Quarterly insurance update Q1 2025

For professional clients/qualified investors only, not suitable for retail investors. This is a marketing communication.

Summary

Welcome to the Quarter 1 2025 investment update designed for insurers and produced by Royal London Asset Management. Throughout the last quarter, markets were volatile – with the US elections and the potential for central bank rate cuts the main causes of uncertainty.

Within this quarterly update, we cover developments that will have long term effects to insurers' balance sheets – investment markets and themes.

1. Market update:

- Government yields rose over the quarter, as central banks continue to struggle to bring inflation back to target levels and amid ongoing political volatility with elections across Europe and the US.
- The sterling investment grade credit market returned -0.49% over the quarter, with the average sterling investment grade credit spread tightening over the period from 1.03% to 0.86%.
- The fourth quarter was dominated by the outperformance of the US market following the election of Donald Trump on a platform of low taxes and de-regulation which are viewed as pro-business.

2. Insurance investment themes:

For this quarter's publication we share our investment outlook for 2025 across the major asset classes:

- **Investment Outlook 2025**: Mike Fox, Head of Equities and Sustainable Investing, emphasises the importance of sustainable investments and the potential for growth in sectors such as renewable energy and technology. Paola Binns, Head of Credit, highlights the attractive yields in the sterling credit market and the resilience of credit investments despite fluctuations in government bond yields. Craig Inches, Head of Rates & Cash, discusses the impact of recent political changes, including the US presidential election and the UK general election, on global financial markets. Trevor Greetham, Head of Multi Asset, highlights the significance of diversification and active management in navigating the uncertainties of the current geopolitical landscape.

1. Market update

Overview

Markets were volatile during the fourth quarter – with the US elections and the potential for central bank rate cuts the main causes of uncertainty. With the election of Donald Trump as US President, and the Republicans having a majority in both the Senate and House of Representatives, markets moved to price in potentially higher US deficits.

Alongside political events, attention remained on the Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE) to see if expected rate cuts would materialise. However, with inflation remaining higher than central bankers would like, expectations for rate cuts in 2025 were revised down. This backdrop pushed government bond yields higher, leading to negative absolute returns for most investment grade credit markets despite credit spreads tightening and credit excess returns over government bonds being positive, while equities ended a strong 2024 with another positive quarter, with US stocks – notably the 'magnificent seven' – leading the way.

At its final meeting of 2024, and as expected, the BoE kept rates on hold at 4.75%. Meanwhile, according to the minutes, "a gradual approach to removing monetary policy restraint remains appropriate." November CPI inflation rose to 2.6% year-on-year as expected on 'base effects'. Pay growth was stronger than expected. October GDP shrank month-on-month after falling in September, with this contraction (and subdued business surveys since) raising the risk of a mild GDP contraction in the fourth quarter. Away from economic data, the new Labour government presented its first budget. This was less obviously a budget for growth than one for public services repair with a substantial proposed increase in day-to-day fiscal spending and net investment. Public spending was increased substantially, but at the cost of a big increase in taxes. Since the Budget, business optimism has dropped, and firms are indicating a mix of responses to the rise in National Insurance contributions including hiring less and raising prices.

The Fed cut rates 50bps over the quarter to a 4.25% - 4.5% target range. They signalled fewer cuts for 2025 than previously indicated, indicating only 50bps cuts for 2025 (100bps previously). Third quarter GDP (released over the quarter) rose at an above trend pace, supported by strong consumer spending growth. The US PMI composite meanwhile rose further and continued to signal a robust pace of US private sector output growth, although manufacturing business survey measures remain more subdued than services. In November, Donald Trump was elected US President for the second time. A Trump presidency will likely bring a change in both policy-making style and substance. It was a clean sweep for the Republicans, winning the White House, Senate and House of Representatives, increasing the prospects of Trump getting his fiscal policies through. Business optimism on the PMI survey rose, hitting a two and a half year high in December, "reflecting growing optimism about business conditions under the incoming Trump administration," though manufacturers flagged concerns about tariffs (where Trump has promised increases) and inflation.

As widely expected, the ECB's final decision of the year saw another 25bps rate cut, taking the deposit rate to 3.00%. The bank continues to note that domestic inflation remains high, "mostly" attributable to wages and prices in certain sectors, and acknowledge that they are "still adjusting to the past inflation surge with a substantial delay." Third quarter GDP released over the quarter was stronger than expected. The PMI business survey composite, however, remained consistent with subdued private sector activity growth throughout the fourth quarter, ending the quarter below the 50 'no growth' level. The picture for activity outside Germany and France was somewhat better than for those two economies, with both France and Germany affected in recent months by political/policy uncertainty. France's finance minister was replaced after Barnier's budget failed to pass and Germany will now have early elections in the first quarter of 2025. CPI inflation rose on data released over the quarter, reaching 2.3% in November.

Government bonds

Government yields rose over the quarter, as central banks continue to struggle to bring inflation back to target levels and amid ongoing political volatility with elections across Europe and the US. In the US, 10-year treasury yields rose to 4.57% from 3.78%, while German 10-year bonds similarly saw yields rise to 2.36% from 2.06%. Benchmark 10-year gilt yields increased to 4.57% from 4.01%.

In the UK, gilts were caught between the volatility in the US and the instability in Europe. And whilst the move in bond yields was global, this Labour government's first budget had an important role to play in influencing the direction of UK gilt yields. For much of the summer markets had hoped that a stable government with a clear majority would be able to deliver a favourable budget that boosted growth, albeit with a slight increase in borrowing. What transpired was a budget the market wasn't quite prepared for. The OBR's assessment was somewhat negative: inflation up, growth down (across the parliament), and borrowing up; a toxic mix for bond markets that saw yields rise and gilts underperform.

Index linked markets saw similar moves, with this a poor quarter for index linked bonds as real yields globally ended the quarter at their highest levels for the year. Despite rate cuts during the quarter the prospect of substantial cuts across the globe in 2025 were priced out of valuations after the election of Trump, the poorly received UK budget and sticky inflation data.

Credit

Global corporate bonds saw mixed returns in local currency terms over the quarter. For US dollar and sterling markets, the impact of rising government bond yields more than offset the positive impact of tighter credit spreads and the carry on the asset class. Euro investment grade markets saw positive returns, with the impact of rising government bond yields much smaller than in the US and UK.

The sterling investment grade credit market (iBoxx non-gilt index) returned -0.49% over the quarter, with the average sterling investment grade credit spread (the average extra yield available from non-gilt bonds compared with government debt of equal maturity) tightening over the period from 1.03% to 0.86% (iBoxx). The negative absolute return was broad based across the sterling investment grade credit market with the only sectors seeing positive returns being banks and real estate, with both markets benefitting from the potential of higher interest rates for longer. Consumer services and social housing were the relative laggards.

