

Perspectives

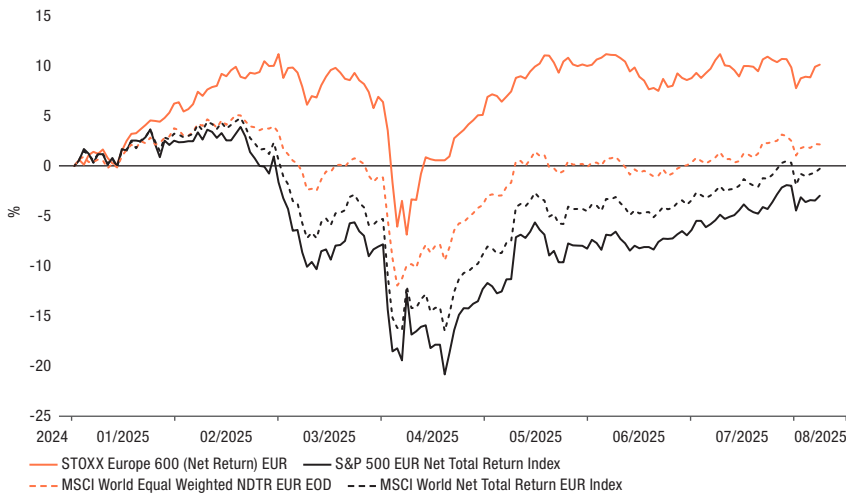
Financial markets analysis

- The global equity index is at an all-time high despite fairly weak global economic growth and the threat – and partial implementation – of tariffs.
- The rise in stock markets in recent years can also be explained by increased investor mistrust of the second major asset class, bonds, particularly G7 government bonds.
- The US market is currently very expensive compared to its historical average.
- The medium- and long-term outlook for the Japanese market is excellent.
- The dollar should continue to depreciate.
- The current environment continues to favour gold.

Visit our website at
www.bli.lu

A BLI - Banque de Luxembourg Investments
publication

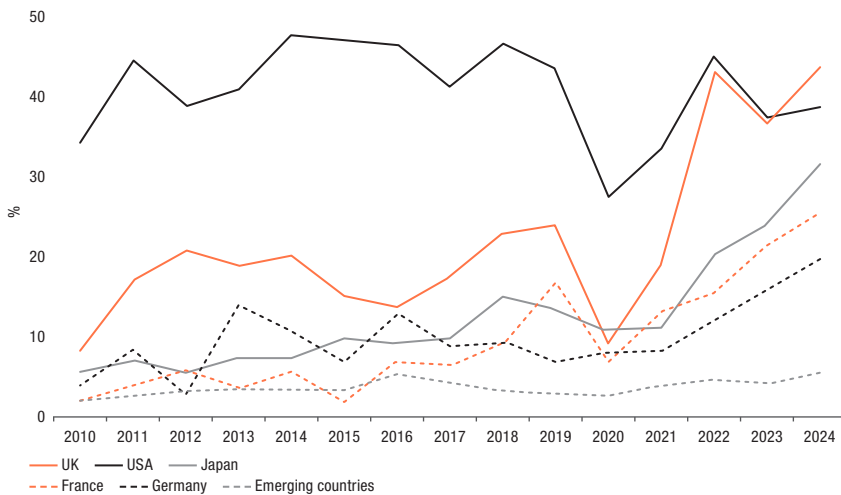
PERFORMANCE OF MSCI WORLD, MSCI WORLD EQUAL-WEIGHTED, S&P500 AND STOXX 600 IN EUR SINCE THE BEGINNING OF THE YEAR



Source: Macrobond, Bloomberg

Despite a sharp correction between February 19 and April 8 following the Trump administration’s tariff announcements, stock markets have generally performed well so far in 2025, with European and Asian markets outperforming the US market. At the sector level, technology continues to show strong growth, while defensive sectors such as healthcare and consumer staples are lagging behind. The global equity index is at an all-time high despite fairly weak global economic growth and the threat – and partial implementation – of tariffs. The fact that the tariffs imposed are lower than those announced by Donald Trump in early April seems to have been enough to restore investor optimism, even though these tariffs will be the highest since 1934 and will clearly have an impact on the two main economic variables, growth and inflation. The easing of monetary policy by several central banks, expectations of more accommodative monetary policy in the US and resilient corporate earnings in the first half of the year were among the factors contributing to the strong performance of equities.

