Wealth Insights
Q1 2025 Outlook

By KFH Capital Investment Company

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At KFH Capital, we pride ourselves as one of the largest and most reliable investment companies in Kuwait, growing regionally & globally as a thought leader on Islamic financial solutions.

We are pleased to share the first edition of our Quarterly Insights which outlines the group's House view on global markets along with views on topical investment themes. A Quarterly initiative for our clients expressing our views and expertise on global markets and investment themes.

In this issue, we look at three key topics that are at the forefront and impact Investors / Clients:

I. Inflation - Have central banks done enough to reduce inflation to an acceptable level? Furthermore, little discussed and analyzed, what caused the rise in inflation in the first place? Understanding the root cause may help us understand the outlook for 2025 and beyond.

II. Private Markets - We look at the economics and behavioral aspects of investing in private markets where typically, investors give up liquidity relative to the public markets. Has it been worth it historically? What is the right way to think about the trade-off between liquidity and potential return?

III. The Compounding Effect of Long - Term Investing in Equities - We look at the nature of returns, what investors should expect in terms of corrections (or drawdowns) and why 2024 was unusual.

If you would like to know more about any of the content in this article contact your dedicated team of Relationship Managers to provide you with needed information on available Investment opportunities.

1. Inflation – The Cause and outlook for 2025?

Introduction

Graph 1: Eurozone and China CPI, Source: Bloomberg

Graph 1 above sets out inflation in the last 20 years in the US, Eurozone and China. The UK went through a similar experience to the US and Eurozone except with a higher peak level of inflation. What conclusions can we deduce from this graph?

There were undoubtedly several factors that contributed to recent elevated inflation. However, in this issue, we discuss why we believe that US monetary policy has been the most important contributing factor, and what we believe this means for inflation going forward?

In summary, we see good prospects for relatively low levels of US (and G7) inflation in 2025. ***There may be many reasons to worry about the economic outlook in 2025 and beyond but in our view a resurgence in inflation is not one of them.***

Historically, China's inflation rate has been higher than the US and the other major seven economies (known as the G7), for example reaching 8.0% in early 2008 when the US and the Eurozone were centered around 4.0%.

However, unlike the 2021/ 2022 inflationary pressures experienced in the G7, China did not experience any of this inflationary surge. Why was there such a divergence in inflation between an economy like China that normally has higher inflation than the rest of the G7?

Graph 2 sets out China versus US money supply growth - strong evidence that there was something very different happening in the US. Note that China's money supply growth has historically been significantly higher than the US which is consistent with the overall higher level of economic growth in China. However, between 2020 and 2022, we see quite a different picture, a surge in money supply in the US, versus monetary policy normality in China.

Graph 2: US and China money supply, Source: Bloomberg

Even when looking backwards, an interesting but ultimately frustrating part of economic analysis is that absolute proofs do not exist, instead we must rely on theories, even on events in the past that may seem to be clear cut but cannot be absolutely proved. This applies even if historical quantitative analysis work seems to provide some of the answers, again this is only evidence.

For example, nobody can absolutely prove the cause of the 2021 / 2022 run-up in inflation in the G7 economies. But we can resort to theory. In this case, multiple factors were responsible.

But understanding the key factor will help us to have some confidence about the inflation outlook for 2025 and beyond. Put simply, if we have confidence in knowing what caused the run-up in inflation in 2021 / 2022 this can greatly help the forward-looking analysis.