In the high yield market, the ICE BofAML (BB-B) Global Non-Financial High Yield Index (sterling hedged) benchmark returned 0.25% in the quarter with spreads at 269bps. At the end of the period, the index's yield-to-worst stood at 6.64%, drifting higher since the third quarter on the back of rising yields but partially offset by spreads tightening. In the broader-based high yield index, which includes CCC rated bonds, spreads tightened to 325bps, with a yield-to-worst of 7.2%.

Equities

Global equities finished slightly lower amid losses in many non-US markets. US shares advanced following Donald Trump's presidential election victory, but other regional markets lost ground owing to concerns about trade tariffs.

The fourth quarter was dominated by the outperformance of the US market following the election of Donald Trump on a platform of low taxes and deregulation which are viewed as pro-business. In addition, third quarter corporate results, which are issued in the fourth quarter, highlighted weaknesses in manufacturing activities but continued strength in the technology and financial sector.

Overall, the best performing sectors were consumer discretionary, technology and communication services all driven by the mega-cap stocks such as Tesla, Nvidia and Alphabet. On the opposite, healthcare and rate sensitive sectors such as utilities and real estate underperformed. Healthcare stocks underperformed due to concerns about political reforms under the new Trump administration.

During the fourth quarter, the MSCI World Growth Index posted a gain of 3.85% while the MSCI World Value Index posted a loss of 4.06%.

In the fourth quarter, the UK equity market fell 0.4% (FTSE All-Share index), giving back some of the gains made earlier in the year. In overall terms, UK equities outperformed the Europe ex UK index but were behind the World index which was driven by the outperformance of US equities particularly large technology stocks.

	Yield (%)*		Total 3 month return*	
	30 September 2024	31 December 2024		
Euro Treasuries†	2.62	2.72	0.27% (GBP)	-0.09% (EUR)
UK Gilts†	4.28	4.80	-3.10% (GBP)	
US Treasuries†	3.76	4.45	-3.27% (GBP)	-3.62% (EUR)

	Spread (bps)*		Total 3 month return*	
	30 September 2024	31 December 2024		
Global IG Corporates†	99	88	-1.64% (GBP)	-2.00% (EUR)
Euro IG Corporates†	113	98	0.77% (EUR)	
UK IG Corporates†	107	90	-0.49% (GBP)	
Emerging Market Debt†	361	325	-1.56% (GBP)	-1.91% (EUR)
Global High Yield†	262	254	0.25% (GBP)	-0.14% (EUR)

	Price index*		Total 3 month return*	
	30 September 2024	31 December 2024		
Global Equities†	21023.08	22480.72	6.93% (GBP)	7.61% (EUR)
Euro Equities†	5000.45	4895.98	-2.09% (EUR)	
UK Equities†	4511.00	4467.8	-0.35% (GBP)	
Emerging Market Equities†	694.74	684.5	-1.47% (GBP)	-0.85% (EUR)

	Index*	
	30 September 2024	31 December 2024
Volatility†	16.73	17.35

* Source: Bloomberg, IHS Markit.

† See appendix for details on index used and returns quoted.

Past performance is not a guide to future performance. The value of investments and any income from may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

2. Insurance investment themes

With 2024 behind us, we look ahead to key investment trends and themes for 2025, sharing insights from some of our investment desk heads at Royal London Asset Management and a comprehensive overview of the investment opportunities and challenges that lie ahead.

Mike Fox, Head of Equities and Sustainable Investing, emphasises the importance of sustainable investments and the potential for growth in sectors such as renewable energy and technology. Paola Binns, Head of Credit, highlights the attractive yields in the sterling credit market and the resilience of credit investments despite fluctuations in government bond yields. Craig Inches, Head of Rates & Cash, discusses the impact of recent political changes, including the US presidential election and the UK general election, on global financial markets. Trevor Greetham, Head of Multi Asset, highlights the significance of diversification and active management in navigating the uncertainties of the current geopolitical landscape.

Sustainable

Mike Fox
Head of Equities

The path of least resistance is up

One of the indisputable truths about investing is the past is certain, but the future is all probabilities. Hindsight is a wonderful thing, as the saying goes. It seems obvious now that there would be no recession in 2023 in the US, due to high levels of government expenditure and strong wealth effects from property and share prices within large parts of the consumer economy. Yet, at the end of 2022 a recession was viewed as inevitable. At the end of 2023 similar concerns over economic growth were also well founded, but incorrect. Why do forecasters have such pessimism when reality teaches them otherwise?

Part of the answer to this question is behavioural. Losses impact us much harder than gains, so it is rational that human nature seeks to protect us from them. Caution is often viewed as wise, whereas optimism is viewed as reckless. Another reason is a failure to understand base rate probabilities – essentially what is the probability of an event in any given year. If we look at past occurrences, the probability of a recession in any given year is about 15%. Using the same approach, the probability of the US stock market being down in any given year is approximately 25%. In summary, the most likely path in any given year is rising economic growth and share prices. The path of least resistance is up.

Atoms, bytes and genes

Another reason for optimism is the high level of innovation we are currently seeing in the global economy. This can be best summarised with the concept of atoms, bytes and genes. In theory everything in existence is one of these. Atoms represent the physical world, bytes the digital, and genes the natural world. In my opinion, if we can understand trends in these three areas, we should be able to understand everything.

The physical world is undergoing a once in a generation investment boom, led by reshoring (as overseas manufacturing is moved back home for geopolitical reasons), decarbonisation and the need to build out data centres to support the increased use of artificial intelligence. The digital world is also seeing an unusual level of growth as cloud computing combined with generative AI becomes more pervasive. Not to be left behind, in the natural world new treatments are being created for diseases such as Alzheimer's and obesity. Any one of atoms, bytes and genes could be enough to drive economic growth but all three together are a powerful tailwind that could exist for many years to come. I think that sustainable investing is a great way to invest in all three of these areas.

When we add base rate probabilities to a high level of innovation it seems to us the potential for 2025 to be another good year for equity investors is high.

Always something to worry about

Investors are worriers. No matter how good investment returns are, or how positive the outlook is, there is always a sense of impending negative news. This does have some degree of rationality about it. The world looked a good place on September 10, 2001, economic growth was strong in early 2007, and in January 2020 hardly anyone had heard of Covid. Within a short space of time, we saw a terrorist attack, financial crisis and the global economy largely shut down.

Although each of these events was traumatic in their own unique way, none had a permanent impact on investment markets – and for long-term investors, these were ultimately an opportunity to save for future needs at a more favourable price. Worrying is often not a profitable experience.

