NEPC 2025 MARKET THEMES

NEPC Asset Allocation Committee

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At the beginning of each year, we identify the Market Themes that we believe will influence the investment landscape over the next 12 months, impacting asset values, sentiment, investment opportunities, and capital market dynamics. We see the potential for an extraordinary level of volatility associated with these themes and expect they will meaningfully impact markets in 2025.

2025 MARKET THEMES

POCKETS OF EUPHORIA | **AI SPENDING** | **TARIFFS EXPLAINED** | **WORLD AFFAIRS**

POCKETS OF EUPHORIA

Can these shiny baubles—the Magnificent 7 and Bitcoin—coveted by investors do no wrong?

We are seeing inflated valuations in several market segments, especially in cryptocurrency with the price of Bitcoin hovering around $100,000 and the market capitalization of all crypto totaling over $3.5 trillion. Still, cryptocurrency's hold on the broader financial system and investor sentiment are unclear; it also remains to be seen just how disruptive its potential collapse would be to markets.

To a lesser degree, we also see exuberance in the Magnificent 7—Apple, Amazon, Microsoft, Alphabet, Meta, Nvidia and Tesla—and AI stocks of the S&P 500. The top 10 holdings of the S&P 500 have posted outsized results and helped the index deliver back-to-back gains of 20% in 2023 and 2024, a first since the late 1990s. The top 10 names now account for over 35% of the S&P 500, which is one of the most concentrated markets we have seen since Japanese equities relative to international stocks in the late 1980s. Still, it is fair to say their financial profile is a far cry from the extreme valuations of the dot-com bubble. We believe their lofty valuations are supported by certain unique structural elements: they are high-growth companies with mostly cash-heavy balance sheets and relatively low levels of debt. In addition, these so-called hyperscalers seemingly possess the ability to meet the escalating consumer demand for their products and services. As a result, despite their elevated valuations and the bullish investor sentiment, their long-term sustainability gives us confidence to lean into the index today.

ARTIFICIAL INTELLIGENCE SPENDING

Outsized spending in artificial intelligence by technology heavyweights such as Amazon, Microsoft, NVIDIA and Alphabet is shaping the future of this space. There is no doubt that AI in homes, markets and industries is driving technological innovation, boosting economic productivity, bolstering growth, and driving investment gains. Investors are intently watching how companies integrate AI into their operating models and the resulting impact on profit margins and revenue. While faith in AI adoption has propelled U.S. equities to great highs, it also leaves the market exposed to any reversal in sentiment. (Exhibit A: the sharp drawdown in Nvidia and AI names following DeepSeek's announcement regarding the capabilities of its cost-efficient AI models.)

We believe the expanding capital expenditure on AI from the largest names in the S&P 500 will have an immense impact on market sentiment over the course of 2025. While there is no question that data centers are the engines for artificial intelligence, we need to see sizable productivity gains to capture the return on investment associated with AI spending to support the lofty status of the Magnificent 7 and AI stocks of the S&P 500.

TARIFFS EXPLAINED

The new administration's hard stance on tariffs on imported goods from Canada, Mexico and China could have unintended consequences for the U.S. economy. With globalization out of favor, the past economic world order cannot be relied on to provide market stability. The key question likely to be asked this year is whether the tariffs announced by Trump are economic policies to be executed or a tool to negotiate with. In addition, the fine print will also matter around how tariffs are carried out, their scope, timeline, exemptions, and retaliatory actions from the affected countries. That said, we believe the economic implications of tariffs are likely to be muted in 2025, but an escalation that restricts the flow of goods poses a larger market risk with its ability to adversely affect prices, inflation and economic growth.

WORLD AFFAIRS

Markets and investor sentiment in 2025 will be keenly focused on geopolitics and the policies of new governments taking office. As the world moves away from a period of relative geopolitical stability to one with fractures and fragmentation, we are likely to see greater uncertainty. Key questions will include how a shift to more protectionist policies will impact inflation and growth, within and outside the U.S. Also under scrutiny: China and its role in the global economic order as the world's second largest economy wrestles with internal economic challenges, while dealing with trade and geopolitical tensions with the U.S.

The potential for market disruption has tempered our view of non-U.S. equities. We are also observing a lot more divergence around the world in terms of growth and inflation rates, which drive volatility in currencies. We would advise clients to be mindful about unhedged currency exposure in their portfolios.

We remind clients that a charged geopolitical climate shouldn't warrant shifts in portfolio allocations. Our advice: stay focused on long-term core investment objectives and do not deviate from your strategic targets that were a result of thoughtful deliberation and governance initiatives.

At NEPC, we believe our role is to not predict geopolitical outcomes, but rather to study their potential impact, if any, on growth and inflation through disruptions in economic activity, trade and supply chains. History has shown that market sensitivity to geopolitical events can be acute, but is often short lived. Over time, markets tend to shrug off geopolitical conflict and we encourage investors to lean into volatility amid market drawdowns and rebalance to strategic portfolio targets.

INVESTMENT OPPORTUNITIES

As we begin 2025, we see the potential for substantial volatility. On the heels of a blockbuster 2024, where U.S. equities delivered returns of over 20% (for the second straight year), inexpensive investment opportunities with significant upside are hard to come by.

Viewing the current investment landscape through the lens of our four market themes, we advise investors to embrace risk, but not chase returns. In the absence of cheaply priced investments, this could be the year to look inwards and stay close to strategic targets, review investment policy benchmarks, and lean towards simplicity.

While our market themes inform many of the key trends we are likely to see in 2025, we assess investment opportunities on the basis of fundamentals, market sentiment and risk management. Overall, we are cautiously optimistic on equities across public and private markets.

In the U.S., we do not see a bubble for the S&P 500 at this time despite the bullish investor sentiment in public stocks. While the S&P 500 and U.S. equities remain a mainstay in portfolios, we encourage investors to complement this holding with value and quality exposures to reduce concentration risk and produce a more balanced U.S. large-cap position.

Outside of the U.S., we continue to believe global equity strategies offer a compelling alpha opportunity and we recommend greater use of active approaches. Furthermore, volatility may be beneficial for global equity as active managers can more efficiently exploit dislocations across markets with tactical allocation shifts.

Meanwhile, in private markets, we suggest investors remain disciplined and stick to long-term pacing plan schedules. Within private equity, we are constructive on value investing in buyouts, while also looking to opportunities in the lower middle-market segment. Separately, in private real assets, we see significant growth in spending on digital infrastructure, and we continue to favor digital infrastructure and energy transitions strategies. Overall, we encourage investors to be liquidity providers and re-up with proven managers.

Across fixed income, we see interest rates at normalized levels, differentiated from the low rates and easy monetary policy of the past decade. Broadly, credit is still relatively attractive on a risk-return basis; however, we are shying away from high-yield corporate debt as credit spreads hover near cyclical lows and offer limited value. In addition, we recommend introducing a dedicated exposure to U.S. TIPS to strategic policy targets due to attractive real interest rates and the potential benefit from an inflation surprise. It is important to highlight one of the core functions of fixed income in a portfolio: to offer liquidity and mitigate portfolio drawdowns in periods of market stress. To this end, we remain comfortable holding excess portfolio liquidity and maintaining neutral duration targets relative to safe-haven fixed income.

At NEPC, we are trained to avoid the temptation of doubling down on the best performing asset, and to apportion assets across a portfolio to support a wide range of critical risk functions, including stability during a crisis. To that end, from a strategic asset allocation perspective, we believe it is critical to look for diversification opportunities across the portfolio. We are confident diversification will be rewarded over time as we see a greater range of outcomes across capital markets.

IMPORTANT DISCLOSURES