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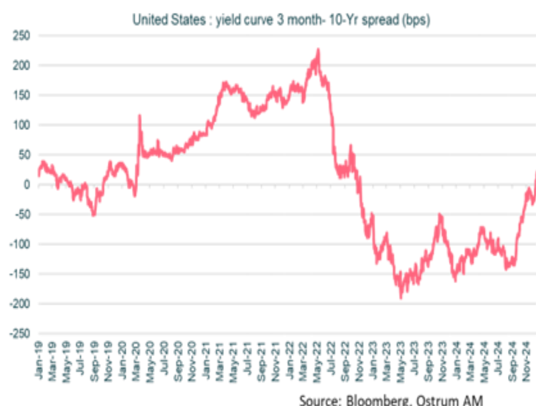
Topic of the week: Three major risks for 2025
by Axel Botte, Zouhoure Bousbih & Aline Goupil-Raguénès

- In 2024, the U.S. stock market just recorded its fourth year of 20%+ return in the past six years. A handful of stocks, the Magnificent 7, now represent about a third of the market capitalization of the S&P 500.
- This situation of extreme concentration draws comparisons to the TMT bubble, which bursts in 2000 causing large losses at lenders, a credit crunch and tipped the economy into a recession.
- Trump's goals of weakening the dollar to reduce the U.S. trade deficit while maintaining the dollar's privilege seems very complicated to achieve. However, the critical question for 2025 will revolve around China's choice.
- In France, the risk is an escalation of the political crisis leading President Emmanuel Macron to resign. This would create a real shockwave in the financial markets, with a high risk of recession and an intervention by the ECB to ensure the transmission of monetary policy.

Market review: The market review will resume next week
by Axel Botte

- The market review will resume next week.

Chart of the week



One of the most closely watched financial indicators is the U.S. yield curve. The spread typically foreshadows shifts in the economic cycle and inflation risks.

While market participants have increasingly focused on the 2-10 year spread, economists have long favored the 3-month to 10-year spread, which is seen as a more representative gauge of monetary policy transmission to the real economy. This spread has turned positive for the first time since 2022. A rapid steepening of the curve is generally associated with an impending recession.

Figure of the week

827

827 billion dollars: the represents the contraction in the Fed’s balance sheet in 2024. The Fed’s total assets have shrunk to 6.89 trillion dollars at the end of last year.
Source: Federal Reserve

Topic of the week

Three major risks for 2025

Our main scenario is for modest global growth, some further disinflation and monetary easing. But there are risks to this central scenario that could dampen the growth outlook and materially change the outlook for financial markets. We have identified three major risks for 2025. In this piece, we discuss the fallout of a potential Minsky Moment in U.S. equity markets, a significant decline in the US dollar, and the resignation of French President Emmanuel Macron.

S&P 500: a Minsky Moment in 2025?

Demanding valuations are no signal of a downturn, but the downside risk from high multiples is greater

Clearly, the direction of the S&P 500, Wall Street's key equity benchmark and the global proxy for risk, will depend on Trump policies. Forecasting equity returns is not easy to say the least. Forecasters tend to pencil in price annual returns in the 0-10% range. The mode of the distribution is 5-10%. The actual distribution of yearly returns since 2000 is much more uniform than the bell-shaped distribution of forecasts. Tails of equity are much fatter than generally expected. S&P 500 returns exceeded 25% five times in the past 25 years whilst the S&P 500 lost 15% or more on three occasions. Wall Street forecasts have been too pessimistic in four of the last five years. In sum, forecasters may get the market's direction right, but the magnitude of the price changes is often understated.

At first glance, the earnings picture looks pretty good for the S&P 500 in 2025. Top-down analysts forecast EPS growth in the vicinity of 12.3% on average. The most pessimistic forecaster penciled in flat earnings for next year (+0.5%) whilst the most optimistic forecast is for 19.4% EPS growth. That's good enough for a consensus price target of 6,508 for the S&P 500 by the end of the year although the range of price forecasts is much larger than that of EPS from -25% to 19%. That stems from the valuation multiple assumption.

For 2025, the starting point for valuations is indeed in focus. The price to earnings ratio of the S&P 500 has increased significantly through 2024 to 24.8 times using 12-month trailing earnings. The valuation bar is thus high for the market to make further progress. Furthermore, the valuation overhang is concentrated in a handful of mega-cap stocks that now account for fully a third of the market capitalization. Tesla is trading at absurd multiples of 150 times. This is reminiscent of the TMT bubble of the late 1990s which then Fed Chair Alan Greenspan described as irrational exuberance… 4 years before the bubble eventually popped. Valuations are not necessarily a signal of near-term weakness. High price-to-earnings ratios go together with the bullish sentiment evident in individual investors' surveys and current institutional investors' positioning. In other words, investors are willing to pay up for stocks as they anticipate a continuation of the bull market.