That said, it does pay to be aware of risks that may occur in the year ahead. It seems reasonable to expect tensions between China and the US will increase. This could be in several forms, from trade tariffs to disputes over geographical regions. There is also a risk that inflation will come back again, a function of economic growth being stronger than expected at a time of economic stimulus. Were this to occur, interest rates would have to increase again, whereas expectations currently are they will fall. Concerns around fiscal deficits are also valid. The level of borrowing being proposed by major economics such as the US is unprecedented, and no one knows how debt markets will respond to this. If debt levels are seen to be too high, bond yields will rise, making the situation of funding government expenditure plans even more difficult.

Don't worry, be happy

One of my favourite sayings is if you want to be a successful journalist, be a pessimist; if you want to be a successful investor, be an optimist. This is not to say that investments can only go up – they clearly do not in some years – but it is to say that over the long term, societies improve, economies grow, innovation thrives and optimism wins. Whilst we expect 2025 to have unforeseen challenges, we also think it is a great time to be a long-term investor with more opportunities today than ever before. As always, we choose to be optimistic about sustainable investing and equity markets generally.

Sterling Credit

Paola Binns
Head of Credit

At the end of 2023 we pointed out that, in our view, the all-in yield on sterling credit was very attractive. That remains the case now. Yield matters; the strong income element of credit yield is useful for many investors and can also act as a cushion against rising bond yields. That was the case in 2024, where underlying UK government bond (gilt) yields saw a sell-off for the first few months of the year, rallied through the summer and then increased late on due to fears about increased issuance. That higher credit yield (supported by income), as well as the credit market's shorter overall duration and a tightening of credit spreads over the year, meant that a negative return for gilts in 2024 (at the time of writing) didn't mean negative returns for credit investors.

We said the same as we headed into 2025. While the yield of the gilt market, as indicated by the FTSE Gilt All Stocks index – was around 4.5%, the iBOXX Sterling Non-Gilt index – the measure that we use as a benchmark for the UK sterling credit market – yielded just under 5.5% as we headed towards December. In addition, we aim to achieve an above-market yield – this has been a key element in our portfolios over many years and in our view helps underpin performance: of course, if yields rise dramatically then this 'buffer' can be overwhelmed, but that is not our core view today.

The underlying picture

If we pull back from the numbers, we look for lessons to learn and apply. Like many others, we underestimated the resilience of the US economy last year – that resilience and the impact on global markets meant that sovereign bond returns were negative as yields rose, but risk assets such as equities and credit did okay. Does that continue or reverse course in 2025?

The long-term picture for sovereigns is not good from a fundamental point of view. Budget deficits are still high and debt sustainability is an issue. In the short-term, issuance is only going higher, as governments that promise to cut deficits tend to lose elections: In the UK, we've seen the incoming government raise spending – partly funded by tax increases but also a big jump in gilt issuance. In the US, Trump promised tax cuts, so we expect US treasury issuance to increase substantially.

Key drivers for 2025

Interest rates are always one of the first considerations for fixed income investors – are these going up or down? In one sense, both have advantages and disadvantages: rising rates and yields do lead to more attractive yields, but create capital losses and more negatively impact investors with longer duration; falling interest rates, conversely, create capital gains for existing exposure, but mean that each maturing bond is replaced with a lower yielding one.

Rates expectations swung violently over the course of the last 12 months. At the end of 2023, markets were optimistically predicting an avalanche of rate cuts – and then started 2024 by swinging to maximum pessimism. At the end of 2024, markets priced out a number of rate cuts, believing that higher deficits and government spending are more inflationary and hence central banks will be more cautious cutting rates. That felt about right.

However, with those higher inflation expectations, we'd expect to see less downward movement (or even further increases) in longer yields than the falls at the short end – so steeper yield curves. Short-dated credit has lower credit risk simply due to the shorter maturity, and steeper curves would help it outperform. We are not expecting any major move in UK credit spreads – we are not forecasting a recession that would push these wider, but nor do we see a buoyant economy that helps these tighten materially.

As we are not looking for major moves in yields or spreads, our focus remains on exploiting market efficiencies to enhance yields, supported by income, to produce better risk-adjusted returns over the long term. The UK market is undoubtedly a smaller proportion of global markets than it was 10 years ago – the popularity of US dollar and euro credit markets and the multi-currency funding/borrowing models used by the world's largest companies means that demand for sterling funding is not as great. However, certain sectors and types of companies will continue to look to sterling lenders such as the banking and insurance sectors that remain robust, and will likely dominate issuance. However, some other areas will also see robust sterling issuance: utilities are an obvious example – these need sterling funding and, while some do not like them, the government cannot afford to nationalise these. A more pragmatic regulatory regime and the continued involvement of sterling credit markets are key elements in a long-term solution. Social housing is another area that we expect to see more issuance and where funding needs dovetail well with long-term investor objectives.

Staying selective

In fact, the main lesson I take from 2024 and into 2025 is about the power of diversification and selection. Even in a benign environment, bond returns are asymmetric: we have capped upside and but full exposure to a loss. So we retain a focus best described by opening lender position: we may have areas such as social housing or subordinated financials that we think are more interesting, but each bond has to earn its position in any portfolio. Diversification is the double-check on that – so that when we get things wrong (and every fund manager does) we mitigate the impact. These factors have underpinned our success in this market over the past 20 years or so, and will be the basis of our outlook both for this year and beyond.

Rates and Cash

Craig Inches
Head of Rates & Cash

The US economy, the world's largest, often hogs the headlines and garners the most attention of investors. As we head into 2025, this will be no different. Donald Trump's win in the US Presidential election – with the Republican party claiming a clean sweep of the Senate and Congress too – will shape world's financial markets for years to come resulting in clear winners and losers. This will undoubtedly lead to heightened uncertainty and volatility.

President-elect Trump ran a campaign promising to revitalise the US economy and making America great again, which translates to be a positive for US growth, negatively impact non-US growth, and likely lead to higher levels of global and US domestic inflation. While risk markets have so far traded positively on the prospect of looser regulation and fiscal stimulus, there may be potential downside risks ahead.

But first, let's look closer to home. The Labour party claimed a sizable majority in the UK General Election and, in late October, nearly four months on from its landslide victory, they delivered its first budget in nearly 15 years. Chancellor Rachel Reeves outlined the vision for the new government which bond markets did not receive well, with the Office of Budget Responsibility's forecasts of above target inflation and the sheer scale of additional government borrowing spooking investors.

