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As we look forward to 2025, it is important to think about what is driving the markets today and where potential risks might lie. At the beginning of 2024, many doubted whether the economy could achieve a soft landing or whether Artificial Intelligence (AI) would live up to its expectations. By the end of the year, those doubts seemed to have faded, replaced by confidence that these trends would continue. AI is expected to produce large productivity gains, and the economy will not fall into a recession. This is a good time to reflect on what could surprise investors during the coming year.

1. Risks with Artificial Intelligence

AI has been a big driver of optimism in the market, but there are risks that the adoption of AI may slow or fail to meet expectations. Companies heavily involved in AI may be vulnerable due to large investments in technology and infrastructure.

AI optimists continue to expect that the capabilities of AI will increase as hyperscalers (Amazon, Google, or Microsoft, etc) allow larger and more complex models. Results from the development of newer versions have been somewhat disappointing. The growth might be slower than investors are anticipating.

Finally, many businesses are adopting AI to cut costs and while this can boost profits in the short term, it doesn't necessarily lead to the kind of revenue growth that makes a company truly successful. It remains to be seen if these short-term cuts can drive sustainable long-term growth.

2. U.S. Debt and Deficit Challenges

As Federal Reserve Chair Jerome Powell has noted, the country's deficit is on an unsustainable path. The primary deficit represents the difference between the U.S. government's total revenues and its expenditures, excluding interest payments on existing debt. In fiscal year 2023, the primary deficit was approximately \$1 trillion. Even if every single government job in U.S. was eliminated - that would only save \$275 billion in expenses. The U.S. can not "grow out" of its debt problem easily.

The deficit matter doesn't create immediate market disruptions but will worsen quietly over time until it reaches a breaking point. It is hard to predict the breaking point but the message for investors is to be cautious about over-relying on U.S. markets and to consider investment opportunities outside the U.S.

3. Inflation Risks

Inflation has eased significantly. The Federal Reserve has managed to keep the economy growing while inflation rates have come down. However, inflation could make an unexpected comeback, especially if policies like U.S. tariffs increase the cost of goods. The outcome of the recently proposed U.S. tariffs on Canadian goods is yet to be seen. Higher inflation could hurt both bond and stock markets, so it's something to watch closely.

Investment Opportunities for 2025

- 1. Case for Active Management:** Simply buying the index may not deliver strong performance going forward. The U.S. stock market can appear overall expensive, but looking further down the capitalization spectrum, smaller and mid-sized companies are priced closer to historical averages indicating that they may offer opportunities for investors. Selecting investments that offer better value can generate better risk adjusted returns.
- 2. Investing Internationally:** Today international markets are generally cheaper than the U.S. market, and a weaker U.S. dollar would make selection of these investments more valuable. We see attractive investment opportunities in international and global markets.
- 3. Allocating to Fixed Income:** Historically, fixed income has provided stable income, lower volatility, and liquidity. Currently, bonds and other fixed-income investments are offering attractive returns compared to just a few years ago, hence making it an attractive portfolio allocation.

Final Thoughts

While chasing the hottest trends might feel rewarding, it's often when markets are overly focused on one idea that they become the most vulnerable. By diversifying across geographies and investment themes, investors should consider reducing short-term rewards for greater stability and success in the long term.

Happy Holidays and Happy New Year to you and yours from all of us at Cidel.

We look forward to seeing you in 2025.