Interesting times ahead

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Diversification is key

This 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.

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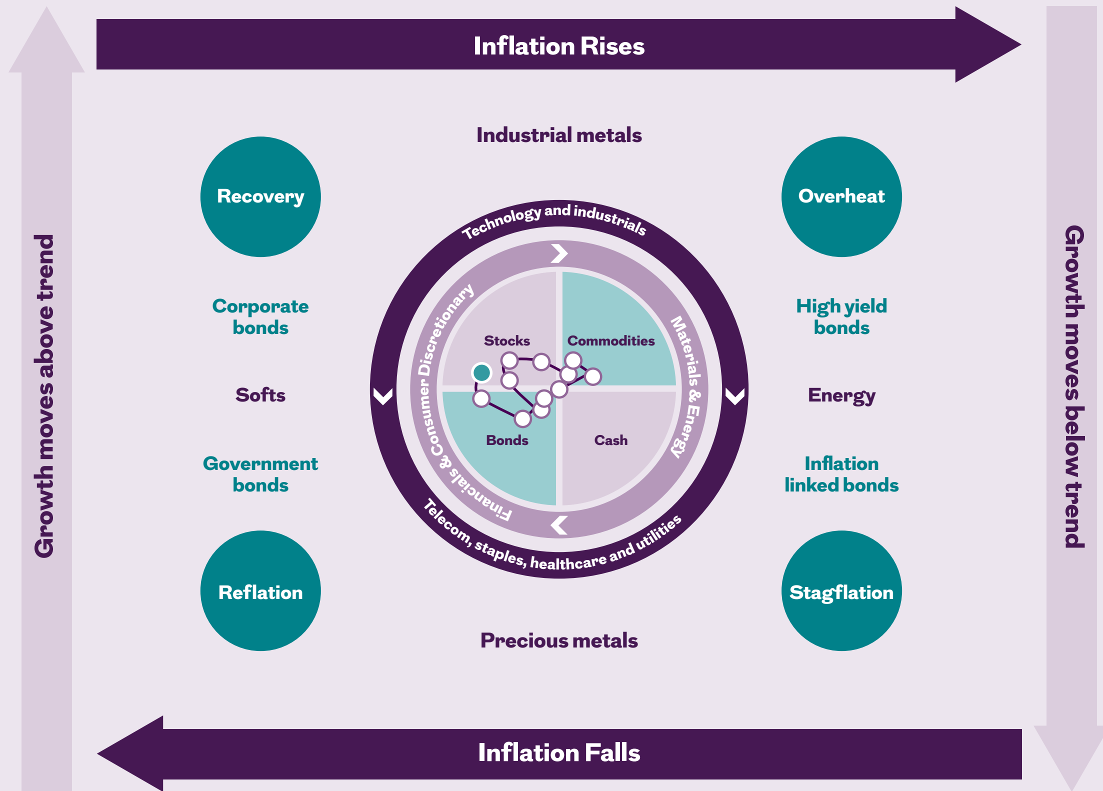
The post-pandemic period has been highly unusual. Global growth collapsed in the lockdowns and surged in the re-opening before flattening out again. Meanwhile, wartime levels of fiscal and monetary stimulus in a supply constrained world economy coupled with Russian oil sanctions and Brexit pushed inflation 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 Federal Reserve, the Bank of England and other central banks to cut interest rates, raising the prospect of better times ahead. The Investment Clock model that guides our asset allocation has moved into the disinflationary recovery quadrant (chart 1). 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.

> "The geopolitical backdrop has rarely been less predictable as we head into 2025."

Chart 1: The Investment Clock moving into Recovery



Source: Royal London Asset Management. As at November 2024. For illustrative purposes only. Trail shows monthly readings based on global growth and inflation indicators.

If we only had the economics to think about, we'd be happy. The geopolitical backdrop has rarely been less predictable as we head into 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 dominant force in semiconductor manufacture.

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 Federal Reserve independence into action.

Here comes Spikeflation?

