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M&G Investments

Investment Perspectives 2025
Outlook: No time for complacency

Contents

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Introduction

In what was an eventful 2024, the world saw a record number of global elections, conflicts reaching new heights, a Japan 'flash-crash' – and a normalisation of interest rate cuts. These events, however, did not impede equity markets: the S&P 500 was up 25% for the year at the time of writing[1]. Now, then, is a natural juncture to consider the factors and events which could impact financial markets over the next 12 months.

But where should investors set their focus – and what trends are likely to shape returns – in 2025 as we reach the quarter-way point of the 21st century? With market volatility likely to continue, it's no time for investor complacency.

In his foreword for this edition of Investment Perspectives, Mason Woodworth, Head of Investment Solutions, analyses whether markets are too optimistic in their assumptions about economic growth. He explores why this could be the case – and what the implications might be for investors.

Our CIOs for equity, public fixed income and private markets discuss their key areas of focus for 2025 as they evaluate the likely drivers for their respective markets and, most importantly, offer a roadmap for investors to help them to successfully navigate the year ahead.

M&G Investments does not follow a single 'house-view' allocation model, rather we encourage diversity of thought across our investment teams. A central element of our investment approach is a continual exchange of views and ideas between experts from different asset classes for the wider context, as well as the specifics. We call this 'Intelligence Connected'.

By connecting the dots in an increasingly complex and interconnected investment landscape, our global experts seek to spotlight promising long-term opportunities across regions and sectors. We hope you find this edition of Investment Perspectives an insightful and practical guide to 2025.

[1] Source: LSEG Datastream, 25 November 2024.

Finding the conditions for growth

Mason Woodworth,
Head of Investment Solutions

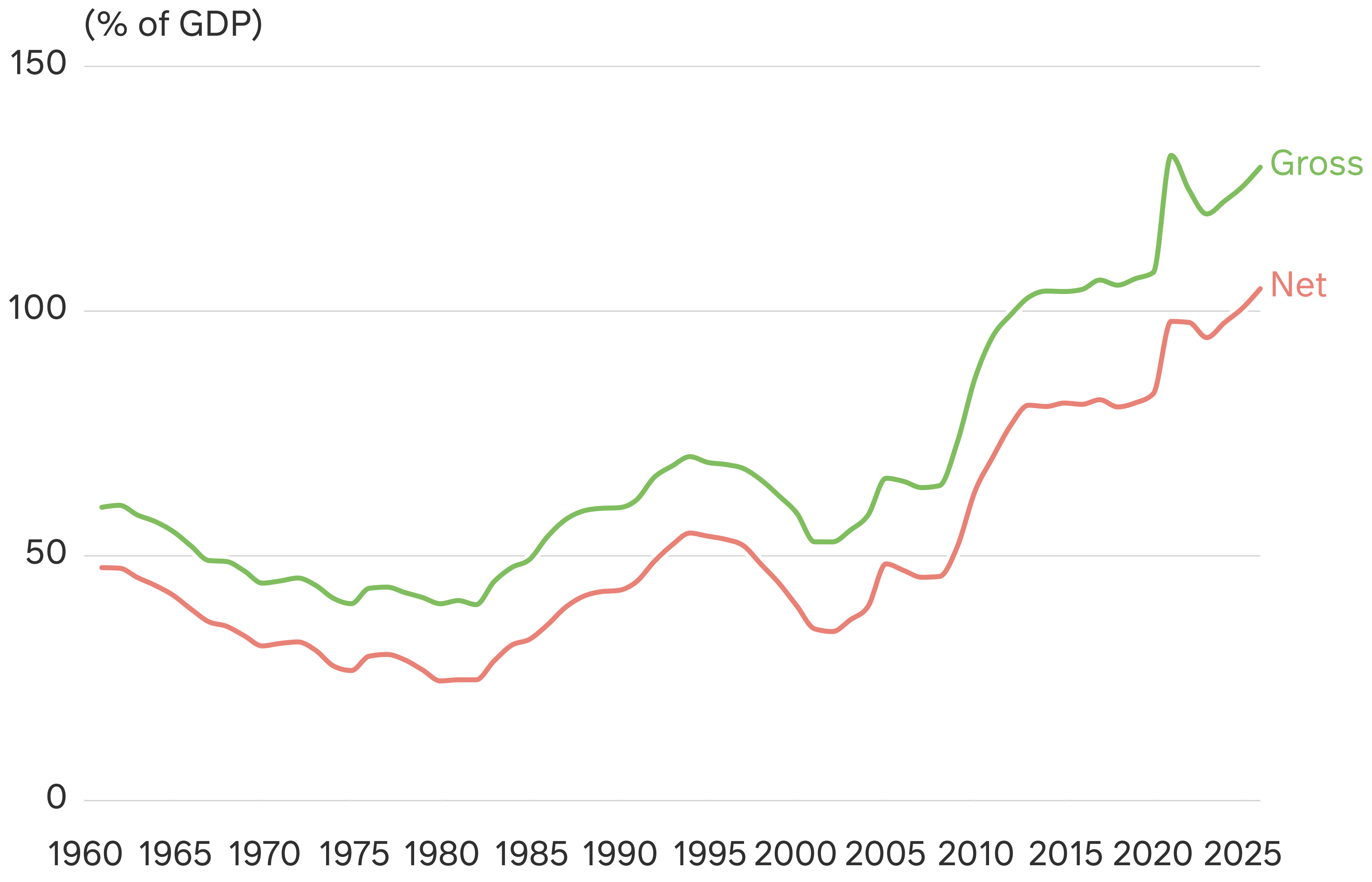
Key takeaways

- Record-high government debt and rising borrowing costs are sparking concerns about the sustainability of government finances.
- Policymakers are prioritising economic growth as a solution to this challenge but there are concerns that growth may not return to 'normal' levels.
- In this uncertain context, an active approach may help investors identify opportunities and mitigate potential disappointments.

In a world of high government debt and lacklustre growth, it is tempting to assume economic activity will return to more 'normalised' levels, allowing governments to reduce national debts toward more sustainable levels. But might this be an overly optimistic assumption? Do we have the conditions to generate sufficient growth and, if growth proves weaker than expected, what might this mean for investors?

Government debt levels, most notably in the US but in other countries too, have risen dramatically in recent years. In 2024, the US debt to GDP ratio hit 123%[2]. This increase can be traced back to the COVID-19 pandemic and the global financial crisis of 2008/9. These exceptional events saw governments and central banks, predominantly in developed markets, provide vast amounts of fiscal and monetary stimulus to bolster their economies.

US debt burden has grown dramatically



Source: LSEG Datastream/Fathom Consulting, November 2024 (including OECD forecast).

This situation might have been sustainable when interest rates were at zero but now that borrowing costs have risen sharply and the cost of meeting debt payments has increased, there are growing concerns about the sustainability of government finances.

Focus on reviving economies

How do we get out of a situation characterised by high government debt, elevated household borrowing (despite reasonably high savings rates), and tight labour markets?

One potential route out of this stranglehold is economic growth. Robust economic expansion accompanied by moderate inflation would make debt easier to manage, but the big question for investors is whether we have the conditions for economies to flourish.

Reviving economic activity after years of lacklustre growth is currently a priority for politicians globally. It has become part of the narrative – from UK Prime Minister Keir Starmer to leaders in Europe, and even China where a blitz of stimulus measures was announced by legislators.

[2] Understanding the National Debt | U.S. Treasury Fiscal Data, accessed November 2024.

"Robust economic expansion accompanied by moderate inflation would make debt easier to manage."

Although policymakers are focusing on growth, it can't take place without the right conditions being in place. This makes it important to look beneath the surface to better understand whether a strong recovery in economic growth is realistic. With a clearer understanding of where growth might come from, investors can assess what is embedded in prices and the expectations of equity and bond markets.

Tailwinds for growth?

