Outlook 2025

ROYAL LONDON ASSET MANAGEMENT

Contents

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.

"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."

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.

"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."

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.”

Be an optimist

Mike Fox
Head of Equities

Sustainable equities

The path of least resistance is up

One of the indisputable truths about investing is that 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.

"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."

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 10 September, 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 economies 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 generally 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.

> "It seems reasonable to expect tensions between China and the US will increase."

An eventful 2024

Paul Schofield
Head of Global Equities

Global equities

Q What important lessons did you learn from 2024?

A I suppose I have learned that the equity markets don't always follow the rules! We have seen markets move higher in 2024 (and 2023) with barely a pause and all against a backdrop that could be generously described as 'mixed'. We have seen gold prices as high as they have ever been, oil much lower than one would expect, a cost-of-living crisis in many parts of the world, relatively muted economic growth, pretty high valuations and geopolitical turmoil. However, markets continue to move higher.

In 2024, much of the world went to the polls and the vast majority of those elections across the world saw the incumbents lose which, in many ways, reflect certain uncertainties – many people feel that their countries and their lives are moving in the wrong direction, and they came out and tried (mostly successfully) to change governments to do something about it.

Q In what way will 2025 be different from 2024?

A I would imagine that we should brace ourselves for more of the same. In 2025, we stop voting and we start watching as the winners must roll up their sleeves and start to govern which is never an easy task. In the UK, for example, the Labour Party are learning, and very quickly, that the spotlight shines far more brightly on you when you are in power versus when you are in opposition.

Q What is your view on global equities? Are there any areas of global equities that you would avoid or be cautious of investing in next year?

A For our portfolios, we try to focus on the companies rather than take a particular macro view and hence I don't have much value to add regarding regions or sectors. We try to diversify away the factor risks where we can and allow the stocks to do the heavy lifting.

Having said that, take a cursory look at equity valuations around the world and we can see some sizable differences. The US has led equity markets higher while Europe and the UK, for example, continue to lag, meaning the valuation difference between these regions gets ever wider. But from my perspective that is probably warranted. What might change that is unclear. Resolution of the conflict in the Ukraine might help – although despite that clearly being good news, I doubt it would be a major catalyst for markets one way or another over the medium term

The trade of the year in equities must surely have been Artificial Intelligence (AI) related with NVIDIA, the poster child of the space, now having a market cap of nearly USD 3.5 trillion and representing nearly 5% of the MSCI World Index. So far, so good. The question we must now ask ourselves: is all the hype warranted or is it just that, hype? What is undoubtably true is that the adoption rate has been rapid. A recent paper by the National Bureau of Economic Research indicates that some 39.4% of the working population in the US used generative AI in August 2024, which in terms of the adoption curve, surpasses the PC and the internet. Having said that, the adoption of AI to this point has been predominantly individuals using free tools rather than business adoption, which has been much slower. Whilst many of the initial forecasts for AI on, say, productivity gains were extremely impactful, I am reading more and more reports downplaying its potential impact. I don't have all the answers, but I do get the sense that the bulk of productivity gains will be some way down the track and that the story will be with us for many years to come. Are the stocks expensive? One could probably argue that either way.

> "Civil unrest continues to rise across the globe caused by many factors, not least economic inequality and a cost-of-living crisis."

Q What are your expectations for geopolitics next year?

A We worried about the conflict in Ukraine at the start of 2024 and we continue to worry. The Middle East added to those worries and we, as investors, watch nervously hoping these concerns are short-lived and wrestling with the perhaps secondary issues of commodity prices and how these may translate through to inflation going forward – particularly as much of the world broke the back of inflation in 2024. It feels to me that we will likely see resolution to some of these conflicts in 2025 which would surely be good news, but I doubt tensions across the globe will ease significantly.

There is clearly more to worry about than 'just' the conflicts we see on the news every evening. We continue to see the rise of nationalism and protectionism, and cyber-attacks are becoming more severe and frequent. Civil unrest continues to rise across the globe caused by many factors, not least economic inequality and a cost-of-living crisis, while we also worry about climate risks and energy security. The list goes on and on and each of these can impact the global economic outlook in one way or another, influencing growth, inflation, supply chains and, of course, the financial markets. I suspect these issues will consistently create headlines through 2025 and the simmering tensions will manifest themselves in many ways through the year, including some we probably haven't thought of yet.

> "Nuclear power has many advantages and disadvantages but probably deserves its place in the energy mix, although regulators need to keep a close eye on the deep pocketed tech companies and make sure they don't monopolise all new power generation."

Q What is your view on oil prices in 2025?

A To my mind, the oil price would have been much higher in previous years if the events of the past year or so in the Middle East tensions had played out back then. Arguably, the truth is that these tensions have never been far away. So why isn't the oil price higher?

So far there is no evidence that oil demand is falling – far from it. However, supply is more than keeping up. We have started to see signs that some large oil companies have cut back on growth capital expediture in the last couple of years so one wonders if the supply may roll over at some point soon. Then we will debate if more investment in exploration and production (E&P) is needed or if we have enough alternative energy sources to take up the slack. My suspicion is the former and we may see oil prices a bit higher, on average, through 2025, although I wouldn't be taking a position either way at this point, preferring to be neutral to oil and spending a bit more time working on other areas of the market that are a little more forecastable.

Q What does the landscape for alternative energy look like?

A 2024 was another tough year for many solar and wind-related stocks as higher interest rates, competition, supply chain issues and government subsidies moving in various directions held back many stocks, leaving them well below their 2022 peaks.

We saw a different story for nuclear stocks, many of which sit at new highs as it appears that nuclear power is now the 'go to' for big tech: the likes of Amazon, Alphabet and Microsoft have all done deals recently to secure some nuclear power after investing fairly heavily in wind and solar in earlier years. Nuclear power has many advantages and disadvantages but probably deserves its place in the energy mix, although regulators need to keep a close eye on the deep pocketed tech companies and make sure they don't monopolise all new power generation.

Indeed, the International Energy Agency recently declared that after the ages of coal and oil, we are now entering the age of electricity. Renewables will obviously do much of the heavy lifting with regards new electricity generation, partially because of lower emissions, partially for energy security but also because, increasingly, renewables offer the cheapest option to add power plants across the globe. Soggy performance to one side, this power generation theme isn't going away anytime soon.

A rewarding long term

Henry Lowson
Head of UK Alpha Strategies

UK equities

This time last year, the UK was emerging from a technical recession and the stage looked set for improving economic growth, a declining rate of inflation towards the Bank of England target of 2% and a series of cuts to UK interest rates.

Together, these conditions should have been conducive to better equity returns. Rarely, however, do consensus macroeconomic forecasts turn out to be reality. While the UK has delivered GDP growth and UK CPI inflation has eventually stabilised closer to 2%, the decision to cut interest rates (the first cut since March 2020) was delayed until August and it looks unlikely to be followed by the sequential reductions that many expected.

