MARKET VIEW

Defense, China, Deficits and Money Markets: Four Charts of Interest to Investors

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There's no shortage of topics of interest for investors, so below, we briefly examine four key metrics that are expected to help shape the investment landscape in 2025. On our watchlist are the following: global defense spending, which is set to increase; China's soaring trade surplus and expectations of rising global protectionism; the federal budget deficit, which we believe is still quite manageable; and the mountain of cash parked in money market funds, which we believe could gradually seep into other asset classes next year.

Global Defense Spending: Too Low but Set To Rise. The world is at war, but you would never know it looking at Exhibit 1A. Notwithstanding ground wars in Europe and the Middle East, rising geopolitical tensions in the South China Sea and the budding Great Power Rivalry between the U.S. and China, in addition to the 24/7 war in cyberspace, global defense spending as a percentage of world GDP remains near historic lows. The world spent just 2.3% of world GDP on defense in 2023—a near-record low and well below the 3.5% annual average from 1960 to 2023.

With a global arms race underway, however, defense outlays are in a secular upswing. Record outlays are expected again in 2024 and beyond unless the doves of peace suddenly appear on the horizon. We continue to favor Large-cap defense plays not only in the U.S. but also in Europe, as well as Japan and Asia.

China's Alarm-Ringing $1 Trillion Trade Surplus. There is no better indicator of China's growth model than its stunning trade surplus with the rest of the world. As Exhibit 1B highlights, the mainland is on track to print a near $1 trillion merchandise trade surplus this year, a figure that reflects Beijing's hyperfocus on supply (greater manufacturing of strategic products like electric vehicles, batteries, solar panels, etc.) at the expense of demand (suppressed consumer spending).

This imbalance has not gone unnoticed by the rest of the world. Both the U.S. and Europe have pushed back against the flood of China exports, i.e., raised various barriers to trade. Many developing nations including Brazil, India and Indonesia have done the same. The bottom line is that China's export-led growth blitz threatens to trigger/stoke more global trade and investment protectionism, with President-elect Trump leading the charge with proposed 60% tariffs on China imports. China's stunning trade surplus could contribute to volatility in global growth in 2025 and accelerate the global reconfiguration in supply chains.

Do Budget Deficits Matter? Federal budget deficits are not uncommon in the U.S., as Exhibit 1C shows. The deficit, not unexpectedly, ballooned during the pandemic but has remained historically high (as a percent of GDP) over the past few years, clocking in at 6.4% of GDP in FY 2024. With the incoming administration showing no inclination to rein in spending, investors remain acutely attuned to Uncle Sam's finances. The so-called bond vigilantes are on watch.

So is the Chief Investment Office. The good news, however, is that America enjoys more financial space than most other nations because Washington's finances are backstopped by the most dynamic, innovation-led private sector in the world, which entails greater fiscal sustainability over the long run. America's finances are also supported by the world's reserve currency, the U.S. dollar, which makes U.S. government securities still among the safest and most desirable in the world. And finally, the U.S. enjoys the benefit of issuing debt in its own currency, allowing for a higher debt-carrying capacity relative to other nations. In the end, deficits matter but just not yet in the U.S.

Investment Implications

Looking ahead to 2025, we remain watchful of global defense spending's rise (think Large-cap defense plays in the U.S. and abroad), further trade and investment protectionism (expect diversifying supply chains and potential volatility in global growth), manageable U.S. budget deficits for now (watch U.S. growth led by the private sector), and sticky money market assets (monitor the path of interest rates).

RETURN TO FIRST PAGE

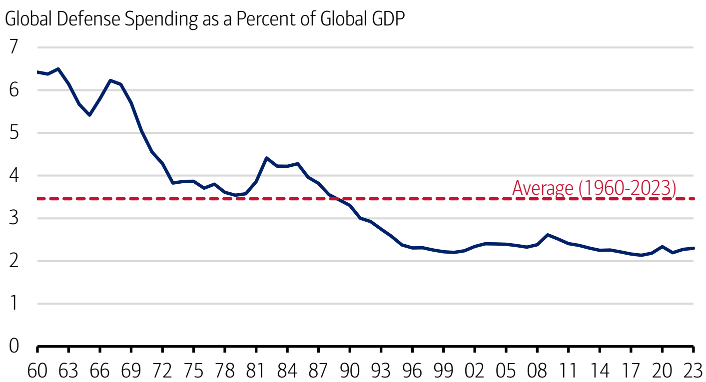
Money Markets: Cash Is Still King. Remember TINA—or the common lament that with real yields on debt near zero or negative in many parts of the world, "there is no alternative" to Equities? Well, those days have long passed as indicated by Exhibit 1D. Portfolio construction is a great deal more dynamic today, with Equities competing more against Fixed Income, Private Credit and good old cash.