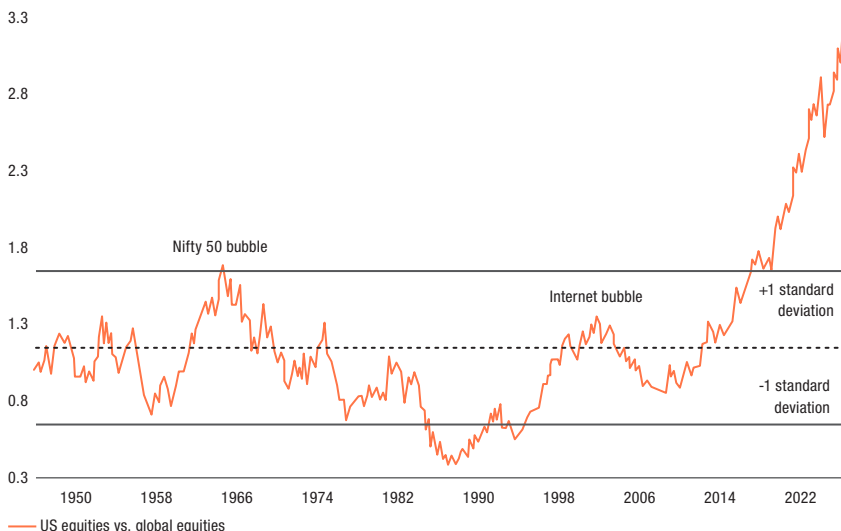
PROPORTION OF COMPANIES BUYING BACK 1% OR MORE OF THEIR SHARES



Source: Schroders

However, the rise in stock markets in recent years can also be explained by increased investor mistrust of the second major asset class, bonds, and government bonds in particular. High levels of public debt, a proliferation of announcements of major public spending and rising budget deficits in most industrialized countries, particularly in the United States, have led many investors to question the sustainability of debt at a time when yields on government bonds in industrialized countries often remain below inflation. The sharp increase in bond supply contrasts with a decline in equity supply, with high-quality companies buying back their own shares on a massive scale. Many investors are therefore favouring real assets such as equities, which are becoming scarcer, and shunning monetary assets such as bonds, which are becoming increasingly abundant.