This has held back consumer and corporate demand, resulting in a UK stock market which stuttered and started through 2024 as corporate earnings struggled to find much positive momentum.

As well as interest rates remaining elevated, the industrial destocking cycle proved to be more extended than anticipated (the last vestiges of the Covid-related impact on supply chains). Consumer and business confidence, which had been on an improving trajectory after the election, was thrown into uncertainty as the new government set a late first budget date – some 118 days after the election – and spent the interim period sending mixed messages about the state of the UK balance sheet, along with their spending and funding intentions. This uncertainty delayed corporate decision making and led to some deferral of expenditure, stalling the economic recovery seen through the first half of the year.

A tough budget

From a business perspective, the first Labour fiscal event after nearly 15 years in opposition was a tough budget. Businesses will bear much of the brunt of the tax rises due to employer national insurance contributions increasing to 15%, in addition to having to shoulder the burden for another substantial increase in the minimum wage, particularly for the 18–20-year-old age group (+16.3%), while business rates relief was reduced from 70% to 40%. The impact is likely to be felt most keenly by the retail, leisure, hospitality and food retail sectors and more generally for labour intensive industries with lower margins. Companies will have to work hard to mitigate these structural cost headwinds but automation, labour efficiencies and higher prices are likely to be part of the solution and companies have proved adept at doing this in the recent past. On the positive side, housebuilding, construction, infrastructure and the defence sectors look well positioned to benefit from increased government spending and available funding.

> **After three years of obsessing over macroeconomic and political headlines we believe that the focus can switch back to the analysis of business fundamentals and prospects.**

We view the removal of political uncertainty as a significant clearing event for markets, while acknowledging that this fiscal stimulus risks further higher inflation. Corporate balance sheets and cost bases are generally in good shape, UK consumers have generally come through the interest rate cycle in good health and with multiple headwinds removed we now have the basis for a cyclical upswing in the UK economy. After three years of obsessing over macroeconomic and political headlines, we believe that the focus can switch back to the analysis of business fundamentals and prospects. This is what ultimately drives earnings and long-term shareholder returns, and is where we spend most of our time.

The importance of strong balance sheets

The last three years have demonstrated the importance of strong balance sheets (in the face of the rising cost of debt), healthy free cashflow (providing companies strategic optionality to enhance financial returns) and management teams who understand how to allocate capital efficiently to deliver shareholder value creation. Capital allocation is particularly important as we look to 2025 because capital is no longer 'free'. Not all companies will be able to raise and deploy capital easily in a 'higher for longer' world; well capitalised public companies will be at an advantage, leaving management teams with a range of opportunities to put capital to work in organic expansion, acquisitive expansion or through share buybacks. The opportunity to deploy capital at attractive rates of returns should be positive for corporate earnings growth, and as such it should be a good time to be an active investor in public companies.

In recent years, UK equity market valuations have been heavily distorted by the macroeconomic and political factors mentioned previously, as well as technical selling pressures – UK equity funds have been subject to over three years of significant and persistent outflows. In my view, these depressed valuations are part of the reason why elevated merger and acquisition activity has been such a feature of the UK small and mid-cap market. Takeover approaches have provided a material source of returns due to the premiums offered by acquirers, demonstrating healthy private equity and international corporate appetite for UK stocks. It is also why an increasing number of UK public companies sought to enhance shareholder returns by buying back their own stock through 2024, permanently reducing their equity base and accreting their earnings per share. If valuations remain depressed, we expect elevated takeover and buyback activity to persist in the near term.

A rewarding long term

In his parable of 'Mr Market', Benjamin Graham said that 'over the short term the market is a voting machine but in the long run it is a weighing machine'. This seems a very appropriate statement in view of the recent short-term headwinds that the UK stock market has faced and as alluded to earlier. Looking into 2025, I think the fundamentals of UK equities look very compelling – cheap valuations (on almost any metric), with the potential for a re-rating and an earnings recovery.

It has been an exercise in delayed gratification for UK investors but has the potential to be very rewarding over the long term.

“I think the fundamentals of UK equities look very compelling – cheap valuations (on almost any metric), with the potential for a re-rating and an earnings recovery.”

Interesting times ahead

Trevor Greetham
Head of Multi Asset

Multi asset

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.

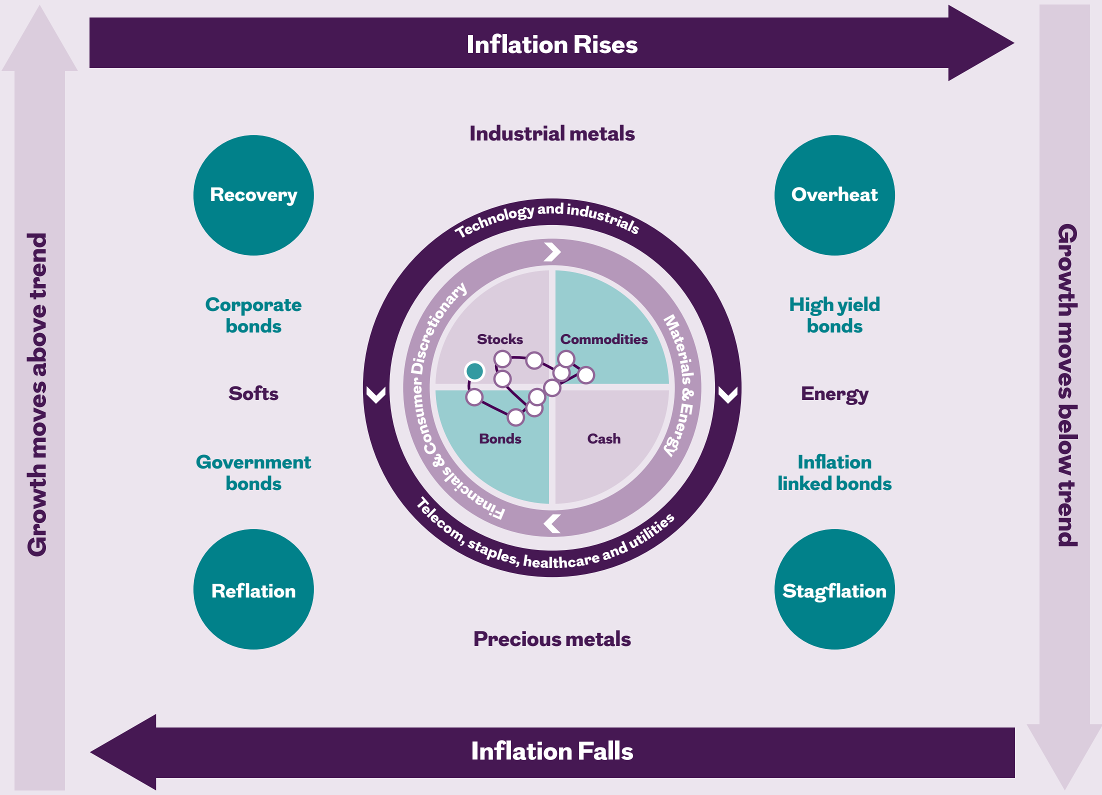
With US stocks eye-wateringly expensive, I think broad diversification is more important than ever, with multi asset portfolios able to balance these with more reasonably valued UK equities, bonds and inflation hedges like commercial property and commodities.

