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Markets and the return of **sovereignty**

- **After AI and tariffs, markets' focus turn to geopolitics with Ukraine and German elections**
- **Policy action is in the US, but market outperformance is elsewhere, with an acceleration last week**
- **Our recommended allocations are broadly diversified and doing well so far.**

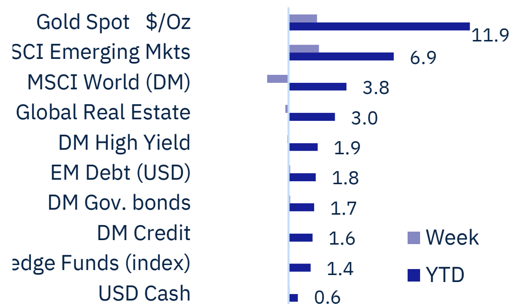
Last week was mixed on global markets, which can be put in relation with overall soft flash PMI surveys across developed markets. Considering that on average, these leading indicators of activity are near their lowest since late 2023, including for the so far ultra resilient US services, it is quite logical to have seen US Treasury yields decreasing by 4 to 6 basis points and stocks from developed markets falling -1.4%. Oil prices ticked lower, and gold rose further to now almost +12% YTD.

This is rational. However, as we develop in our Global Investment Outlook, we do not believe that 2025 will be driven by 2025. New policies and new technologies are "Winds of Change" which start now but will have a deep and lasting impact on economies and markets. It has already started: while the US economy continues to outperform others, US stocks, with their 2.4% 2025 performance, are lagging behind others: China, the Eurozone, UK, the GCC and Japan are doing better. India is outright negative despite still being the fastest growing economy. Finally, sticky inflation in the US and a clearly very patient Fed did not support the dollar or put a floor under Treasury yields.

As markets look into the future, their focus turns to geopolitics and the broad theme of sovereignty: some agreement in Ukraine looks increasingly possible, at a time when Germany holds important elections, which for the first time in decades put the topic of fiscal spending and defence on the table. We will also soon see if China's important March session of their National People's Congress will confirm the recent inflexion in its economic policy.

Our positioning is unchanged, still fully invested with a broad regional diversification. With unpredictable events and rapid news flow, we do not bet on an outcome. We focus instead on solid portfolio construction, and on the ability to identify opportunities to adjust exposure when/if markets overreact.

ASSET CLASSES USD % TOT.RETURN, LAST WEEK AND YTD 2025



MAURICE GRAVIER
Chief Investment Officer
MauriceG@EmiratesNBD.com

GIORGIO BORELLI
Head of Asset Allocation
GiorgioB@EmitatesNBD.com

SATYAJIT SINGH, CFA
Head of Fixed Income Strategy
SatyajitSI@EmiratesNBD.com

NAWAF ALNAQBI
Head of Equity Strategy
NawafALNA@EmiratesNBD.com

ANITA GUPTA
Equity Strategy
AnitaG@EmiratesNBD.com

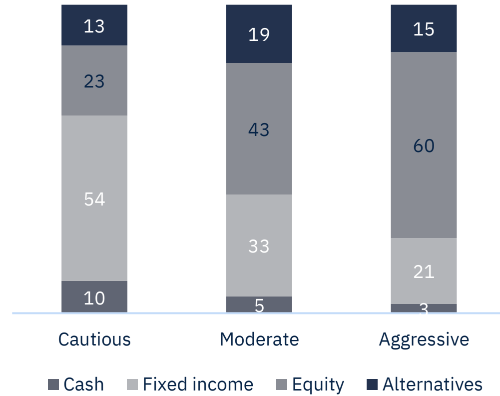
Cross-asset Update

US stocks are underperforming their peers two months into the year. According to some historical statistics, in the last 35 years whenever US stocks lagged by more than 280bps at the start, as it is now the case, they struggled to recover in the end. Not only their slow start does not bode well for their relative performance in 2025, also it tells us a lot about lingering inflationary pressures. Usually, US benchmarks do well in a disinflationary environment. The United States is a heavily indebted country, so yields cannot stay at high levels for long without denting economic growth, with the Fed eventually coming to the rescue by easing in some form or fashion. And this kind of framework has worked as long as price pressures have been contained. Indeed, the most important variable for the classical 60-40 equity-bond portfolio is inflation, with low inflation identifying the ideal macroeconomic backdrop for traditional USD asset classes.

