Goldman Sachs Exchanges

Navigating 2025: Why investors need to diversify and hedge their portfolios

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Allison Nathan: 2024 was a great year for many US investors, but will the same strategies that worked so well keep working in 2025? I'm Allison Nathan, and this is Goldman Sachs Exchanges. To get their fresh outlooks for asset classes and portfolio strategies, I'm sitting down with Christian Mueller-Glissmann, who heads asset allocation research in Goldman Sachs Research, and Alexandra Wilson-Elizondo, Co-Chief Investment Officer of the Multi-Asset Solutions business in Goldman Sachs Asset Management.

Alexandra is joining me in our New York studio, and Christian is joining us remotely from our office in London. Christian, Alexandra, welcome to the program, and Happy New Year.

Alexandra Wilson-Elizondo: Happy New Year.

Christian Mueller-Glissmann: Happy New Year to you.

Allison Nathan: So it's the first podcast of the new year, and I cannot think of a better way to kick it off. But before we get into our 2025 views, let's start with a quick recap of what worked well and maybe not so well for portfolios in 2024. Alexandra, maybe give us a quick sense of that.

Alexandra Wilson-Elizondo: Absolutely. The headline should read long risk. Long risk worked very well as both US and global economies outperformed what the expectations were more broadly. But underneath that in the broader indices, there was actually meaningful dispersion in sectors, regions, and size. Just some

examples are that US large caps outperformed small caps to the tune of 12.5%. Europe underperformed the US by one of the largest margins that we've seen in a very long time. But there were also interesting stories, not just in the US and Europe, but across the rest of the globe, so you saw places like Argentina, experience a strong revival. The indices within China posted positive returns for the first time in a few years. And then in other risk assets in particular, credit markets, especially in the US, had a banner year. So you had IG spreads tightening by about 25 basis points, bringing us close to historic lows at 75 basis points, and you saw similar moves in high yield, lesser extent in emerging market debt.

So very strong storyline for broader risk assets. Now there were some other, you know, spaces where you saw some real outperformance and underperformance, so for example in the currency market, you saw the yen be a strong underperformer and the US dollar be a strong outperformer, largely due to yield differentials but also there was the storyline of what's happening in politics in the US. And then last but certainly not least, I can't not

talk about duration and in particular US interest rates because the expectation was you're coming into a Fed cutting cycle. The Fed did cut 100 basis points, but we actually saw the market restrike the price for growth. and for what could be ultimate change in fiscal policy. And so you saw yields back up since September, the 10 year, about 100 basis points. So it was certainly not a dull year to say the least.

Allison Nathan: Right. But certainly a friendly macro backdrop for risk assets, as you just said, and especially US assets in 2024, and a lot will depend this year, again, on how friendly that macro backdrop is. So Christian what's your view on that? Does this business cycle still have legs?

Christian Mueller-Glissmann: Yeah, I think broadly our macro baseline is still friendly. We still have global growth that's healthy, probably not too dissimilar to what we had last year. We still have inflation coming down a bit further and central banks cutting rates. But there is a subtle shift. I think what we had in the last two years is you might

remember this. We talked about the inverse Goldilocks scenario where I think risky assets in particular, but generally most assets, have benefited from this inflation normalization where inflation came from very high levels and declined. And we called it the inverse Goldilocks scenario because normally Goldilocks means growth picks up without inflation. And what happened in the last two years is inflation went down without growth going down. The result is the same. You're improving the growth inflation mix, and that usually anchors risk that helps risk premia compress and it's a very friendly backdrop for multi asset portfolios because 60/40 type portfolios can do well equities and bonds can go up together. And generally, Sharpe ratios tend to be high.

And I think now we're going into a bit more of a reflationary type backdrop. I think we still have good growth, but inflation is unlikely to come down as much anymore. So I think that is a shift that investors need to deal with. That kind of means potentially lower Sharpe ratios, less risk premium compression, less kind of valuation expansion. And to some extent, it might also mean less narrow

performance. I think Alexandra mentioned earlier yes, equities did well. US equities did particularly well. But it was very narrowly concentrated on the Magnificent Seven on momentum as a factor. And that is a lot linked to this inverse Goldilocks scenario, because what we find is in Goldilocks regimes carry trades. Tend to do particularly well. Alexandra mentioned credit spreads tightening. Again, that's very much a symptom of an inverse Goldilocks scenario or Goldilocks scenario. Credit doing very well. Carry trades doing very well. And the Magnificent Seven are a bit like a carry trade because you have like recurring revenue in structural growth in most people's minds. So valuations can expand for those areas, and it's going to be much tougher with the type of macro regime, that we anticipate for this year.

