CIO View Special

10 themes for the year ahead

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Marketing material

11 unlikely events with even more unlikely results

For the last of our "10 themes for the year ahead," we let our thoughts run free. We look at events that are outside our core scenario and sometimes quite radical. The market reactions too could be surprising.

Since the outbreak of the Covid pandemic in 2020, risk managers have found it easier to quiz asset managers' investment experts about unexpected but extreme risks. And yet, would advanced epidemiological knowledge of the pandemic in 2020 have led to better investment results? Only if one had also anticipated the decisive intervention of governments and central banks to prevent the markets and economy from collapsing. Covid was not a disaster for the financial markets. Instead, the MSCI World Index closed 2020 up by 14%. The pandemic proved a lesson in just how unpredictable both the world and the markets can be.

In the following we will look at scenarios outside our core view, and we consider the potential reactions in the capital markets. These thought experiments may help investors question their own assumptions.

1) What if: Trump's wishes are all fulfilled

Trump's plans to raise U.S. import tariffs dramatically are, we think, likely to be unhelpful for the U.S. economy, pushing up inflation and reducing competitiveness and growth. But what if Trump's tariffs attract direct investment in the U.S. economy, as foreign companies try to avoid the tariffs and benefit from the deregulation and tax cuts U.S.-based companies are expected to profit from? Economic growth might prove surprisingly high as companies invest and consumers consume.

Potential consequence: With the U.S. growing fast and immigration reduced – another Trump policy -- an intense battle for labor, but also for other production resources, ensues. Inflation rises well above 4% as the immigration pressure release valve has been closed. The U.S. Federal Reserve (Fed) has to intervene and pushes interest rates up considerably.

Potential capital-market reaction: As the equity-market rally that started in mid-2024 continues, valuations are very demanding. At one point the bond markets collapse, followed by the stock market. Higher bond yields are unfavorable for equity valuations, and the pressure on margins also weighs on sentiment as companies are unable to pass inflation on to their customers as they did during the pandemic. The real-estate market does not fare well either in the new high yield environment.

2) What if: Europe under fire – fighting back

U.S. foreign policy becomes as isolationist as feared, China also turns further away from Europe, the war in Ukraine continues and at the same time so-called populist forces in Europe gain further popularity.

Potential consequence: Europe's heads of state decide to take the bull by the horns: fiscal policy and debt will henceforth be managed jointly. In addition, European countries – including those outside the EU – agree to better coordinate their defense policy and, in particular, to coordinate purchasing and procurement, as well as to set up a joint defense fund.

Potential capital-market reaction. When debt mutualization is announced, Anglo-Saxon newspapers, banks and brokers rejoice, and their colleagues on the continent are influenced by their enthusiasm. Stock markets rise and the first real euro bond is a market success. This strengthens the back of the politicians and also makes large sections of the population view the development positively.

3) What if: Bitcoin fully established – and therefore redundant

Shortly after taking office, Donald Trump ensures that Bitcoin becomes a state-recognized means of payment. The Fed builds up its own Bitcoin reserves.

Potential consequence: With this ultimate recognition for Bitcoin, there is now no financial institution that is not active in this market. But even though Trump promised little regulation, Bitcoin now receives a complete institutional framework. This means that the center of gravity of Bitcoin trading moves finally to the U.S., where most of the coins are already mined. Other regions and user groups lose interest in Bitcoin and turn to other coins.

Potential capital-market reaction: Bitcoin loses a large proportion of its most active investors and degenerates into an indicator of market liquidity, but the momentum of the past is gone. In countries critical of the U.S., alternative coins fight for dominance. After some time, one emerges as the winner. And we learn it has been massively supported by China or Russia.

4) What if: Artificial intelligence and artificial profits

AI applications penetrate more and more areas of life, both privately and professionally. Everyone uses them, just as everyone uses telecommunications networks to surf the web, without telecom providers being able to show a 30x price-to-earnings (P/E) ratio. A toxic mix develops when the technological progress stalls, monetizing efforts don't bear much fruit and initial AI budgets are being cut.