The past week stoked up inflation concerns, hence that the S&P 500 closed in the red should be no surprise, at least after the fact. Prices paid forecast 6-month ahead in the Philadelphia Fed manufacturing survey reached new highs for the year, while longer term inflation expectations in the University of Michigan consumer sentiment survey reached the highest levels since 1995. Consumers see the inflation rate 5-10 years ahead at 3.5%. Commodity prices have been rising year-to-date, and comfortably beating global equities. In this kind of environment dollar-centric assets tend to underperform. If higher inflation simply means stronger growth, investors sell some US assets to buy something more pro-cyclical like European or EM equities. While they have both outperformed the S&P 500, Europe stock could also owe their renaissance to the rapprochement between the United States and Russia for the start of a mote peaceful phase. EM stocks are being driven by China alongside enthusiasm for DeepSeek and the impressive progress made by Chinese companies in AI. Overall, if stocks are to take inflation in their stride, global growth must be more supportive. European growth would indeed improve in the case of a durable peace deal between Russia and Ukraine, that currently is a very big if, while China needs to announce much more convincing stimulus measures, and the next deadline for this is set in early March, when the National People's Congress reconvenes. At the same time, US growth has disappointed, with services activity slowing down, and manufacturing now in the early phases of a tepid recovery.

European and Chinese stocks are still quite cheap, while US equities are priced for perfection. In terms of valuations differential the current rotation can have further to go, a scenario that was anticipated in the Year Ahead section of our 2025 Outlook. But for markets to veer away from US exceptionalism in a more sustainable way, they need some big help from the global business cycle, as well as geopolitics.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

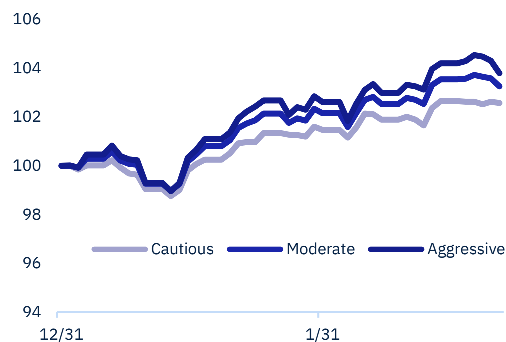


TAA – RELATIVE POSITIONING – MODERATE PROFILE

UW/N/OW: Underweight/Neutral/Overweight

	UW	N	OW
Cash			>
DM Gov.			>>
DM Credit		=	
DM H. Yield		=	
EM Debt		=	
DM Equity			>
EM Equity		=	
Gold		=	
Hedge Funds	<<		
Real Estate		=	

TAA – 2025 INDICATIVE PERFORMANCE



Source: Bloomberg. CIO Office calculation based on TAA applied to market indices, net total return in USD.

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Fixed Income Update

U.S. Treasuries rallied during the week, 2Y/5Y/10Y/30Y UST yields were lower by 6/6/4/2 basis points, closing at 4.20%, 4.27%, 4.43%, and 4.68%, respectively. Start of the week, the yield curve bear steepened, driven by concerns over higher issuance to fund defense spending and increased U.S. corporate supply. European government bonds, including Bunds and Gilts, also sold off due to speculation about joint EU bond issuance for defense funding and a rise in UK inflation to a 10-month high. Despite early weakness, USTs pared losses as soft housing starts, an uptick in jobless claims, and dovish FOMC minutes. Later in the week, weaker PMI data and a decline in University of Michigan consumer sentiment raised concerns about economic momentum. The January FOMC minutes reinforced policymakers' stance on keeping rates steady, highlighting that "many participants" saw the need for restrictive policy to persist if economic strength and inflation remain elevated.