Allison Nathan: And Christian already started to talk about how some of these differences this year from 2024 might impact allocation strategies. Where are you on that, Alexandra? How are you looking at allocation strategies in 2025 versus 2024?

Alexandra Wilson-Elizondo: Yeah, so we all know that the economy is not the stock market, and a lot of returns got pulled forward in ‘24. And while we might be looking at the expansion of the cycle, or a different phase of the business cycle, we are looking at late-cycle valuations. And equity valuations are very challenged when you look at premia versus the rate market but at the same time, you've got this meaningful supply demand shift that's happened in rate markets, and it's caused rates to back up, even though you do have disinflation, even though we are in a much better place in the economy.

So, where does all that cocktail leave you in terms of allocating your portfolio? We do still believe that being overweight risk in equities is the right place, although we've reined that in from a much higher level of risk taking, just given that valuation backdrop.

And in duration or rates, we're more focused on relative value across the globe, rather than just expressing it in the US. Places like the UK where the inflation picture has been a little bit stronger in terms of how they've been able to rein

it in, or spaces like China where they're going through some of a deflationary regime.

And away from that, we've talked a lot about dynamism and how this bifurcation is happening. That's going to be a really great space for alternatives and alternative managers, so increasing allocations to things like hedge funds makes sense to us.

Allison Nathan: I want to dig into some of that a bit more, but, Christian, do you generally agree with what Alexandra just said in terms of thinking about this?

Christian Mueller-Glissmann: So the main message we're giving is twofold. First of all, you want to think about more diversification across assets, a bit like what Alexandra said, maybe mix bonds and equities a bit more. I think 60/40, we've already said in our podcast last year, will start to look a bit better and it did. but mainly because equities did well, not because the bond market did well.

I think this year, you might actually see more performance contribution, further risk reduction contribution from bonds in multi-asset portfolios. So you want to think about diversification across assets, more balance in the portfolio.

And the other thing that will be important for this year is more diversification within assets. Don't just rely on a few stocks, and possibly the same momentum stocks that have driven most of the equity return the last year. Try to find opportunities outside of these winners. And that's again, typical late cycle. When you're late cycle, you shift towards barbell strategies where you're marrying or you're combining winners, quality stocks that are already doing really well with selective laggards.

And the key challenge will be where are those laggards? Do you diversify internationally? Do you go towards Europe? Are there opportunities to look selectively at emerging markets laggards, which might benefit from a bit of stabilization in China?

Allison Nathan: But let me just play devil's advocate for a moment because you have talked about the risk that Magnificent Seven outperformance can't continue, the market concentration risk related to that, and valuations being so stretched as reasons to be more concerned for 2025. But if I think back to our conversation a year ago, 18 months ago, those risks were also front and center, and yet that outperformance continued. So why are you convinced that those trends won't continue today?

Christian Mueller-Glissmann: From my perspective, I'm not saying that we expect the Magnificent Seven to massively underperform, but you have to consider starting point. I think valuations have expanded further. Valuations are higher now, and I think the key challenge you have is what we found in our work is a large part of the valuation premium of the Magnificent Seven can be justified by the superior profitability and cash flow generation and so far that has made us actually quite relaxed about the Magnificent Seven. The problem is this last year, um, the valuations of the Mag Seven and the S&P 500 and aggregate has started to overshoot our structural fair value

model that incorporates profitability and to some extent free cash flow margins. So the challenge you have now is the market is somewhat overpaying a bit.

And the other thing you have to consider is that these companies occasionally can disappoint. And this is particularly relevant to your question on concentration from an asset allocation perspective. Normally as an asset allocator, you try to diversify idiosyncratic risk, but if you are in the business of asset allocation with benchmarks, the benchmarks are very exposed to some of those names currently.

Just to give you a sense currently, the top 20 stocks in the S&P 500 are driving more than 50 percent of the volatility of the S&P 500. That's never been as high as that. And the volatility contribution is actually higher than the market cap weight of the top 20 stocks because often the Mag Seven or the largest stocks in the index are more volatile as the index.

So to your point, I'm worried from two perspectives. The first one is those stocks are more valued. They've seen valuation expansion at the macro fundamentals, the micro fundamentals for those stocks might start to disappoint a bit considering they've had such a strong run because they need to get better to some extent to justify those valuations.

And the second factor is that from a kind of asset allocation point of view, the concentration now with regards to risk is actually even more extreme than it was at the beginning of last year. The contribution to volatility from those names is actually significantly higher now, so it needs a bit more addressing now compared to the same time last year.

