

Paradigma Stable Return

Helping investors
protect and grow their capital

More than an update

December 2024



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Investment Committee Member

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Germán began his career at CSFB in 2003, followed by VEA. He was also a quant portfolio manager and partner at Tudor and Idalion. He obtained his MA in Economics and his PhD in Statistics from Duke University (2003) with a Fulbright scholarship. His work in computational statistics has been awarded by the American Society for Quality.

Dear investor,

For our closing note of 2024 we will forgo our usual structure, that includes our food for thought and recommendations. Instead we take this opportunity to take stock of what has happened in 2024 and what we see lying ahead for 2025.

We hope you find this note valuable and encourage you to think deeply about the potential surprises that the future might hold.

Thank you for your continued trust and support.

Please do not hesitate to reach out with any questions, comments or challenges.

Wishing you a prosperous 2025.

Best regards,

[Paradigma Stable Return Investment Committee](#)

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01.

December market update

■ Dec 2024: +0.3%; Moving up despite declining markets

Paradigma Stable Return successfully preserved capital and even generated a modest gain of +0.3% in December. This stands in stark contrast to the fixed income losses of -2.3% for the iShares 7-10 Year Treasury Bond ETF, and the equity losses of -2.5% for the S&P 500, -2.6% for MSCI Europe, -8.4% for the Russell 2000.

December is often overlooked in market updates as attention shifts to year-end reviews. This year, many market participants may even prefer to avoid discussing it entirely, given the simultaneous declines in fixed income and equities, making it one of the worst Decembers in the past 20 years. Yet, every month matters when it comes to the growth of capital, and we believe it's vital to reflect on this turbulent month.

As outlined in our extraordinary intra-month update, the anticipated “Santa rally” was abruptly canceled by the Federal Reserve’s surprise hawkish pivot. Seeking to rebuild its credibility as an inflation fighter, the Fed shifted its tone and reduced expectations for future rate cuts. This reversed the sunny clarity of November and brought back the thick “fog of uncertainty” that defined much of the year. Markets responded accordingly, with sharp sell-offs across both equities and fixed income.

The impact of the Fed’s actions was swift and severe. By December 18th, equities had suffered notable losses, with the S&P 500 down -2.6% and the iShares 7-10 Year Treasury Bond ETF falling -2.0%. The days leading up to Christmas saw a sharp equity recovery, but this rally proved short-lived, and equities fell back during the final days of the year. Fixed income markets, from December 18th onward, continued their downward trajectory, offering no reprieve.

Amidst this backdrop, at Paradigma Stable Return our adaptable and disciplined approach once again proved invaluable. Being prepared for the unlikely but high-risk scenario allowed us to mitigate the generalized market pain.

Navigating volatile periods like December underscores our steadfast commitment to protecting and growing our investors’ capital. As the fog of uncertainty lingers, our strategy remains rooted in adaptability and rigorous risk management, aiming for resilience through both turbulent and tranquil market conditions.

02.

2024 Review

■ 2024: +11%; Delivering stable and solid returns in an unstable world

The set-up for 2024

As 2024 began, investors were reflecting on a banner year for equities in 2023, where global equities had risen 22% and MSCI Europe delivered 16%. Looking ahead, expectations for 2024 were notably cautious, shaped by:

- Anticipation of a weaker economy and sharp declines in inflation, with scenarios ranging from soft to hard landings.
- Predictions of significant interest rate cuts by central banks.
- Concerns over geopolitical risks in a year when more than half the global population was heading to the polls.

This backdrop drove many to consider cashing-in on 2023's outsized equity to buy fixed income. Particularly as bonds had delivered attractive returns in 2023 and were promising yields far above pre-COVID levels. For instance, Bloomberg's Global Fixed Income Bond Index returned 5% in 2023 and offered a 3.5% yield to maturity, while iShares European High Yield Bond ETF returned 11% and promised a 6.2% yield to maturity. In summary, the play was to sit on the sidelines in 2024 waiting for better days in equities while collecting a "rewarding and stable fixed income".

At Paradigma Stable Return, our outlook for 2024 was off-consensus as we anticipated stronger growth and fewer interest rate cuts, as we saw expected that the fiscal policy in a global election year would be stimulative and a stabilizing force. We did share the market's concerns about geopolitical risks but on top of those risks we saw monetary policy as a potential source of market instability and volatility. Hence, our play wasn't to sit in fixed income and wait but to instead remain extremely flexible to capitalize on equity market opportunities while being ready to move quickly to preserve capital in turbulent times.