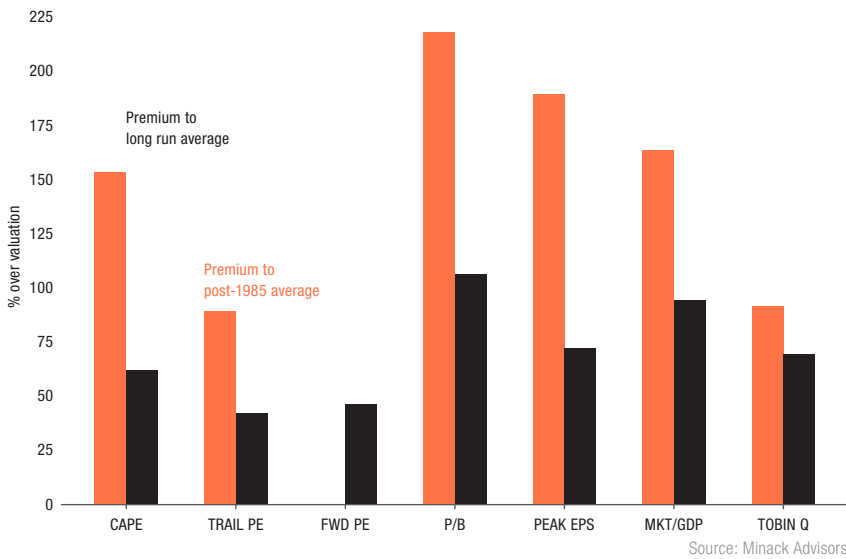
OUTPERFORMANCE OF US MARKET



Source: BofA Global Investment Strategy, Global Finance Data, Bloomberg

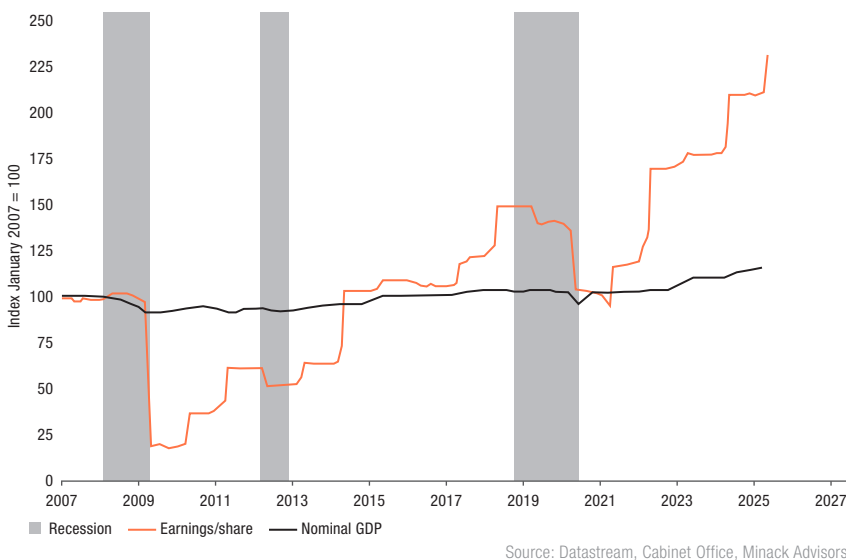
The outperformance of the US market in recent years has been exceptional. It has far exceeded what has been seen during certain bubbles in the past. The US market now accounts for around 70% of the global index, and foreign investors are heavily exposed to this market. Given the deterioration in the US fiscal situation, many of these investors have preferred to recycle the dollars from their trade surpluses into equities rather than bonds. As a result, for investors interested in absolute performance and capital protection, the US market has become dangerous because it is overbought and expensive. For investors interested in relative performance, however, it is dangerous to underweight this market in a world dominated by passive flows.

US MARKET PREMIUM TO ITS HISTORICAL AVERAGE



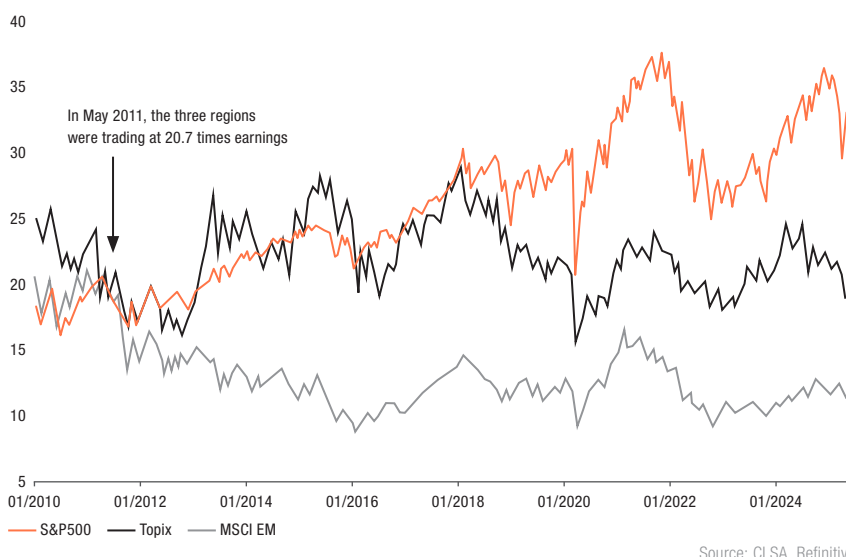
The arguments often put forward in favour of the US market are greater economic dynamism and the fact that US companies largely dominate the digital economy. In reality, the US market's outperformance since 2017 is mainly due to a rise in valuations, just as the higher economic growth in the United States is primarily due to a significantly higher budget deficit. As a result, based on all valuation criteria, the US market is currently very expensive compared to its historical average. While large technology stocks certainly deserve a valuation premium given their high profitability, the current premium seems exaggerated. This is all the more so as the increase in their profitability over the last few years can be partly explained by the use of greater financial leverage. As for the rest of the market, it is also trading at a significant premium to non-US companies despite very similar profitability.