Allison Nathan: Alexandra, do you have thoughts on that? Again, investors are like, look this has been working, uh, and the macro backdrop generally remains friendly. Why should I change course here?

Alexandra Wilson-Elizondo: Harry Markowitz famously declared that the only free lunch in investing is diversification.

And to Christian's point, it's important to pay attention where there's been unknown biases introduced into your portfolio that could drive high levels of volatility that are unexpected. And you know, just some further data points to what he mentioned, 20 percent of the S&P 500 is concentrated into three big names with the average trailing P/E of about 44. 70 percent of the ACWI is concentrated into the US, which implies 14 percent exposure to those big names. And when you're looking to asset allocate, you're being thoughtful about allocating across markets, regions, size, active management, and you need to be very thoughtful about do you want that to be part of your structural bias in your portfolio or is that a dynamic or tactical decision.

And so we're very thoughtful about explaining it from a long term perspective versus medium and short term. In 2024, the bar to diversify away from large tech was really

high because you were starting to see capex cycles kicking off and it was just really the beginning of seeing how corporates were going to hone into these AI projects and how growth was going to be elevated for many of those names.

Now we're a little bit later into that capex cycle and we have improved clarity and so we don't expect returns for ‘25 to be the same as ‘24. We're not similarly to what Christian's saying, we're not saying run away from tech, but there's a lot of different opportunities that don't have the same length or extension or leverage in them, if you will.

Allison Nathan: And one of those, again, you had mentioned was private markets. So talk to us a little more about that and where you see the most compelling opportunities there.

Alexandra Wilson-Elizondo: We believe that private equity firms will have a much easier time exiting over the next few years relative to the ’22-‘24 period, and the IPO market is

already primed up for some explosion there, and that should really do well for IRRs.

And then we've also mentioned that, you know, this backdrop of a lot of potential volatility, divergence, more tactical trading is very good for hedge funds, so we want to add things like that, those alternative premias into our portfolios. It's more about adding different layers of diversification to your portfolio, especially even though bonds, to Christian's point, higher levels of yield provide more diversification.

We could see a regime where it's much stickier or higher when we discuss inflation, and that will prove challenge to adding more duration to portfolios. So, finding ways to get more diversification, be in private markets, by the way, which move, in particular private credit, moves less violently than public markets, and then you can reallocate when public markets have experienced a big drawdown from some of those tight levels we saw in high yield. From our perspective, it's going to be a very important allocation going forward, in particular this year.

Allison Nathan: So let's talk a little bit more about risks to these views, because if I'm hearing both of you correctly, there’s still upside, you still want to be leveraged to risk assets, but you want to think about diversification. What would meaningfully change your view of the world, Christian?

Christian Mueller-Glissmann: Yeah, so you have a highly concentrated equity market with the same winners that that have been the winners for a long time. So anything that challenges their business model or changes the perception about what investors are willing to pay for those is dangerous.

And to your point, it might not seem very likely considering, as you were saying, it's something that has worked before. Why should it not work now? But I think we're getting to a point in terms of valuations, as I mentioned earlier, that certainly makes us a bit more worried, but also we're getting to a different phase in, to

some extent, the AI trend and there's more capital intensity.

There's more competition. This kind of risk of concentration and overpricing or over extrapolating of success is something that worries us and we're watching particularly ROE we want to understand if the ROE can continue to stay at these high levels for the largest stocks in the S&P 500. If you only get a trend down in the ROE, the market might start extrapolating that as well. So I think that's the first concern.

The second concern that matters both for equity stand alone, but also for multi asset portfolios is, of course, inflation. Yes, inflation momentum has turned less negative. If I look at inflation surprises like in the G-10 economies, actually the proportion of countries that are currently seeing large inflation surprises up or down is close to the lowest level on record.

So in other words, inflation risk has really moderated. The bad news is the market is pricing that as well. So one way to assess inflation risk premium is to look at break-even inflation. So what the market is pricing for inflation for the next 5 to 10 years and compare that to consensus economics' forecasts for inflation.

And currently what you find is that the inflation break-evens like the market pricing of inflation is actually below the forecasts. So the market prices is very little inflation risk premium. So, so the fact is, it's not necessarily that you have to worry about inflation reaccelerating massively. It could just be the fact that inflation is just a bit stickier and a bit picking up that considering where inflation risk pricing is could cause a bit of a setback, and I think the last few weeks were a bit of a preview of that, where I think the hawkish December FOMC meeting has certainly led to a pretty large reaction in the bond market, possibly larger than justified. Certainly our economists think so, where now there's very little priced for fat cuts for this year and also the term premium. So the steepness of the yield curve has significantly picked up. So, this is still making us very

nervous, like how the bond market is still finding its equilibrium and similarly how the inflation risk and the inflation risk premium are still finding their equilibrium.