> I think broad diversification is more important than ever.

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?

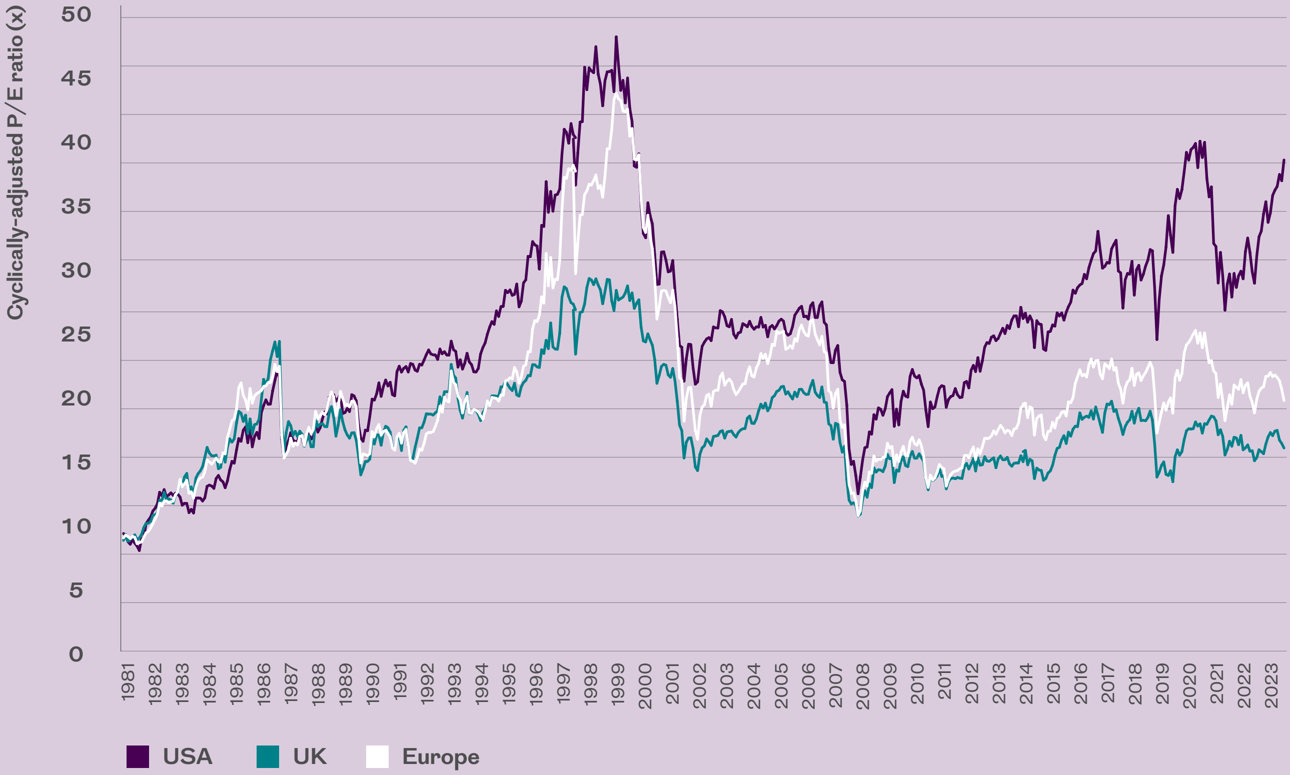
These developments support our belief that we are in a new, more uncertain era of what we call Spikeflation, where periods of low stable inflation are punctuated by sudden price level shifts linked to geopolitics, populism, high debt levels and a chronic underinvestment in commodity supply as we transition 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!

"We will keep the thesis for bullish positions under constant review as 2025 plays out."

Staying selective

Paola Binns
Head of Sterling Credit

Sterling credit

Last year 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 has been 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 can say the same as we head into 2025. While the yield of the gilt market, as indicated by the FTSE Gilt All Stocks index – is around 4.5%, the iBOXX Sterling Non-Gilt index – the measure that we use as a benchmark for the UK sterling credit market – is yielding just under 5.5% as we head 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 has promised tax cuts, so we expect US treasury issuance to increase substantially.

> **Governments that promise to cut deficits tend to lose elections.**

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 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 have 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. As we come towards the end of 2024, markets have just 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 feels 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 (see the sector focus on the next page) is another area that we expect to see more issuance and where funding needs to 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 but have 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 next year and beyond.

> **"The main lesson I take from 2024 and into 2025 is about the power of diversification and selection."**

Sector focus: social housing
Martin Foden, Head of Sterling Credit Research

We have been lending to housing associations for over three decades, a period that has seen the sector develop from a bond backwater to become a material proportion of credit indices. Whilst the significance of the sector to credit investors has increased, so have the financial and societal challenges. Operating for a long time under a political ideology that favoured home ownership over social rent, as well as austerity over investment, and seeing heightened scrutiny over asset conditions post Grenfell, has squeezed the sector's balance sheet. Specific environmental laws bringing forward additional spending and rising interest rates have only added to the pressure. As a consequence, housing associations are being forced to prioritise balance sheet recovery and improvement of existing assets over development of new affordable housing.

Whilst 2025 is likely to see a continuation of these underlying dynamics, there are reasons to be positive. A new government, led by a party that has historically understood the importance of social housing, should herald more favourable policies – including longer-term rent visibility and additional grant funding. Both of which will help improve issuers' balance sheets whilst increasing resources to deliver much-needed homes. There are also early signs that certain housing associations have managed the challenges better than others and are starting to rebuild financial capacity. More broadly, clear attractions for bond investors remain, not least the critical societal impact that funding the management and delivery of social housing can deliver.

Building on our long-term experience, we will continue to support the sector, which is likely to have a renewed demand for bond funding in the coming years after a recent hiatus. However, our awareness of the increased risks will continue to see us diverting lending to those associations that have navigated recent challenges most effectively and offer an appropriate return for our clients.

What's all the fuss about?

Azhar Hussain
Head of Global Credit

High yield

When looking forward, it's always important to look back first. Heading into 2024, we were keen to note that we expected a continuation of trends seen at the time: maturity wall concerns being overplayed; companies holding high liquidity; private debt markets eating the bottom cohort of public markets; and public markets remaining open, with solid issuance levels.

While we don't want to pat ourselves on the back too much, the year did play out quite close to the above scenario. And, going forward, we see much of the same. As long as public markets stay open, any remaining maturity wall concerns will be swept away. And, as long as private markets are continuing to provide liquidity to the weakest parts of public markets, defaults will stay low.