As of mid-November, some $6.6 trillion was parked in money market funds, a record high and figure well above the long-term average of $2.4 trillion. Currently, the average money market fund is returning 4.5% versus 20%+ returns from the S&P 500 this year.[1] Sitting in cash, in other words, has come at a relative and absolute cost to investors this year.

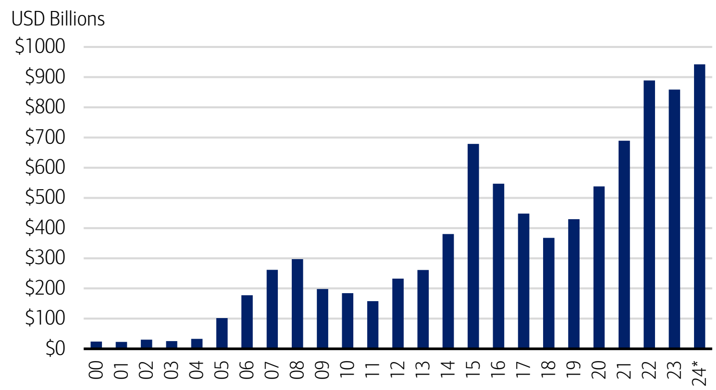
Election uncertainty, for sure, kept investors on the sidelines leading up to the November vote. Meanwhile, with Fed Chairman Powell's more recent hawkish commentary and rate expectations for 2025 continuing to evolve, the prospect of higher-than-initially-expected rates next year may be tempting investors to remain in cash. The bottom line: While appropriate levels of cash should be maintained in portfolios, we continue to urge investors to avoid camping out on the sidelines. It is time in the market, rather than timing the market, that matters.

Exhibit 1: Four Charts to Watch in 2025.

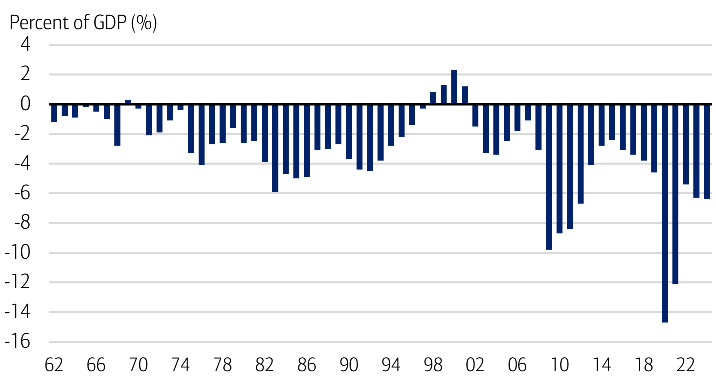
1A) Too Low: The Disconnect Between War and Peace.



1B) Shock and Awe from China: China Nears $1 Trillion Merchandise Trade Surplus with the World.



1C) Deficits Are as American as Apple Pie: U.S. Budget Deficit/Surplus FY 1962-2024.



1D) Cash Is Still King: Money Market Fund Assets Hit $6.6 Trillion (T).

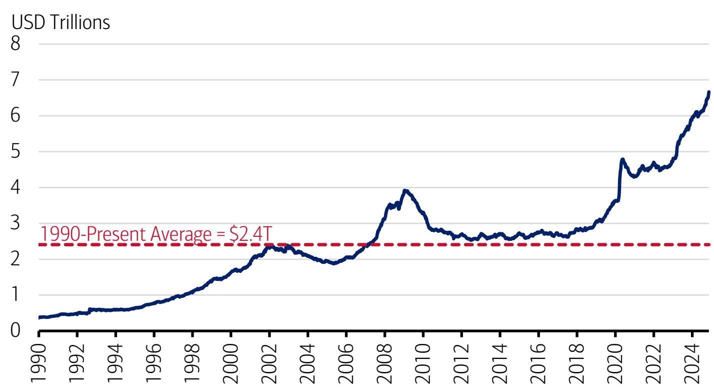


Exhibit 1A) Source: Stockholm International Peace Research Institute. Data as of November 2024. Exhibit 1B) 2024 = Annualized estimate based on year-to-date monthly trade surplus through October. Source: International Monetary Fund, China Customs General Administration. Data as of November 2024. Exhibit 1C) Source: Congressional Budget Office. Data as of November 12, 2024. Exhibit 1D) Source: Bloomberg. Data as of November 18, 2024.

[1] Average yield on 100 of the largest money-market funds tracked by Crane Data. Annualized 7-day current yield as of November 20, 2024

RETURN TO FIRST PAGE