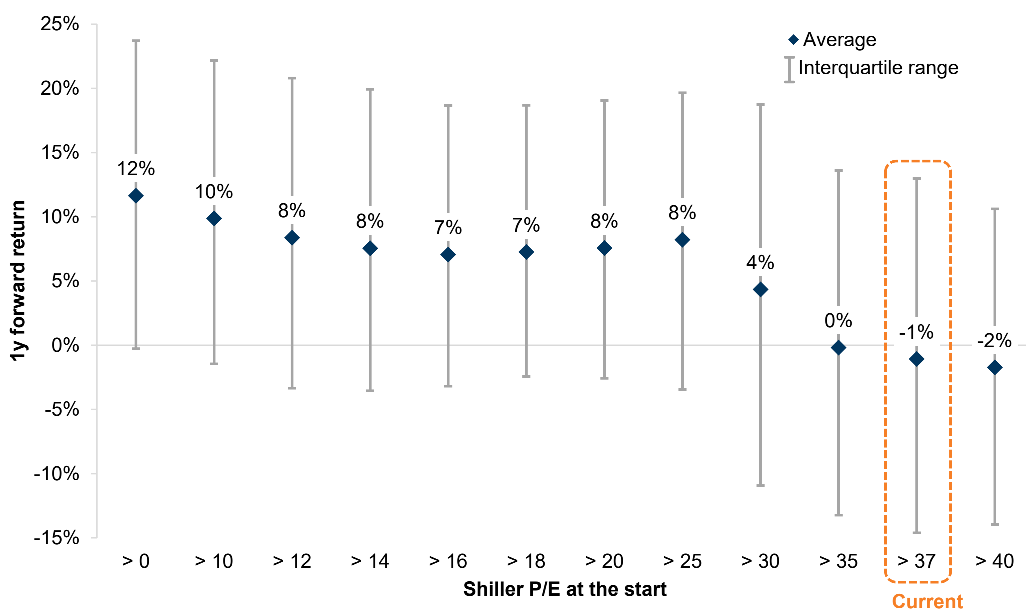
Exhibit 8: Strong past returns does not imply poor subsequent performance
1-year forward S&P 500 returns following 1-year trailing returns; history since 1929



Source: Bloomberg, Datastream, Goldman Sachs Global Investment Research

The current valuation of the equity markets, particularly the US on a 'Shiller', or cyclically adjusted earnings basis, is particularly high (Exhibit 9). There have been few historical precedents over the period since 1929; those few that exist suggest poor future returns on a one-year basis.

Exhibit 9: Current valuation of the equity markets on a 'Shiller', or cyclically adjusted earnings basis, is particularly high
1-year forward S&P 500 returns conditional on Shiller P/E; history since 1929



Source: Bloomberg, Datastream, Robert Shiller, Goldman Sachs Global Investment Research

Given the high starting point in valuations, the index progress from here will depend to a great extent on the pace of profit growth. As Exhibit 10 shows, when global equities have a high valuation (currently around 18x), the next 12-month returns are generally only good if earnings revisions are positive. Periods of high valuation and earnings downgrades are typically associated with relatively flat market returns.

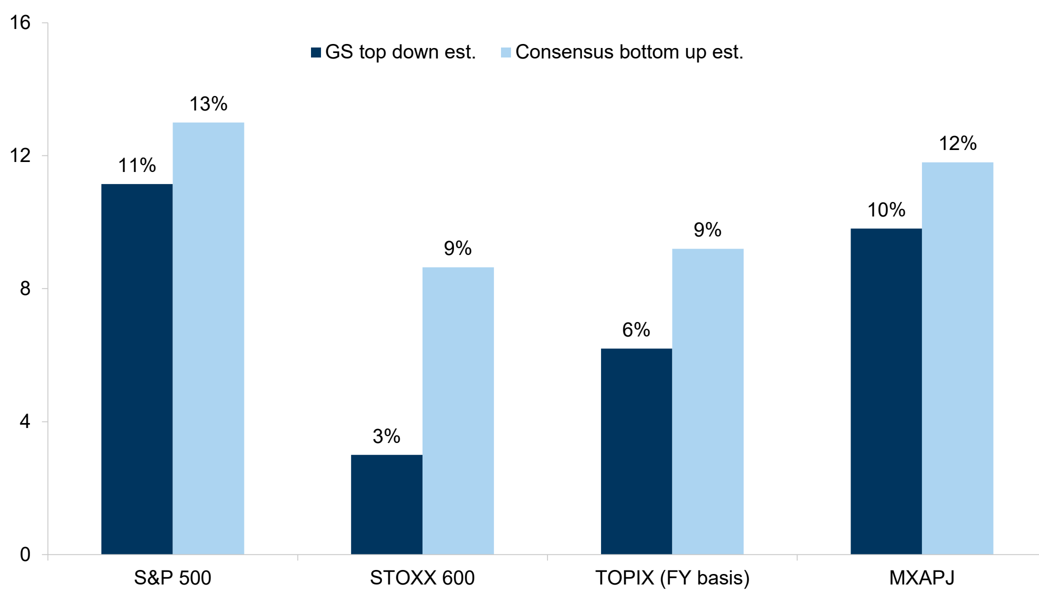
Exhibit 10: When global equities have a high valuation (currently around 18x), the next 12-month returns are generally only good if earnings revisions are positive