> "This evolution underpins the performance of the market: better corporate technicals have resulted in lower defaults, which lends itself to lower volatility."

In 2024, spreads tightened significantly. This offset the risk-free rate moving higher as the government curve has also steepened – providing a healthy single-digit positive return in high yield markets.

For the next year, we see a similar return profile from high yield markets but we expect the inverse: spreads to be a touch wider and the risk free a touch tighter to leave yields at similar levels. Defaults levels look set to remain low, allowing for a high single-digit return from high yield markets but with slightly more assurance shorter on the curve.

> Broadly, companies have used stable revenues to prudently build healthy liquidity runways, leading to little additional pressure to refinance in the near term.

Not your parents' high yield asset class

The high yield market is much more established, deeper in liquidity, diversified and higher in quality than in decades past. This evolution underpins the performance of the market: better corporate technicals have resulted in lower defaults, which lends itself to lower volatility.

This institutionalisation of the high yield market has seen quality improve – with a reduction in lower rated names allowing a considerably higher rating than in decades past. This is clearly seen in the dramatically lower number of CCC rated bonds in the market compared to BBs. In 2003 CCCs were 17% of the market and BBs were 36%; by October 2024 CCCs were just 9% and BBs had grown to 60%. As a result, we see risk-adjusted spreads at fair value.

An ever-increasing important aspect of high yield markets is the role of private debt. We are seeing private debt markets grow in size, hoovering up lower rated companies. This results in public markets being left in a structurally stronger place.

As the CCC portion of the market continues to diminish, taking the most stressed part of the market out of public hands, we can see clear signs of why default rates remain so low. There are no indications of private markets closing up: as closed ended vehicles these have already raised a substantial amount of funding and still have much dry powder: we don't see where else they can use it.

As well as improved credit ratings, we have seen issue sizes grow, with bond issues now on average three times higher – leading to greater liquidity.

The correction in yields seen in 2022 was the worst since the Global Financial Crisis. As a result, valuations look extremely attractive given the yields on offer, especially when you consider credit fundamentals remain robust. Broadly, companies have used stable revenues to prudently build healthy liquidity runways, leading to little additional pressure to refinance in the near term. This has been borne out by relatively low core default rates in the asset class. This is all despite a backdrop of an inflationary environment and higher refinancing costs.

Spreads are tight, will they get tighter?

Spreads are uncomfortably tight but yields are generous. It is sometimes overlooked that high yield is an asset class bought on yield rather than spread so we believe technicals should remain supportive.

Most high yield issuers are domestically focused – so Trump's tariffs may not hurt the asset class the way it might for others. We may only see this as a marginal issue. High yield sectors are now defensive in nature when compared to the past – for example, the energy sector has had two default waves in the last decade, and as a whole the high yield market has far less cyclicals exposure compared to the past.

Central banks usually take the escalator up and the elevator down. Rate hikes are slow and measured but rate cuts tend to be quick and come in bunches. This cycle is the exact opposite. While we expect we've hit the ceiling for rates in this cycle and that these are unlikely to rise from here, they are also unlikely to fall much – so carry matters even more than before.

We expect public markets to remain active. Fresh leveraged buyouts are likely to provide supply and widen the high yield market but only if credit spreads are range bound, whilst private credit issuers may return to public markets – which we see as an interesting trend to keep an eye on.

Where does the risk lie?

As spreads tighten, there is a perception that the high yield market is risky for investors, but we feel this does not tell the full story. The fundamentals in the market are considerably better than previously with the quality of names improving. We believe that the combination of attractive valuations and robust fundamentals provides a constructive environment for 2025.

The main catalyst for volatility on the horizon – as with other asset classes – is a Trump presidency. Until there is greater clarity on what policy path he takes forward, and what policies he decides to focus on, high yield spreads could trade sideways – as the risk is politically driven, not market driven.

The election has been decisive, with the Republicans sweeping the swing states, comfortably winning the Senate, and on track for a 'red sweep'. After the diversion of an election cycle, markets are back to focusing on policy and the macro environment. And the macro outlook is still attractive. As we move further away from the election, however, there is scope for spreads to widen as we expect to see the high pace of issuance continue.

How to navigate these choppy waters

We have seen the global economy survive a year of intense geopolitical risk in the Middle East and the heightened uncertainty that comes from a US presidential election. It has weathered the quickest hiking cycles in decades, and jobless rates are still low. Further afield, China seems serious about putting a floor under the economy, even if growth upside is limited.

In our view, the best pathway through markets is to focus on those risks that you can control and forecast with a higher degree of precision. We will focus on moderating spread duration and, as always, on the quality of issuers' financials, rather than relying on third-party ratings: at a sectoral level, cashflows are the key factor, meaning we need to know about on- and off-balance sheet leverage. Under our investment approach, we prefer not to wait for defaults as the recovery process can take time: however, should they occur, the key is to have an adequate solvency cushion.

> **We have seen the global economy survive a year of intense geopolitical risk in the Middle East; the heightened uncertainty that comes from a US presidential election; it has weathered the quickest hiking cycles in decades, and jobless rates are still low.**

Buy bonds or bye bye bonds?

Craig Inches
Head of Rates and Cash

Rates and 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 make 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