Potential consequence: All of a sudden, all AI business models are called into question and significant risk discounts are applied to growth assumptions.

Potential capital-market reaction: The entire AI value chain is re-evaluated on the stock market. As a result, the U.S. capital market loses its "American exceptionalism" status and investors reconsider their positions. Europe and emerging markets (EM) are rediscovered and the record valuation discounts of these markets compared to the U.S. fall back to their long-term average.

5) What if: Quantum leap in batteries shakes auto sector

A consortium of battery manufacturers from various countries announces a breakthrough in solid-state batteries. Ten minutes of charging is enough for an 800-kilometer (500 miles) journey.

Potential consequence: This breakthrough convinces the last doubters. The direction is set: The combustion engine is history and huge amounts of funds flow into electric vehicles (EVs) and the expansion of the EV recharging network.

Potential capital-market reaction: The stock market thinks that's the end for the established carmakers and punishes the sector across the board in Europe, Japan and the U.S. But after a year or two, the market turns. The batteries and other components and systems in which the established players were previously lagging become widespread and cheap commodities. Now it's all about who builds the best car around the given software, has the best sales network and delivers the best service. The dinosaurs make a comeback.

6) What if: Germany does things that Germany doesn't do

Germany has voted. Only after the formation of the coalition does the government surprise with a large-scale investment offensive, for which it also accepts an increase in the national debt ratio from 60% to 70-80% during its term of office.

Potential result: the plan is skillfully marketed and receives a positive response. Citizens welcome the relaxation of the conceptually outdated German debt brake and the big boost to infrastructure investment. But when it comes to implementing the plan, the government is hit hard by the shortage of skilled workers. Wages rise, as do material costs. Germany's manufacturing companies suffer as a result.

Potential capital-market reaction: Inflation rises, and with it Bund yields. This is especially the case as market participants realize that the European Central Bank (ECB) will not intervene with interest-rate hikes because growth in the rest of Europe is below potential. On the stock market, those companies focused on the domestic market that gained most in the euphoria after the investment offensive was announced, now lose most.

7) What if: Climate crisis hits home

A natural disaster in a developed country attributed to climate change destroys such a large area and claims so many lives that a surprisingly large number of heads of government declare in a united consensus that things cannot go on like this.

Potential consequence: The first emergency measure is a drastic increase in the taxation of fossil fuels. Where market mechanisms threaten to fail, direct intervention is used. In addition, the major industrial nations commit to devote 4% of their economic output to CO_2-reducing technologies.

Potential capital-market reaction: The magnitude of the disaster weighs on equity markets, not least because supply chains are also interrupted. However, when the willingness to act together becomes apparent, renewable energies, as well as all sectors and companies that contribute to lower resource consumption, experience a renaissance. Their shares benefit from a comprehensive repricing, while fossil-fuel-based companies are written off as 'stranded assets.'

8) What if: Javier Milei's medicine turns Latin America around

In the first months after taking office in December 2023, the new president of Argentina Javier Milei was mainly associated with words like 'chainsaw' and 'anarcho-capitalist.' After his first full year in office he hasn't lost his talent for provocation, but his name is now associated with other things: cutting back bureaucracy, falling house prices, a current account in the black for the first time in decades, much lower government bond yields and a stock market (in U.S. dollars) that has almost doubled. The rest of Latin America (Latam) keeps a close eye on these developments. Milei copycats rapidly gain ground politically.

Potential result: Latin America prospers, even if not everywhere at the same pace. More direct investment is attracted to the region. Latam is the new China. Migration flows reverse. U.S. labor shortages are exacerbated, increasing inflationary pressure.

Potential capital-market reaction: The combination of strong equity and bond markets and significant currency appreciation makes the continent the new star among emerging markets, and funds exit EM Asian markets such as China and India.

