# Wealth Insights Q2 2025 Outlook

*By KFH Capital Investment Company*

## 1. Inflation – The Cause and outlook for 2025?

**Introduction**

Each quarter we look forward to answering a selection of the key questions from our clients with respect to the global economy and financial markets.

In this issue, we look at the following:

1. Q1 market overview and our short-term market outlook - Given recent volatility through Q1 of 2025, we explore uncertain tariff policies, elevated inflation, and the potential direction of monetary policy.

2. Equity Risk Premium (ERP) - Exploring the risk and return of equities versus risk free assets such as cash equivalents and government bonds. We explore whether there is a clear relationship between interest rates and equities, and whether equities can continue to perform in a higher interest rate environment?

3. Shariah compliant equity investing – We explore the differences between Shariah-compliant equity investing and conventional equity investing and compare each approach across factors such as historic performance, quality, and risk management.

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## Current Market Decline – What it means for Investors (Prospects during market downturn)

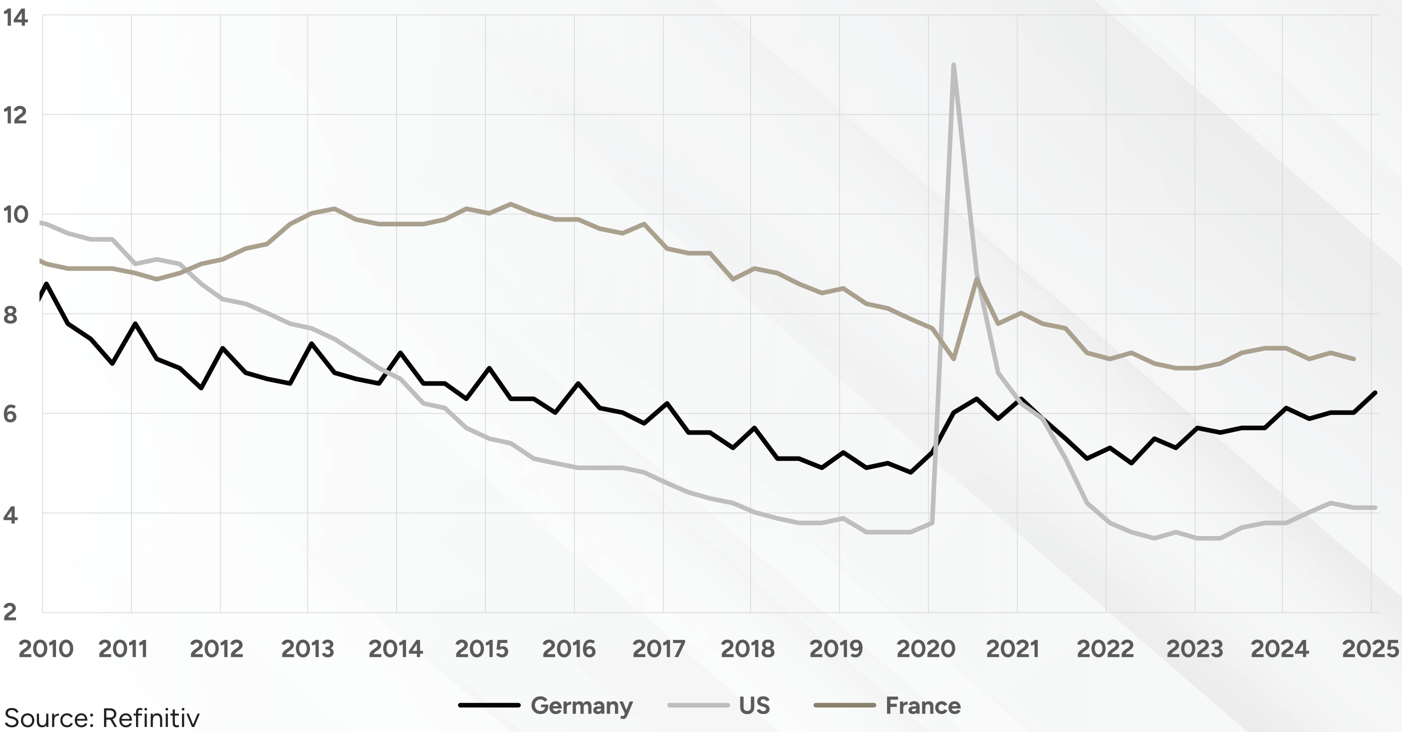
At the time of writing our Q2 report, the financial markets have seen significant volatility associated with US President Donald Trump's announcement with respect to the intention to implement import tariffs ("Liberation Day").

To put numbers to the volatility,Since the beginning of April, the average decline across global equities has been 9-10% as we write. The S&P 500 was down 9.6% on a Month-to-Date (MTD) basis, while the Dow Jones Industrial, a lead indicator of economic growth was down 8.8% during the same period. The S&P500 Index on a Year-to-Date (YTD) basis has corrected 13.7%, while the NASDAQ was down 19.3% during the same period.

There are many longer-term issues that can be considered here for example, trade deficits (what the tariff formulas are based on). Do they cause economic damage? We note that the US economy has been successful globally despite persistent trade deficits and with for example a very low unemployment rate both in a domestic and global historical context. We will come back to this and other longer-term considerations in later reports.

### US vs France vs Germany unemployment rates

| Country | Unemployment Rate | 5-Year Average | 10-Year Average |
|---|---|---|---|
| Germany | 6.4% | 5.6% | 5.8% |
| US | 4.1% | 4.7% | 4.8% |
| France | 7.1% | 7.5% | 8.4% |




Source: Refinitiv

Our intention is not to add to the multiple sources of information about individual countries and potential tariff impacts but take into consideration the more generic market points which would support investment decisions at such uncertain times:

1. Several leading economists have stated that if the tariffs are maintained, the risk of a recession increases in the US. This is to be expected, for us the big question is "if", as we note the nature of this President to seek deals – that is what we have seen before from this administration. We consider a longer-term implementation of this tariff structure as highly unlikely.

2. The US equity market had been correcting before these announcements, the market was long overdue a correction, see our note below and the link to the Q1 report where we have a more in depth note to put these corrections in a historical context. Put simply, our view has been that with or without tariffs, the markets were overdue a correction.

3. We note that Gold, classically a "safe haven" asset, has also turned down sharply in this turmoil – that is a classic sign of much needed general de-risking in assets which have had previous substantial upside and flows (stocks and gold).