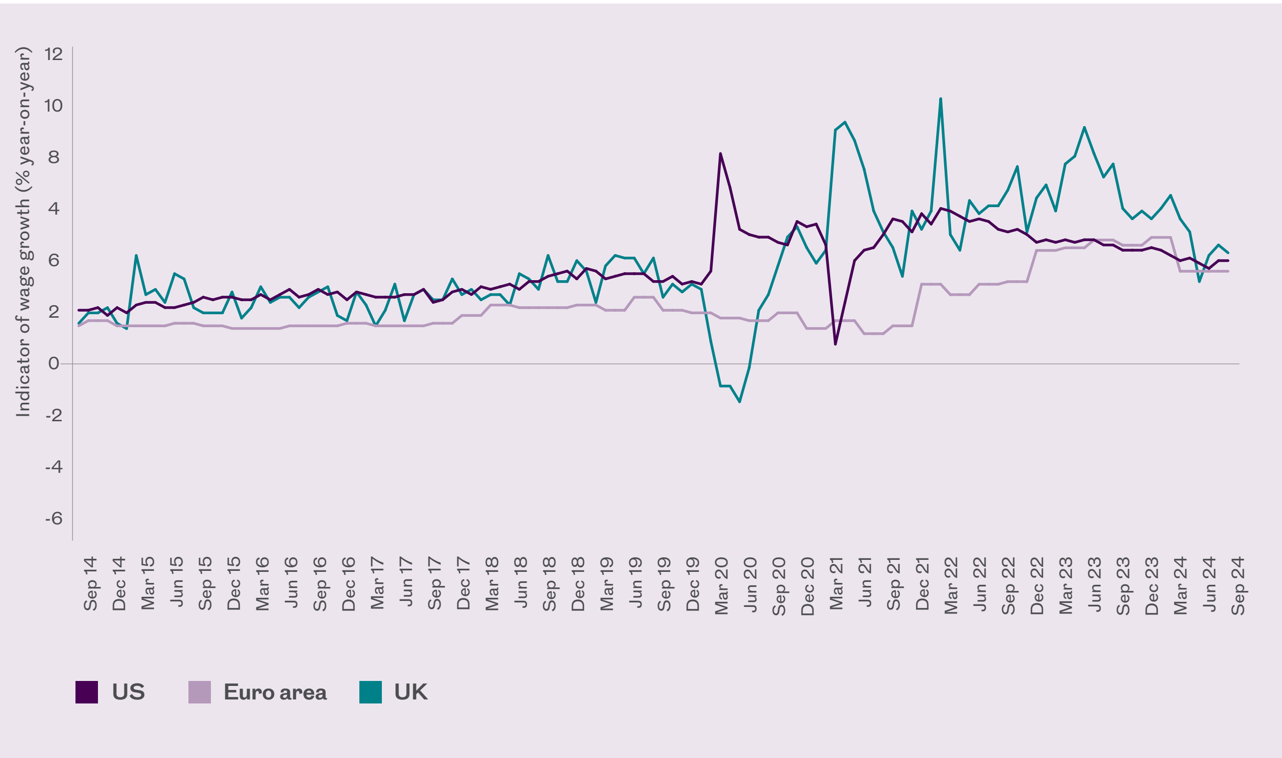
Stagflation is a combination of stagnant growth and high inflation. While we don't see the UK economy going into stagflation, we can see a scenario where growth doesn't excite and inflation remains sticky, so instead of 'stagflation', we see it more as 'bambi'-flation.

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 moderate approach to rate cuts. Next year, the BoE doesn't see wage growth potentially coming down, while unemployment has been revised lower, meaning there will less slack in the labour market. 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 next 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.

Wages declining



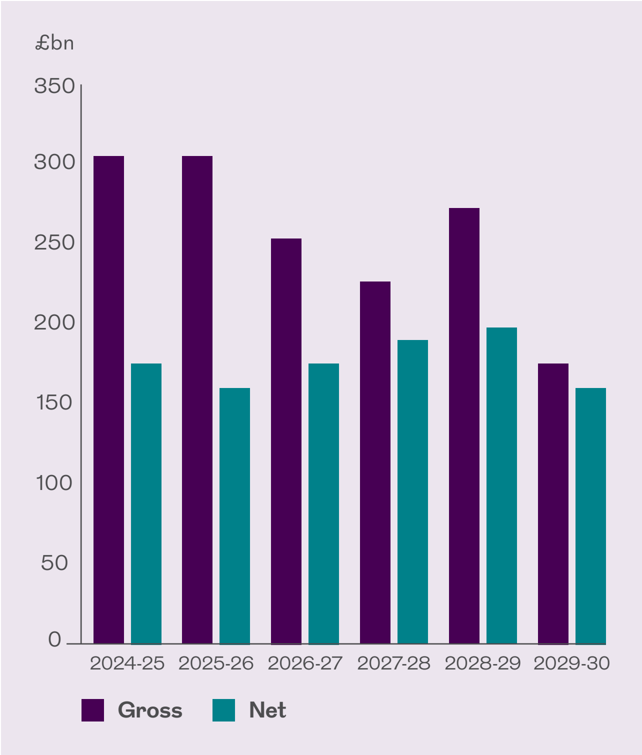
Source: Datastream. As at end of October 2024.

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.

> **We could find ourselves in a private sector recession – putting real pressure on consumers and potentially leading to services inflation cooling.**

UK gilt issuance



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

To Trump it all...

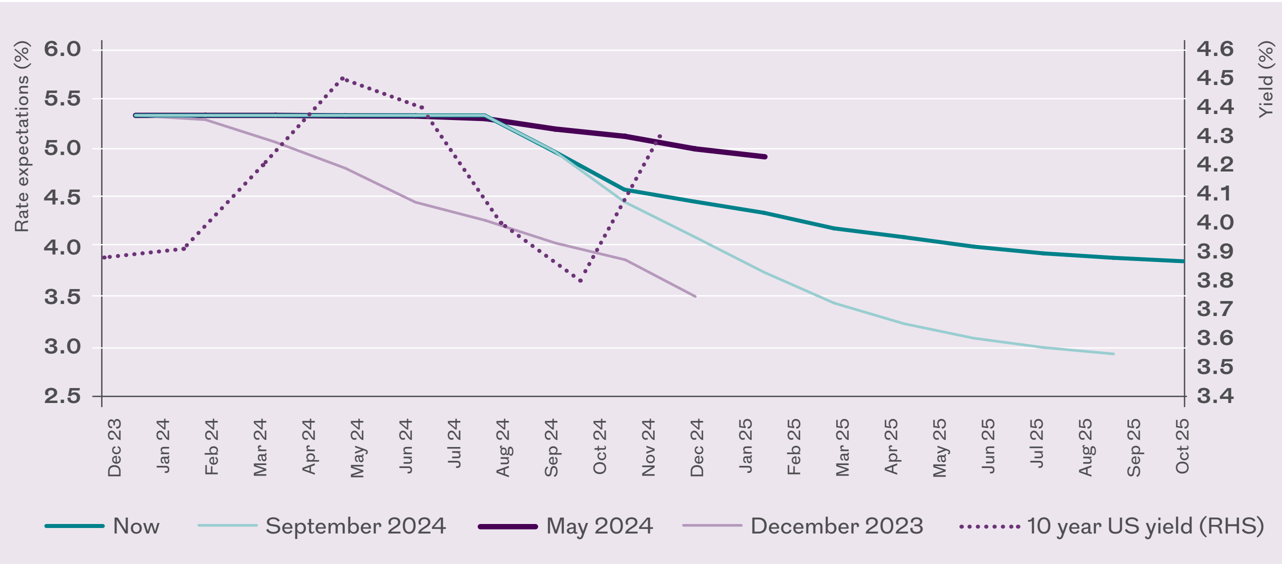
There is still so much to be determined with Trump. The Republicans won convincingly, giving Trump free rein to push his policies, with three main ones taking the centre stage during the campaign: tax cuts, tariffs and deportations. If history is any guide, a Trump presidency can over-promise but under-deliver, 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.