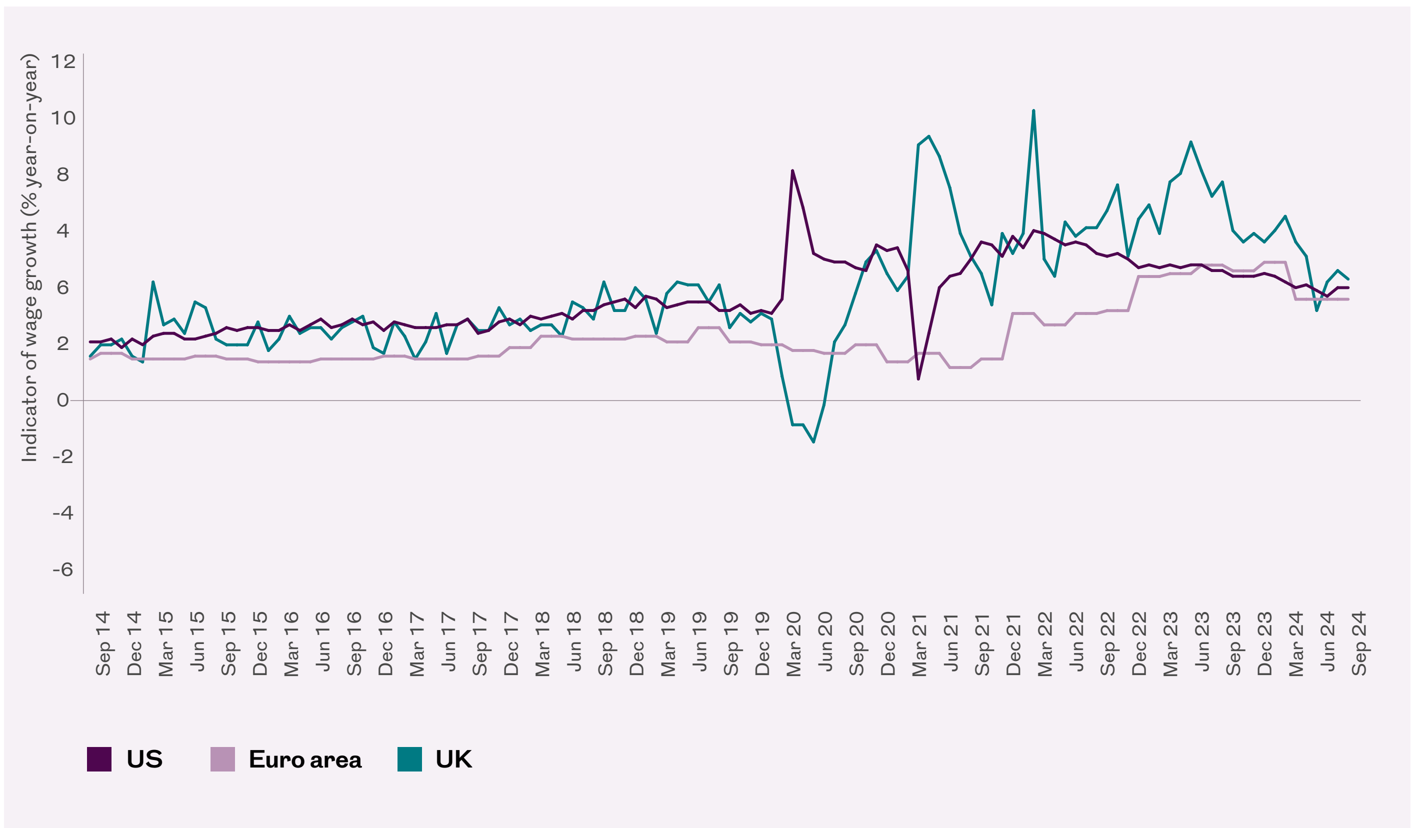
'Bambi'-flation

Stagflation is a combination of stagnant growth and high inflation. While we don't see the UK economy going into stagflation, we can see a scenario where growth doesn't excite and inflation remains sticky, so instead of 'stagflation', we see it more as 'bambi'-flation.

We need to start with the Bank of England (BoE): where market pricing is all but locked in for three or four interest rate cuts for 2025, while inflation is forecast to gradually achieve the BoE's 2% target over a three-year period. We see three rate cuts for 2025 and are comfortable with markets pricing in no more than four.

The overall picture is of a gradual loosening in the labour market which, on balance, supports the BoE's gradual approach to rate cuts. For 2025, the BoE doesn't see wage growth potentially coming down, while unemployment has been revised lower, meaning there will be less slack in the labour market.

Figure 1: Wages declining



Source: Datastream. As at end of October 2024.

The BoE's central case calls for a drop in wages and unemployment, which leads us to ask: if you're looking for a pay rise, will you need to leave for another job?

What, then, does this mean for the UK government and its spending plans? With costs rising, where will the economy see productivity gains? If your pay rise this year is to come from moving jobs, that suggests that there might be upside risk to the BoE's employment figure forecasts. As a result, we would not be surprised to see unemployment rise – but this will likely be offset by a rise in public spending.

With costs and unemployment rising in the scenario above, we could find ourselves in a private sector recession – putting real pressure on consumers and potentially leading to services inflation cooling. Can the government really spend its way out of a private sector recession?

Whilst this isn't our central case, we do feel the Budget has heightened the risk of the UK economy falling into a recession in late 2025.

To Trump it all..