The two halves of 2024: a year of distinct market dynamics:

H1 2024: A Volatile Ride Through Economic Revisions

- The first half of the year was marked by a turbulent recalibration of economic expectations. Upward revisions to growth forecasts and downward revisions to rate cut projections pushed central banks away from dovish stances, while hard-landing scenarios faded. Volatility ensued, with mixed results across asset classes:
 - o Fixed income: Bloomberg's global fixed income index delivered a -1%, and the iShares European high yield bond ETF delivered +1%.
 - o Equities: S&P 500 delivered +14% but suffered a drawdown of -5.4% in April, Russell 2000 rose only +2%, the MSCI Europe gained +9% and the MSCI World ex-US delivered +5%.
- The "sit and collect a rewarding and stable fixed income" strategy proved neither stable nor rewarding, and came with significant opportunity costs. In contrast, at Paradigma Stable Return our "being flexible" strategy enabled us to navigate the turbulence effectively, with only one negative month of -1%

(April '24 when the S&P 500 lost -4% and the iShares 7-10 Year Treasury Bond ETF US 7-10 lost -3%) and deliver a stable and strong +6% return for H1.

H2 2024: Navigating the Rollercoaster of Unexpected Events

- The second half of the year was even more volatile, driven mainly by unforeseen events and surprise policy shifts:
 - o Political Shocks: Two assassination attempts on a U.S. presidential candidate, a last-minute replacement of the US sitting president as candidate, the surprising landslide victory of a supposedly tight US presidential race, divisive French elections, Japan's leadership change, and the collapse of Germany's government.
 - o Policy Shocks: The Bank of Japan destabilization of the global markets with unexpected policy changes, China's announcements of grand stimuli packages, and the Fed's oscillation between surprisingly over-dovish (in September) and unexpectedly hawkish (December).
- Market movements reflected the impacts of these unexpected events
 - o Fixed income: The U.S. 10-year Treasury yield swung from 4.4% to a low of 3.6% in September before ending the year at 4.6% leading the Bloomberg's Global Bond Index to initially rise +4% before giving back part of the gains to close H2 with a paltry +2% return.
 - o Equities: We saw uneven returns with U.S. markets standing out with +8% for the S&P 500 and +10% for Russell 2000, while MSCI Europe and MSCI World ex-USA were flat. But they were also unstable returns as even the S&P 500 investors had to endure a frightening journey, suffering one drawdown of -2%, two of -3%, two of -4% and one of -8%.
- At Paradigma Stable Return our agility shone during this period. The ability to pivot quickly helped us sidestep major corrections and capitalize on market opportunities, resulting in only one negative month (-0.5% in August when the S&P 500 suffered its 8% drawdown) and deliver a stable and solid +4% return for H2.

Flexibility and risk management in focus

During 2024 we didn't have a strong conservative or aggressive bias throughout the year (our net equity allocation averaged 48%, and 61% of the time we had a neutral allocation between 40% and 60%). We were however, extremely flexible and our net equity allocation ranged from 13% to 75% with periods of heightened caution (26% of days below 40%) and others of calculated optimism (13% of days above 60%).

But beyond the top-level year, it's crucial to go into the detail and look at the specific periods when investors suffer most (i.e., when both equities and fixed income fall). As we have discussed previously, we emphasize the importance of a having a truly balanced portfolio/team. As such, go well beyond the traditional diversification across equities and fixed income and we complement it with the defensive power of our proprietary protection strategies (our team's defenders).

This team set-up proved invaluable during three critical months this year when both equities and fixed income suffered simultaneous declines (April, October, and December). In fact, in these treacherous months, Paradigma Stable Return outperformed even a "back to the future" monthly portfolio (when you can invest for the month with perfect foresight of the month's future returns):