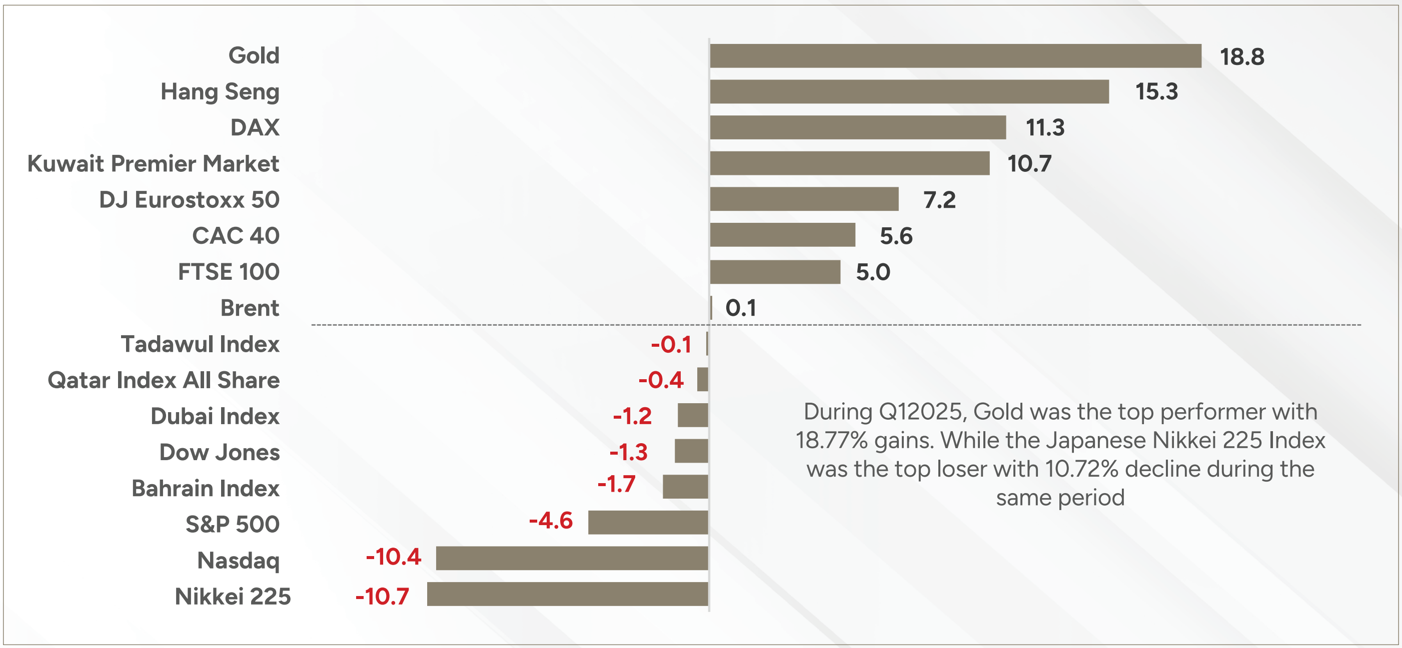
4. Any significant market correction, is nearly always accompanied by very bad news. One extreme example was COVID in March 2020; there has rarely in history been anything as bad as that in terms of news. Also 2022 – significant rises in inflation and interest rates (and a widely expected recession that never happened). The list goes on; 2018 banking / credit market crisis, 2015 / 2016 China property economic issues. The point is to expect to hear the bad news but not overly focus on it – it nearly always happens. In our view we should have expected a correction at some stage this year in any case, this is backed by the data.

What does matter? Our research with respect to the Equity Risk Premium (ERP) shows the resilience of equity returns over long-term horizons. Why? Investment in equities is an investment in longer term growth of cash flows (earnings). This is persistent and historically overcomes many apparent shocks including COVID, many recessions and also this tariff related correction. Put simply, time and time again investors switch to the longer-term attraction of equities despite the apparent continued bad news. For those investors who have had relatively light public market portfolios these corrections provide ideal entry points to earn attractive longer term compounding returns.

## Financial Market Overview – Q1 2025

The first quarter of 2025 (Q1 2025) has seen Asian, European Equities and Gold recording gains. Among Equities, Hang Seng was the top performer with an increase of 15.3% during the quarter. We believe this recovery (after the Index was down 13.2% from its peak during November 2024), was driven primarily by loose monetary policy stimulus by the People's Bank of China to boost domestic consumption.

In the case of European equity markets, the German DAX outperformed with gains of 11.3% during Q1 2025 and the UK FTSE 100 was up 5.0% during the same period. Key growth drivers include increased government spending by Germany with the formation of a new government and the Interest Rate cuts by the European Central Bank (ECB). Loose monetary policy is generally positive for equities.




Global Asset Performance, as of March 31, 2025, Source: Refinitiv

US Equities witnessed increased volatility as it closed in the negative, driven largely by the uncertainty regarding tariff announcements by the US administration, elevated inflation, muted corporate earnings expectations for Q1 2025 and weak consumer spending data.

Among GCC equities, the Kuwait Premier Market Index was the top performer with 10.7% gains during Q1. While the Saudi Tadawul All Share Index (TASI), the region's largest market on market capitalization basis, recorded a decline of 0.1% during the same period. The decline was driven by market heavyweights like Aramco which recorded a decline in earnings coupled with the management indicating 30% decline in dividend payouts for 2025.

Among commodities, Gold was the top performer with 18.8% gains as it recorded new highs driven by increased market uncertainty and its inherent nature as a "safe haven". The average price for Brent during Q1 2025 stood at USD 75.0 per barrel, a decline of 8.4% compared to Q1 2024's average price of USD 81.9 per barrel. Weak demand coupled with steady supply resulted in this decline in price.

## What to expect during Q2 2025 and beyond – An Outlook

We believe markets will continue to be diverse in terms of gains and volatility with increased potential downside risks amid increased uncertainty.

In the case of US markets, the downside risks include:

1. Deceleration in economic activity,
2. Decline in domestic consumption - a key GDP growth driver,
3. Elevated inflation which is yet to discount the increased tariff and,
4. Monetary Policy uncertainty.

The recently released Federal Open Market Committee (FOMC) economic projections indicate a slowdown in economic growth for 2025. Expected US GDP growth for 2025 has been revised downwards to 1.7% from an earlier forecast of 2.1% for the same period. With inflation elevated at 2.8%, and unemployment at 4.1%, the FOMC most recently kept rates unchanged at 4.50% - 4.25%.

In the case of the Eurozone, the ECB has indicated that unemployment rates remain historically low at 6.2% and inflation continues to move towards the 2.0% target (it currently stands at 2.3%). We believe this warrants a case for the ECB to continue with a loose monetary policy during 2025 to stimulate growth, which should be positive for European equities.