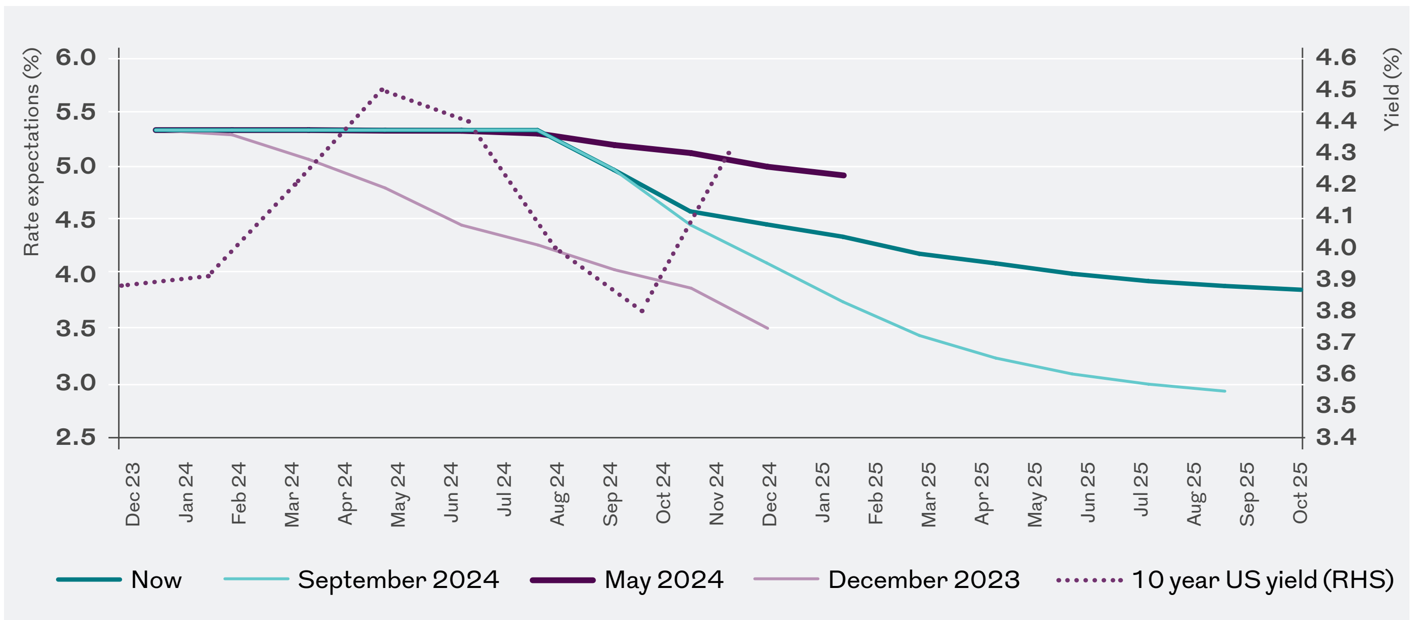
There is still so much to be determined with Trump. The Republicans won convincingly, allowing Trump to enact his policies, with three main ones taking the centre stage during the campaign: tax cuts, tariffs and deportations. If history is any guide, a Trump presidency can over-promise but under-deliver, therefore trying to predict policies before they are announced seems futile.

We do know that the proposed tariffs if enacted, will hurt the EU, which in turn will hurt the UK as it is its largest trading partner. Tariffs hurt everyone, so the outlook for global growth has downside risk. Having said that, Trump will look to insulate the American consumer from the fallout. Will we see the US economy continue to show strength on the back of the spending power of the US consumer? This will be a key indicator for us going forward. Global growth will certainly struggle, but Trump will need more than rhetoric to protect the US economy and consumers.

Financial markets, particularly in the US, reacted positively to Trump's victory – but this could have just as much been a reaction to a clear winner being declared early avoiding a long drawn-out process. We do expect to see a reversal of this initial euphoria, especially when the reality sets in that the Fed may have to curtail its current rate cutting cycle. Fed Chairman Jerome Powell has more than once made it clear that the Fed is not on a preset course. So, like the rest of us, Powell will be standing by and watching how the early parts of Trump's presidency plays out. But if tariffs are imposed, which are inflationary, we could see the Fed potentially keeping rates higher for longer.

Given uncertainty, under a Trump presidency, predicting the course of action he will take is anyone's guess, but we believe it makes sense to assume less (or at least slower) rate cuts than an economy not implementing this combination of Trump's key policies. However, with policy measures unlikely to come at once, and uncertainty about how far he will implement his proposed policies, the US monetary policy path may remain unclear for some time.

Figure 2: US rate expectations



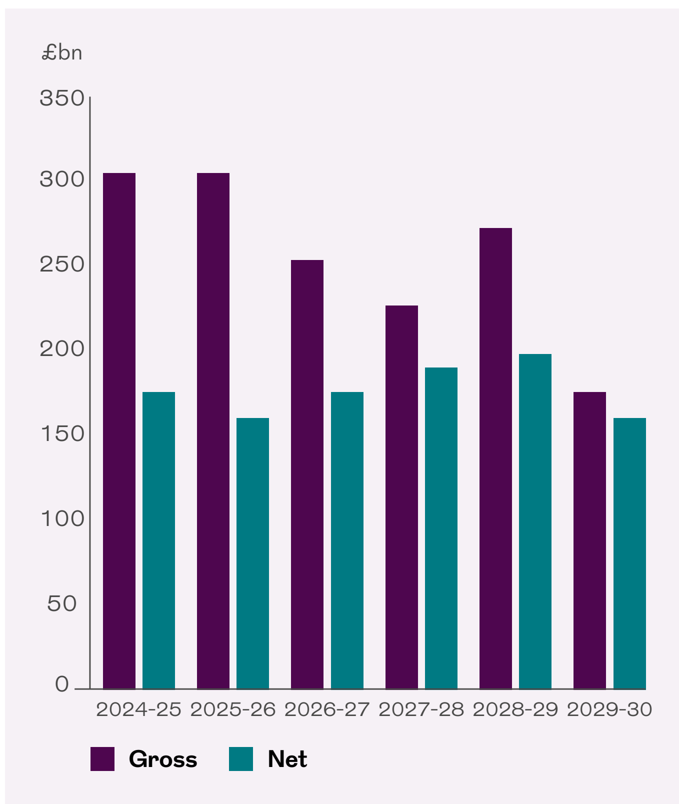
Source: Bloomberg. As at end of October 2024.

Another aspect of the Trump presidency to consider is if his targeting of migrants goes ahead and to what extent. The US economy is bolstered by migrants taking lower paid labour that might not be filled otherwise. This is also inflationary in nature and could therefore impact US economic growth. If enforced, we would definitely see 'Bambi' become a 'Stag' in the US.

What does this mean for markets?

All of the above will lead to steeper government bond yield curves in our view. Global central banks will be forced to keep a close eye on the slowing economic growth, which could be used to justify rate cuts. However, with inflation that may prove sticky and increased bond supply – to pay for new government spending measure on both sides of the Atlantic – we are going to see deficits rise. We think this will increase term premia in markets.

Figure 3: UK gilt issuance



Source: Office of Budget Responsibility.
As at end of October 2024.

European governments could also see an increase in defence spending, depending on how Trump handles Ukraine. It is possible that he may pull back or decrease US spending in Ukraine, forcing European governments to make up the shortfall.

Another element to keep an eye on is Germany's upcoming elections. Germany is in something of a quandary; their economic picture isn't terribly rosy, and it feels as if they may well be particularly exposed should Trump follow through on his tariff pledges and the associated hit to global trade.

However, they have historically been one of, if not the, most disciplined of economies when it comes to fiscal responsibility, and the debt brake notion is even enshrined in their constitution. So they are in a relatively more favourable starting position than most. If economic conditions deteriorate, then they may be more willing to countenance a less fiscally restrictive stance. The campaigning parties will likely factor this into their electioneering.

Cautious on the US, better value elsewhere

In the midst of all these uncertainties, where will we look to invest? When seeking out value, we believe that long-dated UK and Australian government bonds look good, while the long end of the Japanese government bond yield curve when hedged back to sterling also looks very attractive.