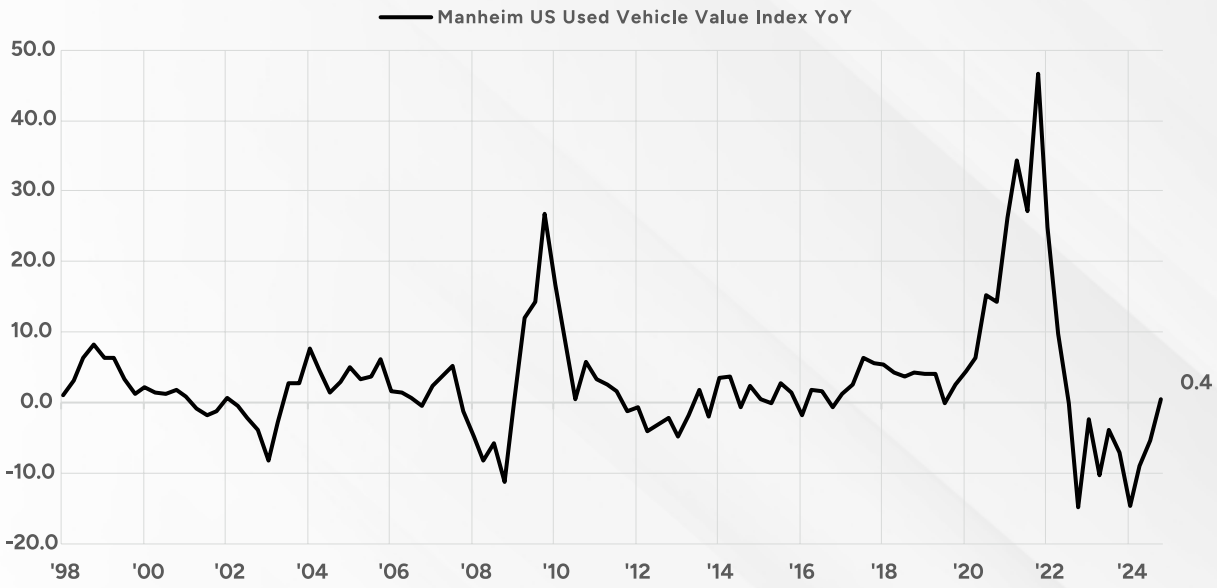
Most economists focus on three theories / events that drove inflation higher during 2021/2022:

1) Higher commodity prices
2) Supply chain pressures
3) Demand driven inflation from very stimulative monetary and fiscal policy

Let's look at each theory in a bit more detail.

1. **The rise in commodity prices** is one aspect that can be mathematically determined in terms of its impact on inflation. For example, there is an 8% weight in the US CPI for gasoline, therefore, the changes in energy prices can be accurately calibrated in the historical (and forward looking) inflation assessment. However, this typically leads to a one-off impact and only gets us to stage one in determining the inflation surge of 2021/ 2022. Furthermore, China's CPI has similar weighting in this sector (transportation), so this one-off rise in commodity prices cannot explain the much larger surge in US CPI during 2021.

2. The poster child for inflation being due to **disruptions in global supply chains** post pandemic is the surge in used car prices, and Graph 3 shows how extreme the 2021 experience was. We don't doubt that supply chain delays were a factor, but China is also a huge importer of commodities, cars etc. yet there was no material impact on China's inflation rate. Additionally, we can see that just like commodities, the used car surge dissipated very quickly.



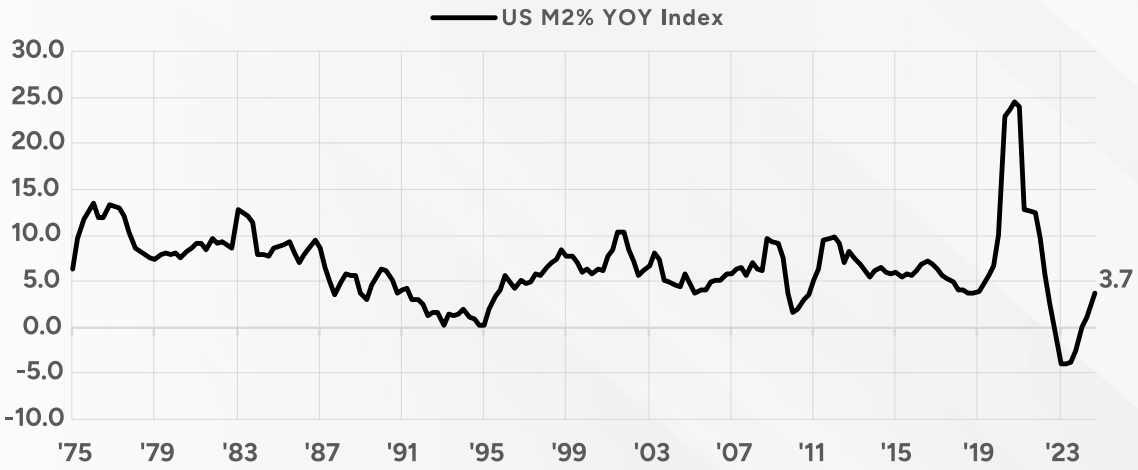
Graph 3: US used car prices (Manheim US Used Vehicle Value Index YoY SA), Source: Bloomberg

3. However, we also ask the question – would used car prices have increased so much if it was not for the demand – and where did that demand come from? **Our theory** (and others including economic luminaries such as former US Treasury Secretary Larry Summers) **considers it the US free money via the CARES act and other stimulus as the most significant driver of inflation.** It is worth reminding ourselves of the extent of that stimulus:

- US$ 931 billion in direct payments to individuals
- 165 million US citizens benefiting
- US$ 5 trillion of US government borrowing

This money was spent and loaned on via the multiplier effect to lead to this extraordinary increase of the money supply as set out below.