UK inflation climbed to 2.98% y/y from 2.5% in December, reaching a 10-month high due to rising airfares, motor fuel, food prices, and VAT on private school fees. However Barring January, UK inflation is heading down. Bank of England Governor Andrew Bailey acknowledged that while UK growth was strong at the end of 2024, the economy remains "static," with subdued underlying growth and a softening labor market. Markets are currently pricing in only two UK rate cuts this year, but expectations for further easing may be underestimated. The UK economy which barely grew in 2024 Q4 (0.1% QoQ) following a flat 2024 Q3, required a boost from looser policy. Given an underwhelming fiscal impulse, the onus is on the monetary authorities to deliver the easing.

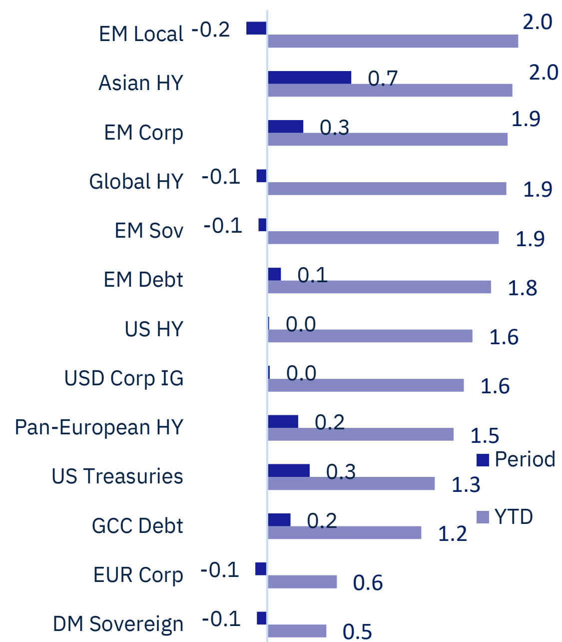
Separately, the Reserve Bank of Australia initiated its first rate cut since 2022, lowering rates by 25 basis points to 4.10%, marking the beginning of its easing cycle. However, policymakers signalled a cautious approach to further cuts, citing a tight labor market and elevated services inflation. The Central Bank of Egypt kept its policy rates unchanged, while Turkey's central bank governor emphasized a "very gradual" approach to rate cuts following the 500 basis points of easing implemented since December. In credit markets, high-yield spreads widened slightly by 8bps, and EM debt and GCC widened by 4bps while investment-grade spreads remained stable.

Coming to GCC, JPM have re-classified Qatar and Kuwait as developed markets and these no longer be eligible for J.P. Morgan Emerging Market sovereign bond indices, with their removal set to take place over six months starting March 31st. As of January 31, 2025, Qatar and Kuwait held 3.2% and 0.6% weights, respectively, in the EMBI Global Diversified index, and their removal is expected to widen the EMBIG Div. spread by approximately 11bps. The UAE may follow suit in 2026. Separately, Fitch revised Bahrain's outlook from Stable to Negative, citing persistently high fiscal deficits, rising debt-to-GDP levels, delays in planned reforms, and broader fiscal challenges that complicate efforts to stabilize debt.

FIXED INCOME KEY CONVICTIONS (2025)

DEVELOPED MARKETS
Overall overweight DM FI
OW Government Bonds
Neutral corporate (IG & HY)
EMERGING MARKETS
Neutral EM Debt
Favor quality and selectivity
Including in GCC

FIXED INCOME SUB ASSET CLASS RETURNS (YTD, LAST WEEK)



Source: Bloomberg

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Equity Update

Overweight DM: OW US/Japan, Neutral UK, UW Eurozone

Neutral EM: OW UAE, Neutral China/India

Global markets last week reacted to mixed macroeconomic data and corporate earnings along with geopolitical de-escalation. Optimism in China tech and European equities clashed with concerns over U.S. consumer spending, inflation, and tariff uncertainties. Safe haven asset classes fared better with gold higher, the US 10-year Treasury yield lower with oil steady.

In a pivotal change from the last 2 years, emerging markets are up +6.9% and Developed markets +3.8% Year to Date.