JAPAN: NOMINAL GDP AND NOMINAL EPS



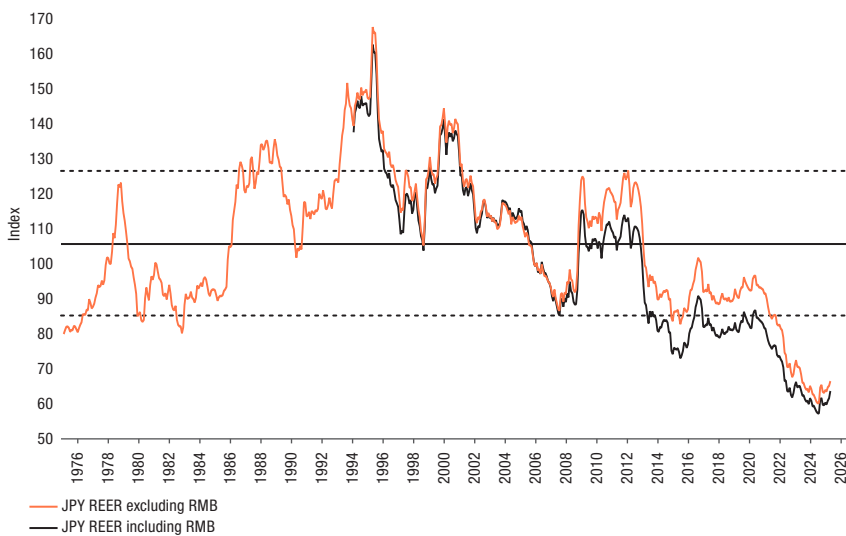
The medium- and long-term outlook for the Japanese market is excellent. Improved corporate governance and the end of deflation are factors that will support this market in the years to come. While the principle of shareholder value has been taken to extremes in the US, it is still in its infancy in Japan. However, the move towards better treatment of shareholders seems irreversible, as it is demanded by all stakeholders, including politicians, the Tokyo Stock Exchange, domestic and foreign institutional investors, and Japanese private investors who are gradually rediscovering their home market. This is reflected in a higher return on invested capital, with Japanese companies gradually closing the gap with their foreign counterparts.

JAPAN IS CHEAP COMPARED TO THE US



The Japanese market also remains attractively valued. The market is trading at around 15 times expected earnings and offers a dividend yield of close to 2%. Many companies are trading around their book value, which is rare for a large developed equity market. Balance sheets are excellent, with strong net cash positions and low debt. Japan thus combines modest valuations with exposure to innovative sectors such as robotics, semiconductors and energy transition, and partial decoupling from Western markets.

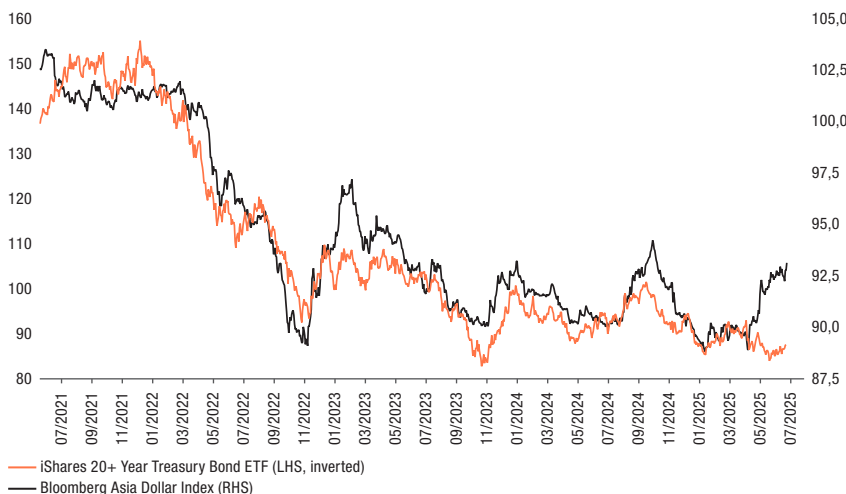
REAL EFFECTIVE EXCHANGE RATE OF THE YEN



Source: Gavekal, Macrobond

The yen depreciated further against the euro in 2025 despite the Bank of Japan's (timid) monetary policy tightening and the European Central Bank's rate cuts. The single currency benefited from renewed optimism about the eurozone following the German elections. However, the yen remains significantly undervalued, which is reflected in a sharp rise in tourism, among other things. Between falling inflation and the Bank of Japan either maintaining or increasing its interest rates, real rates should gradually rise and support the currency. Higher long-term rates and a large current account surplus could also lead to capital repatriation. In the meantime, the yen's undervaluation is helping Japanese companies to better absorb the tariff increases.