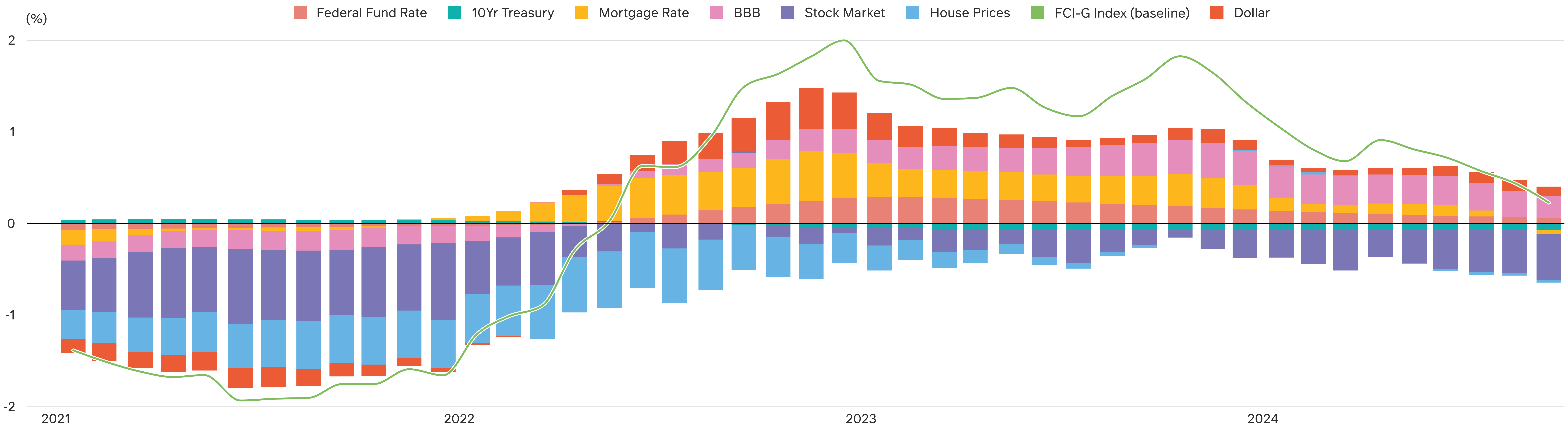
The Federal Reserve's (Fed) financial conditions index (FCI) attempts to measure the broad economic situation in the US, using a range of variables including asset prices and interest rates, and how they could affect future growth.

At present, the FCI suggests that financial conditions are relatively tight but have been easing over the course of 2024. A large part of this has been the continued advance of the stock market (represented by the purple bars in the chart overleaf), but the start of the Fed's rate cutting cycle has also contributed.

Given governments' fiscal positions are constrained and financial conditions for corporates and consumers are also restricted, central bank policy has taken on an ever-greater importance. If borrowing costs come down for consumers and governments, that could help support the growth outlook.

Where they go from here is critical. Interest rates are expected to continue to come down in the next 12 months which could provide a tailwind for GDP growth. But given that we are unlikely to see interest rates return to the low or even negative levels of the post-COVID era, conditions might not become as favourable as they were three years ago.

US Financial Conditions Index



Source: US Federal Reserve, September 2024.

Growth expectations

If we consider the growth expectations implied by asset prices, we can see that in some areas of the market, principally US technology stocks, there is considerable optimism about future growth. Beyond this narrow category, however, equity markets have been rather muted.

Take Nvidia for instance. The stock has rallied more than 195% this year[3], amid anticipation about the potential of artificial intelligence (AI) and future demand for its semiconductors. Clearly, AI could have a broad range of potential applications, and it is starting to be adopted by businesses. However, it is worth asking whether the productivity benefits achieved will match the expectations currently priced into the shares.

Could there be a degree of exuberance in certain parts of the market today? If economic growth does not reach the levels anticipated, corporate earnings could well be lower than forecast, disappointing investors.

What if growth disappoints?

Staying with AI as a focus, in order for it to flourish, there has to be infrastructure investment to underpin its operation: from the energy required to power data centres to the networks delivering the data. If future growth is below trend and governments can't embark on infrastructure spending because of fiscal challenges, this could delay the rollout of the critical infrastructure needed to support AI.

As mentioned above, a potential consequence of weaker growth is that corporate earnings would likely be lower than forecast. This could result in less capital being available for investment (capex), which in relation to AI, for example, might consequently slow the rate of its adoption.

With scenarios such as this, it is worth asking again whether we really do have the conditions required to drive above-trend growth. However, on a long-term view, a level of growth that falls short of expectations might not necessarily be disastrous for investors and markets.

Even if we experience weaker than assumed GDP growth, there will likely still be winners. Below-trend growth, leading to weaker earnings and likely lower levels of capex, may negatively impact the pace of AI adoption, for example. This may unsettle AI investors, but the story doesn't just favour the chip manufacturers.

AI-related investment is needed for the additional power generating capacity required to enable it. For investors concerned about Nvidia, perhaps there are linked, but less GDP-dependent, opportunities. Might power generation and infrastructure providers prove to be safer and more rewarding opportunities?

[3] The information provided should not be considered a recommendation to purchase or sell any particular security.

A time for active investing?

Having examined a scenario where economic growth fails to revert to 'normal' levels, the critical question is what does this mean for investors? One observation is that only investing in broad markets presents a potential risk. As Carlo Putti points out in his article further on, corporate bond spreads are extremely narrow, suggesting limited concern about defaults and the economic outlook.

Meanwhile, the government bond yield curve is pricing in some level of below-trend growth, or even recession in pockets. Does this mean that credit spreads might be vulnerable to a more challenging economic environment?

Within the equity market, there is plenty of excitement about tech, but little else.

Hitherto, investing broadly has been successful but as we look ahead, a more selective approach would appear prudent. If the growth story disappoints, some expectations could be upended.

This is not to say a recession is going to happen; that is not our prediction. But, in our view, there is still a great deal of normalisation that needs to happen to return to an equilibrium where relative values make sense.

In this scenario, we believe a more selective, active approach is needed to identify investment decisions likely to deliver the best returns. This is no time for investors to become complacent.

Valuation framework: Assessing valuation signals across a spectrum of asset classes

Stuart Canning,
Global Macro Fund Manager

Key takeaways

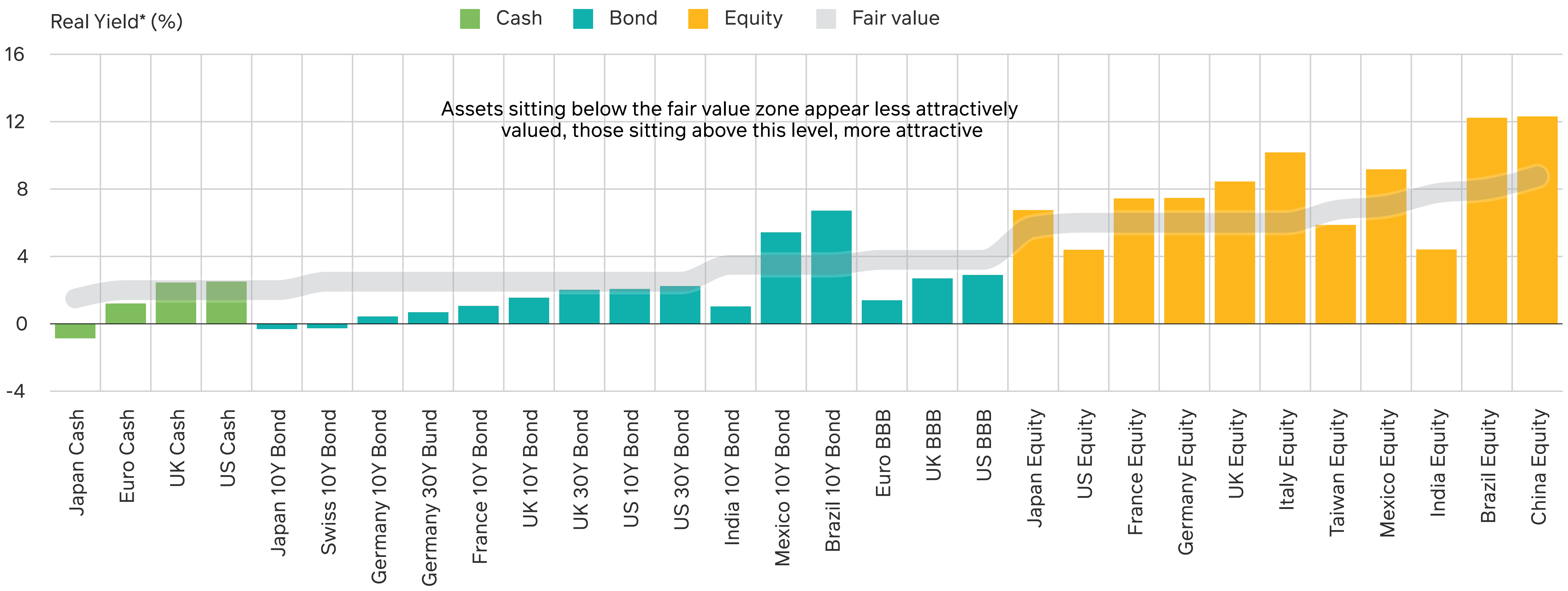
- Our proprietary valuation framework indicates that while a number of equity markets appear reasonable or attractive versus fixed income, many regions (including the US) are offering less compensation relative to bonds than they have for some time.
- Relatively high developed market bond yields offer potential insurance properties in the event of economic weakness.
- In the diverse emerging markets, selective opportunities could exist across both equities and fixed income.