This helps to explain why in particular we had excessive money supply growth in the US, whilst China, with no meaningful monetary / fiscal stimulus did not join the G7 inflationary surge.



Graph 4: US money supply alone (Federal Reserve Money Supply M2 YoY % Change), Source: Bloomberg

So where do we stand? What theory do we go with on inflation?

We are very much in the "Larry Summers camp", the inflation surge of 2021/ 2022 was primarily caused by ultra loose fiscal and monetary policy which led to a surge in the money supply. What does this mean for inflation going forward?

The good news is that excess credit is largely through the system, with the Federal Reserve Board belatedly tightening monetary policy. The money supply is growing again after briefly contracting but at relatively low levels (3%), a little lower than long term averages.

In summary, good prospects for relatively low levels of US (and G7) inflation in 2025. ***There may be many reasons to worry about the economic outlook in 2025 and beyond but in our view a resurgence in inflation is not one of them.***

2. Private Markets: How much of a client's portfolio should be in less liquid assets?

We define less liquid assets as investments / structures which are typically associated with restrictions on access for multiple years. These normally include private equity and debt, real estate, infrastructure and some hedge fund strategies e.g. distressed debt investing.

Why would investors place a constraint and give up potential liquidity and flexibility on their investments? The correct answer of course is related to higher potential returns. For example, we note that (until recently) classic (buyout) private equity has outperformed US and global listed equities.

Asset Class	Annualized Return
Private Equity Index	12.1%
US equities	7.9%
Global equities	6.7%

Source: Preqin, April 2024

What is private equity?

It reflects the ownership of companies that were either previously publicly quoted companies or existing private companies which are typically held for several years before selling them to other investors or listing them (back) in the public markets. Consequently, it is quite simply equity as per listed in terms of ownership without the natural feature of mark to market volatility of the public markets.

Private equity (and debt and real estate) is not typically marked to market in line with the public (quoted) markets. This has the effect of reducing the volatility of the specific underlying investment to the client. Is this a good aspect? It is clearly not technically correct, as if any of the private equity, real estate or private debt assets were put up for sale then one would typically see many changes in the underlying valuations and therefore higher volatility of the asset.

In practice, inside private equity funds, changes to valuations of the underlying companies are infrequent and typically much less than what we see in the public markets. However, in extreme circumstances they can change substantially but still much less than the quoted markets. For example, the highest beta we have observed in private equity is about 0.5 (in the 2008/2009 financial crisis) where stock markets (listed equities) fell circa 50% and private equity was eventually marked down by about 20% to 25%.

One of the understandable - but also weaker - reasons that some investors favor private assets is because they take too much comfort in the apparent lack of volatility in a fund. This is a purely behavioral approach to investing, and in some respects, it is completely natural for investors to dislike volatility of their financial assets. AQR's founder and CEO, Cliff Asness has coined a phrase for this - "volatility laundering" - the practice of over-embracing the apparent low volatility of private assets.

One famous fraud took advantage of client's behavioral preference for the absence of volatility. Namely Bernie Madoff's Ponzi scheme, by using made-up performance data. Several victims mentioned that they were not chasing high returns (which was to a certain extent true), and Bernie Madoff engineered his return to be about the same as the stock markets – but with very little monthly volatility. His fund had a Sharpe ratio* of about 4 versus the stock market of about 0.4. Investors were not "greedy" for returns, instead they were chasing apparent low monthly volatility.