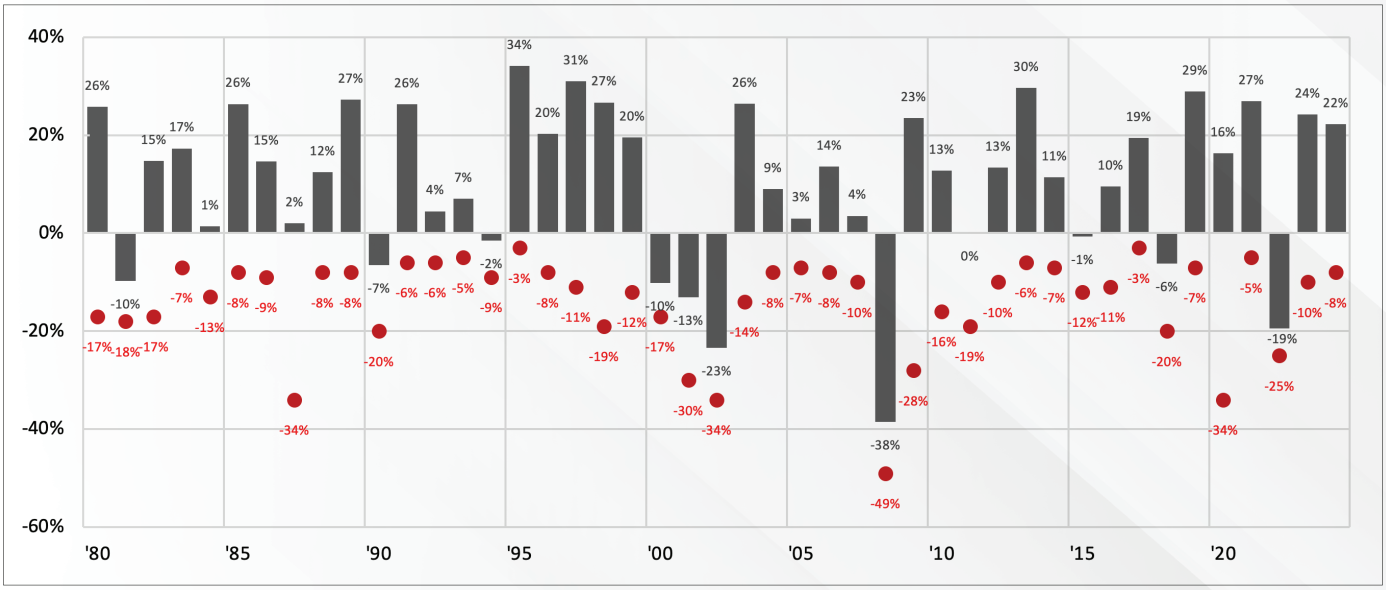
In the case of GCC equities, potential downside risks include continued geopolitical concerns coupled with weak crude prices.

In China, consumer inflation is negative (deflation), and producer prices are down 2.2% during the same period. The primary reason for this weak demand is the increased savings rate due to economic uncertainty. We expect that this will negatively impact commodities as China continues to be the primary demand driver.

This weak demand from China, coupled with steady supply, also presents downside risks for Crude prices. OPEC+ members have announced that they will continue to unwind the production cuts as scheduled, starting April 2025. In the case of Crude oil, as per Refinitiv data, the expected global demand for Q2 2025 is 103.8 million barrels per day (mbpd), a decline of 0.1% versus Q1 2025, while the global supply is expected to increase by 0.2% to 104.1 mbpd during the same period.

**Despite these challenges, historical data suggests that market corrections often result in higher returns for investors who adopt a strategy of accumulating during market declines. With the S&P 500 recording a decline of 4.8% since the start of 2025, and with an outlook of increased uncertainty potentially leading to intra-year declines, we see an opportunity for long-term investors to consider investment opportunities to improve portfolio returns.**

This reflects an enduring theme that we will cover this quarter: equities are a growth asset, so even investors with unlucky timing can prosper. More generally, in our previous quarter's publication, we covered historic corrections in the stock market, especially focusing on intra-calendar year periods. Also included in our previous publication, the key charts below act as a reminder for investors to embrace inevitable intra-year corrections as part of the price for long-term compounding wealth in equity markets.




S&P intra-year declines vs. calendar year returns Source: JP Morgen

It is important to put the negative returns (especially in the US) on a year-to-date basis in the major benchmarks and market corrections in perspective. It is five years on from the global COVID crisis. This effectively shut down the global economy accompanied by significant stock market corrections with drawdowns in excess of 30%.

It is useful to look at investing from a worst case perspective. It is widely understood that if one is fortunate enough to buy equities "at the bottom" of the market that returns will be attractive, but what about those unlucky clients that buy equities at market peaks? Five years on, we can consider the case of an investor who bought just prior to the Covid related market decline in March 2020. What would happen if investors were unlucky enough to buy global equities right at the peak of the market? The answer is short-term losses but five years of quite remarkable and substantial gains, as set out below:

| Security | Currency | Price Change | Total Return | Annual Return |
|---|---|---|---|---|
| MSCI World Index | USD | 80.5% | 80.5% | 12.5% |


Source: Bloomberg

## Equity Risk Premium – comparing equities with risk free assets – cash / bonds.

One of the key questions in finance right now is to ask whether equities are now expensive or unattractive due to higher interest rates on cash and bonds?

To answer that question, we delve into a complex-sounding concept - namely the Equity Risk Premium (ERP). It can be more simply thought of as how much extra return is available from equities compared to cash or risk-free bonds (the most commonly used risk-free asset is the US Treasury 10-year bond).

## Historic data on the ERP

Historically, it is clear that over longer-term horizons, equities have outperformed both cash and bonds.

For example, the table below looks at the last 20 years.