Valuation signals: finding the value across a spectrum of global assets

The valuation framework compares the real yields of a spectrum of global assets with an assessment of their 'fair value', which is calculated using the M&G Global Macro team's proprietary analysis.

When an asset's real yield is higher than the estimate of fair value, it is considered to be attractively valued; if lower, the asset's current valuation would be considered expensive.

Real yield against an assessment of fair value



*Real yield. For cash/bonds = prevailing interest rate/nominal yield minus consensus long term inflation expectations. For equities = inverted p/e ratio, using forward consensus earnings data. The above data is a hypothetical representation for illustrative purposes only and is not representative of any M&G product or strategy. No representation is being made that any account, product, or strategy will or is likely to achieve profits, losses, or results similar to those shown. Source: Bloomberg, 22 November 2024.

Valuation overview

The following observations relate to the valuation framework.

The bigger picture

Cash remains a competing asset – the key issue for global investors remains the policy (cash) rate in the US: both where it stands at present and where it will end up.

The return on US cash is often regarded as a 'risk free' rate that other investments have to exceed to justify the extra risk that is being taken.

Low fixed income yields – a number of fixed income assets offer lower yields than developed market cash after inflation.

Elevated valuations of some equities – many assets exposed to growth risk (equities and credit spreads) offer less of a return 'pick-up' than they have historically.

Rates to fall and supportive economic growth – these valuation signals suggest confidence that cash rates will come down eventually and that growth conditions are sufficiently benign to warrant lower compensation for risk in credit and equity.

Cash

Lower rates ahead – confidence that policy rates are on a downward trajectory in the US, Europe and UK is high. This has underpinned recent positive returns on many investment assets – investors holding cash over the last year will have missed strong equity returns.

Japan is on a different path – in Japan, real yields on cash remain negative and are expected to rise, albeit modestly. Where the expected paths of cash rates differ between economies, it can create significant currency volatility. This is part of the explanation behind the large moves in the Yen and Japanese assets seen in August 2024.

Rate cuts in emerging markets – policy rates are also anticipated to fall in many emerging economies, though Brazil is one notable exception.

Bonds

New era for government bonds – government bond yields in many economies are materially higher than they have been since the 2008/9 financial crisis. They are close to where they were for much of the 2000s, but below 1990s levels.

Yields could fall if the economy weakens – uncertainty over the economic outlook has driven higher volatility in bond markets and even challenged their role as 'safe' assets. However, even with the degree of near-term rate cuts currently priced-in, there is scope for bond yields to rally in the event of genuine growth problems.

Narrow credit spreads – for corporate bonds (credit), the additional yield currently on offer for bearing default risk in the UK and Europe is low relative to history, both for secure (AAA) companies, and those perceived as more speculative (BBB and High Yield).

Investors compensated for emerging market risk – selected emerging markets like Brazil, Mexico and South Africa are currently offering more attractive levels of compensation for risk.

Equities

Focus on US valuations – currently, the main talking point from a valuation perspective in equity markets is the level of US equity markets.

High expectations for US growth – prevailing earnings yields are comparable to the technology bubble of the late 1990s. Given the excitement about AI the parallels between today and that period are telling. But the underlying profit picture is very different, as are sector weights, and accounting standards have also changed. However, there is arguably little compensation on offer for any failure of the US growth story.

Expensive markets in Asia – Taiwan (also driven by tech and AI), India (on the back of very positive structural domestic growth), and Australia also look less attractive relative to history.

Opportunities beyond the US – most of the rest of the world, including Europe and Japan look reasonably or even attractively valued, in our view, while the pessimism over the Chinese economy has created value in that market as well as Korea.

CIO Perspective: Broadening markets offer a wider opportunity set

Fabiana Fedeli,
CIO Equities, Multi-Asset and Sustainability

Key takeaways

- In 2025, taking advantage of short-term sentiment-driven dislocations, while sticking to fundamentals, will be a more successful strategy than trying to time the market.
- When it comes to equity investing in 2025, we believe in a strategy based on stock selection rather than one driven by top-down exposure to countries or sectors.
- Supported by expectations on deregulation and tax cuts, Wall Street still has room to run but not all stocks have the ability to perform equally well. We expect further broadening of returns across the market in areas that, until now, have remained in the shadows.
- While the US market is likely to continue to outperform in 2025, we still see compelling stock-specific opportunities in other markets, including Europe and Asia. Selection, as ever, remains essential.

"We have learnt to take advantage of short-term sentiment-driven dislocations"

In our Investment Perspectives 2024 Mid-Year Outlook, we argued that we did not believe the macroeconomic backdrop lent itself to either trying to time the market with short-term trading or taking broad index exposure. We also stated that equity performance was broadening and stock-specific drivers were coming to the fore.

Markets extrapolating from individual datapoints

Low and behold, since then, markets have taken us on an emotional roller coaster ride. In the three weeks between 15 July 2024 and 5 August 2024, worries started to mount that the world, driven by the US, would enter a full-fledged recession.

The obvious script followed with equity markets dropping and bond prices rising. By the end of August 2024, recession had been forgotten, equities, both the S&P 500 and the MSCI All Country World Indices, had recuperated the lost ground and, by the third week of October, the yields of 10-year Treasuries were roughly back to mid-July levels, with the 5-year Treasuries not far behind.

What happened? Not much. We are simply at a juncture where market participants appear to be extrapolating long-term forecasts from individual datapoints. As these datapoints change direction, so do the forecasts. This is likely to continue as we move into 2025.

Hence, we remain of the opinion that trying to time the market is not the best trading strategy for the year ahead. Rather, we have learnt to take advantage of short-term sentiment-driven dislocations, judging the most likely outcome over the longer term, while sticking to fundamentals.

Since the end of summer, courtesy also of the US elections, equity markets have rallied while fixed income markets have had a tougher time. At the time of writing, bond yields had just come down after Scott Bessent was nominated as US Treasury Secretary, on the hope he'd save the US's fiscal health from Trump's largesse, just before rising again the next day as President-elect Trump made comments on a broader set of tariffs. Another set of truths that we will not be able to ascertain until we see which policies Trump implements in 2025 but, from which, the market has decided to extrapolate.

Broadening markets

Resilient macroeconomic growth and expectations for further rate cuts are a positive combination to support corporate earnings and, hence, equity markets. It is not surprising, therefore, that the US has been the outperformer among major equity markets in 2024.

Looking ahead to 2025, with overall market valuations having reached new post-COVID highs, the question that investors are most likely to ask is: “Does Wall Street still have room to run?” The answer is yes, in our view, but not all stocks have the ability to perform equally well.

While market chatter and media reports remain focused on the Magnificent 7 (Mag7)[4], equity market performance has been broadening, even in the US.

For example, since the beginning of the year, the median Mag7 return has been 36.8%, while, in the S&P 500 Index, the median returns of the Top 200 performers (ex Mag 7) and the Top 100 performers (ex Mag 7) have been 43.1% and 57.2% respectively. At the same time, the technology sector has recorded a median return of 13.5% compared with 20.2% for the Index ex technology stocks[5].

Two conclusions can be drawn: first, that investors are broadening their search for investment opportunities where valuations and expectations have been more reasonable. Second, that there are other areas that present positive prospects beyond technology.

As a result, the ‘Trump trade’[6] is a trade on the broadening of returns across the market in areas that, until now, have remained in the shadows, rather than simply being a trade on the S&P 500 Index. The latter remains strongly influenced by the idiosyncrasies of the Mag7.

Among the most recent top US equity performers are stocks in the utilities, industrials and energy sectors, along with financials names.

The current earnings season also continues to indicate that stocks within the same sector are generating different growth and profitability, not only due to industry exposure, but to elements more specific to each company – such as product quality, innovation, balance sheet management and, of course, the quality of management.

For this reason, when it comes to equity investing in 2025, we believe in a strategy based on stock selection rather than one driven by top down exposure to countries or sectors.

[4] The so-called Magnificent 7 are a group of large US companies: Apple, Microsoft, Amazon, Alphabet (Google’s parent company), Meta (formerly Facebook), Nvidia, and Tesla.
[5] Source: M&G Investments, Bloomberg. Currency: USD. Median returns year to date through to 28/11/204. Based on analysis of constituents of the SPDR S&P 500 ETF TRUST that fully replicates the S&P 500 Index.
[6] Investments that are expected to be affected positively by the president-elect’s policies.

Focus on Trump

Heading into 2025, the Trump trade is likely to remain the focus of many investors. Expectations of less regulation and lower taxes are positive for the immediate US macroeconomic picture, although the latter is not for the longer-term fiscal picture.

Import tariffs, however, represent a question mark. High import tariffs would have a negative effect on the US economy and, in particular, on inflation. Any inflationary impact from Trump's policies could change the trajectory of US Federal Reserve (Fed) decision making in the coming year.