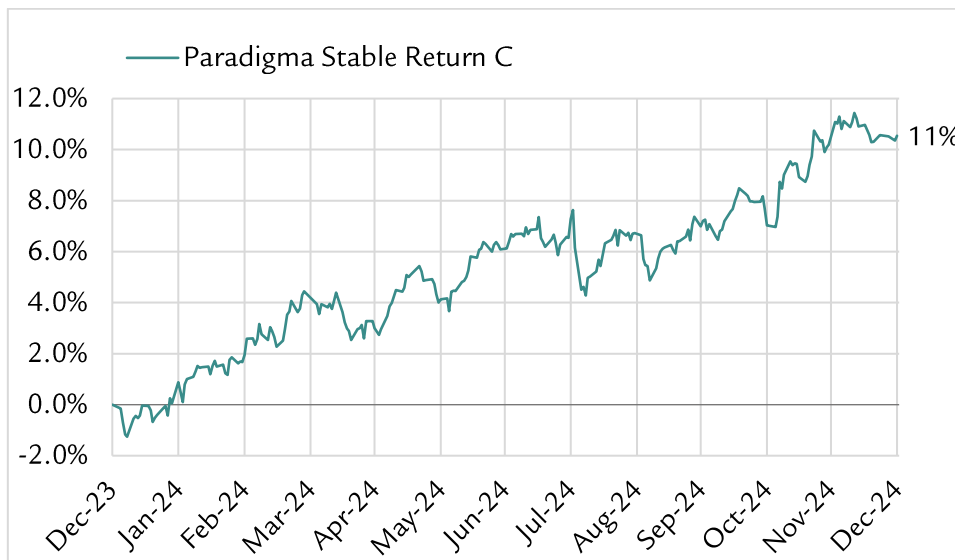
- April: fund -1% versus -4% for S&P 500 and -3% for iShares 7-10 Year Treasury Bond ETF.
- October: fund +0% versus -1% for S&P 500 and -3% for iShares 7-10 Year Treasury Bond ETF.
- December: fund +0% versus -3% for S&P 500 and -2% for iShares 7-10 Year Treasury Bond ETF.

In any of these 3 months even knowing the future would have been worse than having the right team set-up and being flexible.

The outcome of 2024

Looking back at market performance for 2024

- Fixed income delivered low and unstable returns: +2% for Bloomberg Global Bond Index and +6% for iShares European High Yield ETF
- Equities delivered unstable and uneven returns: large drawdowns globally and strong performance mainly in U.S. markets with +25% for S&P 500 and +12% for Russell 2000, and moderate gains elsewhere with +9% for MSCI Europe and +5% for MSCI World ex-USA.
- Paradigma Stable Return delivered a stable and attractive +11% return standing out and ensuring limited drawdowns, including preserving capital during the 3 worst months of the year, when equities and fixed income both declined sharply.



31 December 2023 – 31 December 2024 | Source: Bloomberg, AyG Global Investors

03.

2025 Outlook

■ Follow Voltaire and thrive in 2025

As the calendar flips to 2025, financial markets are once again inundated with forecasts from analysts and pundits, confidently outlining what lies ahead. These projections can feel reassuring, offering a false sense of certainty in an unpredictable world. However, as history consistently demonstrates, such forecasts can be misleading and are frequently wrong.

Firstly, forecasters tend to focus on strong, confident predictions to draw one future path. This can be an extremely misleading way to prepare for the future by not considering the alternative scenarios, their probabilities, and their respective impacts.

- Likelihoods of the possible scenarios matter: Even the most probable scenario can still be unlikely overall. For instance, when tossing two standard dice, the most likely outcome is rolling a seven, with a 17% probability. Yet, there is still an 83% chance it won't occur. Would you bet everything on a 17% likelihood scenario?
- Payoffs of the possible scenarios matter: Even when the most likely scenario is overwhelmingly probable, the magnitude of gains of that scenario versus the losses of alternate outcomes can outweigh the probabilities. Consider Russian roulette: an empty chamber is the most likely outcome (83%), but the loss of the 17% alternative is catastrophic. Would you ignore the impact of that 17% likelihood?

Additionally, forecasters cannot account for the ever-changing nature of markets and the unforeseen developments that inevitably shape the future. As a result, their start-of-year predictions are, by design, prone to significant error.

The false clarity of focusing on a confident prediction can be dangerous as it fosters complacency and leaves investors unprepared for the unexpected when vigilance is most needed.

“Uncertainty is an uncomfortable position but certainty is an absurd one.” – Voltaire

At Paradigma Stable Return, we reject static forecasts. Instead, we focus on understanding the current market environment, mapping a range of plausible scenarios, and identifying the key macroeconomic and geopolitical dynamics shaping the landscape. This flexibility allows us to adapt swiftly as new realities emerge, ensuring we remain prepared for both risks and opportunities.

As we look ahead to 2025, one thing is clear: heightened uncertainty and volatility will dominate the market landscape. With Donald Trump's return to political leadership, we anticipate a mix of bold policy announcements, unpredictable fiscal policies, and conflicting objectives. These factors are poised to keep markets on edge, as campaign promises evolve into actionable policies with tangible consequences.

Armed with this approach, let's delve into the key challenges and opportunities that are likely to define 2025.