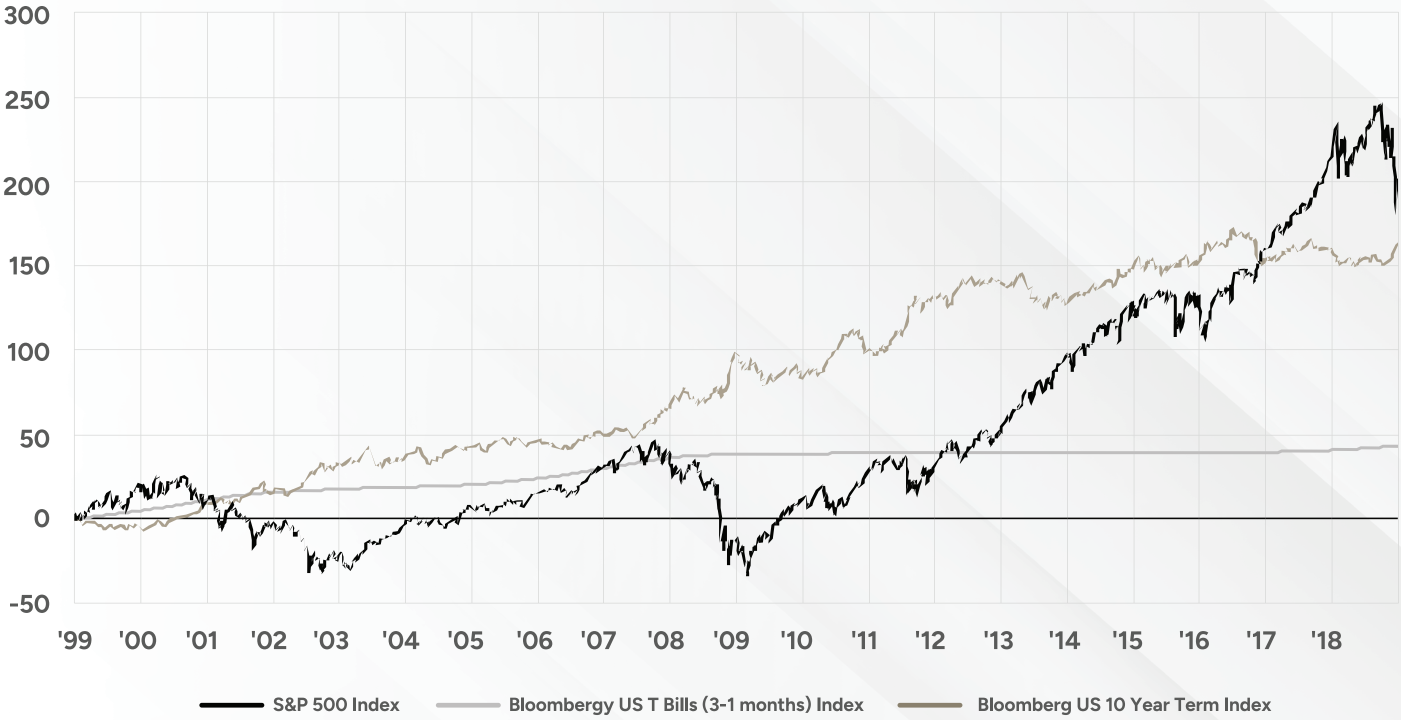
### Period: 20 years to Feb 2025

| Asset Class | Total Return (%) |
|---|---|
| US equities | 10.4 |
| US 10-year bonds | 3.4 |
| US T Bills | 1.6 |

This was a very good 20-year period for US equities and an era when cash rates, in particular, were very low.

In contrast, we also chose a very difficult 20-year period for equities, namely 1999 to 2019. This time horizon includes periods of very poor performance for equities, for example see the table below which includes two drawdowns in excess of 50%, namely 2000 to 2002 (the tech bust), 2008 to 2009 (the financial crisis) and numerous 20% drawdowns including right at the end of this period in 2018.

| Security | Annual Return |
|---|---|
| Bloomberg US Govt 10Y Index (Bonds) | 4.9% |
| S&P 500 Index (Equities) | 5.7% |
| Bloomberg US T-Bills Index (Cash) | 1.8% |




Source: Bloomberg

As can be observed even in this extreme 20-year period, US equities significantly outperformed cash with also excess returns versus 10-year bonds. The superior performance of equities is persistent even in very challenging economic and financial market backgrounds.

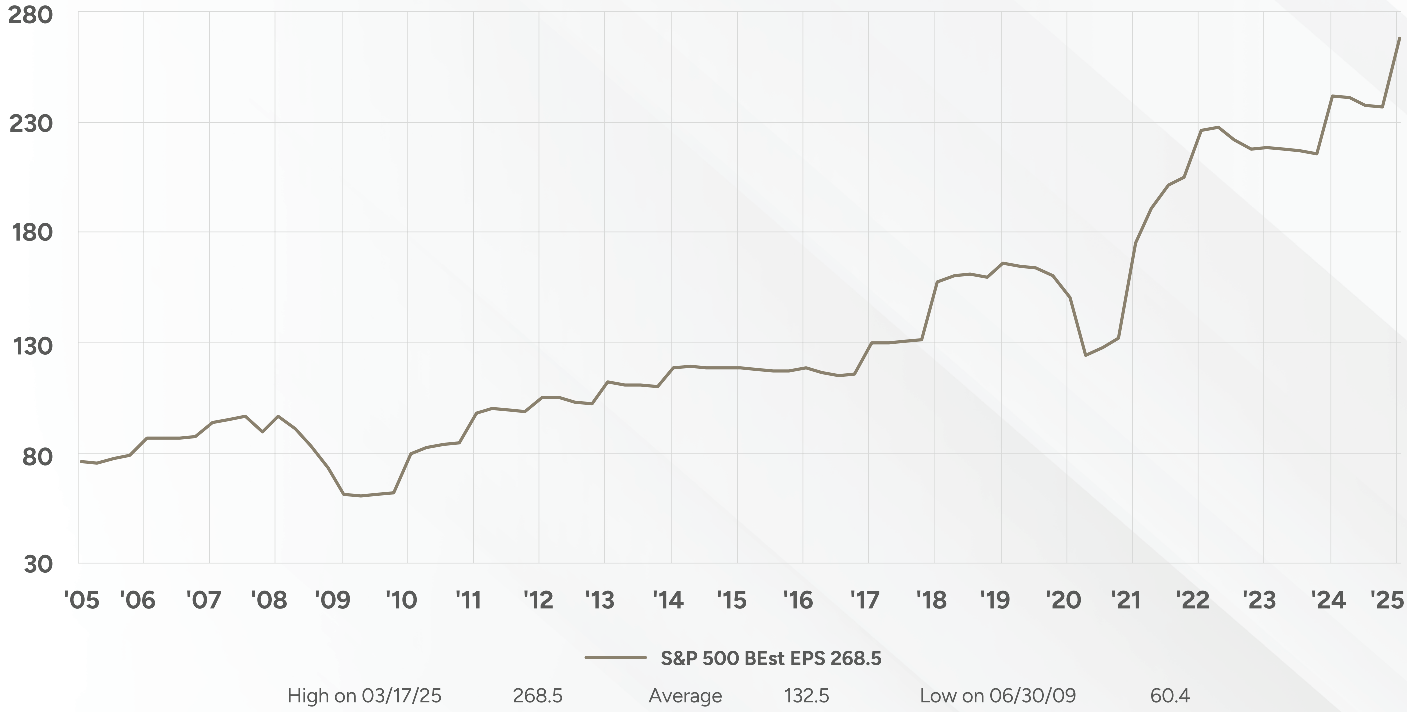
## Forward looking analysis of the ERP

We will focus on the prospective return on equities versus US 10-year Treasuries as the most often used definition of risk premium. Purists complain that you are comparing a real asset (namely shares in a company) versus a nominal asset - conventional US 10-year bonds. However, see appendix 1 with respect to conventional (nominal) versus real (inflation linked) bonds to see that these concerns are overdone.