But there is a timing issue. Any potential impact on inflation will not take immediate effect and, until now, the Fed has looked at historic data to inform decision-making on interest rates.

The question that investors may ask in 2025 is: "Will the Fed start to look at the potential for Trump's policies to impact inflation, or continue to cut interest rates based on pre-Trump data points and subsequently raise them again if Trump's policies start to have an inflationary effect?" The second option could bring more volatility in the coming year, particularly to fixed income markets.

Trump's policies are also likely to result in a strong dollar in 2025, with implications for other markets outside the US. Importantly, however, the Trump trade is not the only trade in town, if you'll pardon the alliteration. A deterioration of the macroeconomic backdrop in the US could spoil the party for equity markets.

Opportunities in Europe and Asia in 2025

While the US market is likely to remain a relative outperformer in the near term, driven by more robust growth and Trump policy expectations, we still see compelling opportunities in other markets, including Europe and Asia. Here too, we seek bottom-up, stock-specific opportunities, rather than top-down or broader market index exposures.

Within Europe, for example, we are finding opportunities within more cyclical areas, such as chemicals and materials, given the depressed valuations reflecting a bottoming of end markets' demand. We are also finding opportunities among well-capitalised, less rate-sensitive Northern European and UK banks.

Within Asia, the risk of higher US tariffs has increased investor caution, particularly towards Chinese equities, at a time when there is heightened uncertainty around China's domestic economic stimulus and recovery. We believe this is creating interesting stock-picking opportunities for bottom-up investors to exploit in 2025.

We are seeing industry consolidation and corporate restructuring laying the groundwork for both top line and margin expansion in certain domestically-orientated sectors like real estate agency and hotels.

At the same time, it's also worth noting that many China-based businesses have adjusted their supply chains toward Southeast Asia – so the impact of higher tariffs will be complex and likely quite different in some cases compared to six years ago, again creating potentially interesting stock-picking opportunities in the year ahead.

Selection remains essential

Looking at 2025, from our current vantage point, it is difficult to time a meaningful worsening of the macroeconomic backdrop. Common sense tells us that at some point it will happen, but calling it too soon can, as it has in the past, be a significant opportunity cost for equity returns. With that uncertainty in mind, we believe the key focus for investors should be to select the areas of the market that can offer the best performance, rather than trying to forecast overall index returns.

Since the beginning of 2024, in comparison to the 57.1% median return of the top 100 stock performers within the S&P 500 Index, the remaining 400 stocks returned a much lower 12.7%[7].

As investors prepare to navigate the year ahead, we believe selection will continue to be essential in generating superior portfolio returns.

In the following article, Johnny Hughes, Investment Director in the Equities and Multi-Asset team, provides his perspective on the outlook for global equities in the year ahead.

[7] Source: M&G Investments, Bloomberg. Currency: USD. Median returns year to date through to 28/11/204. Based on analysis of constituents of the SPDR S&P 500 ETF TRUST that fully replicates the S&P 500 Index.

Global equities: Alluring or alarming?

Johnny Hughes,
Investment Director, Equities and Multi Asset

Key takeaways

- Gold prices soaring amid geopolitical fears and fiscal concerns, while credit spreads tightening on economic optimism, create a complex backdrop for risk assets.
- Global equities have defied expectations with AI-driven gains but as interest rates come down, there is scope for market leadership to broaden beyond the US.
- With volatility likely to persist in 2025, active management could be crucial to react and exploit the varied opportunities in different equity sectors and regions.

Gold prices near all-time highs, yet high yield credit spreads close to record lows. That is the backdrop for risk assets towards the end of another confoundingly resilient year for global equities.

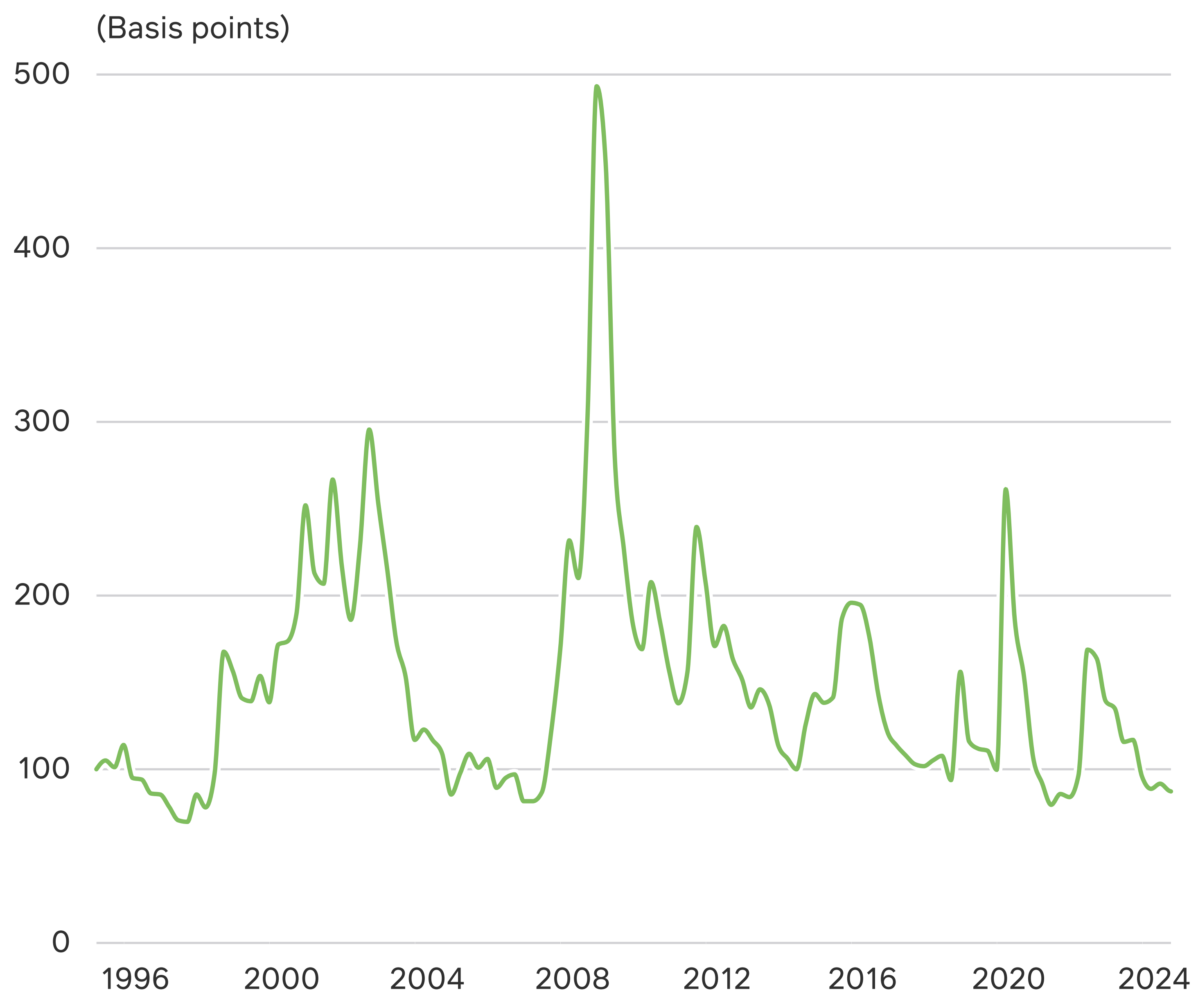
Signals: Credit spreads

This risk asset class itself is a powerful signalling mechanism but is also hostage to global asset market peers. Gold speaks to a world of geopolitical tensions, unsustainable government fiscal agendas and an increasing fear of fiat currencies. Credit spreads, on the other hand, talk to a land of economic nirvana where corporate earnings remain buoyant. Which is right? Maybe both.

Starting with the positive messaging from credit spreads. It is worth remembering that equities tend to spend a large proportion of time close to all-time highs so it would be wrong to fear equities for just being themselves. There is a survivorship bias to stock indices, and history shows that performance is led by a concentrated part of the market who gets rewarded with a lower cost of capital that allows the advantage to be sustained for long periods of time.

> **“Gold speaks to a world of geopolitical tensions, unsustainable government fiscal agendas and an increasing fear of fiat currencies.”**

US High-Yield credit spreads near record low



Source: Bloomberg, October 2024.

Past performance is not a guide to future performance.

Irrespective of whether the Fed has played a blinder or just got lucky with global supply chains self-healing, the current macro scorecard shows close to normalised inflation and still record levels of employment. The recent rate cuts are a loud and proud message that the 'Fed put' exists and Chair Powell has got our back.