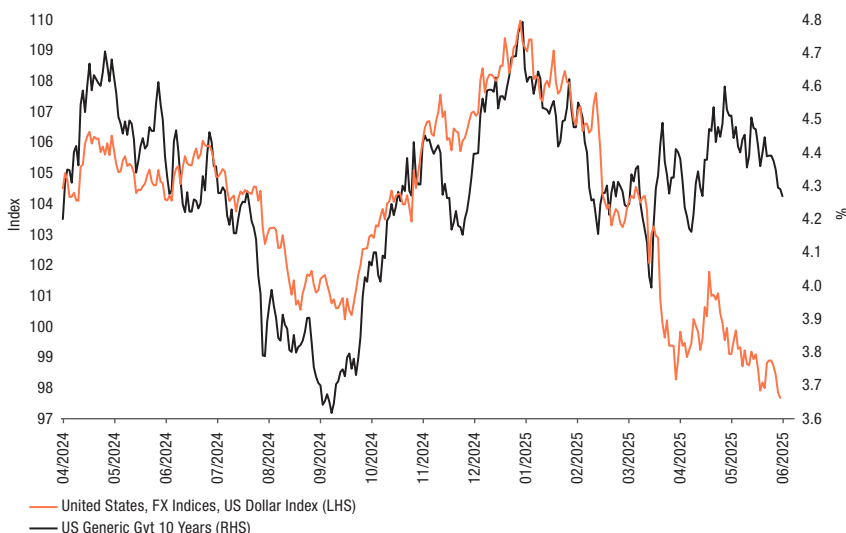
ASIAN CURRENCIES HAVE APPRECIATED DESPITE THE RISE IN US BOND YIELDS



Source: Macrobond/Bloomberg

For a long time, other Asian markets suffered from a gap between GDP (gross domestic product) growth and the growth in their companies' earnings per share. In other words, strong economic growth has not translated into value for shareholders. Reasons for this include poor corporate governance, numerous capital increases, overcapacity in many sectors, and poor capital allocation geared towards growth at any price. However, things are changing. Regulatory reforms in countries such as China, South Korea and India are aimed at improving transparency, limiting conflicts of interest and protecting minority shareholders. Alongside these reforms, there is increased pressure from domestic and international institutional investors for value-driven management practices, which is reflected in a stronger focus on return on invested capital, dividend increases and/or share buybacks. At the same time, higher value-added sectors are gaining ground at the expense of cyclical sectors with low margins. All of this should enable the potential for economic growth to be better converted into profits for local companies and their shareholders. In the meantime, these markets offer attractive valuations and potential for currency appreciation. It is interesting to note that the region's currencies have recently appreciated despite the rise in US long-term interest rates.