## What could we use as a valuation metric for equity?

- Dividend yield – This has the advantage of a direct comparison of income streams. However, dividend income has been supplanted by equity buybacks for many years now and many of the most attractive fast-growing companies do not pay a dividend (or pay a small token one) at all.

• Current / next 12 months earnings - This has the advantage of looking at the overall return from companies in aggregate. However, it will be artificially (and temporarily) depressed in times of recession. For example, as discussed earlier, in the 20-year graph below. Additionally, there are times when buoyant economic and corporate conditions lead to above trend earnings per share (EPS).




Source: Bloomberg

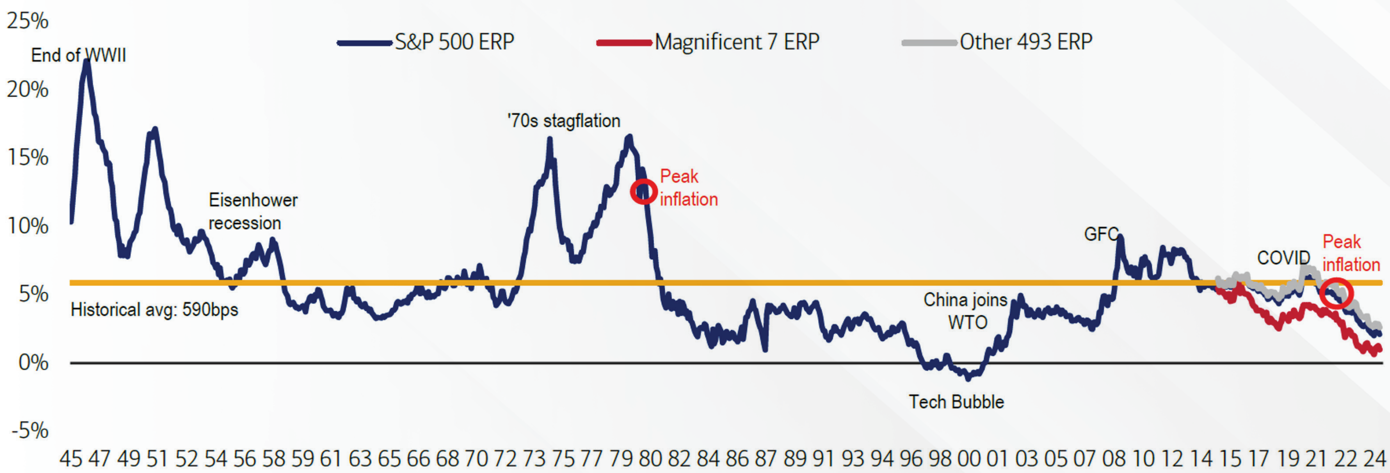
• Trend / Long term average earnings: This has the advantage of smoothing out earnings and is used in CAPE (Cyclically Adjusted Price Earnings Ratio) – an industry standard longer term valuation metric which is classically a 10-year average earnings number. The inverse of this would make a long-term earnings yield. This is superior but has two distinct issues.

i) Firstly, equities are a growth asset as can be observed by the upward trend of earnings in the graph.

ii) Secondly, the nature of the quality of earnings has changed over the years - put simply, we have asset-light, higher quality, low-debt companies generating earnings today versus more industrial cyclical companies many years ago. Instead, we prefer to focus on the upward trend as set out below by Bank of America. Note the long period in the 1980s and 1990s when risk premiums were also low, equities continued to perform.

Meanwhile, for a very long-term analysis and to see where there is some market concern, we set out the data in the graph below.

## Long term analysis of the ERP (Source Bank of America)




Source: Bank of America

The graph shows that whilst the "magnificent seven" (Microsoft etc.) are highly priced versus bonds, the ERP does look skinny compared to history. However, we can see that this level of ERP has certainly been consistently low in the 1980s and 1990s.

The table below shows the returns in these periods.

Equity returns in the 1980s and 1990s when the ERP was at similar levels.

| Period | MSCI World in USD |
|---|---|
| 1980s | 458% (19% compound) |
| 1990s | 193% (11% compound) |

Finally, over a shorter-term horizon, as a good example of market performance in a higher rate environment, we look at the last time we experienced a higher interest rate regime, namely the 2002 to 2007 period. US rates averaged 3.1% with a high of 5.25% whilst UK rates averaged 4.5% with a high of 5.75%. The table below shows how equities performed in this higher rate environment.

| Market | Performance 12/2002 to 12/ 2007 |
|---|---|
| US | +83% |
| UK | +94% |

In conclusion, whilst cash / bonds have become more attractive and the equity risk premium has shrunk, we have seen this relationship before.

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## Islamic Finance: Introduction

### What is Islamic Finance?

Islamic Finance as a concept is very broad and can be defined in several ways. In simple terms, Islamic Finance or Shariah Compliant Finance can be defined as financing activities that comply with Shariah or Islamic Principles or Laws. As the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) describes, "the Cornerstone of Islamic Finance is adherence to and compliance with the rules and principles of Shariah."

### What are Islamic Equity Funds?

Islamic Equity Funds are Shariah-Compliant Investment Funds which include listed companies that are screened for Shariah-compliance. The screening process is broadly a two-stage process:

**I. Stage I: Business Screening:**

Excludes those companies whose primary business activities are prohibited by the shariah (e.g., Interest-based banking and financial services, alcohol, gambling, production of non-halal consumer staples). Per the AAOIFI standards, this means any company in which these activities account for 5%+ of total revenue.