Inflation may be structurally higher than the last decade but is manageable given modest corporate and household debt, providing companies with that forgotten panacea of pricing. Even the deflationary force of China seems to have been nurtured by the multi-pronged stimulus attack of 2024.

AI earnings saved equities during the post-COVID boom manufacturing slowdown, allowing time for inventories to correct. Now the baton needs to pass to 'the other 493' as rate pressures moderate and ex-US growth recouples.

Japan is resurgent as the three arrows finally hit their target. India is a growth phenomenon, and China could increasingly evolve to become the value play in emerging markets. Europe is struggling but that is nothing new and a rebound in China coupled with supportive fundamentals for greater market breadth could help its stock markets push on further.

Signals: Gold

And so to the signals from gold. The list of what could go wrong is exhausting, and that's just the known unknowns. Encouragingly, markets have been buoyed by a clear and swift outcome in the US presidential election.

However, the yield curve recession prediction could finally come through irrespective of the Fed's early efforts to loosen monetary conditions.

Markets could balk at government spending plans and a resurgence in inflation could trigger a bond market sell-off causing the risk-free rate to de-anchor again.

Gold prices near record highs

Source: LSEG Datastream, 26 November 2024.

Past performance is not a guide to future performance.

Broken markets?

Many commentators also fear the plumbing of the system. Markets appear 'broken' – bullied by beta and indexation, the pricing signal is corrupted.

The influence of high frequency trading, systematic quant funds and commodity trading advisors (CTAs) have rendered the equity market a no-go zone for those with a valuation discipline and a momentum repulsion. Volatility episodes like 2024's summer of 'yen-aggedon' seem likely to become prevalent, eroding investors' faith in risk assets.

The wall of worry

Summing it up, the lack of a major US recession so far could be seen as a triumph or a source of gravity. Perhaps we actually had our 'recessions' but just not an old fashioned joined up co-ordinated one.

COVID-19 threw the market off kilter, de-linked goods and services. The Fed saved a credit crunch with its quick resolution of the Silicon Valley Bank episode and a fiscal fountain for consumers did the rest. A series of 'rolling recessions' were likely experienced in areas such as housing, regional banks, ex-tech earnings, China, Europe, manufacturing, autos, and rate sensitive equities. Fortunately, AI and government balance sheets provided a macro cushion.

So as 2025 looms, equities continue to scale the wall of worry. The macro signals for equities are sending extreme messages but can be justified. Arguably the biggest risk is not being able to exploit equities' greatest strength, which is their geographic and sectorial variety.

We believe that active management remains the best way to react and effectively risk manage to what will inevitably be a tumultuous year ahead.

CIO Perspective: Positioning for resilience in fixed income

David Knee,
Deputy CIO, Fixed Income

Key takeaways

- Uncertainty and unpredictability have been the watch-words of the past few years and that is set to continue into 2025, with questions lingering over the impact of Donald Trump's policies, as well as the trajectory of global growth.
- Moderation in inflation will allow interest rates to fall, counteracting rising protectionism and other anti-growth policies, while absolute yields in very short and longer maturities may offer some inflationary protection in the new year.
- Against a backdrop of tight spreads, rising deficits, as yet unknown fiscal policy and moderating GDP growth, portfolios could benefit from defensive positioning.

The last two years have challenged accepted economic theory: despite the 5% rise in US interest rates, and elsewhere, advanced economies have displayed remarkable resilience. The US, in particular, has surprised the world with above potential growth spurred by higher productivity.

However, with economic norms challenged, markets are left struggling to interpret what might happen next as long-term anchors have weakened; instead, investors pore over every data release for indications of the potential path of the global economy.

Even the Fed isn't immune from this self-doubt with the dispersion of long-term interest rate views of its governors at its most extreme since the advent of the dot plot in 2012. As a result, markets will enter another new year faced with uncertainty; so what will we be looking at in 2025?

"Bond markets will be watching for key policies such as tariffs, tax and immigration."

The impact of Trump 2.0

In markets, the predictable response to a more unpredictable environment is increased volatility. The election of Donald Trump only serves to amplify this with markets waiting to see how his second administration might pan out. Trump campaigned on some broad-brush policy statements. However, only time will tell whether these become reality. The first Trump presidency showed what Trump said he would do and what he actually did were very different.

Bond markets will be watching for key policies such as tariffs, tax and immigration. These policies could potentially reignite inflation and limit the ability of the Fed to act, as well as add to already growing deficits.

Economic reality doesn't change

Despite the uncertainties, economic facts don't change: deficits are rising. The upward sloping nature of the long end of developed market yield curves suggest bond investors are cognisant of this. After more than a decade of real interest rates sitting below real growth rates and the subsequent belief there was no limit to the ability to borrow (remember Modern Monetary Theory), the environment has pivoted. Debt interest for the fiscal year 2024 stood at $1.1 trillion[8], exceeding the cost of the Medicare healthcare program ($1.05 trillion) and military defence spending ($830 billion)[9]. Going forward, Trump's potentially expansionary fiscal policy may even accelerate the deficit, leaving the Treasury market to bear the burden.

Where next for growth and inflation?

For bond investors looking into next year and beyond, the International Monetary Fund (IMF) does not offer much solace. In its October World Economic Outlook, the organisation paints an uninspiring picture over the next five years. Global growth for 2024 and 2025 is predicted to be 3.2%, and is forecast to bumble along at a similar pace, hitting 3.1% in 2029[10].

If AI is really going to be the driver of the fourth Industrial Revolution, there's scant sign of it here. Nor do we see it in productivity figures either; in the US, productivity has been strong, which in no small part has been attributed to a surge in immigration. However, this seems unlikely to persist. Still, if there is a silver lining in this mediocracy, it's that there's no dramatic downside either. Moderation in inflation will allow interest rates to fall (perhaps more slowly than fixed income investors would like), counteracting rising protectionism and other anti-growth policies, like curbing immigration.

Attractive yields going into the new year

For global bond investors, as we enter 2025, absolute yields are still attractive at both the very short and the longer maturities, in our opinion. These offer some protection against prospective inflation, with real yields on government bonds close to 2% – a level not seen since before the Global Financial Crisis (GFC). Longer maturity bonds also offer a decent hedge for equity exposure if the macroeconomic story weakens. Given that expectations for rate cuts are embedded in mid-maturity bonds, this makes them a more difficult call, as what happens from here will continue to be very data dependent.

[8] US Government Accountability Office, 'Financial Audit: Bureau of the Fiscal Service's FY 2024 and FY 2023 Schedules of Federal Debt', (gao.gov), November 2024.
[9] Government spending: US Bureau of Economic Analysis, November 2024.
[10] World Economic Outlook, International Monetary Fund, October 2024.

US government benchmark yield

Source: LSEG Datastream/Fathom Consulting, 27 November 2024.

What to watch in 2025

The case for corporate bonds is nuanced. The credit spread across almost every category of the fixed income market is below its long-term averages. Investors are not being well compensated for longer term corporate risks, either in investment grade (IG) or high yield.

That said, absolute yields look close to long-term averages, for example US IG yields are at 5.2% now versus an average of 4.8% since 1996[11]. This is attracting capital into the market which drives a self-reinforcing cycle of lower spreads making credit increasingly expensive. It will be impossible to see the catalyst that leads credit spreads to normalise but with four cycles in the last 15 years, the odds don't favour an indefinite continuation of the present trend.

Against this backdrop of tight spreads, burgeoning deficits, as yet unknown fiscal policy and moderating GDP growth, caution is required for 2025 and it is beneficial for portfolios to be defensively positioned.

In the following article, Carlo Putti, an Investment Director in the Fixed Income team, provides his perspective on the current macroeconomic environment and why he believes it presents a favourable context for bonds.

[11] ICE, Bloomberg, November 2024.

Where are we in the economic cycle?

Carlo Putti,
Investment Director, Fixed Income

Key takeaways

- With growth and inflation seemingly constrained, significant rate hikes are unlikely, enhancing the attractiveness of bonds, especially if economic conditions worsen.
- Narrow credit spreads indicate limited compensation for risk, warranting caution due to potential default risks in a tighter policy environment.
- Bonds seem favourable in a challenging macroeconomic environment and weakening labour market, but investors should be selective within credit due to potentially inadequate risk compensation.

Market movements often fluctuate between extremes rather than following a smooth path. One day, the consensus is that the economy is about to fall apart with several rate cuts needed, then suddenly, sentiment shifts and investors revert to 'higher for longer' rhetoric, expecting a re-acceleration of inflation and growth.

Of course, the reality is that economies usually don't move that fast, rather they follow a steadier and slower pace. Zooming out a bit helps us better understand where we are in the economic cycle and what that might mean for bonds.