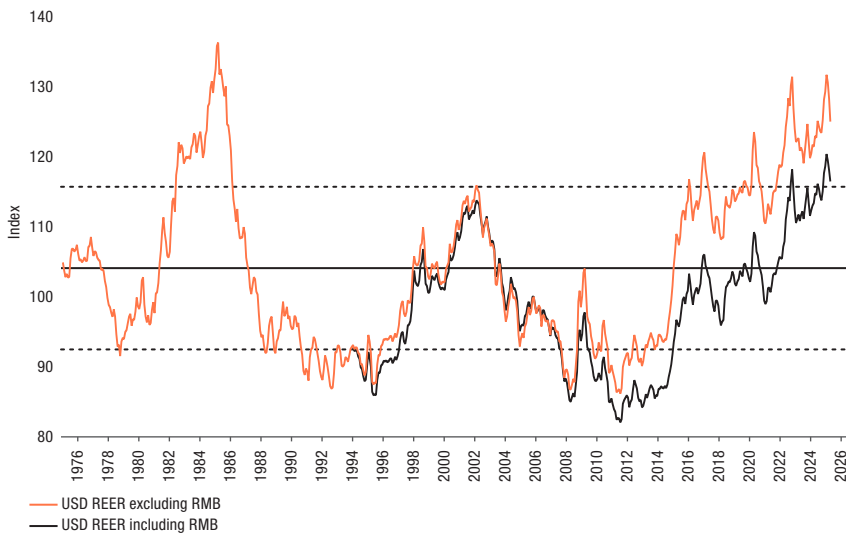
DISCONNECTION BETWEEN THE US DOLLAR AND US BOND YIELDS



Source: Macrobond/Bloomberg

Since the beginning of the year, the euro has appreciated by more than 12% against the dollar. This appreciation may come as a surprise, given that the European Central Bank has repeatedly eased its monetary policy while the Federal Reserve has maintained the status quo on interest rates. The greenback therefore has a clear advantage in terms of short- and long-term interest rate differentials, but has nevertheless depreciated quite sharply against the single currency. Nor has it benefited from the rise in US bond yields in April and May and the resumption of the outperformance of US growth stocks since April, whereas in the past its performance was strongly correlated with that of the latter. Its decline is mainly due to the erosion of the United States' attractiveness and the loss of confidence in the greenback, with the Trump administration clearly favouring a weak dollar. Rather than selling their US assets, foreign investors have so far preferred to hedge their currency risk on the dollar.

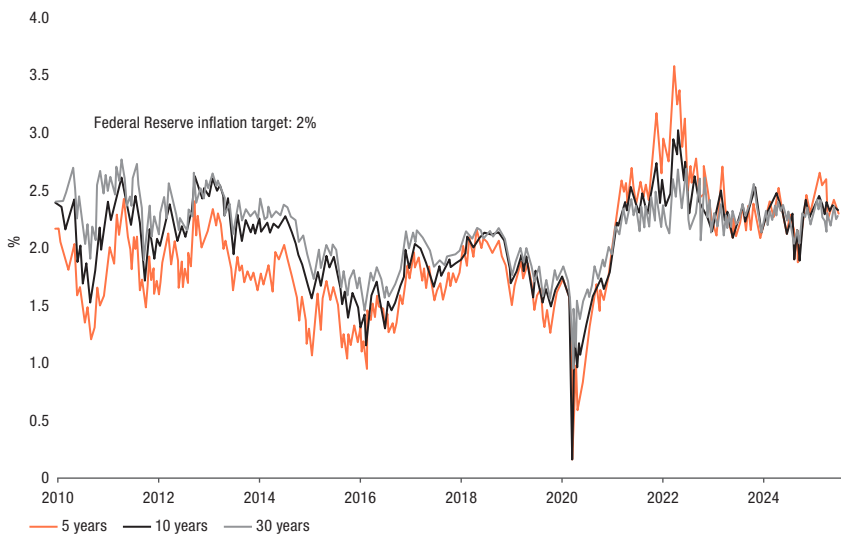
REAL EFFECTIVE EXCHANGE RATE OF THE US DOLLAR



Source: Gavekal, Macrobond

The US net international investment position is heavily in deficit, and foreigners now receive significantly more income from their assets in the US than the US does from its assets abroad. The deterioration of the US fiscal situation, its large current account deficit, the questioning of the independence of the Federal Reserve, and the possibility of some form of financial repression to contain the cost of servicing the debt could lead foreign investors to reassess the risk of holding very large dollar positions. This makes the greenback vulnerable, especially as it remains expensive despite its decline in recent months.

US MID TO LONG-TERM INFLATION EXPECTATIONS



Source: Gavekal Research, Macrobond

In a context of rising inflationary pressures in the medium to long run, inflation-linked bonds are preferable to traditional bonds. Unlike traditional bonds, a rise in inflation does not reduce the real yield on inflation-linked bonds, as coupons and principal repayments are adjusted in line with the consumer price index. Inflation-linked bonds are attractive for investors who believe that actual inflation will exceed expectations. These expectations remain surprisingly moderate at present, given expansionary fiscal policies, geopolitical tensions, and the gradual disappearance of the factors behind disinflation in recent decades, with the tightening of labour markets and supply chain disruptions. It should also be noted that inflation is traditionally the government's preferred means of combating excessive debt, as it reduces the real cost of said debt. It is therefore no coincidence that the German government decided at the end of 2023 to stop issuing inflation-linked bonds.