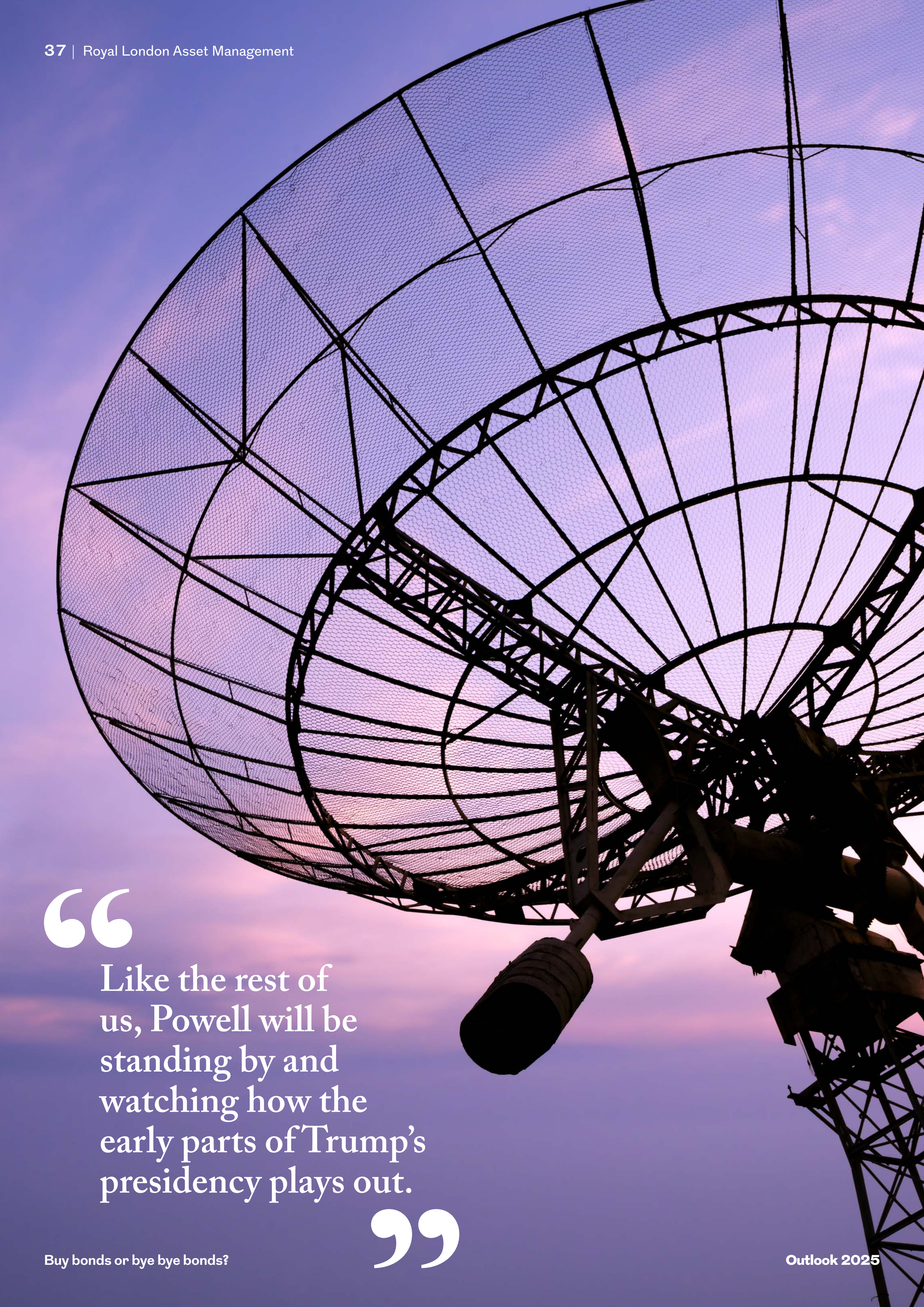
Financial markets, particularly in the US, reacted positively to Trump's victory – but this could have just as much been a reaction to a clear winner being declared early avoiding a long drawn-out process. We do expect to see a reversal of this initial euphoria, especially when the reality sets in that the Federal Reserve (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.

US rate expectations



Source: Bloomberg. As at end of October 2024.



“Like the rest of us, Powell will be standing by and watching how the early parts of Trump’s presidency plays out.”

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.

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 measures on both sides of the Atlantic – we are likely to see deficits rise. We think this will increase term premia in markets.

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 do we see opportunities? 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 currently see little value in the US government bonds, which is our least favoured market, until the picture becomes a little clearer on just what Trump will look to do.

As yields rise, it may be beneficial to generally increase duration relative to the benchmarks. Looking at inflation, despite breakevens looking quite expensive at this point – with a lot of inflation priced in – 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.

Growth, diversification and fragmentation

Jeremy Deacon
Head of Public ABS

Asset-backed securities

Asset-backed securities (ABS) are an area that is coming into the foreground for many more investors. The combination of value, yield and a degree of security is a powerful one, and more investors are looking at this area and considering adding exposure to their portfolios.

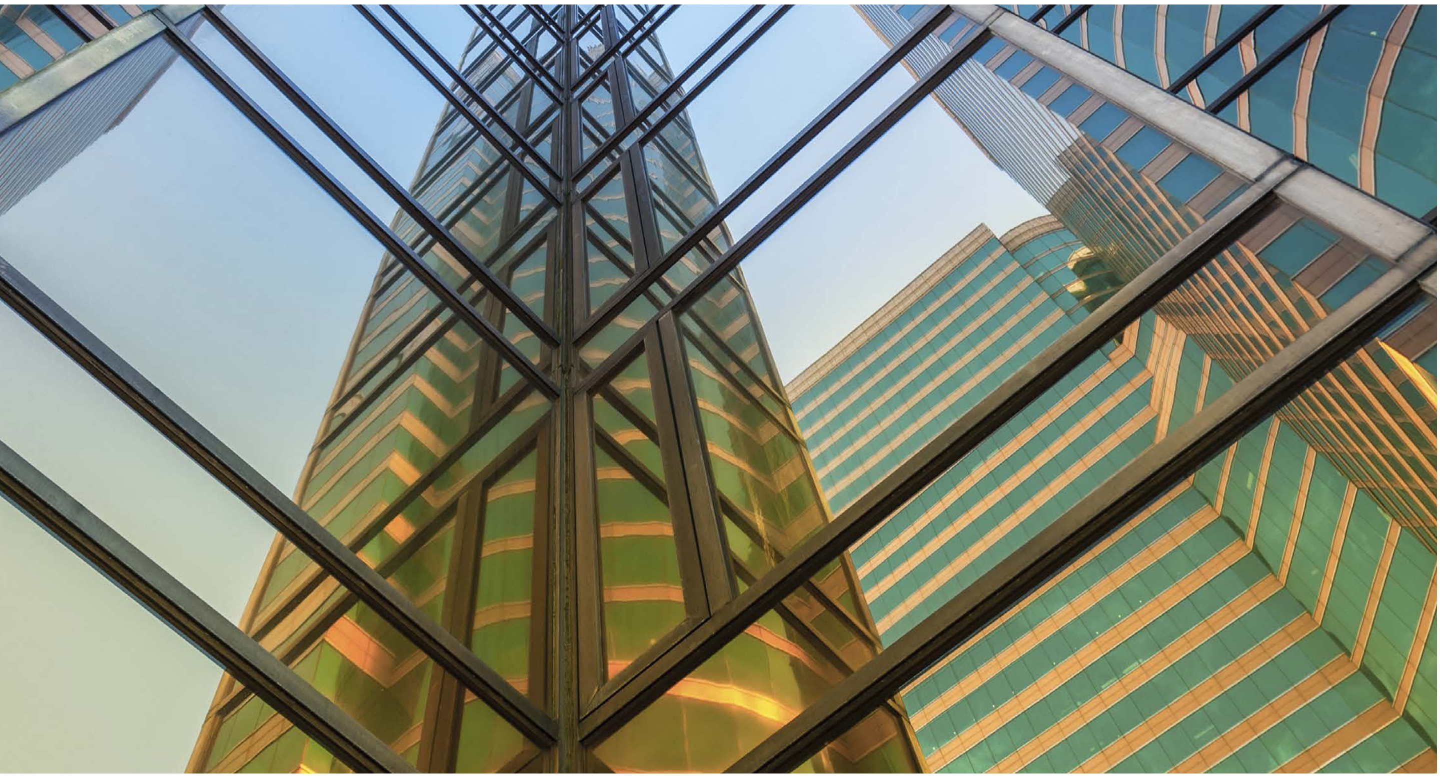
2024 has been notable for swings in interest rates and interest rate expectations. This has contributed to volatility in most parts of the fixed income universe, but public ABS has been relatively insulated thanks to the floating rate nature of the market, helping it have a pretty solid year.