We will avoid making any major strategic bets in the US government bonds, which is currently our least favoured market, until the picture becomes a little clearer on just what Trump will look to do.

As yields rise, we will generally increase duration relative to the benchmarks. Looking at inflation, despite breakevens looking quite expensive at this point – with a lot of inflation priced – real yields still look quite attractive as a hedge, perversely in the US. Finally, the combination of lower rates on slowing growth combined with excess supply and sticky inflation should see global yield curves steepen.

Our investment philosophy in rates markets is based on the belief that volatility is the friend of an active manager. While it is hard to be certain about a specific end point for bond yields in 2025, we do expect those macro factors and uncertainty around them to lead to some swings in yields which in turn provides opportunities to tactically add value.

Multi Asset

Trevor Greetham
Head of Multi Asset

Diversification is key

Last year saw further strength in stock markets with global equities up strongly, led by the US, while bond markets moved sideways or saw relatively small gains. The business cycle is supportive of this trend, with global growth lead indicators positive and central banks cutting interest rates. Geopolitics has rarely been more uncertain, though, with a more extreme incarnation of Donald Trump back in the White House and conflict raging across the Middle East and Eastern Europe. Events on the world stage could create short-term noise amid generally improving macro fundamentals, but they could also derail a fragile recovery, and active managers like us will be watching developments closely. With US stocks eye-wateringly expensive, I think broad diversification is more important than ever, with multi asset portfolios able to balance these with more reasonably valued UK equities, bonds and inflation hedges like commercial property and commodities.

The post-pandemic period has been highly unusual. Global growth collapsed in the lockdowns and surged in the re-opening before flattening out again. Meanwhile, wartime levels of fiscal and monetary stimulus in a supply constrained world economy coupled with Russian oil sanctions and Brexit pushed inflation to levels last seen in the 1970s. Central banks responded with dramatic interest rate rises in 2022, but the subsequent recessions were mild in the UK and Europe and absent in America, despite warning signals from deeply inverted yield curves. Where we stand today, inflation has dropped sufficiently for the Fed, the BoE and other central banks to cut interest rates, raising the prospect of better times ahead. This backdrop, and continued strong tech earnings in the US, explains stock market strength, with the re-election of Donald Trump adding a short-term kicker in the form of greater deregulation and tax cuts.

If we only had the economics to think about, we'd be happy. The geopolitical backdrop has rarely been less predictable as we move through 2025. If you take Donald Trump literally and seriously, he plans to impose tariffs on imports at a level not seen since the 1920s while deporting undocumented workers.

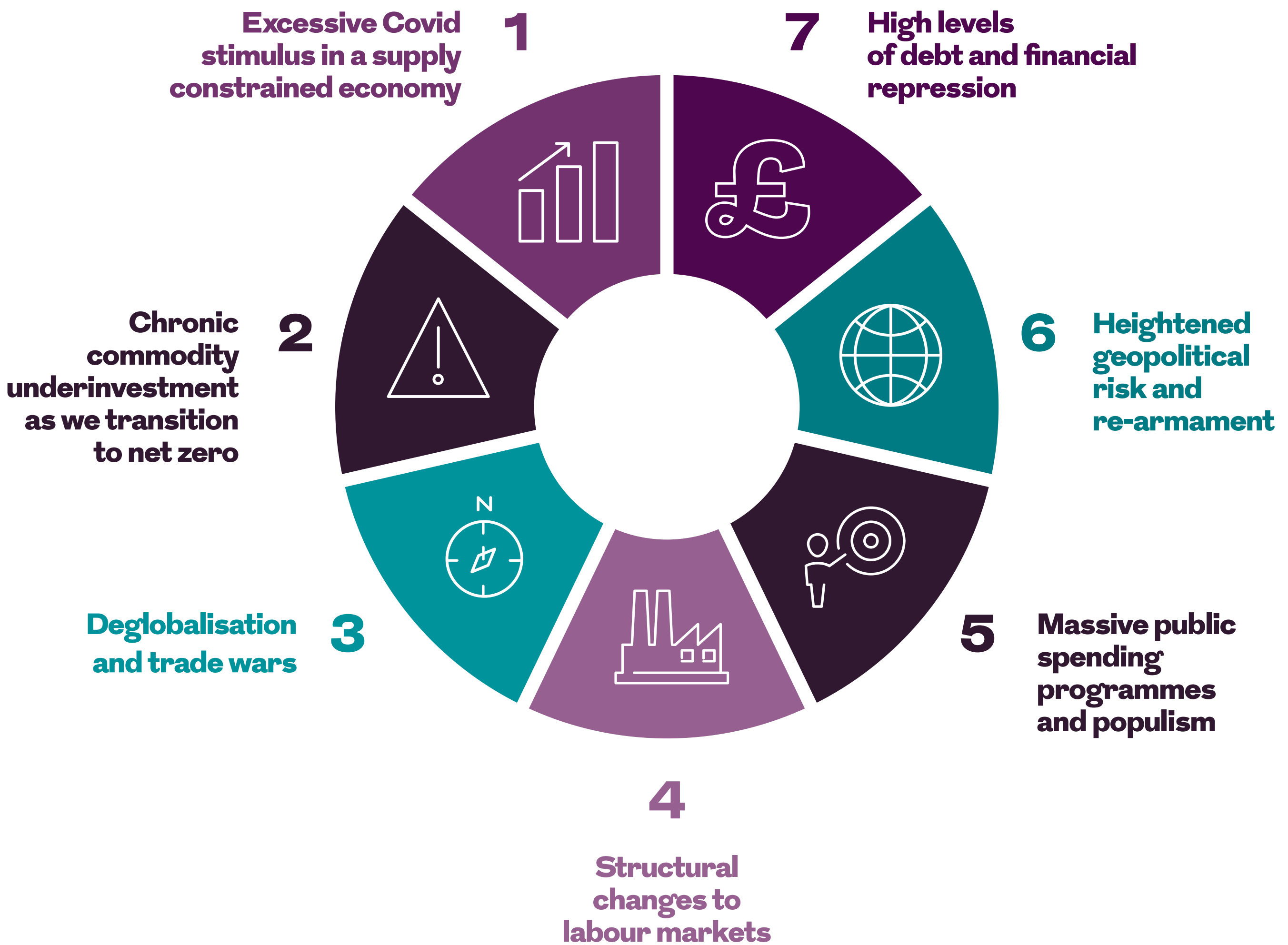
This would form the largest adverse supply shock ever inflicted on America, raising inflation, slashing growth and pushing the world into stagflation. An escalation of war in the Middle East or with Russia could result in further disruption to commodity supply and international trade, with a similar effect, as could conflict between China and Taiwan, the Saudi Arabia of semiconductors.