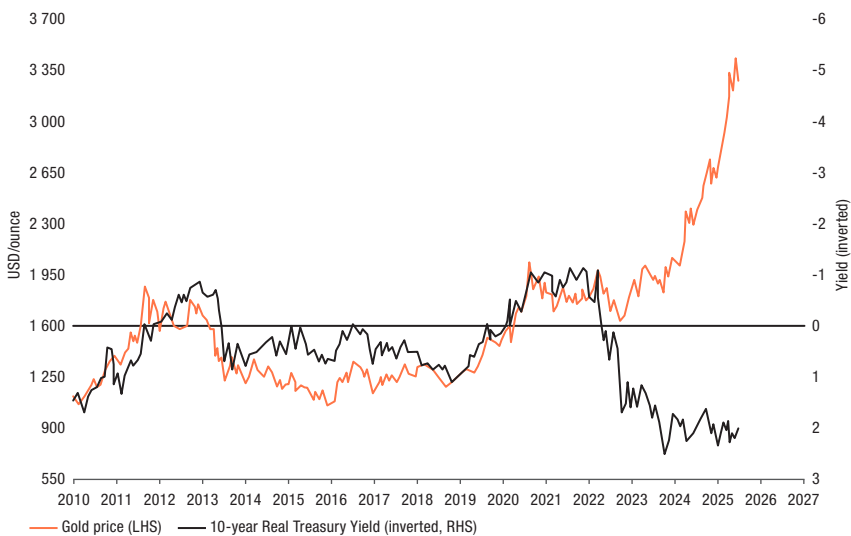
EMERGING MARKETS LOCAL-CURRENCY GOVERNMENT BOND INDEX RELATIVE TO G7 GOVERNMENT BOND INDEX



Source: Bloomberg, Jefferies

Since 2020, emerging market government bonds have significantly outperformed those of industrialized countries. This outperformance can be explained by much more cautious macroeconomic management and an improvement in these countries' fundamentals. It should therefore continue. On the monetary front, the authorities in these countries were ahead of their counterparts in industrialized countries in the fight against inflation and maintained positive real interest rates. On the fiscal front, they avoided excessive stimulus measures. As a result, their public debt is often lower than that of industrialized countries and more sustainable given their young and growing populations. The increased presence of local institutional investors is also enabling more issuance in local currency and reducing dependence on industrialized countries' currencies and vulnerability to external shocks, especially as many of these countries now have comfortable foreign exchange reserves. In addition to higher yields, these bonds offer potential currency gains given the undervaluation of their currencies.

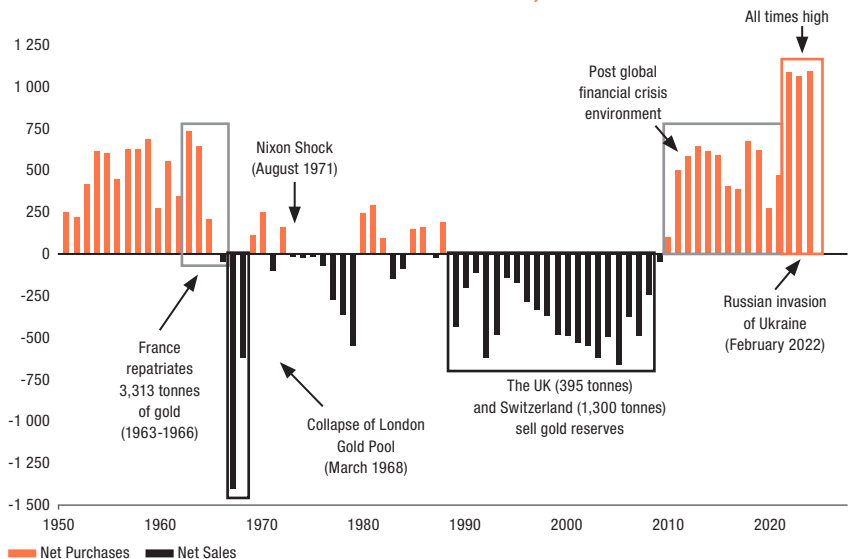
GOLD PRICE AND 10-YEAR REAL TREASURY YIELD



Source: Minack Advisors

With an appreciation of more than 27% since the beginning of the year, gold is continuing its momentum. The yellow metal seems to have permanently broken its negative correlation with real interest rates, as its price has nearly doubled amid rising real rates (and a strong dollar until the end of 2024). Since gold does not generate cash flow, it has historically tended to fall when interest rates rise, as this increases the opportunity cost of investing in gold. However, against a backdrop of deteriorating financial conditions in Western countries and heightened geopolitical and trade tensions, gold offers an intangible asset that paper money increasingly fails to provide: confidence. It also offers a hedge against the risk of debt monetization by central banks.