> “Public ABS has been relatively insulated thanks to the floating rate nature of the market.”

With a few weeks of 2024 still to go, it looks like European securitisation issuance will reach €100bn or higher in the full year 2024. This will certainly set a new record high for 2.0 securitisations (see box) issuance. The issuance has been met with strong demand from investors, probably partly due to the floating rate structures but also as investors look to decrease risk by moving assets from equities into fixed income. The record issuance is seen from the full gambit of the securitisation market: ABS and collateralized loan obligations, synthetic risk transfers, and regions such as Australia are set to have a record year of issuance within structured finance. Within ABS, we've seen a host of new issuers and sectors in the market, notably solar, data centres and residential mortgage-backed securities master trusts.

ABS changes over past 10 years

The global financial crisis saw all ABS under the spotlight – despite most of the problems during that period being caused by excessively-levered vehicles exposed to US sub-prime mortgages. These changes are often described as securitisation 2.0 – not a specific set of regulations, but a variety of changes. One key change is the move to Simple Transparent and Standardised (STS) securitisation, which aligns with Solvency II and allows a degree of capital relief for banks and other institutions to encourage investment in this area.



A pan-European market

The UK remains the biggest securitisation sector, by volume and with a diversity of asset classes (including commercial mortgage-backed securities). However, issuance from the periphery jurisdictions has been on the rise since the second half of 2023. Issuance from Italy, Spain, Portugal and Ireland accounted for around €24bn of 2024 issuance – compared to just €13bn in 2023 – its highest level in a decade. Much of this issuance is from banks and we believe that there is sufficient support seen to keep this momentum going in 2025. Bank issuance increased materially to €41bn in 2024 YTD, which is the highest since 2012 (due to cheaper central bank funding). As these cheaper sources of funding expire, it is expected that this trend will continue with banks being the more dominant issuer in 2025.

It should be noted that 2024 saw a steady pace of supply throughout the year, with many records taking place, notably May seeing the highest single month of issuance since the GFC and issuance still continuing through the summer when historically these have been very flat months. In comparison, in 2025, the expectation is that H1 will be stronger with a mild slowdown in H2 as rate cuts filter through and potentially, demand for bond markets fades slightly. One difference we are expecting is STS-labelled issuance. Around half of all issuance was STS-labelled in 2024, we expect that to increase to over 50% in 2025.

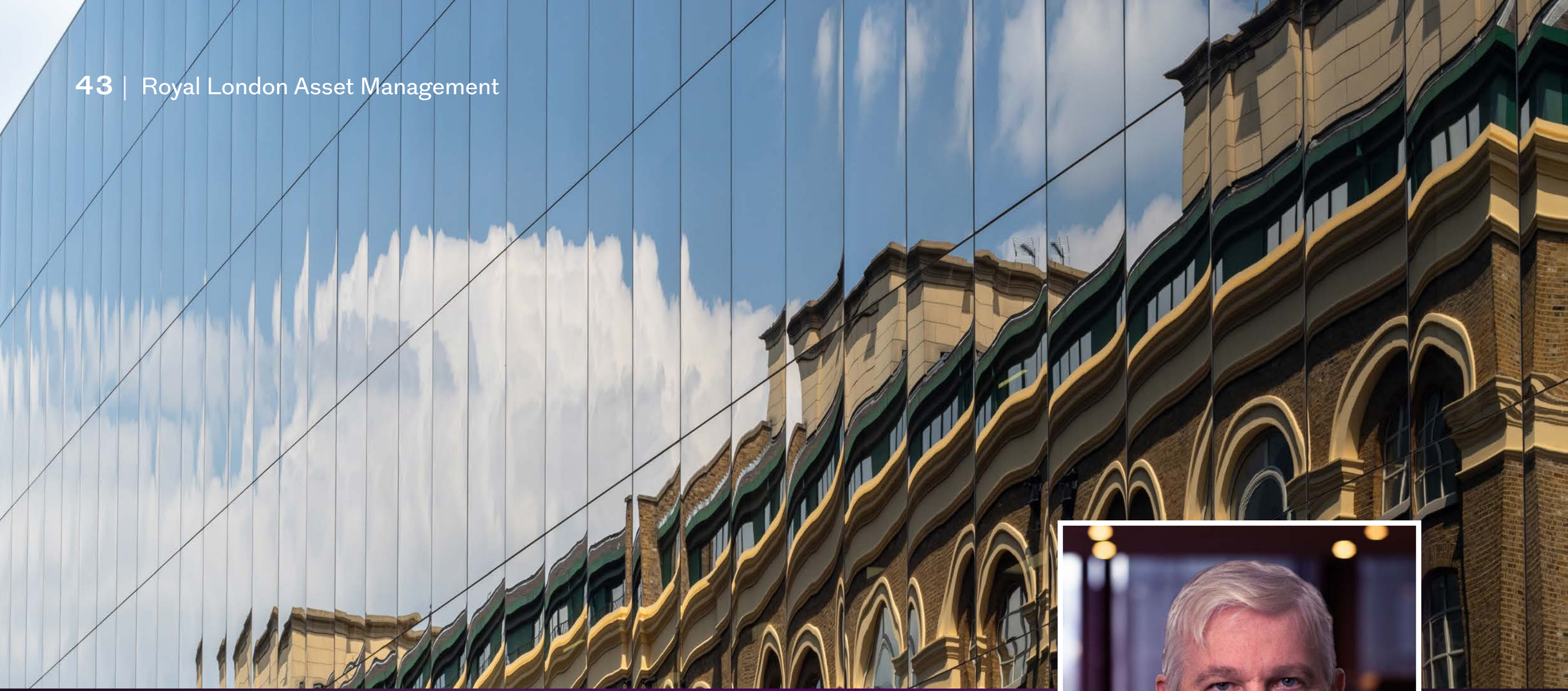
Private ABS also growing rapidly

Asset-based finance is already a $5tn market that is expected to exceed $7tn in the next two to three years. For the banking sector, a mix of increased regulation, higher capital requirements and their preference for scale rather than niche opportunities means that we see less participation from incumbents, creating room for new players. This should apply equally to the middle market – which we expect to remain fragmented.