MSCI ACWI Forward Return by Starting PE and Forward Earnings (past 20 years)							
		With Upgrades in Earnings			With Downgrades in Earnings		
Starting PE	# obs	3-mo	6-mo	12-mo	3-mo	6-mo	12-mo
Less than 13x	51	6 %	13 %	26 %	(1)%	(0)%	4 %
13x to 14x	32	4 %	9 %	19 %	3 %	3 %	3 %
14x to 15x	64	4 %	6 %	11 %	1 %	2 %	2 %
15x to 16x	46	4 %	9 %	15 %	0 %	1 %	6 %
Greater than 16x	48	3 %	5 %	10 %	(1)%	2 %	(2)%
Aggregate	**241**	**4 %**	**7 %**	**14 %**	**0 %**	**1 %**	**3 %**

Source: MSCI, FactSet, IBES, Goldman Sachs Global Investment Research

In general, our forecasts point to positive earnings growth but lower than forecast by consensus, largely reflecting our view that margins have peaked in most regions (Exhibit 11).

Exhibit 11: Our forecasts point to positive earnings growth but lower than forecast by consensus
GS top-down vs. consensus bottom-up estimates of 2025 EPS growth



Source: I/B/E/S, Toyo Keizai, STOXX, MSCI, Goldman Sachs Global Investment Research

With these positive but moderate earnings growth rates, we expect slower index returns than have been experienced in recent months (Exhibit 12). Over the course of 2025 (Exhibit 13), for the asset class overall we forecast total US$ returns of c.10%.

Exhibit 12: Key market forecasts
Data as of November 14, 2024

	Index Level		Price Return		Total Return**	
	Current	12m	Local	USD*	Local	USD*
S&P 500	5949	6500	9%	9%	11%	11%
STOXX Europe 600	507	530	5%	2%	8%	6%
TOPIX	2701	3100	15%	13%	17%	15%
MSCI Asia-Pacific ex Jp ($)	574	630	10%	10%	12%	12%
Global Equities***	-	-	9%	9%	11%	11%

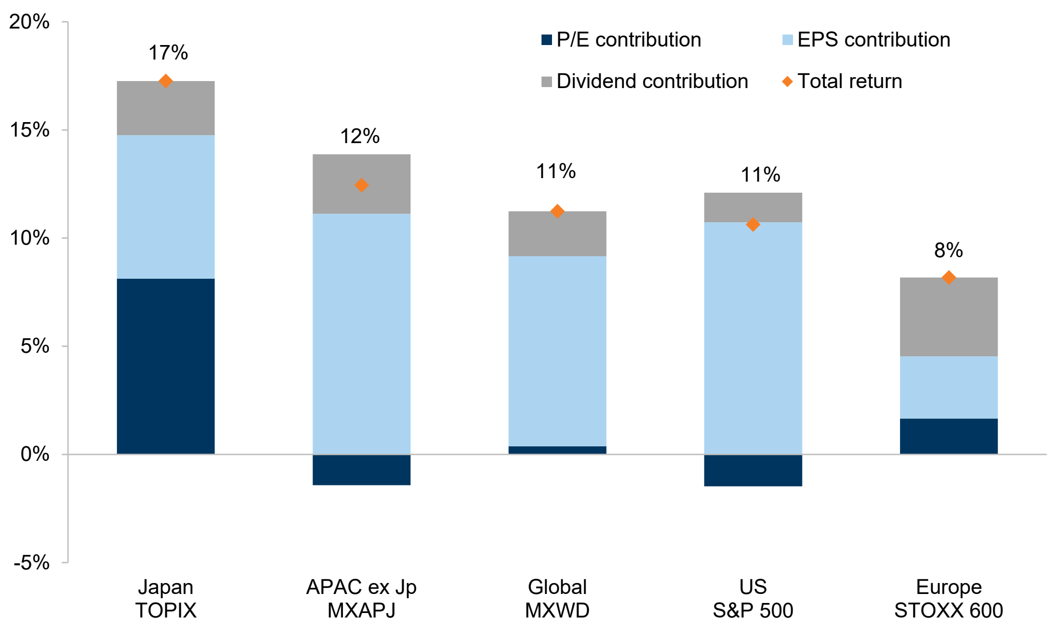
** GS FX Strategy forecast*

*** Consensus 12m fwd Dividend*

**** Mkt cap weighted avg of our regional forecasts*

Source: Bloomberg, Datastream, FactSet, STOXX, Goldman Sachs Global Investment Research