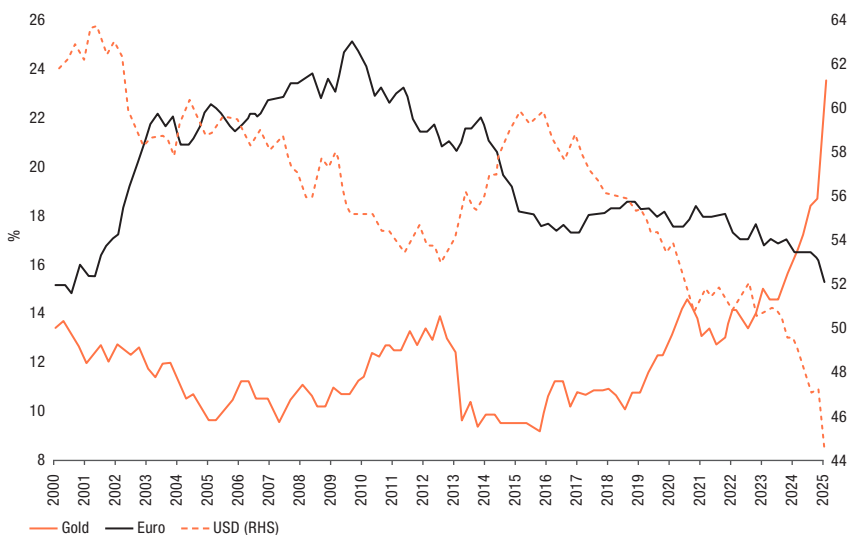
GLOBAL CENTRAL BANK GOLD PURCHASES, 1950-2024



Source: World Gold Council, Incrementum AG

The rise in the price of gold in recent years is mainly due to physical demand, and more specifically purchases by Eastern central banks. The West's decision to freeze a significant portion of Russia's foreign exchange reserves in 2022 has had a profound impact on a number of central banks and governments. The latter are now seeking to reduce their dependence on the dollar and invest their foreign exchange reserves in assets that are free of counterparty risk (and therefore default risk) and cannot be seized by a foreign jurisdiction. At the same time, there is a growing desire among many countries to establish an alternative to the current financial system based on the dollar and US government bonds, and to have alternative payment systems.

SHARE OF GOLD IN OFFICIAL WORLD FOREIGN EXCHANGE RESERVES



Source: World Gold Council, IMF, Jefferies

In a world where confidence in currencies and financial systems is weakening, gold remains the ultimate asset with no liabilities. Since the middle of last year, there has also been a return of financial demand. The latter had reacted negatively to the rise in real interest rates, with assets held by gold ETFs falling between April 2022 and June 2024. However, the prospect of monetary easing in the United States has sparked renewed interest in gold among institutional investors. This has also enabled gold mining companies to participate more fully in the upturn. Unlike in the past, they are now demonstrating greater financial discipline by avoiding unprofitable projects, controlling their unit costs and reducing their debt. Against a backdrop of falling energy costs, they are therefore seeing their free cash flows explode and are passing on the benefits to their shareholders through dividend increases and share buybacks.

If you no longer wish to receive “Perspectives”,
please unsubscribe via the online form at
www.bdl.lu/noperspectives

This document is issued by BLI - Banque de Luxembourg Investments (“BLI”), with the greatest of care and to the best of its knowledge and belief. The views and opinions published in this publication are those of the authors and shall not be binding on BLI. Financial and economic information published in this publication are communicated for information purposes only based on information known on the date of publication. Such information does not constitute investment advice, recommendation or encouragement to invest, nor shall it be interpreted as legal or tax advice. Any information should be used with the greatest caution. BLI does not give any guarantee as to the accuracy, reliability, recency or completeness of this information. BLI’s liability cannot be invoked as a result of this information or as a result of decisions that a person, whether or not a client of BLI, may take based thereon; such persons retain control over their own decisions. Interested persons must ensure that they understand the risks involved in their investment decisions and should refrain from investing until they have carefully considered, in conjunction with their own professional advisors, the appropriateness of their investments to their specific financial situation, in particular with regard to legal, tax and accounting aspects. It is reiterated that the past performance of a financial instrument is no guarantee of future returns.

No. **183** – 2nd half-year 2025

Perspectives

Draft date:
14/08/2025

Editor - Publisher:
BLI - Banque de Luxembourg Investments
16, Boulevard Royal
L-2449 Luxembourg
Tel.: (+352) 26 26 99 1
info@bli.lu
www.bli.lu