**II. Stage II: Financial Screening or Screening based on Financial Ratios**

As per the AAOIFI standards, this examines the following ratios:

- Total Debt on Books should not exceed a third of Total Assets or Trailing Twelve Month Average of company Market Capitalization (Debt / Total Assets < 33.3%)

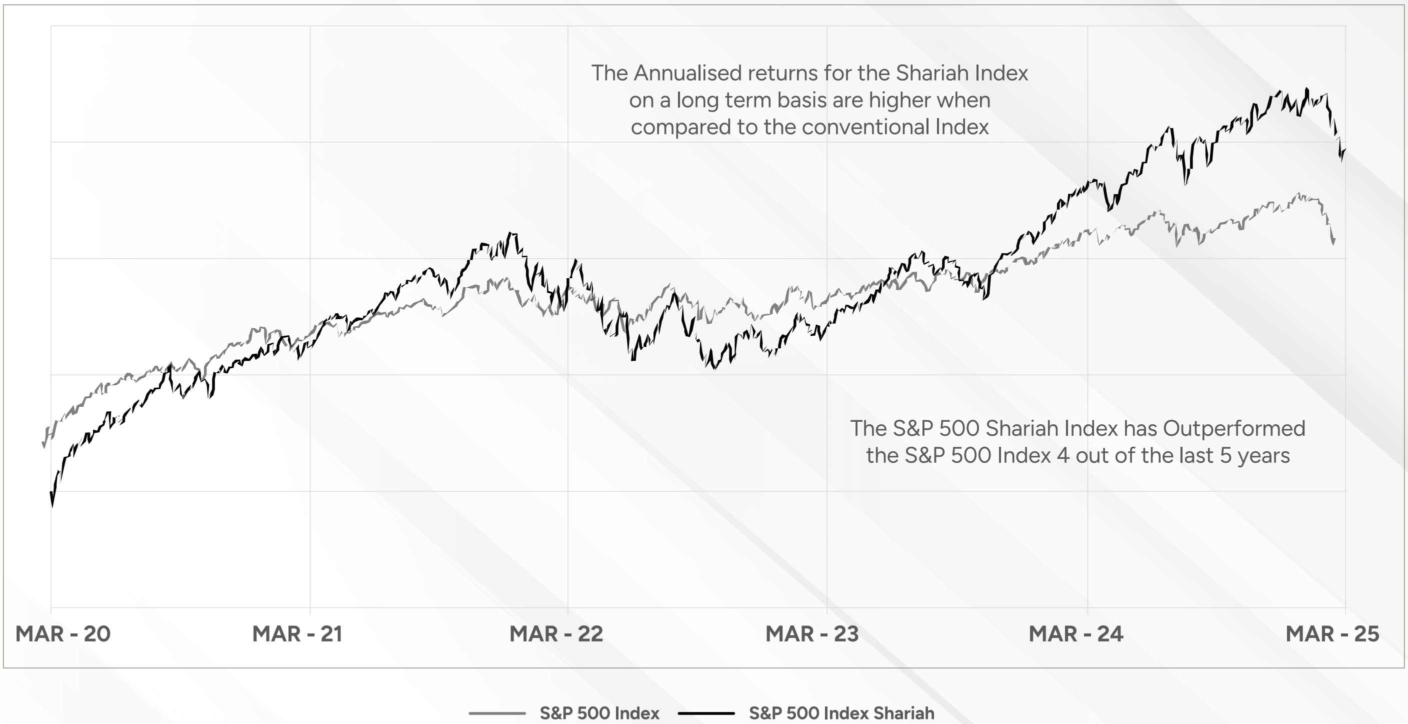
- Total Interest-Bearing Cash and Investments should not exceed a third of Total Assets or Trailing Twelve Month Average of company Market Capitalization (Interest bearing Cash and Investments / Total Assets < 33.3%)

- The Sum of Trade Receivables as a Ratio of Total Assets should not exceed 50% (Accounts receivable / Total Assets < 50%)

### Why Shariah Compliant Investments?

(i) **Excellent Returns:** If one were to invest in the S&P 500 Shariah Index, the 5Y historic annualized returns would be 18.1%, compared to 16.9% returns for investments in the S&P 500 Index. While the 10Y annualized returns for Shariah Investors would be 14% versus conventional returns of 13.0%

**S&P 500 Shariah Index: Historical Performance**




S&P 500 Shariah Index V/S S&P 500 Index, Source: Bloomberg, Graph is rebased to 100.

**Calendar Year Performance:**

| S&P 500 | 2020 | 2021 | 2022 | 2023 | 2024 |
|---|---|---|---|---|---|
| Shariah Index | 23.9% | 33.3% | -22.5% | 33.3% | 25.9% |
| Conventional Index | 18.4% | 28.7% | -18.1% | 26.3% | 25.0% |

Source: S&P Dow Jones Indices

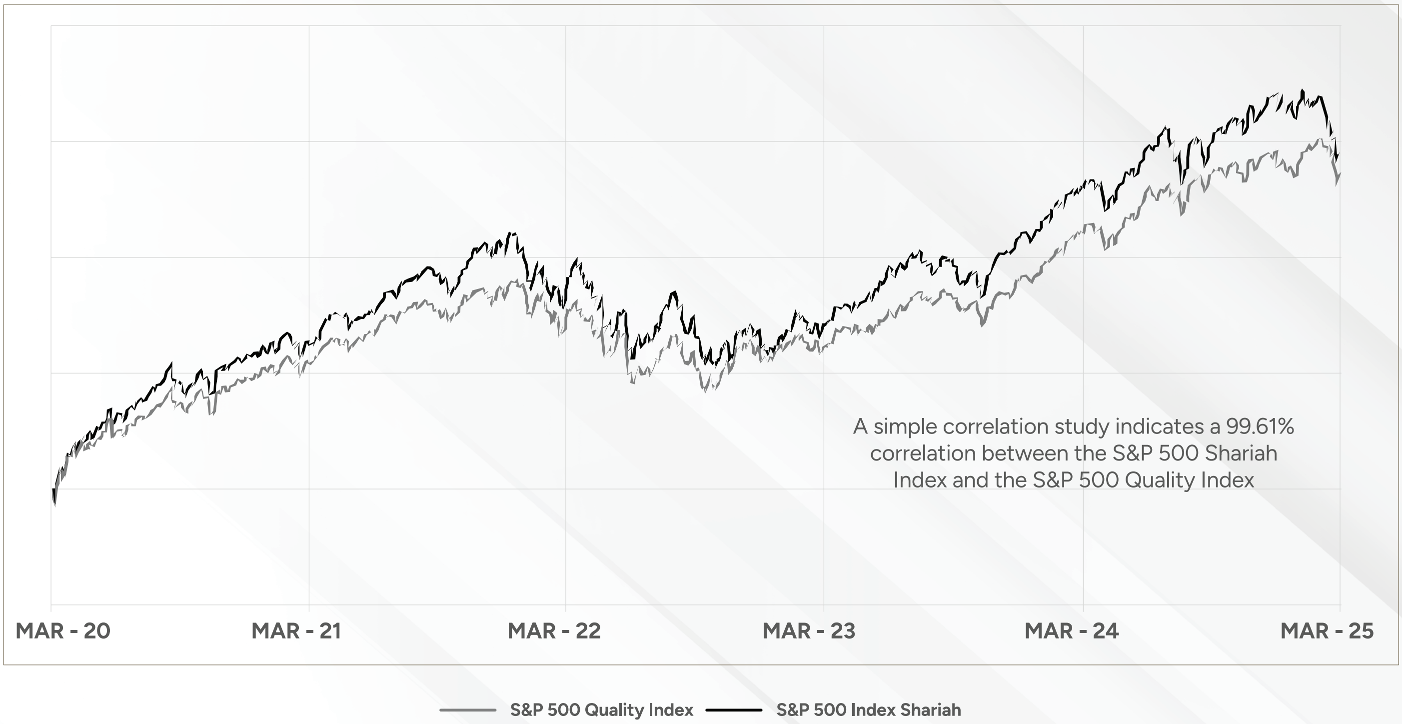
**Annualized Returns:**

| S&P 500 | 1Y | 3Y | 5Y | 10Y |
|---|---|---|---|---|
| Shariah Index | 15.2% | 12.8% | 18.1% | 14.0% |
| Conventional Index | 18.4% | 12.6% | 16.9% | 13.0% |