Bear in mind that high multiples potentially increase the magnitude of market downturn when negative shocks derail the economic cycle. What is more, the macro-market causality may work in reverse. A Minsky moment, or a sudden drop in equity markets, is always possible. Given the sheer size of the U.S. equity market, market participants would incur losses which could undermine their financial health. A deleveraging cycle would

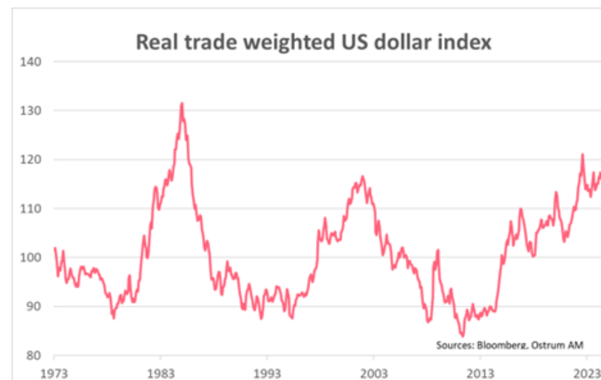
ensue with fire sales of assets creating a self-fulfilling market panic.

The market crash in the 2000s hit a very strong U.S. economy and tipped it into a short-lived recession that nevertheless had very profound and lasting economic consequences. The balance sheet recession meant that financial institutions were no longer able to extend credit. The ensuing credit crunch forced corporate restructurings, a wave of defaults with very low recoveries (as fire sales dampen asset values) and soaring unemployment even as economic activity eventually stabilizes.

The dollar and China

Donald Trump has been elected the 47th President of the United States. His second term is expected to be more radical than the first. The Republicans have gained control of both chambers, giving him the latitude needed to implement his agenda. While his tariff policies have generated significant discussion since his reelection, the weakening of the dollar is also a crucial aspect of his economic agenda and could represent the second phase of his industrial policy. The president has frequently indicated during his campaign that the strength of the dollar hampers the competitiveness of American companies, thus advocating for a weaker dollar. However, the policies he intends to implement may produce the opposite effect by strengthening the greenback. His tariff policy creates uncertainty and paradoxically enhances the appeal of the dollar as a safe haven. The corporate tax cuts he aims to introduce will also attract foreign capital to the United States, further bolstering the value of the dollar.

Since his reelection in November, the ICE Dollar Index has increased by 4.5%, in anticipation of the implementation of his electoral program. The Fed's trade-weighted dollar index has risen by 41% since its low in August 2011. Several factors explain the strengthening of the dollar since that date, such as the European sovereign debt crisis and the structural slowdown of the Chinese economy. However, this seems paradoxical for a currency of a country that has a significant trade deficit of $865 billion (as of the end of October). It is the privilege of the dollar as an international reserve currency that attracts capital flows globally, leading to its appreciation. The dollar represents 57% of global foreign exchange reserves, compared to 20% for the euro, 5.8% for the yen, and 2.17% for the yuan.



Trump does not wish to challenge the dollar's privilege, as its loss would signify the end of the United States' hegemonic power. R. Lighthizer, who was responsible for the tariffs during Trump's first term, aims, much like Reagan in 1985, to impose or threaten tariffs on the United States' trading partners if they do not take initiatives to appreciate their currencies against the dollar. The Plaza Accord of 1985 was an ultimatum from Washington directed at Japan. The United States negotiated with France, the United Kingdom, Japan, and Germany to intervene in the foreign exchange market to weaken the dollar, which worked except for Japan. The appreciation of the yen against the dollar

hampered the competitiveness of Japanese exports, plunging the Japanese economy into deflation from which it struggled to recover. (This context helps explain the current reluctance of the Bank of Japan to significantly raise interest rates to avoid appreciating the yen). China will never accept a new Plaza Accord, as China is not Japan. Chinese authorities will never agree to a significant appreciation of the yuan to reduce the American trade deficit.

Trump's goals of weakening the dollar to reduce the U.S. trade deficit while maintaining the dollar's privilege seems very complicated to achieve. However, the critical question for 2025 will revolve around China's choice. Will Chinese authorities try to buy time by allowing Trump to remain in his contradictions? Or will they decide to create a sort of new Bretton Woods with the BRICS, where the yuan could replace the dollar as the centerpiece of the BRICS zone, similar to how Bretton Woods positioned the dollar at the heart of its system? Such an initiative would mark the irreversible end of the dollar's hegemony. Trump has understood this well, as evidenced by his warning directed at the BRICS via his social media platform, Truth Social, should they consider an alternative currency to the dollar. China has yet to make this decision, but who knows...

Shockwave in France if Emmanuel Macron resigns

The year 2024 was marked by the outbreak of a political crisis in France, resulting in the appointment of four Prime Ministers within a year. In 2025, the risk is a significant intensification of this crisis, leading to an unmanageable political situation and the resignation of President Emmanuel Macron. This could create a real shockwave in the financial markets and trigger an economic crisis.