Exhibit 13: Our expectation is that in most regions, earnings will become the key driver of index returns over the course of 2025
GS 12-month total return forecast (in local currency)

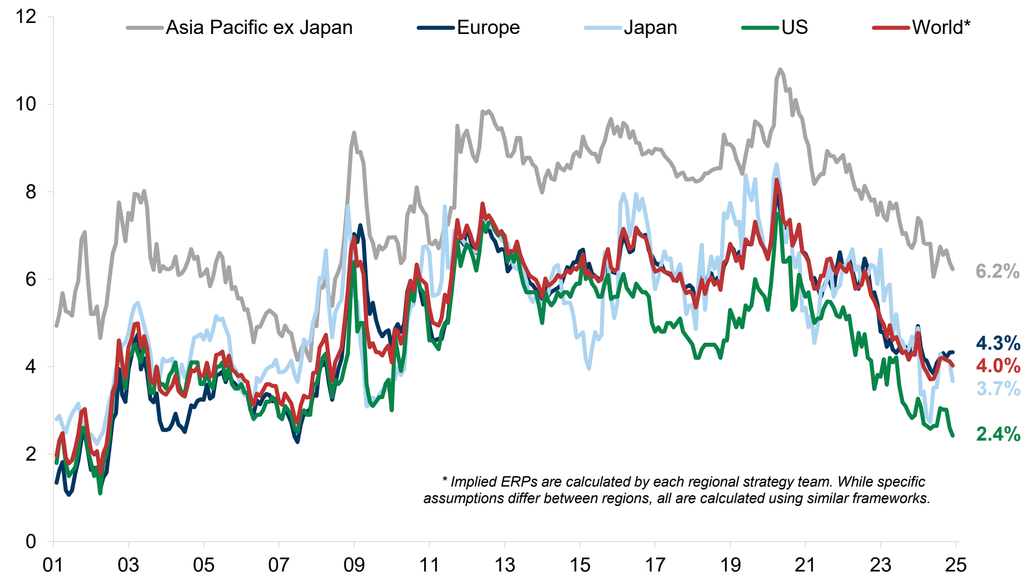


Source: Goldman Sachs Global Investment Research

Navigating the risks

There are two risks in particular that investors face as we approach 2025. The first is that the recent wave of optimism has front loaded returns, leaving them vulnerable to a correction. There are still many unknowns around tariff risks, for example, and the impact on global growth and inflation. While we expect a modest decline in bond yields in 2025, any further rise in bond yields - driven by fiscal pressures - would likely tip the balance for equities given the relatively low ERP (Exhibit 14).

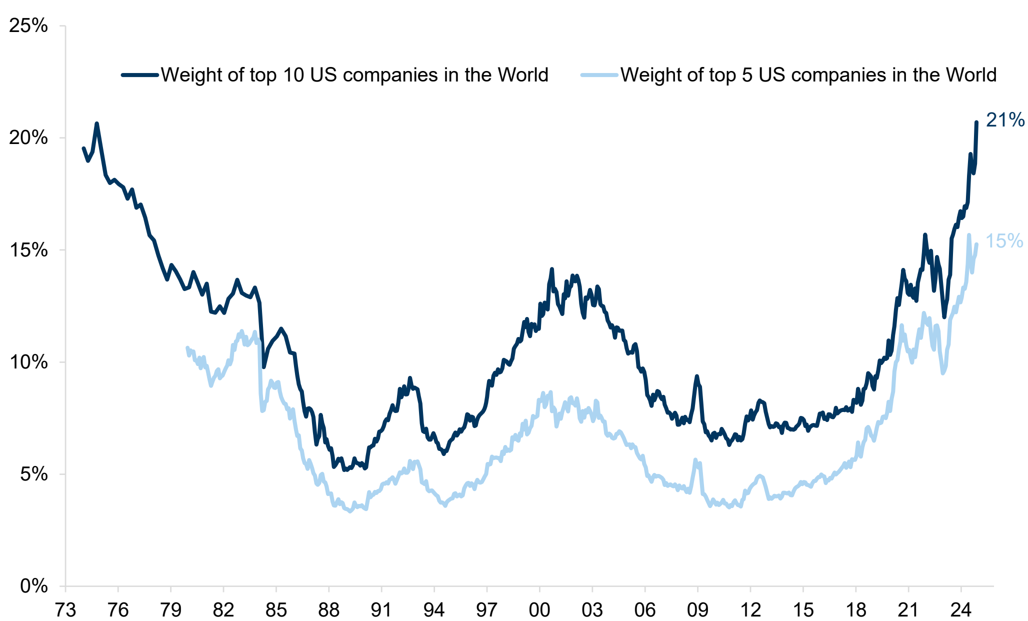
Exhibit 14: Any further rise in bond yield would likely tip the balance for equities given the relatively low ERP
Global market implied ERP (%)