The dollar dilemma: contradictory goals

Trump's approach to the U.S. dollar will remain a significant source of market volatility. Historically, he has advocated for a weaker dollar to bolster U.S. exports and stimulate domestic growth. However, he also supports the dollar's critical role as a global reserve currency, which requires a strong dollar. Adding to this

complexity of conflicting objectives, there is still Trump’s past openness to alternative financial systems such as cryptocurrencies that challenge the dollar’s dominance.

This duality creates a “dollar dilemma,” as conflicting objectives could lead to arbitrary announcements and policies with contradictory effects. Each of these could drive sharp movements in currency markets, making 2025 a year of heightened unpredictability for currencies.

Stop-and-go monetary policy: a volatility catalyst

Central banks will likely persist with their “stop-and-go” approach in 2025, a dynamic we highlighted in our [November Food for Thought](#). These abrupt policy shifts between combating inflation and stimulating growth will heighten market uncertainty and amplify volatility. This environment poses unique challenges for fixed income, equities, and currency markets, which could all experience sharp swings driven by global central bank decisions.

From Promises to Reality: Lessons from China’s Policy Moves

The disconnect between bold policy announcements and actual implementation is a recurring theme. We saw a valuable case study of this risk in September 2024, when China made sweeping promises to stabilize its economy and drive growth. These announcements sparked sharp market rallies, driven by heightened expectations. However, as we noted in our [September Food for Thought](#), the implementation details were scarce at the time and by the end of September did not justify the full upswing in market prices. Since then, the measures rolled out have significantly underwhelmed relative to the initial market reaction, leaving markets disappointed.

Trump’s policy playbook may follow a similar trajectory, with bold announcements on taxes, infrastructure, and trade often overshadowed by delayed or incoherent implementation. This disconnect between expectations and reality could fuel frequent episodes of market exuberance followed by steep corrections.

Understanding this dynamic will be critical for navigating the swings between optimism and disappointment.

Minsky’s warning: stability breeds instability

Hyman Minsky’s famous observation that “stability breeds instability” feels particularly relevant as we reflect on the equity market’s recent trajectory. The S&P 500 has risen over 50% in the past two years, a rare feat that has occurred only four times since 1927. Each of these periods was eventually followed by either modest gains or notable corrections:

- 1936: The rally was followed by a steep -39% drop.
- 1955: A meagre rise of +2.6% followed.
- 1976: This rally ended with a -12% decline the following year.
- Late 1990s (Dotcom Era): The rolling 2-year S&P 500 rose by over 50% in four consecutive years, delivering in each following year returns of +31%, +26%, +19%, and finally -10%.

The late 1990s demonstrate that “bull markets don’t die of old age”, as the first two years of a 50% rally were followed by three more years of exceptional returns. However, such extended rallies are rare, and history reminds us of the need to stay vigilant against potential reversals after significant gains.

Prepare for the Unexpected

While the challenges and opportunities outlined above can be anticipated and planned for, 2025 will also demand vigilance for completely unforeseen events and developments. Trump, together with the tech disruptors that now surround him, have shown early signs that they are keen to change not only the US but also the world order. They are also willing to put forward unconventional ideas and policies we can't even imagine today. In 2025, reality might outpace even the most creative fiction. It will be crucial to be ready to act when the unexpected arrives.

How key asset classes may fare in 2025

- Currencies: The dollar will remain the focal point of global markets, with potential swings driven by Trump's policies and Fed decisions. Alternative currencies, including gold, may gain prominence as questions around the dollar's dominance persist.
- Equities: Volatility will create both risks and opportunities, particularly across regions and sectors exposed to trade, technology, and policy shifts (fiscal policy and also foreign policy). Additionally, the S&P 500's significant outperformance relative to global equities has reached historic highs, raising the possibility of a shift in dynamics as new policies take hold. Portfolio repositioning could trigger sharp moves across global equity markets.
- Fixed Income: Bond markets will continue to grapple with the interplay of inflation expectations and central bank actions, leading to sharp movements in yields and performance across fixed income investments.

Navigating the uncertainty: active and flexible management

If there is one certainty in 2025, it is that uncertainty will reign. Markets will remain highly reactive to unexpected policies, central bank decisions, and geopolitical developments.

While it might be more comforting to hear a clear and certain outlook, uncertainty and discomfort are the breeding ground for good returns. For flexible and adaptable investors, volatility is not a threat, but an opportunity.

At Paradigma Stable Return, we view uncertainty as a source of attractive opportunities. By preparing for a range of scenarios, remaining vigilant, and adapting dynamically, we aim to capitalize on the turbulence ahead and keep delivering stable and solid returns.

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