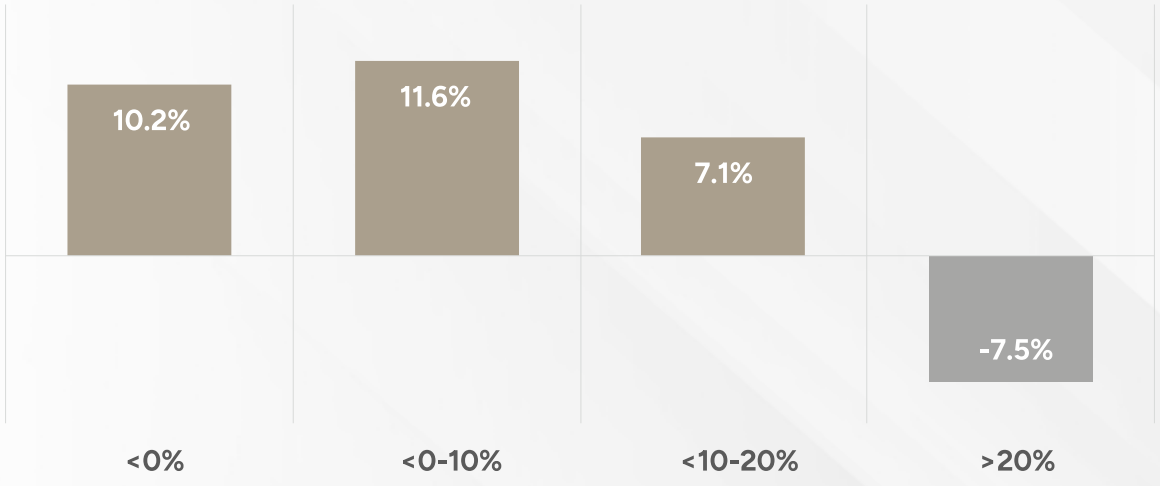
*Sharpe ratio measures the return relative (divided) by the volatility of any investment / fund etc. Any investment with a Sharpe ratio approaching 1 should be regarded as unusual.

Some of the earliest and most expensive users of private assets were the endowment funds of major US universities, in particular Yale's endowment fund, led by ex CIO David Swenson in the early 1990s. Swenson and others recognized that the very long-term nature of the funds was inconsistent with an almost exclusive investment in daily liquidity public markets. In essence, the funds could afford to give up some liquidity to achieve higher returns. The table below sets out more recent returns based on publicly available filings (June 2023) of a selection of leading endowment funds.

	10 Year annualized returns	Size (US$bn)
Brown University	11.3%	6.6
Yale	10.9%	40.7
Princeton	10.8%	34.1
Dartmouth	10.7%	7.9
University of Virginia	9.8%	13.6
Duke	9.8%	11.6
University of Pennsylvania	9.7%	21.0

These funds typically have a weighting of 40% towards private assets including venture, real estate, infrastructure and private equity. The historic long-term returns are absolute evidence that allocations to private assets can be additive to overall returns.

What about diversification? For example, if public equity markets are weak how will private assets perform?



Graph 5: US PE average relative returns in various public markets environments (x axis shows public markets performance, and y-axis shows private market performance) Source: JP KRR, Cambridge Associates

Graph 5 shows the excess returns for the average Private equity manager in different environments for the public markets. Note that when public markets are very strong like in 2023 and 2024, then private equity typically underperforms on a short-term basis as valuations remain relatively stable. In contrast, when markets are weak that is typically when private equity returns shine on a relative basis. This of course reflects the lagged and smooth valuations that we observe in most private market allocations but can be particularly helpful to an investor's overall portfolio in bear (negative returns) markets in the public markets.

There is no single answer to the weighting in private assets relative to public, especially for private clients where risk tolerances differ significantly. However, the endowment model at circa 40% gives us a sensible upper bound for clients' with very long-term horizons and a growth risk profile.

3. What to expect about (public) market corrections and distributions of returns in individual years?

At this time of year there are multiple 2025 forecasts for stocks, bonds and currencies from esteemed analysts at investment banks and money managers. For example, with the S&P 500 at the 6,000 level at the time of writing, here are some of the forecasts for 2025:

Firm	End 2025 S&P500 forecast
Bank of America Merrill Lynch (BAML)	6,666
Deutsche Bank	7,000
Goldman Sachs	6,500
Morgan Stanley	6,500
UBS Wealth	6,600
Yardeni	7,000
JP Morgan	6,500
BMO Capital Markets	6,700

It is often a thankless task for these analysts but interesting to see how they are drawn to the "+10%" number plus or minus.