Source: Goldman Sachs Global Investment Research

The second relates to the unusual degree of market concentration. The US equity market is around 70% of the MSCI AC World Index and the biggest 10 US stocks account for over 20% of the entire value of the global index (Exhibit 15).

Exhibit 15: The biggest 10 US stocks account for over 20% of the entire value of the global index
Weight of biggest US companies in global market cap

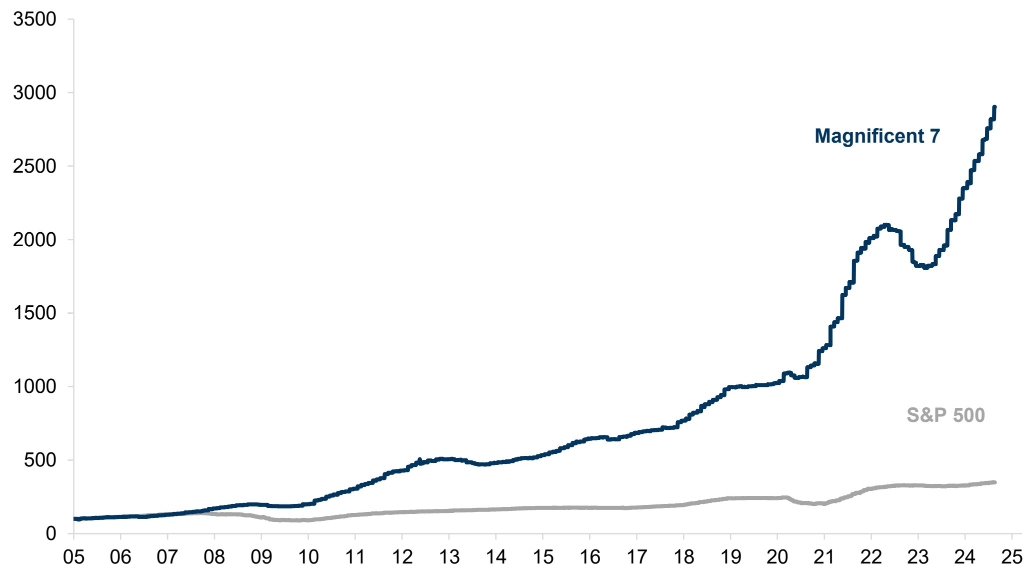


Source: Datastream, Goldman Sachs Global Investment Research

The good news is that the biggest US companies have outperformed the index for good reason – they have generated much stronger profit growth (Exhibit 16).

Exhibit 16: The biggest US companies have outperformed the index for good reason – they have generated much stronger profit growth