And the last thing I would say — and this is a bit more fuzzy — is tariffs and geopolitics. I think we're going into a year where the policy uncertainty is unusually high. If you look at these famous economic policy uncertainty indices, and you look at the trade policy component, it's through the roof. It's actually at the levels from 2019 already without even any tariffs or any significant trade policy changes being enacted. That could be good and bad. It could be good in the sense that this trade policy uncertainty is already very high. And that that means the market is already pricing that risk, but it could also be bad in the sense that we might make new highs. With regards to trade policy uncertainty, and maybe the market is not prepared for that.

Allison Nathan: So a long list from Christian. Alexandra, anything to add to that?

Alexandra Wilson-Elizondo: Yeah, so I'll just reiterate two things along the same vein. I think any Fed communication error as it relates to where they see the neutral rate being and adjusting higher going forward could lead to more volatility in the bond market.

We see some risks of the divergence across the globe showing some fragility in currencies which could have a domino effect. And last but certainly not least, I'm going to come back to the bond market. There has been a material supply demand shift in the bond market, and yield sensitive buyers versus price sensitive buyers, you don't have as many yield sensitive buyers, and you have central banks coming away from that market.

Meanwhile, supply has grown in the Treasury market, something to the fact of, in 2019, the market has grown $11 trillion since then. These are staggering numbers. But on the other side, private borrowing on a net basis has been really contained, and so the aggregate issuance in the bond market has been somewhat understandable and easier for, for buyers to digest.

But I do think that that indigestion still exists, and that's why we're having this hard time with term premium, where the ultimate level of the 10 year should be. And so we're trying to pay very close attention to auctions, how they're performing, do they have big tails. This week alone we're supposed to see something up to the tune of, you know, $120 in U.S. Treasuries and $50 in billions in corporate credits. So how does that, how does that look? How does it get digested by the market? I think supply demand is still going to be really interesting there.

Allison Nathan: Understood. So both of you, if you think about the risks that investors are facing today, have talked a lot about diversification during this conversation. Are there any other hedging strategies that you are observing investors taking advantage of in the face of these risks?

Christian Mueller-Glissmann: I think, listen, the first line of defense in asset allocation is always diversification. So I think you want to look at alternatives that can help you

with the scenarios when equities and bonds together don't really work well.

We've been quite constructive on gold. Central bank demand for gold in particular remains strong and should drive a further upset to gold prices. I think you can think about diversification to certain currencies that maybe help you with the risk of central bank repricing. So the dollar is clearly one that screens very highly.

We have the stronger for longer view. It's a bit tougher. We have to be completely honest after the rally we've had since December. It's been a quite remarkable rally. But certainly, it's a strategic view that we hold for the next year that the dollar will also help you for tariff risk. It will help you potentially for geopolitical risk, and you can possibly mix in other safe haven currencies there.

In terms of broader hedges, in in the options world, etcetera, we certainly looked a lot at credit. We do find that credit spreads have been remarkably tight. We are entering a world that might be a bit less carry friendly.

If you look at implied volatility and credit, it's remarkably anchored and low. So we've looked at opportunities there, but to keep it simple. Just a simple equity put into kind of the January inauguration into kind of the earning season to us makes a lot of sense right now. It’s picked up a bit because obviously, since December. The kind of skew has picked up a bit.

It's been a bit more volatile, but I would still say the cost of options broadly considering the uncertainty for next year in both directions, but for us, we're obviously concerned about hedging our existing portfolio and our existing allocation. I think options seem cheap to me in equities. So we just like the idea of hedging into, especially the inauguration and the US Earnings season because we're very nervous about ROE and corporate profitability.

Allison Nathan: So we've covered a lot today. What I'm taking away is the investor outlook still looks relatively

positive for 2025, contingent on the macro backdrop remaining benign.

But there are risks and diversification, other hedging strategies might make sense in this environment.

Thanks so much, Christian and Alexandra, for joining us today.

Alexandra Wilson-Elizondo: Thank you so much.

Christian Mueller-Glissmann: Thank you so much for having us.

Allison Nathan: This episode of Goldman Sachs exchanges was recorded on Monday, January 6th, 2025. I'm your host, Allison Nathan. Thank you for listening.

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