Key drivers: Growth and inflation

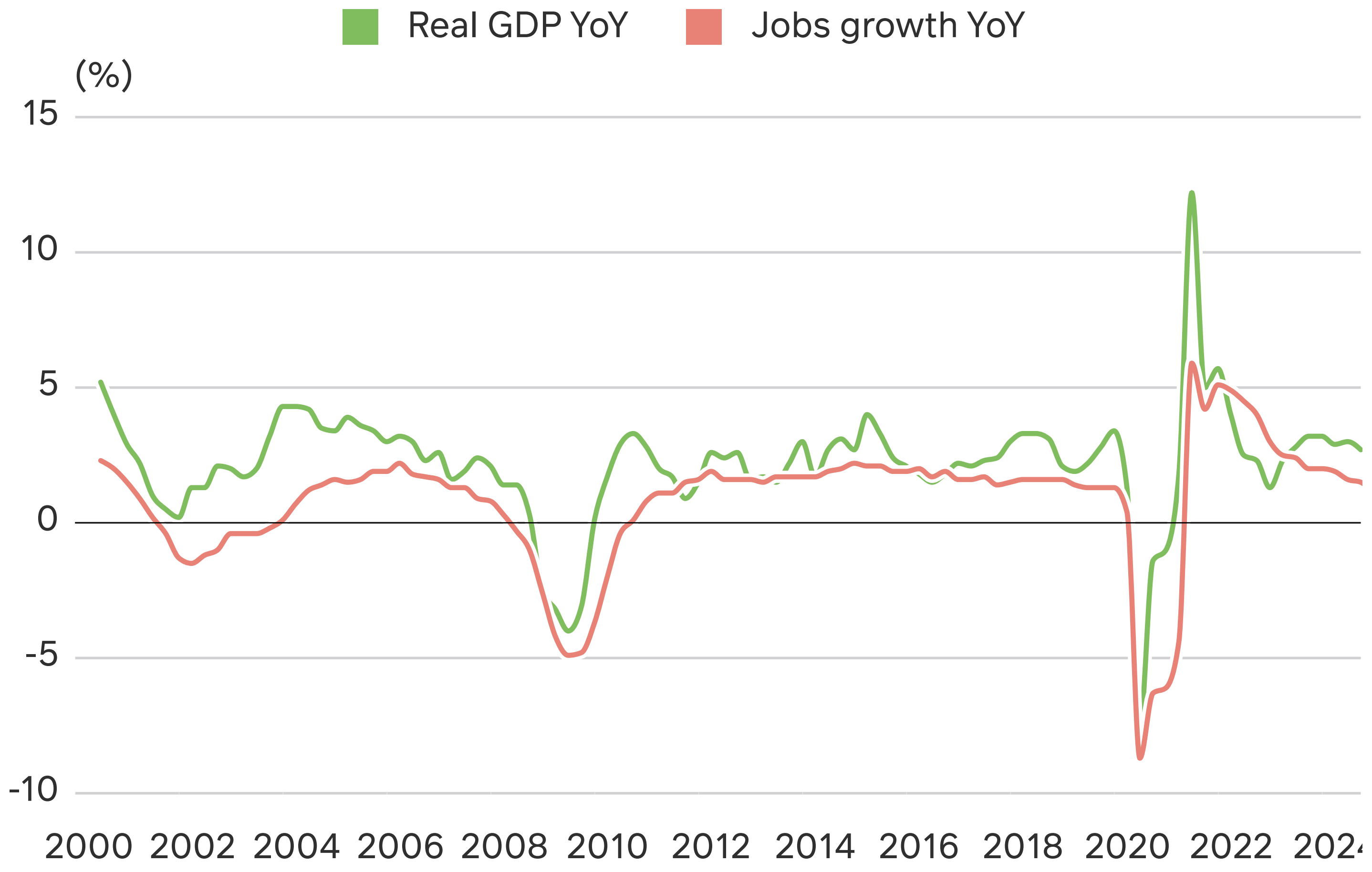
Essentially there are two key drivers for bonds: growth and inflation. Higher growth and higher inflation will likely push yields higher; conversely, yields will come down, pushing bond prices higher. After a period of extraordinary growth and elevated inflation, fuelled by easy monetary and fiscal policies, things have finally started to normalise, prompting central banks to cut rates.

When looking at growth and inflation more closely, it appears that both are currently constrained, limiting the ability for rates to move much higher from current levels.

Growth is likely constrained by the labour market, with the size of the workforce a key determinant of growth. The more people who work, the higher growth is likely to be. Conversely, a shrinking workforce will likely lead to a slowdown in economic activity.

The following chart plots job growth versus real GDP growth for the US. Employment growth is slowing and currently sits around 1.5% year-on-year. With this level of growth in the labour market, it will be hard to generate 2% or above GDP growth on a sustained basis.

Potential growth likely constrained by weakening labour market



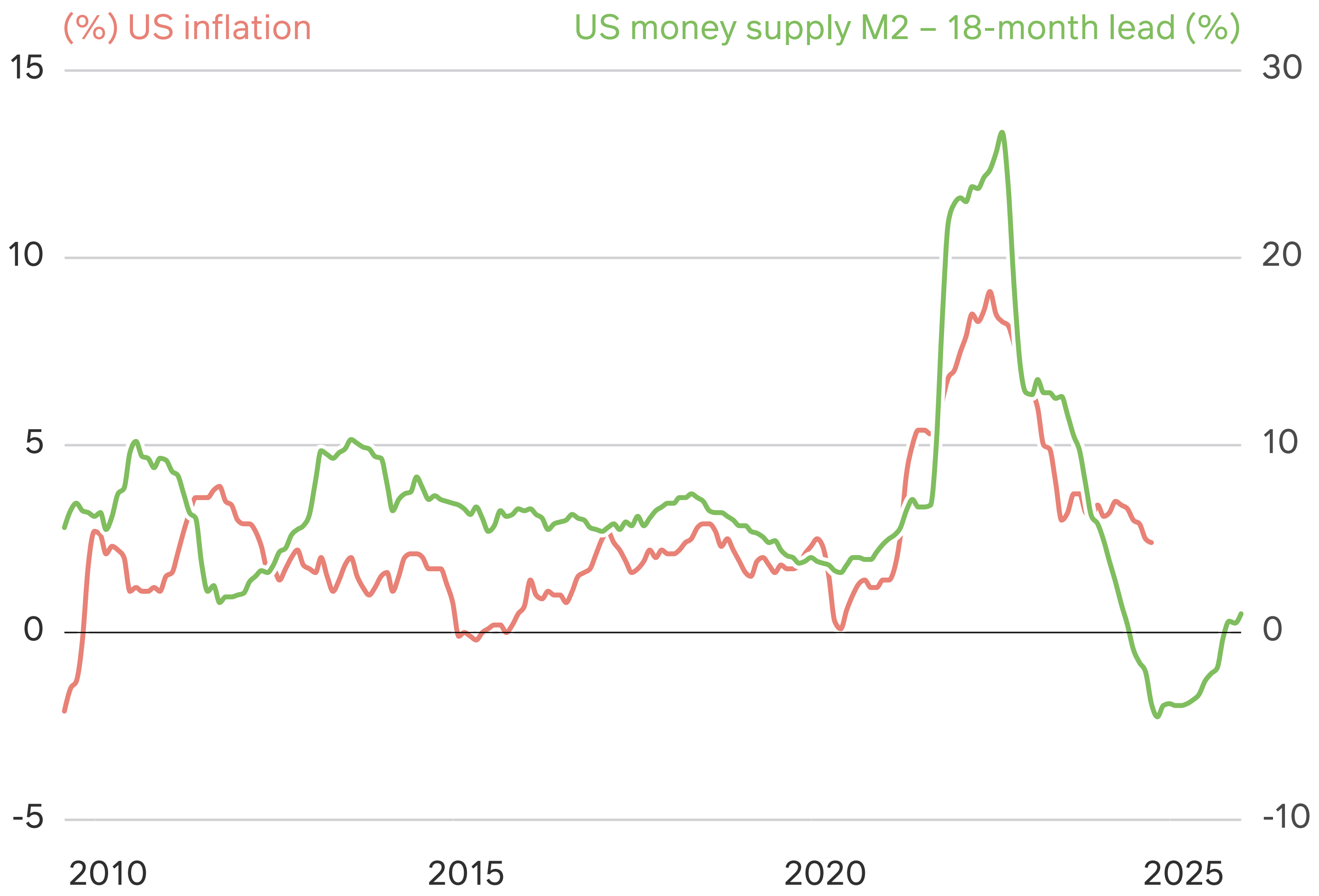
Source: Bloomberg, 30 September 2024.

Turning to inflation, money supply has been a key determinant of prices during this cycle. As the next chart illustrates, the large increase in money supply around COVID led to a surge in inflation a few months later.