Magnificent Seven and S&P 500, 12m trailing EPS

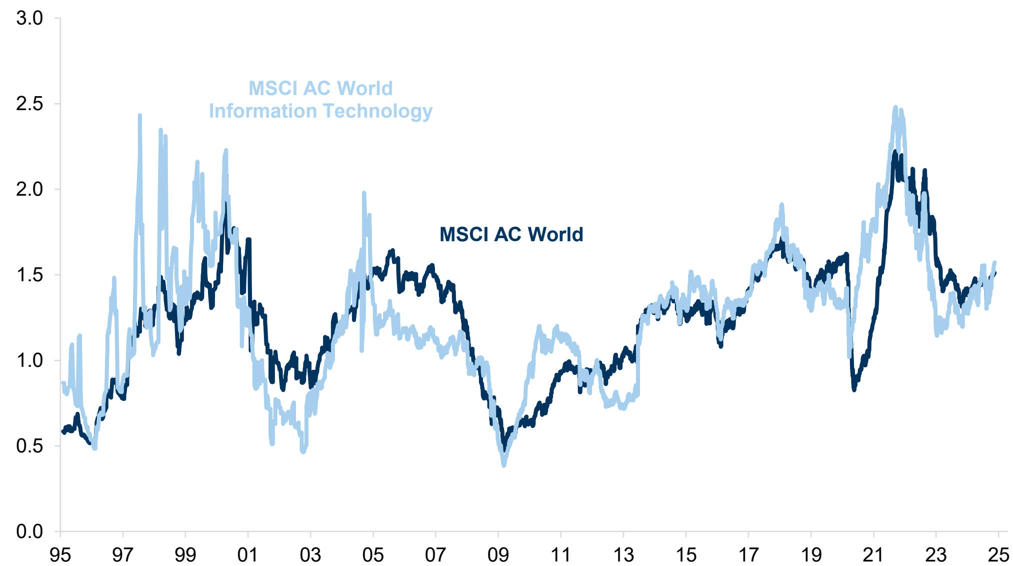


Magnificent 7 is a list of companies including: Meta, Amazon, Apple, Microsoft, Alphabet, Tesla, NVIDIA

Source: Datastream, Goldman Sachs Global Investment Research

This means that their prominence has reflected their premium fundamentals, and has not been driven by excessive valuation. The technology sector, for example, has a PEG ratio (valuation relative to expected growth) which is in line with the rest of the equity complex (Exhibit 17).

Exhibit 17: The technology sector has a PEG ratio which is in line with the rest of the equity complex
PEG ratio (12m fwd P/E divided by second 12m EPS growth)



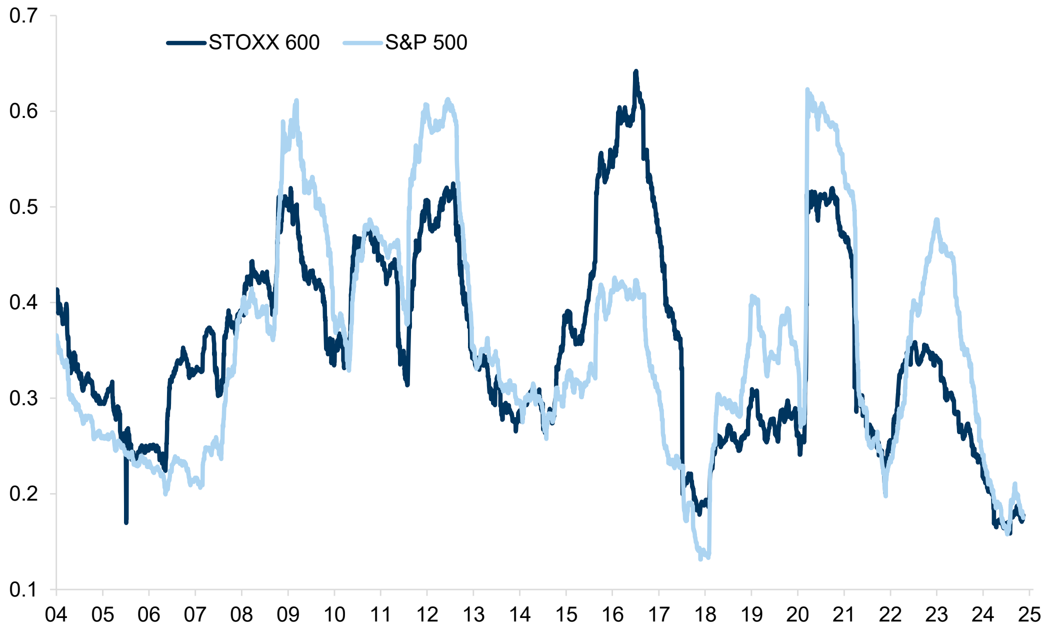
Source: Datastream, Goldman Sachs Global Investment Research

Nonetheless, there are risks when markets become highly concentrated. One risk is reflected in the shift in mega cap technology from being relatively capital-light to capital-intensive. The prospective return on this capital invested is likely to fade. Historically, it has been difficult for any firm to maintain high sales growth and profit margins over sustained periods of time. During the past 40 years, the share of companies that have been able to grow sales at a rate of 20% faded sharply over a decade and only 3% of firms maintained this pace of growth for 10 years. Our US strategists have also emphasized that fewer than 1% of firms maintained EBIT margins of >50% for 10 consecutive years. Despite this historical context, consensus long-term growth expectations for the 10 largest stocks in the S&P 500 are currently in the 99th percentile relative to the past two decades. This is not a reason to underweight large cap technology - we do not think that these companies are in a valuation bubble, but we do think this provides an opportunity for investors to diversify exposure to a greater extent in 2025 in order to enhace risk adjusted returns.