BAML's analyst, Savita Subramanian, has an elegant but somewhat scary 6,666 forecast - her tongue in cheek (but very well researched) theme is from 666, the bottom in March 2009 to 6,666 in 2025. I have read the BAML report in detail and there is well-researched and detailed information on earnings and the equity risk premium (essentially the difference between equity and bond valuations). However, how does all this work stack up against historical returns?

In the US (and multiple other markets), long term quoted listed equity returns are attractive e.g. the S&P 500 index as compounded at 9.7% since 1926. Consequently, you can understand how analysts are drawn to a "+10% scenario". However, when we break returns down into individual years we get the following distribution:

Frequency of annual returns for the S&P 500 since 1926

Negative years	"Normal" 0-10%	Above Average >10%
29%	14%	57%

Put simply, returns from equity markets are skewed and rarely (14% of the time) provide the "steady" annual return that most investors expect. Instead, in approximately 3 out of 10 years the market is down and in roughly 6 out of 10 years, the market is up substantially. Investors cannot afford to miss out on large compounding days or years.

When it comes to thinking about the prospects for equity returns in 2025, or indeed any individual year, the data shows that one could expect a strong performing year, which you would simply need to be invested for, but one should also accept that such years of particularly strong performance (eg. 2023 and 2024) will be offset over time by years when the return from equities will be negative.

Whilst investors can come to terms with that annual return profile, for an analyst's forecast, based on historical data, it would more sense to forecast +20% in an annual year or even a negative return but almost no analyst will do that!

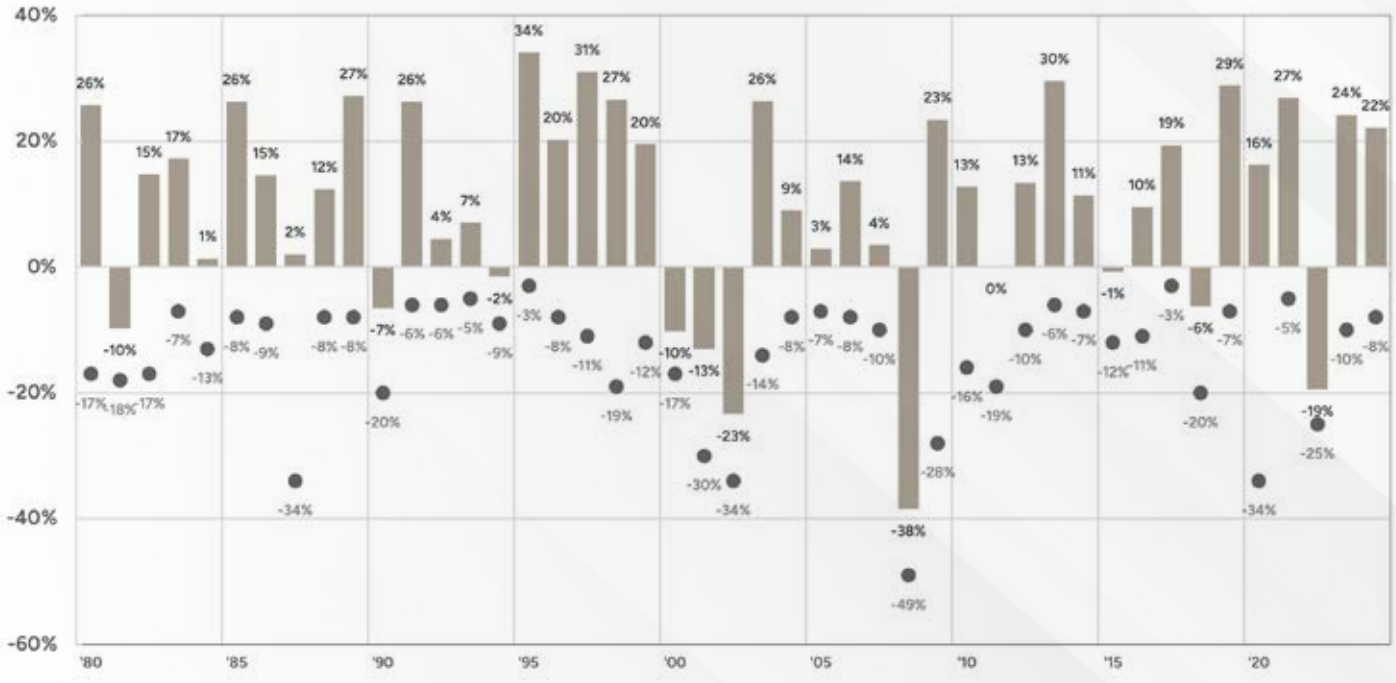
We shy away from the thankless task of predicting year-end numbers and instead focus on long run compounding and note how returns can be drastically lower by excessive market timing.