Source: S&P Dow Jones Indices

(ii) **Quality Investing:** The S&P 500 Shariah Index generated excess returns or Alpha over the S&P 500 Quality Index in 4 out of the 5 years during the 2020-2024 period. The S&P 500 Quality Index includes constituents which are selected from the S&P 500 by a S&P developed quality score which takes into consideration the Return on Equity (ROE); the Financial Leverage (Debt / Equity). We believe this is inherent in the process of stage II shariah screening for companies based on financial ratios.

**S&P 500 Shariah Index: Historical Performance**




S&P 500 Shariah Index V/S S&P 500 Quality Index, Source: Bloomberg, Graph is rebased to 100.

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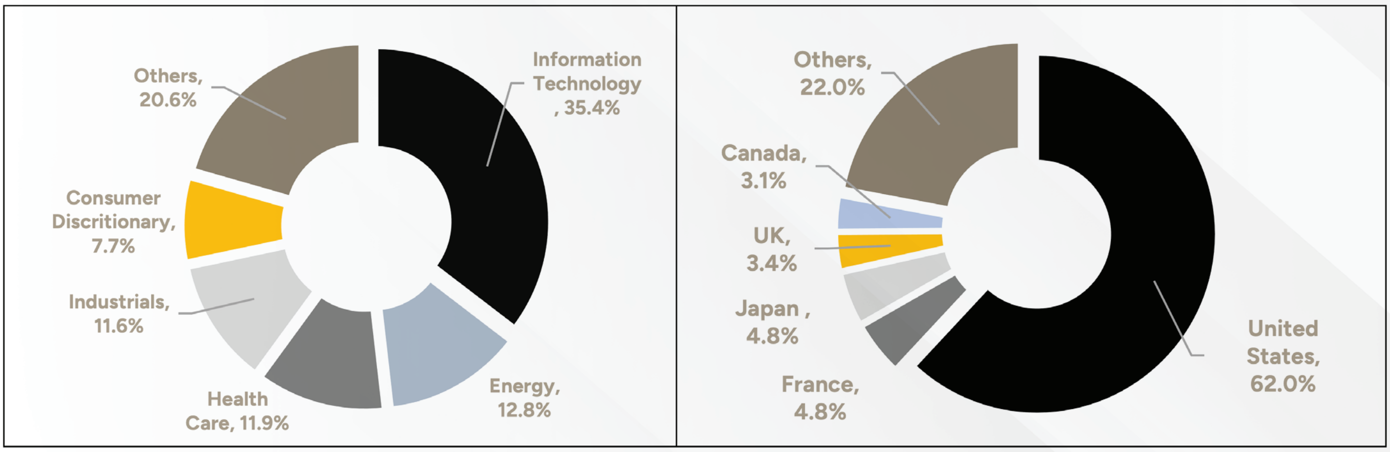
Source: S&P Dow Jones Indices

(iii) **Better Risk Management:** Built-in Rigorous financial screening provides quality stock with a sound balance sheet thus protecting potential downside risks for investors. Generally speaking, Shariah Indices provide an edge over their conventional peers as they are overweight on factors which include **Quality Factor** i.e. companies with sound balance sheet and earnings quality.

Below is a table that summarizes the key differences in factor exposure between Shariah-compliant and conventional indices:

| Factor | Shariah-Compliant Indices | Conventional Indices |
|---|---|---|
| **Quality Factor** | Overweight in quality factors: strong balance sheets, high earnings quality, low debt levels. | High-quality companies included but may have higher leverage and lower earnings quality. |
| **Yield Factor** | Higher dividend yields: companies that sustain and pay higher dividends. | Mixed dividend-paying companies, no specific screening for dividend sustainability. |
| **Volatility Factor** | Lower volatility, includes low beta stocks, reducing overall portfolio volatility. | Higher volatility; broader range of companies, including those with higher market risk. |
| **Value Factor** | Neutral to slight underweight in value factors, focus on quality and low leverage. | Significant exposure to value stocks, lower price-to-book ratios, higher earnings yields. |
| **Size Factor** | Underweight in small-cap stocks, focus on large and mid-cap companies. | Broader range of market capitalizations, from large-cap to small-cap stocks. |
| **Growth Factor** | Slight overweight in growth factors, strong growth potential and high earnings growth rates. | Varied growth exposure, includes both high-growth and mature companies. |
| **Momentum Factor** | Neutral to slight overweight in momentum factors, positive price momentum, strong performance. | Varied momentum exposure, includes both high and low momentum stocks. |
| **Liquidity Factor** | Highly liquid stocks, easy entry and exit positions. | Varied liquidity, includes both highly liquid and less liquid stocks. |

(iv) **Diversified Sector Classification:** In the case of sector classification, the Shariah Complaint Indices have a blend of defensive sectors such as healthcare and economically sensitive sectors such as Consumer Discretionary, Industrials and Technology. The sector diversification is very much in line with the conventional peer group except for non-shariah businesses like Conventional Banking & Financial Services, Alcohol, Entertainment (Casino, Gambling etc.), Production of non-halal consumer staples etc.