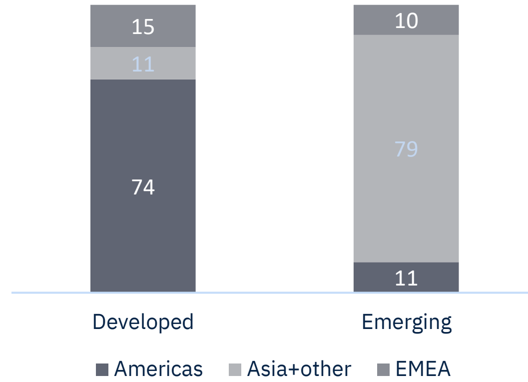
All about China and emerging markets in February with China tech gaining 25% Month to Date and MSCI China +17% lifted by AI-related stocks and hopes of milder U.S. tariffs. Late to join the party China big tech leaders, Alibaba and Tencent adopters of DeepSeek/ other reasoning LLM AI models, announced further investment in AI, and this boosted their stocks. They have dominant market share in cloud, payments, ecommerce and social media chat in China and the China government is no longer branding them as monopolistic. BYD the leader in EVs in China also gaining as quick to roll out enhanced self-drive features.

The MSCI UAE +7% YTD, with new issuance aiding market breadth. Alpha Data is the latest UAE IPO, planning to list on the ADX, early March.

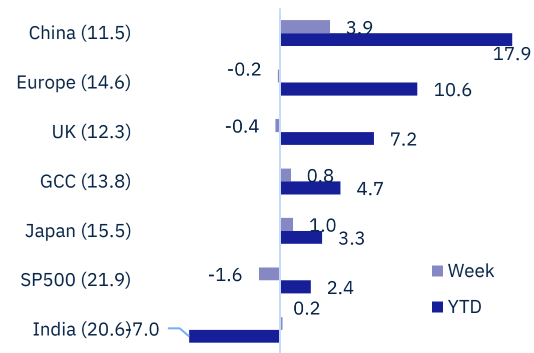
The US markets which saw a record high for the S&P 500 at the beginning of the week saw main indices fall over 2% last week. Year-to-date gains, for the S&P 500 and Nasdaq are at 2.4% and 1.2% respectively, and the MAG7 group -2%. The pullback was influenced by a combination of factors, including a significant drop in retail sales—the largest in two years—signalling potential consumer slowdown, and persistent inflation concerns keeping the Fed cautious about rate cuts. Walmart's disappointing outlook reinforced the view of slowdown in consumption. Berkshire announced record profits with $334bn in cash, booking gains on some of its largest US holdings, while adding to Japan equities. European markets, the STOXX 600 at new highs, buoyed by better-than-expected earnings from companies like Siemens. Japan's Nikkei faced downward pressure amid trade war fears and a strengthening yen.

Volatility is here to stay, with trade news making daily headlines. We are constructive on equity gains in 2025 as revenue/earning/ margin growth looks healthy with a broadening away from tech. The cap-weighted S&P is on par with the equal weighted index, a positive sign for breadth. 2025 is all about earnings growth and expect c.10% return for equities with valuation multiples expected to stay at current levels.

EQUITY RECOMMENDED REGIONAL POSITIONING

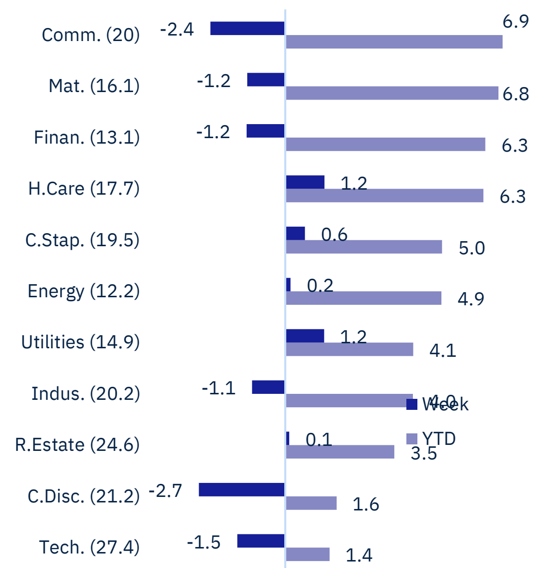


MAJOR INDICES PERFORMANCE (TR, US$), P/E in brackets



Source: Bloomberg consensus. MSCI Indices unless specified.

GLOBAL SECTOR PERFORMANCE (TR, US$), P/E in brackets



Source: Bloomberg consensus. MSCI All Country World sectors US$.

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