Diversify to amplify

Given that broad equity valuations are full, profit growth is likely to be moderate and markets are highly concentrated, we continue to focus on **diversification and alpha generation.** Pairwise correlations on a 12-month rolling basis have fallen (Exhibit 18), suggesting a more attractive opportunity set for alpha generation. **What strategies might investors look at?**

Exhibit 18: Pairwise correlations on a 12-month rolling basis have fallen, suggesting a more attractive opportunity set for alpha generation
12m Average Pairwise Correlation

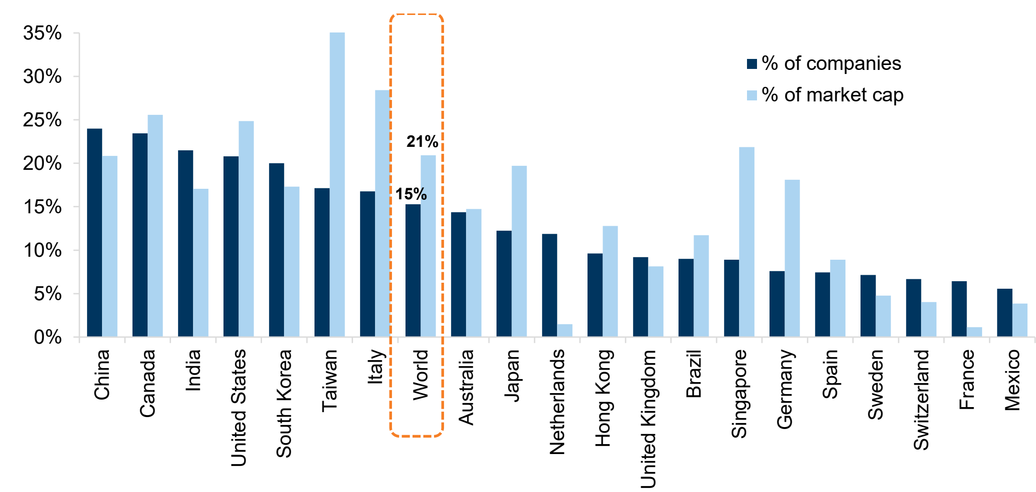


Source: Bloomberg, Goldman Sachs Global Investment Research

1) Broader participation

The reality for portfolio managers is that it has been particularly difficult to outperform mega cap US technology stocks through 2024 with only 15% of companies globally having outperformed the Mag7 in 2024 (Exhibit 19).

Exhibit 19: Only 15% of companies globally have outperformed the Mag7 in 2024
% of companies that did better than the Magnificent 7 in 2024 - World and US exclude the MAG7



Magnificent 7 is a list of companies including: Meta's Facebook, Amazon, Apple, Microsoft, Alphabet's Google, Tesla, NVIDIA

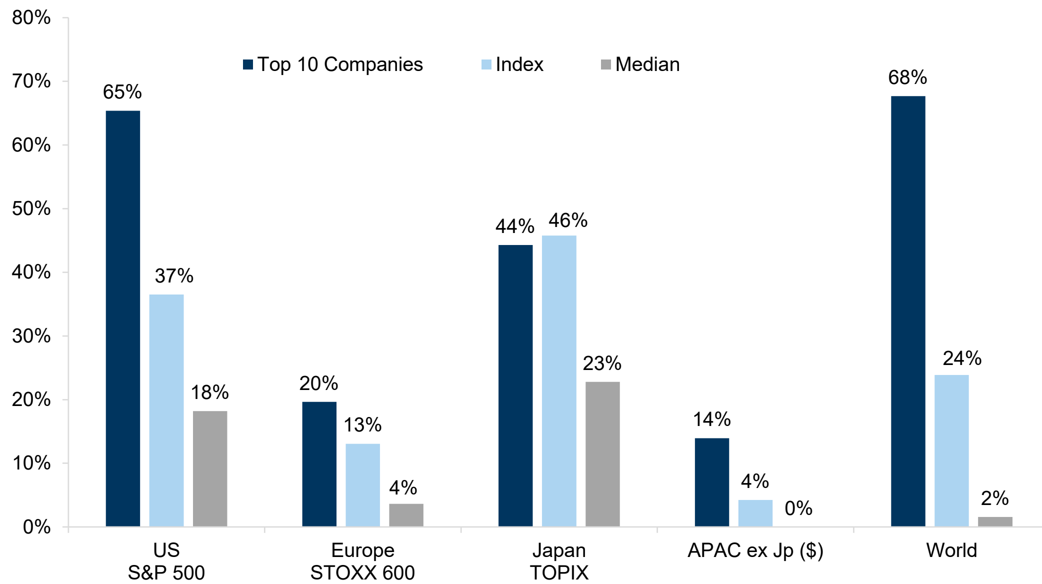
Source: Datastream, Goldman Sachs Global Investment Research

While these companies remain attractive, we believe that investors should broaden their investment universe more than they have been used to in recent years.