Source: MSCI All Country Islamic Index (USD) sector and Country Weights

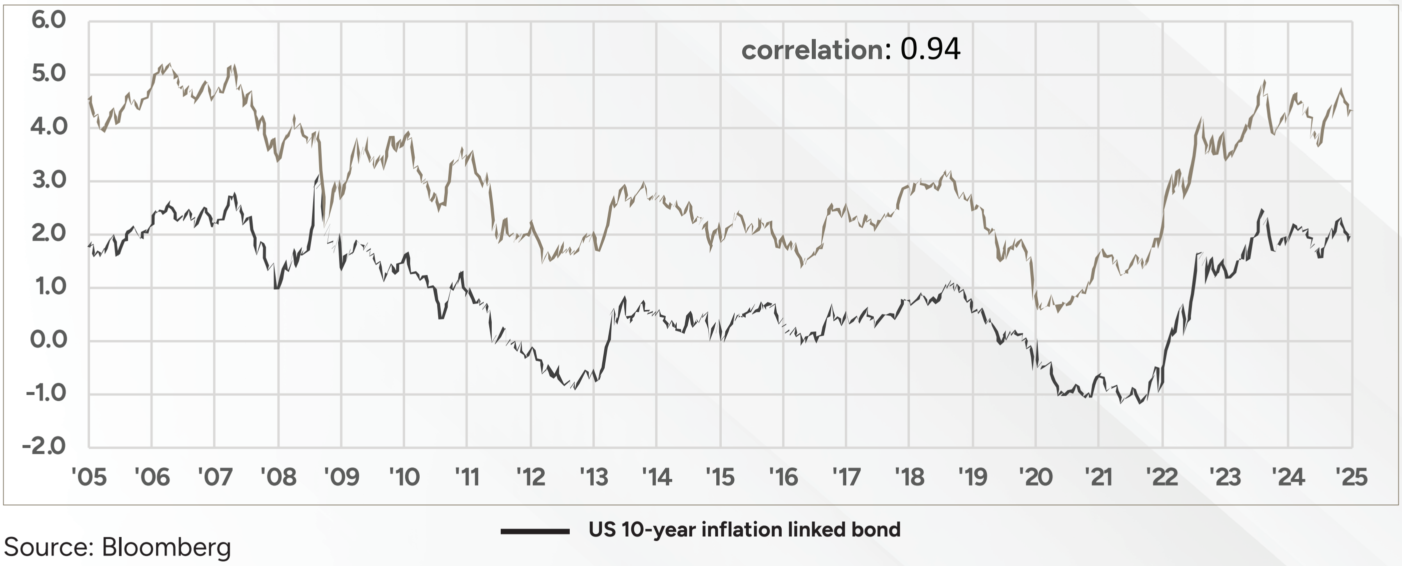
For more on MSCI All Country World Index (ACWI) Islamic Index factor framework, refer to appendix 2.

## Appendices

**Appendix 1: The relationship between conventional bonds and inflation-linked equivalents**

The relationship between conventional bonds and inflation-linked equivalents is very close. For example, we could easily compare with inflation linked bonds but as the graph shows below it is essentially the same analysis – yield changes (and duration adjusted returns) have a very close correlation.

**Graph of US conventional 10-year Treasury versus US 10-year inflation linked bond yield.**




Source: Bloomberg

For debt markets, we have the advantage of using the conventional US 10 year as the global "industry standard" benchmark, from which most USD denominated debt such as corporates, mortgages and sukuk are priced.

**Appendix 2: Example: MSCI All Country World Index (ACWI) Islamic Index:**

The **MSCI ACWI Islamic Index** reflects Shariah investment principles and is designed to measure the performance of the large and mid-cap segments across Developed Markets (DM) and Emerging Markets (EM) countries that are relevant for Islamic investors.

When compared to the **MSCI ACWI Index** the conventional peer index on the above factors it is evident from the MSCI Factor Box that **the MSCI ACWI Islamic Index has** an edge over the conventional peer as it is overweight on:

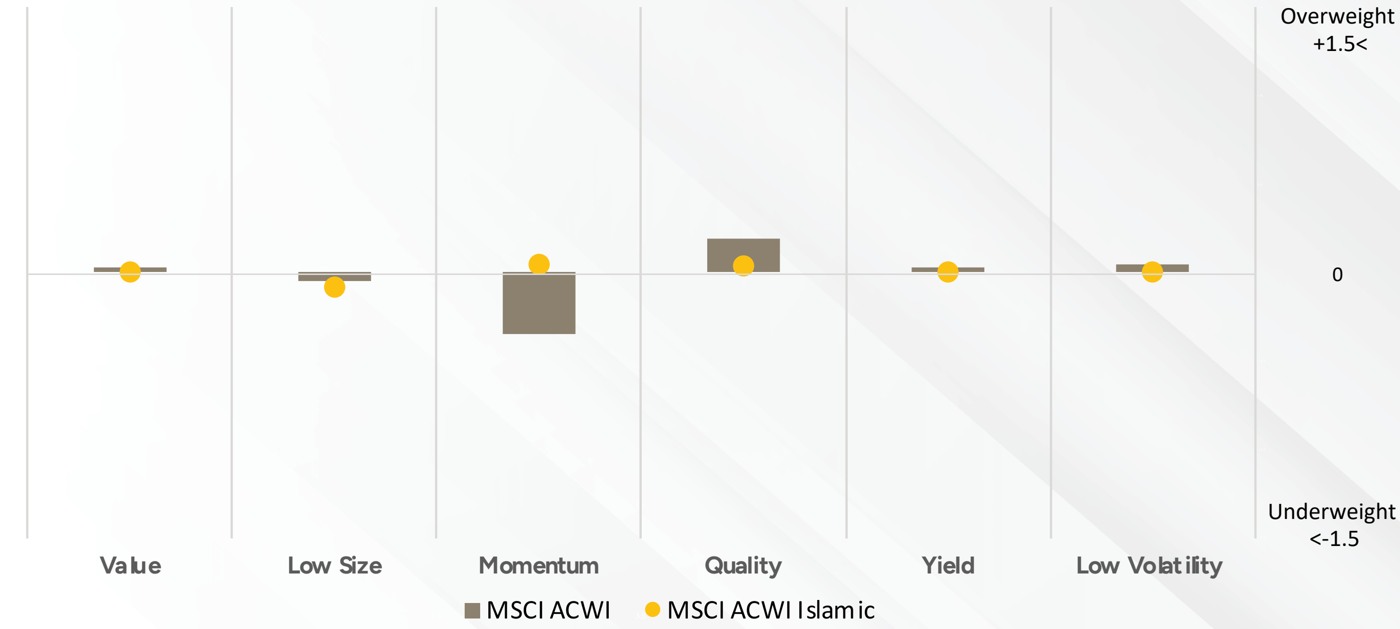
I. Quality Factor i.e., companies with sound balance sheet and earnings quality.

*Example: the Index includes a leading US-based technology company with a Debt to Equity (D/E) ratio of 26.8%, Operating Margins in excess of 50%, and Return on Equity (ROE) of 30-35%. Further, it includes a leading online retailer with a D/E ratio of 26.51% as of FY2024 and a ROE of 24.3%,*

II. **Yield Factor:** The Index includes companies with the ability to pay sustainable and higher dividends, which is suitable for investors seeking regular income.

*Example: the Index includes a group of leading global international energy companies that have a dividend yield of 3-4% respectively.*

III. **Low Volatility:** Includes low beta stocks thus lowering overall portfolio volatility.



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