The subsequent decline in money supply is resulting in disinflationary pressures, with inflation generally returning towards target. While rising, money supply remains historically low, and this should constrain inflation within the near future.

"Money supply has been a key determinant of prices during this cycle."

Potential inflation likely constrained by falling money supply



Source: M&G, Bloomberg, 31 August 2024.

When putting everything together, a picture emerges where economies are generally slowing, and the potential for renewed inflationary pressures or a re-acceleration of economic growth seems limited at this stage. This results in an attractive risk-reward for bonds, in our view.

If growth and inflation are indeed constrained, rates are unlikely to move much higher compared to where they are today. On the other hand, the potential upside is significant, particularly if we end up with a more severe slowdown or even a recession.

Tightening credit spreads

So far, we have discussed the general economic environment and what that means for rates. However, as bond investors, there is an additional area of the market to consider: credit.

When we lend money to a company, we are not only subject to changes in rates but also to changes in credit spreads. These represent the additional compensation we seek for the increased risk we are assuming compared to risk-free assets such as government bonds.

Unlike rates, which have increased significantly over the last few years, spreads have tightened and are now historically low, reflecting an environment of positive growth and limited default risk. This means most of the bad news is arguably already in the price. We believe this leaves investors with an unfavourable risk-reward, particularly considering where we are in the economic cycle, with generally tighter fiscal and monetary policies, which could lead to a further slowdown and therefore higher default rates.

A favourable context for bonds

In conclusion, the macroeconomic environment appears to be gradually worsening. Shrinking money supply and a deteriorating labour market are putting downward pressure on both growth and inflation. In this context, we believe bonds present a favourable investment option, further supported by the risk-reward profile currently offered by the asset class.

However, investors will need to be more selective within credit, as the extra compensation currently received for lending money to companies might not be sufficient if the macroeconomic environment were to deteriorate further.

CIO Perspective: Private market growth trends set to continue

Emmanuel Deblanc,
CIO, Private Markets

Key takeaways

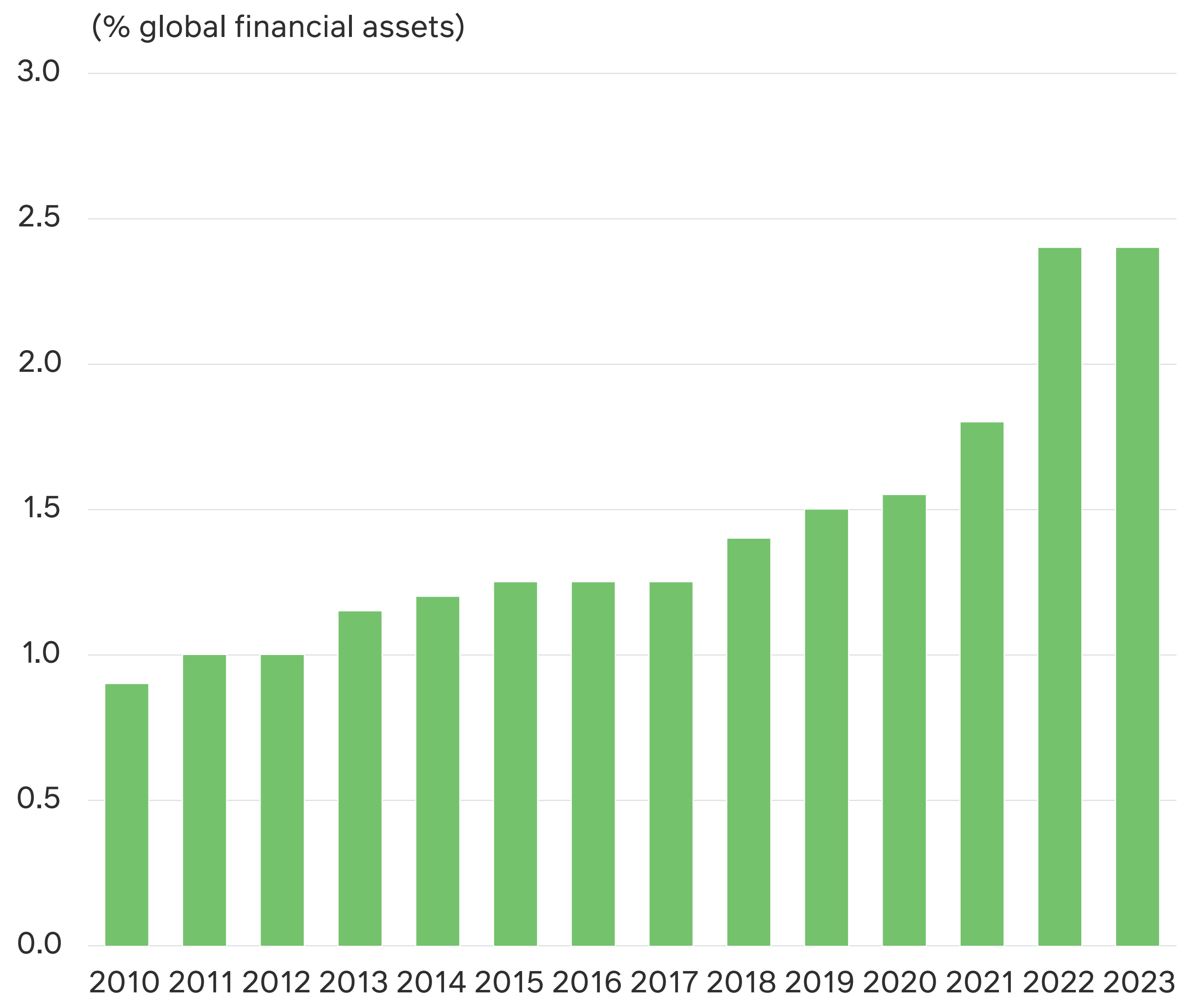
- High interest rates have limited activity levels in private markets, but recent rate cuts could create a more favourable stage for the asset class in 2025.
- Institutional investors are shifting from public to private markets, driven by regulatory support and structural trends like the energy transition and demographics.
- Private equity and real estate show signs of recovery, while private credit is expected to remain resilient, factors which could drive further growth in the coming year.

2024 has been challenging for most private markets, not in terms of performance, but supply of quality deals. For most of the last two years, high interest rates have proven to be a drag on activity levels within the asset class. Despite rates now being cut, there remains a clear expectation that they are set to remain at a high level compared to 2010. Regardless, there are now signs of an uptick in activity levels across most private market sub-asset classes, and 2025 looks set to be a more conducive environment for private market investors.

Allocations to private markets are increasing

There are several factors supporting the private markets growth story, but three are likely to be the main drivers over the next 12 months. The first is a shift in investor allocations. Institutional investors are progressively allocating away from public markets towards private assets. Some surveys suggest the asset class will represent more than 50% of the average institutional portfolio within the next 3 years[12].

Private Markets AuM as % Global Financial Assets



Source: Preqin, 31 December 2023.

[12] State Street Annual Private Markets Survey, 2024

"Private markets are not homogeneous and the outlook for next year will vary market to market."

Further support will come from government regulation and policies driving demand for private market investments. Energy transition, infrastructure build-out, demographic change, deglobalisation – these are all trends where companies delivering change disproportionately sit within the private market universe.