Neither Presidential candidate took the US fiscal position seriously, but Trump disregarded it altogether. His tax and spending plans imply a ballooning deficit, raising the risk of a bond market riot of the kind we saw around the Liz Truss mini budget if he translates verbal attacks on Fed independence into action.

Here comes Spikeflation?

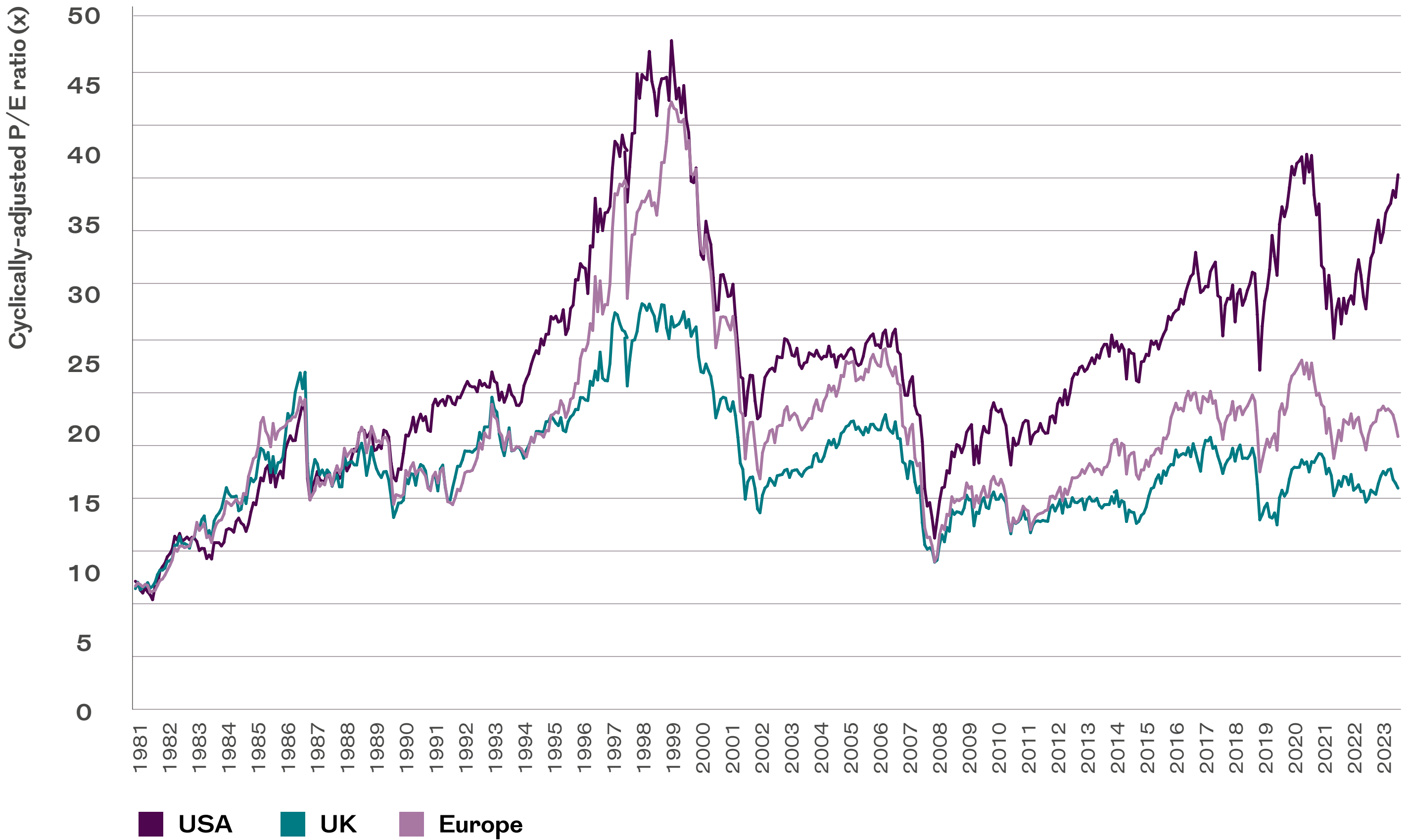
These developments support our belief that we are in a new, more uncertain era of what we call Spikeflation, where periods of low stable inflation are punctuated by sudden price level shifts linked to geopolitics, populism, high debt levels and a chronic underinvestment in commodity supply as we transition towards net zero (chart 1). Spikeflation means shorter business cycles, bigger swings in asset prices and a greater need for inflation hedges like commercial property and commodities.

Chart 1: A new era of Spikeflation



Source: RLAM, for illustrative purposes only.

Chart 2: Cyclically-adjusted price earnings ratios for major equity markets



Source: Barclays; price divided by ten-year average earnings. Latest monthly reading shows predicted level for November, using RLAM prediction based on month to date price changes. As at November 2024. Past performance is not a reliable indicator of future results.

It's hard to argue that stock markets are adequately pricing in the risks. US equities, in particular, are trading at the same cyclically adjusted price earnings ratios we saw in late 2021 when interest rates were zero, Ukraine and Israel were at peace and Donald Trump was a Fox News guest (chart 2). US equities have only ever been more expensive during the dot com bubble of 2000. While valuation is not a good short-term indicator for future returns, over a 5-to-10-year period we'd argue it's the best.

Balancing short-term positives with longer-term concerns is what asset allocation is all about. Tactically, we were positive on equities going into the presidential election with a preference for the US market and growth sectors. We will keep the thesis for bullish positions under constant review as 2025 plays out. A deterioration in the business cycle outlook would mean a tactical move into bonds and cash.