9) What if: An oil glut crashes the oil price

Freed from regulation and environmental protection, U.S. shale oil producers once again expand their output. Russia produces at the limits of its capacity because it has to pay for the war. Iran is also pumping because it wants to strengthen its military position in the face of increasing international isolation. And Saudi Arabia does not play the role of price stabilizer because it wants to gain market share.

Potential consequence: Since China's economy is not really picking up speed and America's growth is based on software and services, demand growth does not keep pace with the expansion of supply, and the oil price collapses.

Potential capital-market reaction: The collapsing oil price puts the U.S. shale-oil industry under severe pressure, the number of bankruptcies increases, and spreads in the high-yield (HY) market widen. However, the low oil price also puts pressure on renewable energy providers, and the energy transition hits another roadblock.

In some OPEC countries the low oil price puts such a strain on national budgets that severe cuts are made and another Arab Spring[1] looms.

10) What if: Debts – who said anything about paying them back?

Germany finally abandons the antiquated debt brake and runs a larger deficit. In France's polarized party landscape, no agreement can be reached on budget restructuring and the deficit gets still larger. Trump's tax-cut policies also drive up debt. In China, the state railway, which is USD 1 trillion in debt, runs into difficulties, drawing attention to China's overall debt problem.

Potential consequence: A seismic shock goes through the global bond markets. Life insurers and other long-term investors increasingly wonder whether they are being adequately compensated for the risk of giving money to highly indebted state issuers. Globally, interest rates rise by 200-400 basis points (bps) within a few months.

Potential capital-market reaction: The enormous loss of wealth in bonds hurts other markets, too. As deleveraging of the entire financial system takes place, almost no asset class and region is spared from the repricing. The gap between capital income and labor income, having expanded for decades, narrows slightly. Furthermore, parts of the workforce shed by the financial sector now turn to more productive endeavors.

11) What if: Straight back from inflation to deflation

In Europe, economic growth weakens further and inflation quickly slips well below the 2% mark, not least due to low energy prices and zero wage increases as a result of mass layoffs.

Potential consequence: Bond yields plunge towards zero and the ECB resorts to its previous tactics of negative interest rates and bond purchases.

Potential capital-market reaction: While bond prices are well supported, this time low interest rates do not spill over positively into the stock and real-estate markets. On the contrary, there is fear that Europe might be losing its connection to the global economy. The population slowly realizes that Europe's spiral remains downwards as fewer people work and ever more regulation and redistribution takes place. Radical market and bureaucracy reformers begin to enter parliaments, promising change. As they quickly deliver promising results, this is the starting point for an economic and market turnaround.

This eleventh scenario marks the end of our exercise in which we have deviated from our core scenario. It's worth doing because one thing about the coming year is always certain: it will prove different in some regards to what we investors expect. Covid took us by surprise in 2020, the property crash in China and global rise in inflation in 2021, the Russian invasion of Ukraine and fast interest-rate hikes by central banks in 2022, the collapse of a regional U.S. bank in 2023 and the remarkable advance of the AI boom and the magnificent seven stocks in 2024. To think about what might possibly happen could help investors be a bit more ready when the world, once again, does not turn out quite as expected.

Footnotes

[1] The Arab Spring was a series of anti-government protests, armed rebellions and uprisings that spread across big parts of the Arab world in the early 2010s and then restarted in late 2018, which all started as a reaction of strongly raised bread prices.

Glossary

One basis point equals 1/100 of a percentage point.

Bitcoin is the first and largest crypto asset, enabling decentralized peer-to-peer transactions.

Bunds is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

The European Central Bank (ECB) is the central bank for the Eurozone.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Magnificent 7 is a name for the group of the 7 largest technology-focused stocks in the S&P 500.

The MSCI World Index tracks the performance of mid- and large-cap stocks in 23 developed countries around the world.

The Organization of the Petroleum Exporting Countries (OPEC) is an international organization with the mandate to "coordinate and unify the petroleum policies" of its meanwhile 12 members.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

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