CIO view: Certain uncertainty

Piers Hillier
Chief Investment Officer

Introduction

Writing an annual outlook can feel like a hiding to nothing. Get it right, and people think it's luck; get it wrong, and people think you're a fool. I find it a valuable exercise — more than just a question of what we got right or wrong, but a chance to question how we do things and decide if the principles by which we make investment decisions still stand.

On the rights and wrongs, we correctly thought that rates would be higher for longer due to inflation being stickier than forecast. We've seen a lot of market volatility around that fact this year, with markets pricing in very optimistic and then pessimistic rate profiles and then reversing direction once again.

I also thought credit default risk would increase due to those higher rates, leading to higher cost of capital – but that hasn't really happened as yet. Why not? Perhaps it is the profile of debt – if we look at the US, consumer debt looks huge, but a large proportion of that is tied to mortgages on fixed long-term rates. A lot of corporates refinanced during 2020 and 2021 at very low rates – so there will be a wall of refinancing to come at some point, but obviously that time was not 2024.

Enough of 2024. What should we all be looking at for 2025? Inflation is still sticky – most notably certain areas of wage inflation – and this may limit the scope for rate cuts more than is currently priced in. Some of that is because of inflation, but 2024 election results have reinforced that view. Donald Trump is going to cut taxes, and increase US debt. In the UK we've already seen the government announce greater spending. France is looking at a precarious domestic political situation where no-one will be promising to cut spending and we expect the same in Germany when they hold elections next year. All of which points to steeper yield curves, with long yields held up by the prospect of those higher budget deficits and inflation, while short ends move down to reflect rate cuts.

Artificial intelligence – stage 2

If we look at markets in 2024, artificial intelligence has been a massive driver of returns. Whether it remains so is a common question for our equity teams in client meetings. I think that the main effect we are looking for in 2025 and beyond is the secondary effects – predominantly in productivity. How are the companies looking to incorporate AI within their businesses? Is it helping control costs, increase output, or both? In our own company we're running a number of AI initiatives that we think will help us make better decisions and provide better client service, while being mindful of the limitations and concerns around these new tools.

In many respects, this is nothing new. Looking back at the industrial revolution, or the impact of the internet, initial excitement was probably around the 'kit' or companies that created it, but the long-term impacts were felt in every household and company. These forms of creative destruction lie at the heart of global economic history and AI will not be the last iteration of this that we see.

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What to expect from the US?

The US elections in November 2024 have given the Republicans a clean sweep of the Presidency and both houses of Congress. The initial reaction from US equities was a surge in stock prices in expectation that a higher growth economy and lower corporation taxes would boost earnings.

As with any incoming administration, we will wait to see how much of the policy discussed during the campaign actually ends up being implemented. But the direction of travel is clear: the onshoring / reshoring theme that started under Trump's first presidency and continued through Biden is going to continue and they will look to cut taxes – or at least extend Trump's first term tax cuts that are due to expire towards the end of 2025. The debt ceiling will be back in focus and whilst the Republicans have a majority in Congress this and appropriations are controversial topics that do not always split on party lines. Trade will come under the microscope, too. Whilst the levels of tariffs already suggested are unlikely to be enacted, I am concerned that markets seem to have priced in little chance of a trade war – this is a real risk that should not be ignored. The impact on geopolitical risk is much harder to foresee: could Trump go for 'certainty' by looking to end conflicts in Europe and the Middle East that both provide 'peace' but at a cost that many dislike? Second term Presidents often become more focused on foreign affairs, but I suspect that this is more an irritant than a focus for the new President.

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A principled approach

Part of our key investment principles is looking for market inefficiencies and ignoring short-term views to try to achieve long-term risk-adjusted returns for our clients. What does that mean in this environment? While the political uncertainty caused by numerous elections in 2024 is now lower – albeit with Germany and Japan notably looking at more uncertainty in 2025 – we now have governments committed to higher budget deficits. Will bond markets be able to digest this – or do we see the return of the bond vigilantes? As we end 2024 there are early signs of their return.

Good government spending can be positive for GDP growth. Is what we're expecting to see in the US and UK 'good' stimulus? That remains to be seen. Even if this does translate into a more positive environment for corporate earnings, the discount rate is now higher and wage inflation is negative for costs. Assessing business models will be a key part of investment decisions for our equity and credit teams.

For risk assets such as credit and equities, expectations of a higher growth, higher inflation environment, with uncertainty over global trade, leans against a broad focus on cyclicals, but instead would put an emphasis on quality – companies that have robust business models that can achieve higher revenues while keeping costs under control. The fact that interest rates, while still expected to fall in 2025, are probably not falling as much as previously thought, decreases the positive impact on equities.

As a CIO overseeing a range of portfolios, I am a firm believer in the importance of diversification within portfolios, but also in terms of approach – building multi asset portfolios that incorporate asset allocation as well as active stock selection is a task that we carry out for many clients because we think it gives the best risk / reward outcome. As we move into 2025, it feels like we have a more certain political environment after the elections of 2024, but these have introduced the uncertainty of policy implementation – as the desires of new governments bump into the realities of funding those plans and the impact of voter-friendly policies on the corporate world and investment markets. As firm believers in active management, this year should provide fertile ground for us, but risk management could be just as important.

> **Do we see the return of the bond vigilantes? As we end 2024 there are early signs of their return.**

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Royal London Asset Management
80 Fenchurch Street
London EC3M 4BY

For advisers and wealth managers
bdsupport@rlam.co.uk
+44 (0)20 3272 5950

For institutional client queries
institutional@rlam.co.uk
+44 (0)20 7506 6500

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

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