During the period of rising interest rates, the largest companies (often with very strong balance sheets) disproportionately boosted returns (Exhibit 20). With the growing trend of lower interest rates, the contribution of index returns should widen out.

Exhibit 20: During the period of rising interest rates, the largest companies (often with very strong balance sheets) disproportionately boosted returns

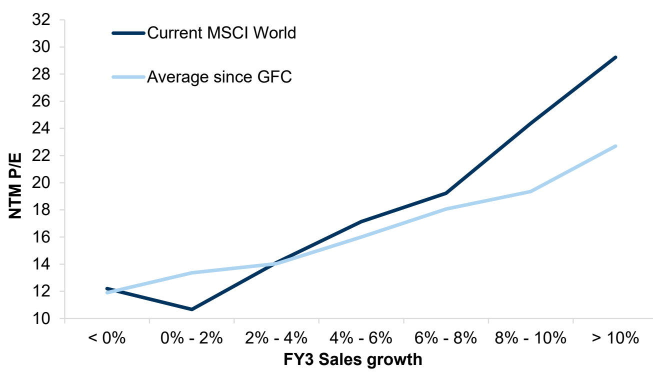
Total return performance since first Fed hike – March 16, 2022. Local currency, except for Asia Pacific ex. Japan in USD



2) Selective Value opportunities

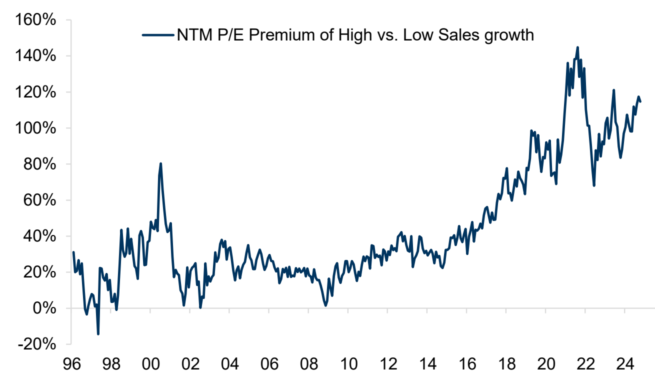
While we like broadening exposure to growth, we also like a bar-bell which includes selected areas of value. Pure growth remains expensive – as Exhibit 21 shows, the premium paid for each unit of additional expected sales growth is higher now than we have seen on average since the global financial crisis. The market has also rewarded higher versus lower revenue generating companies (Exhibit 22).

Exhibit 21: Premium paid for each unit of additional expected sales growth is higher now than we have seen on average since the global financial crisis
MSCI World: Forecast (FY3) Sales growth and relative NTM PE



Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 22: The market has rewarded higher versus lower revenue generating companies
MSCI World: Premium of High vs. Low Sales growth



MSCI World companies with forecast FY3 Sales growth equal or above 8% (High Sales growth) and equal or below 2% (Low Sales Growth).

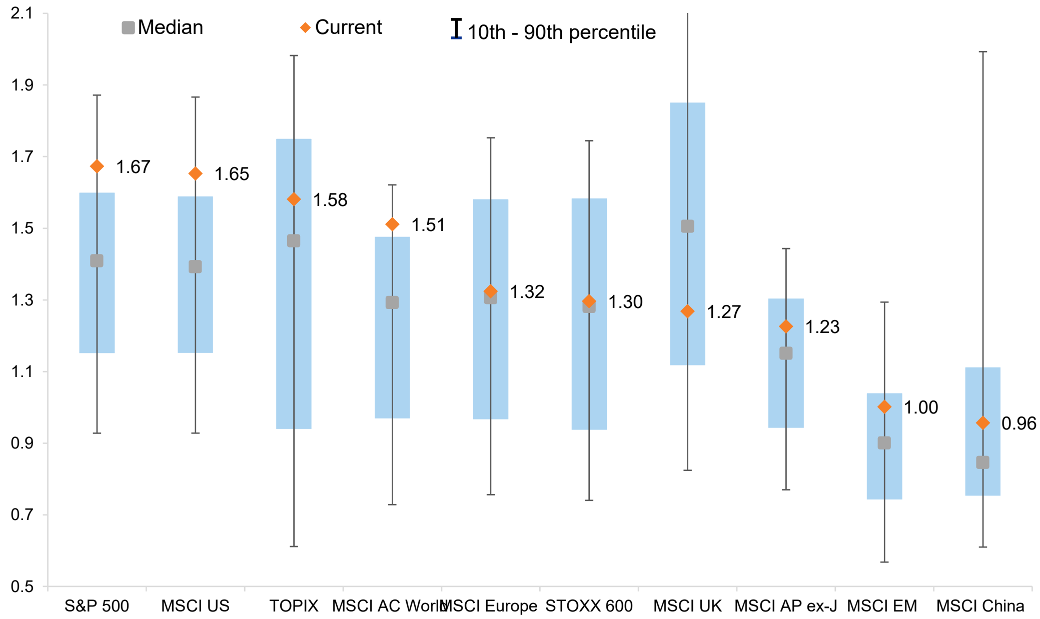
Source: Datastream, Goldman Sachs Global Investment Research