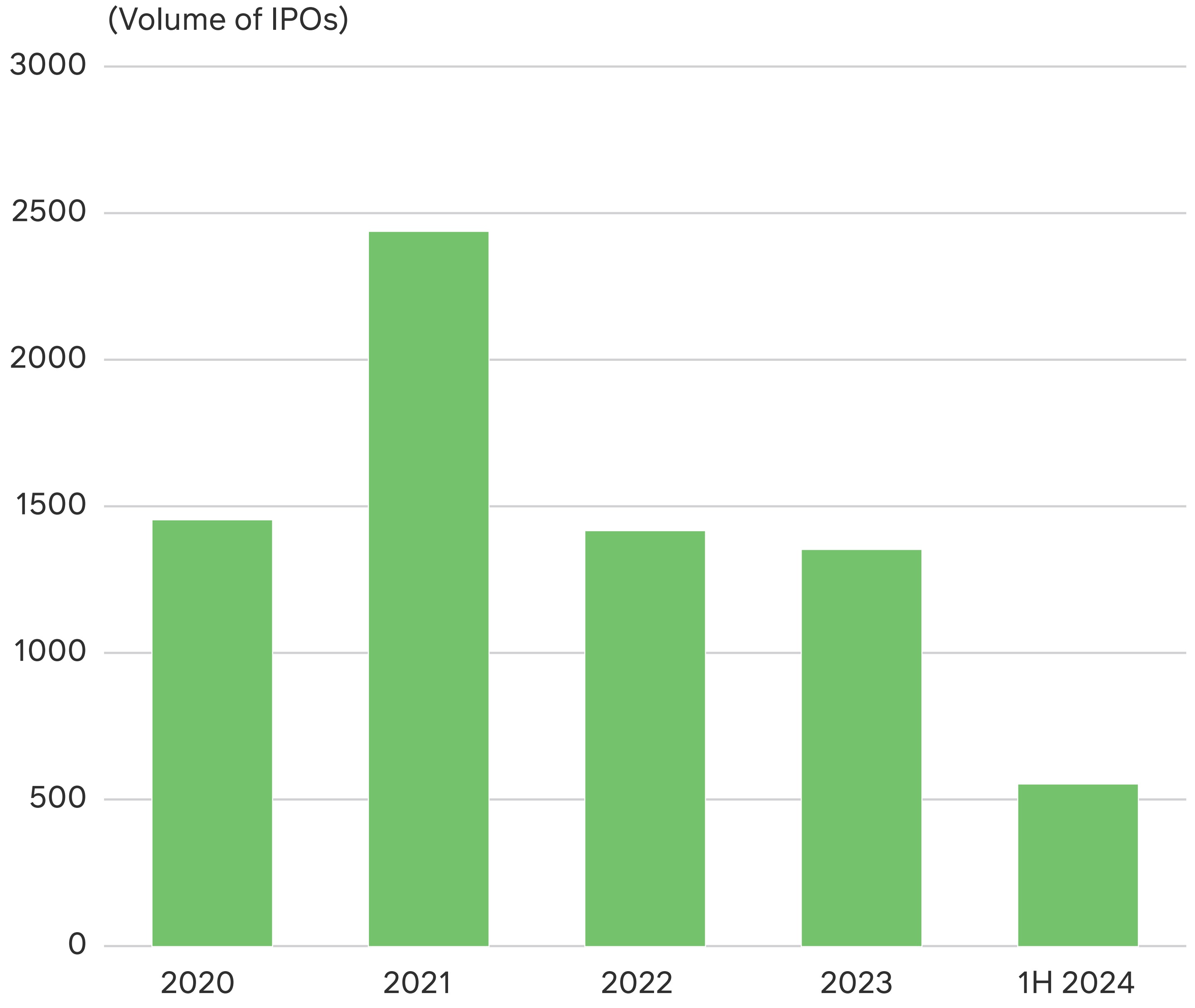
Lastly will be the opening up of private markets to a wider investor base. This is already being facilitated with the introduction of LTAFs and ELTIFs making it far easier for non-institutional investors to gain access. This 'democratisation' process is positive and will likely drive greater investment into the asset class.

Back to life: IPO revival could help private equity

Of course, private markets are not homogeneous and the outlook for 2025 will vary market to market. The private equity sector has had a challenging time lately, not only due to high interest rates, but also because the Initial Public Offering (IPO) market has largely been closed for the last three years. Private equity investors often depend on the IPO market to exit their investments. This has implications as an inability to exit means an inability to recycle capital into new opportunities.

Fortunately, the IPO market is now showing signs of life which should help unclog the backlog of un-exited investments. This should be good news for private equity over the next 12 months.

Number of Global IPOs



Source: EY Global IPO Trends Q2 2024.

Positive trends

Amid a reduced deal flow in 2024 relative to previous years, private credit has been no exception. However, we may see a trend reversal in 2025. Performance has been strong within this asset class, boosted by rate increases since early 2022. For an investment area characterised by floating rates, this may now appear to be a negative as rates come down, but it is not as easy as that.

Investors should look at real yields which remain historically high, not simply nominal rates. It should also be remembered that returns in private credit comprise both yield and credit loss, and lower rates reduce default risk. Lastly, lower rates will incentivise M&A activity – this will lead to greater deal volume, wider spreads and improved potential returns.

With private credit offering multiple strategies, a trend that we are seeing is investors being prepared to diversify their private credit exposure outside of direct lending. For 2025, therefore, we would expect that strategies such as specialty finance increasingly come into focus. Private credit has proven to be a remarkably resilient investment area across market cycles, and we expect this to continue.

Real estate in recovery mode

Private real estate, is a more complex story. The asset class has suffered since the Fed started raising rates in early 2022. This led to higher financing costs for developers and investors, leading to a disconnect between buyers and sellers – real estate valuations consequently fell.

Headwinds also persist for private real estate as rates remain high, new real estate supply has to be absorbed, and fundamentals for sectors such as office accommodation are uncertain. Despite all this, however, the sector clearly enters the new year in recovery mode. Valuations now seem to have bottomed and deal flow is increasing. The timing and strength of this recovery remains to be seen, but with valuations at current levels, we anticipate that opportunities will certainly exist for investors in 2025.

Structural drivers here to stay

Overall, we are confident that the private markets growth story is going to continue in 2025. Investors are progressively allocating more and more into this area, and the structural drivers already mentioned are not going to disappear. We believe that investors will continue to be drawn to the relatively resilient nature of this investment area and appreciate the attractive returns it can offer.

In the following article, Richard Gwilliam, Head of Property Research, provides his perspective on the real estate sector, highlighting increased optimism about the asset class amid evidence of an early stage of recovery.

The real estate recovery begins

Richard Gwilliam,
Head of Property Research

The last two years have been a period of painful adjustment for real estate, almost irrespective of sector or geography. Now though – even in more challenged markets – valuations are have largely stabilised and bottomed out, with evidence of an early stage of recovery coming through in some. Market sentiment has noticeably shifted, and appetite for real estate investment is rising. Coupled with central banks beginning to ease interest rates, this sets the scene for an increase in buying, selling and lending opportunities, as the new cycle begins.

A more optimistic 2025

As we move into 2025 with increased optimism, we believe it is an opportune time to take advantage of the real estate markets' upswing. Globally, we are seeing the most attractive performance prospects the asset class has seen for many years, driven by a combination of more attractive income return potential and strengthening rental growth, as recovering demand meets heavily constrained supply.

While not universal, some yield compression also looks likely to re-emerge as confidence grows, risk aversion starts to fade and investors begin to compete for the most attractive assets, bolstering performance. Core assets, particularly in the ever-attractive 'beds and sheds' sectors, and even in parts of the retail or office sectors, look best-positioned, in our view, to benefit in the early stages of the cycle.

For some investors, now too could be the time to consider moving further up the risk curve. We believe structural challenges, combined with cyclically depressed prices, offer attractive opportunities to reposition assets to generate alpha – outperformance against the wider market – as the recovery strengthens.

An uneven recovery ahead

We see an uneven, K-shaped recovery, however – meaning that while we're confident many assets will enjoy an upward trajectory, we also believe that as we move into 2025, some assets will face further decline. Offices are a clear example. Best-in-class buildings should continue to outperform and see their values rise, while weaker assets look destined to continue on a downward leg, amidst rising risk of obsolescence.

Potential for distress materialising from assets that may struggle to secure refinancing could prolong their pricing pain. It could also bring possible opportunities for improved returns thereafter, for investors that are able to acquire assets more cheaply.

Equally, investing on the other side of the capital structure, through real estate debt, could help to mitigate the downside risk associated with assets that could be more vulnerable to a downward trajectory.

Investors with the ability to execute brown-to-green strategies could shift an asset's course altogether, perhaps moving it from the downward leg of the 'K' to the upward one. This strategy could prove particularly successful for well-located buildings.

Leveraging structural tailwinds

Leveraging structural sector tailwinds will remain fundamental to achieving rental growth, in our view. Housing markets globally are a key focus, with affordability more stretched than ever in many regions, despite wage growth. Demand for housing continues to grow in major urban areas as a result of ongoing robust population growth, driven by high levels of internal and international migration. Yet long-term undersupply in housing markets globally has been compounded by high debt and construction costs.

Lower-income households have borne the brunt of the problem, especially as affordable housing development has been most severely affected by viability challenges. This presents an opportunity for institutional capital to help address this pressing social need by investing in affordable housing solutions. Unlocking more housing supply, across both ownership and rental tenures, will be critical to alleviating the strain on household budgets and improving livability in the world's major cities.

Changing dynamics

As we enter a new cycle, we believe lower entry prices and strengthening rental growth makes for compelling reasons to invest in real estate. However, changing dynamics within real estate sectors suggests that this cycle could play out differently to the last.

Even while wider macro trends will remain supportive for the industrial sector and challenging to retail and offices, for example, the micro-level story is no longer as straightforward. The surge in the supply of logistics space in some locations over the last couple of years has driven significant variation in vacancy rates even for the best quality stock. On the other hand, more dominant regional shopping centres look set to buck the subsector's performance trend, with the high yield potential on offer likely to be supplemented by rental growth as occupiers resume targeting space in the 'right' locations.

Given that we anticipate an uneven market recovery, having the right asset in the right place may therefore be the key to outperformance as the cycle turns.