For example, we analyse a period which includes two severe bear markets for US stocks (2000-2002 and 2008/2009) - both times stocks lost circa 50% of their value. However, over the whole period stock returns were reasonable – provided you did not try and time the market. In contrast, look at the reduction in returns when investors miss out on the best individual days in the market, as set out in the table below, this can severely damage returns.

January 4, 1999, to December 31, 2018,	Annualised Return
Fully invested	5.62%
Missed best 10 days	2.01%
Missed best 20 days	-.33%

What about market corrections?

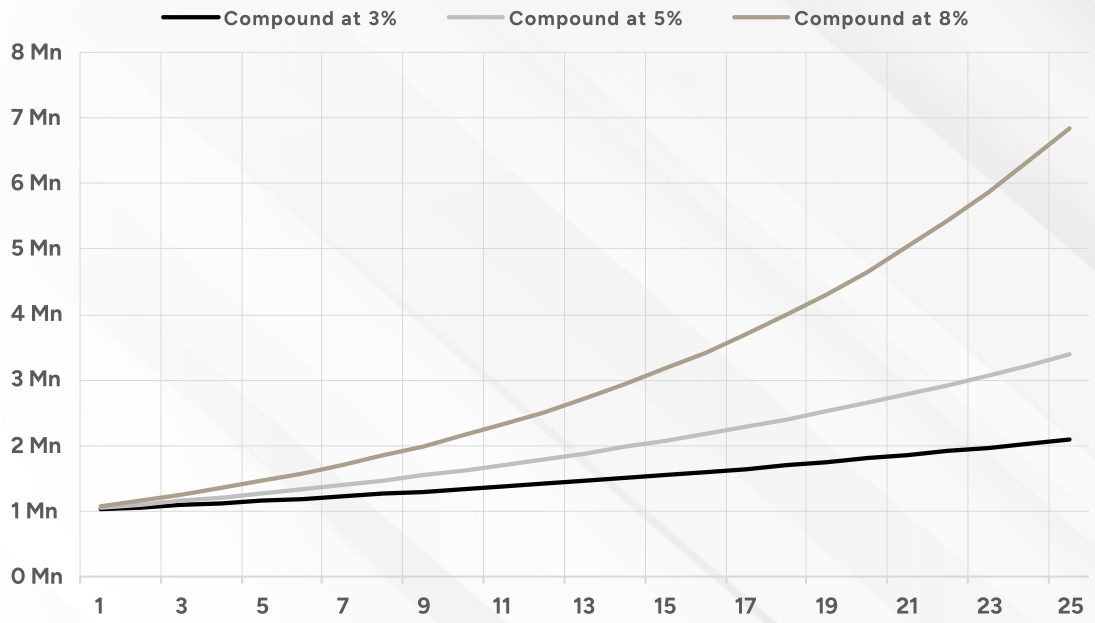
The graph below from JP Morgan shows the annual returns but also the corrections (drawdowns) that were observed during the year. For example, in 2020, the red -34% correction was the Covid related sharp correction yet for 2020 as a whole, the market ended up 16%. The basic message from this data is that investors should expect sharp corrections every single year. In fact, 2024 was unusual, a relatively small -8% correction with the market ending up 23%. The average intra year correction over this period is 14.1%.



Graph 6: ***S&P intra-year declines vs.*** calendar year returns Source: JP Morgan

Consequently, investors should understand and embrace market corrections as completely normal, volatility is effectively the "price" that is paid to achieve attractive long term compound returns.

It is alleged that Einstein called compounding the eighth wonder of the world. Why? The human brain cannot easily process this, for example seemingly relatively small changes in compound rates can make huge differences in wealth once time horizons are extended. Instead, we tend to focus too much on "5% is not that different from 8%", in an individual year. Of course this is true, but as set out below this provides a huge difference in wealth, when compounded over the longer term.



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