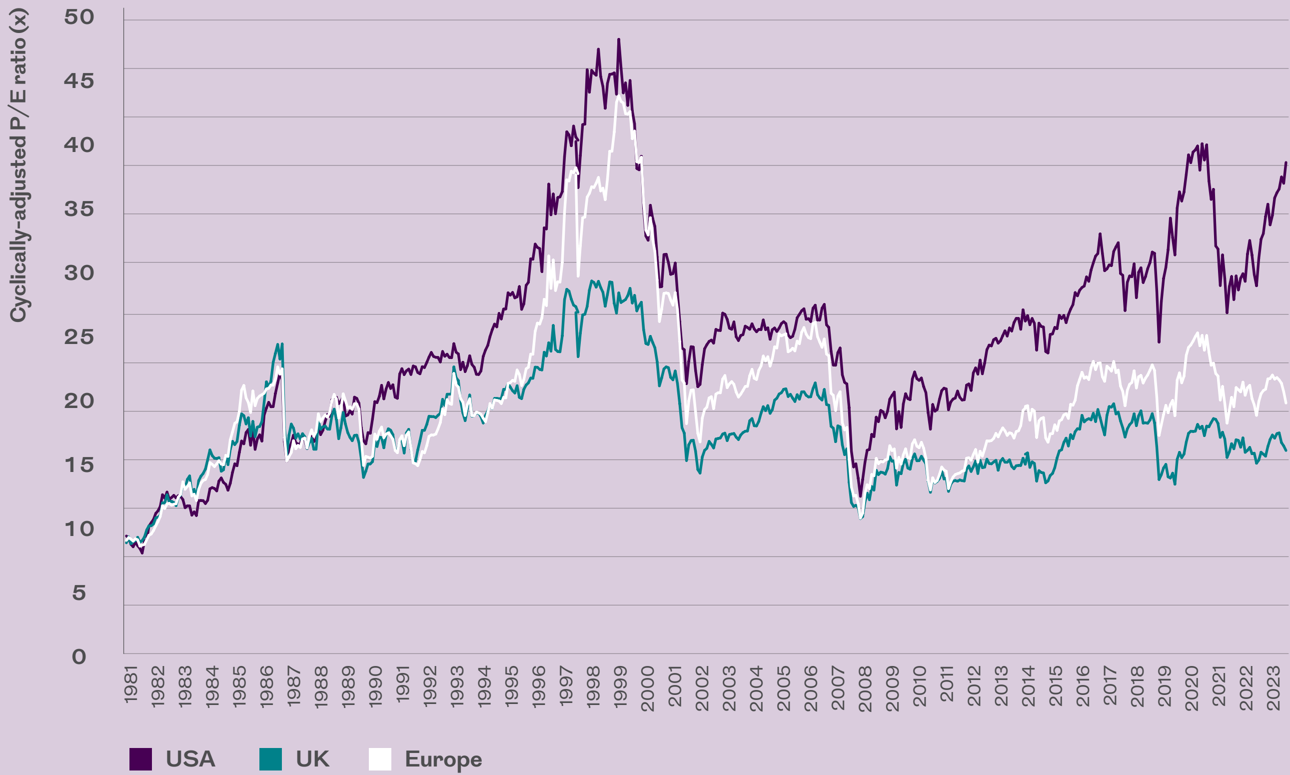
These developments support our belief that we are in a new, more uncertain era of what we call Spikeflation, where periods of low stable inflation are punctuated by sudden price level shifts linked to geopolitics, populism, high debt levels and a chronic underinvestment in commodity supply as we transition towards net zero (chart 2). Spikeflation means shorter business cycles, bigger swings in asset prices and a greater need for inflation hedges like commercial property and commodities.

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 3). 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.

Chart 2: A new era of Spikeflation

Source: RLAM, for illustrative purposes only.

Chart 3: 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.

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 could make a tactical move into bonds and cash more appealing.

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 Chinese curse goes, may you live in interesting times!

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