After four Prime Ministers in one year, the new government remains at risk of another no confidence vote

The announcement of the dissolution of the National Assembly and the results of the early legislative elections led to the formation of a highly divided Parliament: three major blocs, none of which holds a majority. During the discussions on the 2025 budget, no bloc deviated from its red lines, resulting in the collapse of Michel Barnier's government. He aimed for a reduction of the deficit to 5% of GDP this year, following a significant fiscal slippage in 2024: 6.1% of GDP, the highest among Eurozone countries. As discussions on the 2025 budget resume this week, it will be just as difficult for François Bayrou's government to reach compromises to pass the budget. The latter aims for a deficit between 5% and 5.5% of GDP, based on €50 billion in savings, compared to €60 billion for the previous government. This new government is indeed still subject to the risk of a no confidence vote, just like Michel Barnier's government was. In this context, the probability of another dissolution of the National Assembly in July 2025 is quite high. The early legislative elections that would follow are likely to lead again to a highly fragmented Parliament and, consequently, to prolonged political paralysis.

The probability of another dissolution of the National Assembly in July is high

The resignation of the President would generate significant tensions on the French spread and a high risk of recession

On December 5th, due to the increasing calls for his resignation, the President of the Republic declared that he would continue to serve his term until the end. However, if the political situation became unmanageable, Emmanuel Macron could decide to resign. This would significantly increase uncertainty, which has already grown since the announcement of the dissolution. Political risk has manifested itself in a noticeable widening of the French spread relative to Germany (the difference between the 10-year French and German rates), which rose from 48 basis points (bp) before the announcement on June 9th, to 82 bp on June 27th, and peaked at 83 bp this Monday. In the event of the President's resignation, fears of the rise to power of a party likely to pursue economic

policies that would exacerbate the imbalance in public finances would significantly increase tensions on the French spread, likely pushing it well beyond 100 bp. This rise in uncertainty and interest rates would further undermine the confidence of households and business leaders, negatively impacting consumption and investment, with a high risk of recession.

The ECB would intervene to ensure the transmission of monetary policy across all Eurozone countries

To ensure the transmission of monetary policy across all Eurozone countries in the event of "unjustified and disorderly market dynamics," the ECB should use its Transmission Protection Instrument (TPI) in this context. Never used before and with an unlimited amount, it would allow the ECB to purchase French bonds on the secondary market to reduce tensions on OATs, provided that France meets four criteria, including its budget commitments to the European Commission.

Axel Botte, Zouhoure Bousbih & Aline Goupil-Raguénès

Market review

The market review will resume next week

Main market indicators

G4 Government Bonds	06-Jan-25	1wk (bp)	1m (bp)	2025 (bp)
EUR Bunds 2y	2.19%	+11	+19	+11
EUR Bunds 10y	2.44%	+7	+33	+7
EUR Bunds 2s10s	24.9 bp	-3	+15	-3
USD Treasuries 2y	4.25%	+1	+15	+1
USD Treasuries 10y	4.58%	+5	+44	+2
USD Treasuries 2s10s	33.4 bp	+4	+29	+1
GBP Gilt 10y	4.6%	-1	+32	+3
JPY JGB 10y	1.14%	+4	-36	-8
€ Sovereign Spreads (10y)	**06-Jan-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
France	83 bp	0	0	0
Italy	113 bp	-2	-2	-2
Spain	66 bp	-3	-3	-3
Inflation Break-evens (10y)	**06-Jan-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
EUR 10y Inflation Swap	2.01%	+8	+10	+8
USD 10y Inflation Swap	2.46%	+1	+4	0
GBP 10y Inflation Swap	3.56%	+6	+12	+4
EUR Credit Indices	**06-Jan-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
EUR Corporate Credit OAS	102 bp	+1	-4	+0
EUR Agencies OAS	63 bp	+2	-3	+1
EUR Securitized - Covered OAS	57 bp	+0	-1	+0
EUR Pan-European High Yield OAS	312 bp	-5	-22	-6
EUR/USD CDS Indices 5y	**06-Jan-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
iTraxx IG	55 bp	-3	+2	-2
iTraxx Crossover	298 bp	-16	+9	-15
CDX IG	48 bp	-2	+1	-2
CDX High Yield	301 bp	-11	+13	-11
Emerging Markets	**06-Jan-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
JPM EMBI Global Div. Spread	320 bp	-9	-12	-5
Currencies	**06-Jan-25**	**1wk (%)**	**1m (%)**	**2025 (%)**
EUR/USD	$1.041	0.106	-1.542	0.5
GBP/USD	$1.254	-0.080	-1.640	0.1
USD/JPY	JPY 157	0.064	-4.489	0.2
Commodity Futures	**06-Jan-25**	**-1wk ($)**	**-1m ($)**	**2025 (%)**
Crude Brent	$76.9	$3.1	$6.1	3.1
Gold	$2 644.4	$39.2	$11.0	0.8
Equity Market Indices	**06-Jan-25**	**-1wk (%)**	**-1m (%)**	**2025 (%)**
S&P 500	5 942	-1.58	-2.43	1.0
EuroStoxx 50	4 971	1.47	-0.14	1.5
CAC 40	7 437	1.11	0.14	0.8
Nikkei 225	39 307	0.69	0.55	-1.5
Shanghai Composite	3 207	-5.68	-5.79	-4.3
VIX - Implied Volatility Index	16.50	3.45	29.21	-4.9

Source: Bloomberg, Ostrum AM

Additional notes

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