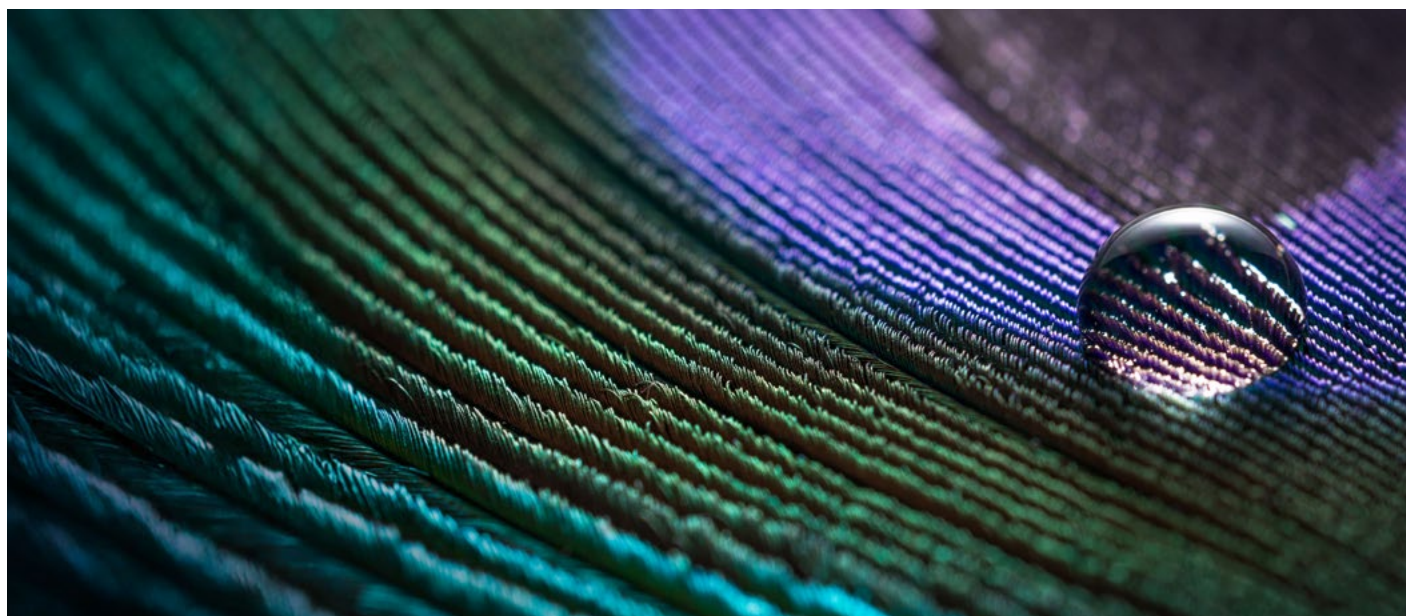
Strategically, we see a strong case to respond to valuations by balancing global equity exposure with more reasonably valued UK equities, with cyclically adjusted valuations close to their 30-year lows. UK commercial property has a place in portfolios where its illiquidity can be managed. Property offers a good yield; rents tend to keep pace with inflation over the long run and capital values are starting to respond to political stability and lower base rates. Commodities give you a hedge against unexpected inflation shocks. Gold was popular over 2024, but broader exposure including energy and agricultural commodities gives a better link to the cost of living. And while government bonds are vulnerable to inflation spikes, real yields are now back in positive territory at 1-2%, which suggests fair value versus real GDP growth and a decent return if inflation shocks don't materialise.

Broad diversification and active management will be the investment watchwords for 2025. As the apocryphal China curse goes, may you live in interesting times!

Appendix

Fixed Income	Index Used	Returns Quoted
Euro Treasuries	Bloomberg Barclays Euro Treasury Index	EUR Hedged
US Treasuries	Bloomberg Barclays US Treasury Index	EUR Hedged
Euro IG Corporates	ICE BofA Euro Corporate & Pfandbrief Index	EUR Unhedged
Global IG Corporates	Bloomberg Barclays Global Aggregate Corporate Index	EUR Hedged
EMD	JPM GBI-EM Global Diversified Index	EUR Hedged
Global High Yield	ICE BofA BB-B Global Non-Financial High Yield Constrained Index	EUR Hedged
Equities		
Euro Equities	Euro Stoxx 50 Index	EUR unhedged
Global Equities	MSCI World Net Total Return GBP Index	EUR unhedged
EM Equities	MSCI Emerging Markets Net Total Return GBP Index	EUR unhedged
Volatility:		
Volatility	Cboe Volatility Index (VIX)	

Source: Bloomberg, IHS Markit



Important information

Investment risks

Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested. Changes in currency exchange rates may affect the value of these investments.

Important information

For professional clients / qualified investors only, not suitable for retail investors.

This marketing communication is a financial promotion and is not investment advice. Telephone calls may be recorded. For further information please see the Privacy policy at **www.rlam.com**

Bloomberg® is a trademark and service mark of Bloomberg Finance L.P. (collectively with its affiliates, "Bloomberg"). Barclays® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approve or endorse this material or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained there from and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

The "SONIA" mark is used under licence from the Bank of England (the benchmark administrator of SONIA), and the use of such mark does not imply or express any approval or endorsement by the Bank of England. "Bank of England" and "SONIA" are registered trade marks of the Bank of England.

This document is private and confidential and only for use by "permitted clients" in Canada.

This document is for information purposes only and is not intended as an offer or solicitation to invest. This document does not constitute investment advice and should not be relied upon as such. Royal London Asset Management Limited ("RLAM") is authorized to provide investment services in Canada under the International Adviser Exemption.

RLAM's principal place for business is in the United Kingdom, and it is not registered as a manager in the provinces of Alberta, British Columbia, Ontario, and Québec.

Issued in March 2025 within Europe (ex-Switzerland) by FundRock Distribution S.A. ("FRD") the EU distributor for Royal London Asset Management Limited. FRD is a public limited company, incorporated under the laws of the Grand Duchy of Luxembourg, registered office at FundRockDistribution S.A. Airport Center Luxembourg, Level 2, 5 Heienhaff, L-1736 Senningerberg, Luxembourg, and registered with the Luxembourg trade and companies register under number B253257. Page 23, FRD is authorized as distributor of shares/units of UCIs without making or accepting payments (within the meaning of Article 24-7 of the 1993 Law), as updated from time to time. FRD is authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF). Portfolio management activities and services are undertaken by Royal London Asset Management Limited, 55 Gracechurch Street, London, EC3V 0RL, UK. Authorised and regulated by the Financial Conduct Authority in the UK, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited.

Ref: PDF RLAM PD 0243

Contact us

For more information about our range of products and services, please contact us.

Royal London Asset Management has partnered with FundRock Distribution S.A, who will distribute Royal London Asset Management's products and services in the EEA. This follows the United Kingdom's withdrawal from the European Union and ending of the subsequent transition period, as UK Financial Services firms, including Royal London Asset Management, can no longer passport their business into the EEA.

Royal London Asset Management
80 Fenchurch Street,
London EC3M 4BY

For any queries or questions coming from UK or non-EEA potential investors, please contact:
institutional@rlam.co.uk
+44 (0)20 7506 6500

For any queries or questions coming from EEA potential investors, please contact:
Arnaud Gerard, FundRockDistribution S.A. Airport Center Luxembourg, Level 2, 5 Heienhaff,
L-1736 Senningerberg, Luxembourg +352 691 992088 arnuad.gerard@fundrock.com

For further information, please visit **www.rlam.com**

We can provide this document in braille, large print and audio.

140133 03 2025

ROYAL
LONDON
ASSET MANAGEMENT