This raises the opportunity to find diversification through selected areas of value where companies are raising shareholder returns.

3) Geographical diversification

To be clear, we are confident about the US economy and like the US equity market. That said, the degree of outperformance and valuation premium leaves selective opportunities for geographical diversification. Most of our equity forecasts are similar from a regional perspective. The highest return forecasts we have is in Japan (where we are overweight), driven by EPS growth rather than multiple expansion, together with the tailwind of a weak yen. Once prospective growth is taken into account, there are pockets of deep value. The UK, selected emerging markets and China all have particularly low PEG ratios (Exhibit 23). We do not see this, again, as a reason to overweight these markets at the expense of US exposure, but we do see opportunities to find selective undervalued companies in these and other markets.

Exhibit 23: The UK, selected emerging markets and China all have particularly low PEG ratios
PEG ratios (12m fwd P/E divided by second 12m EPS growth), data since 1995 where available



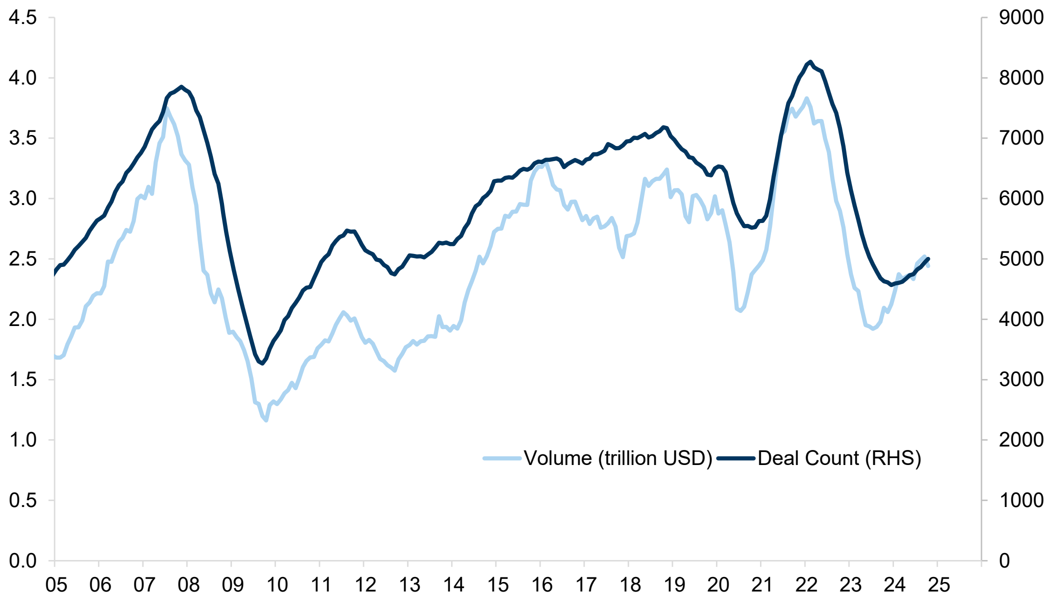
Source: Datastream, FactSet, Goldman Sachs Global Investment Research

4) Capital markets activity

Given the likely push toward de-regulation in the US, and stronger forecast growth, we expect increased capital markets activity. We like to find companies that might be targets of potential M&A.

Exhibit 24: M&A deals globally

Number of deals and volume in USD



Source: Bloomberg, Goldman Sachs Global Investment Research

Disclosure Appendix

Reg AC

We, Peter Oppenheimer, Guillaume Jaisson, Sharon Bell and Lilia Peytavin, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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