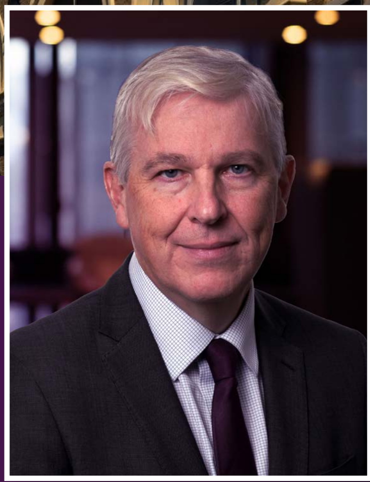
Non-bank lenders and sponsors have struggled in recent years. Low appetite and low valuations, lack of access to public market exits and slower fintech investment flows have all impacted this area. We believe that this creates an opportunity for asset-based finance providers to partner with asset originators to provide part or whole loan financing, particularly in the middle market space. This is an area with a broad spread of sectors and geographies, including sectors such as consumer finance, and infrastructure for automation / innovation assets such as data centres, with the UK, EU, Canada, Australia and the Nordics expected to be more active areas.

We believe that ABS remains cheap relative to other asset classes and that there is a lot of money still to be put to work in the sector. Many expect the momentum from this year to lead into 2025, with a strong level of issuance relative to recent history, although our expectation is that this is probably slightly lower in 2025.

> “We see less participation from incumbents, creating room for new players.”



Recovery expected to pick up in 2025



Kevin McCauley
Head of Strategy & Property Research

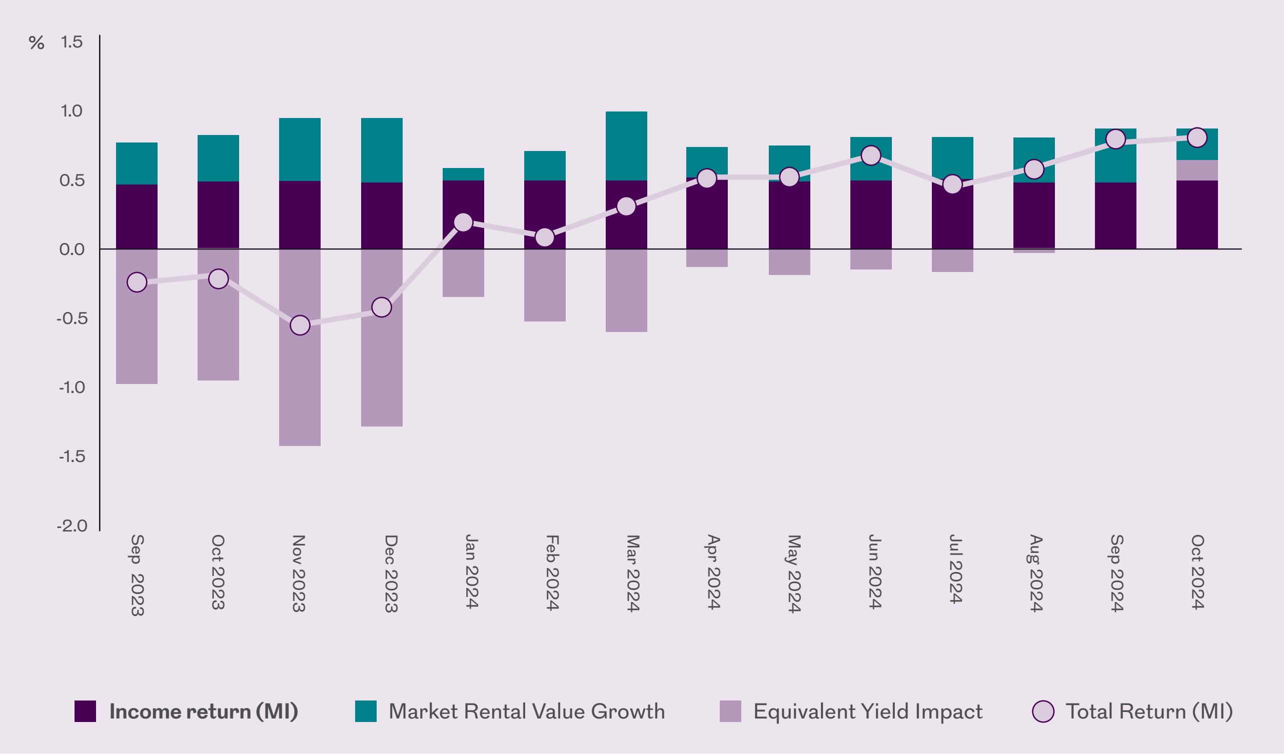
Property

At the start of 2024, we were expecting a recovery in real estate total returns driven by steady income returns, recovering capital values and continued rental growth, supported by a remarkably resilient occupational market.

Much of what we predicted materialised. According to the MSCI UK Monthly Property Index, capital values are marginally positive for the year to October, while they are 0.8% up from April. Total returns turned positive in January and have seen a 4.9% increase for the year to date. Retail with 7.9% total returns led the way, followed by industrial (6.5%) with office the laggard registering -1.0% total returns as capital values fell by 5.6%.

> “As a sector extremely sensitive to changes in the economic cycle, it has been surprising to see the occupational market so strong.”

Components of total return (%) - All Sectors



Source: MSCI Monthly Index October 2024 . Past performance is not a reliable indicator of future results.

As we approach 2025, the prevailing consensus is that an economic recovery is underway. This recovery is being facilitated by central banks beginning to reduce interest rates, which has in turn bolstered investor sentiment in property. Consequently, investors are increasingly seeking opportunities to deploy capital in order to capitalise on this cyclical turning point.

Against this backdrop, the pace and strength of the recovery will depend on the speed at which the Bank of England cuts interest rates, the strength of the economic recovery, property market fundamentals, and the growing influence of net zero carbon on investor and occupier decision making.

> The limited supply of new, high-quality space has driven significant rental growth.

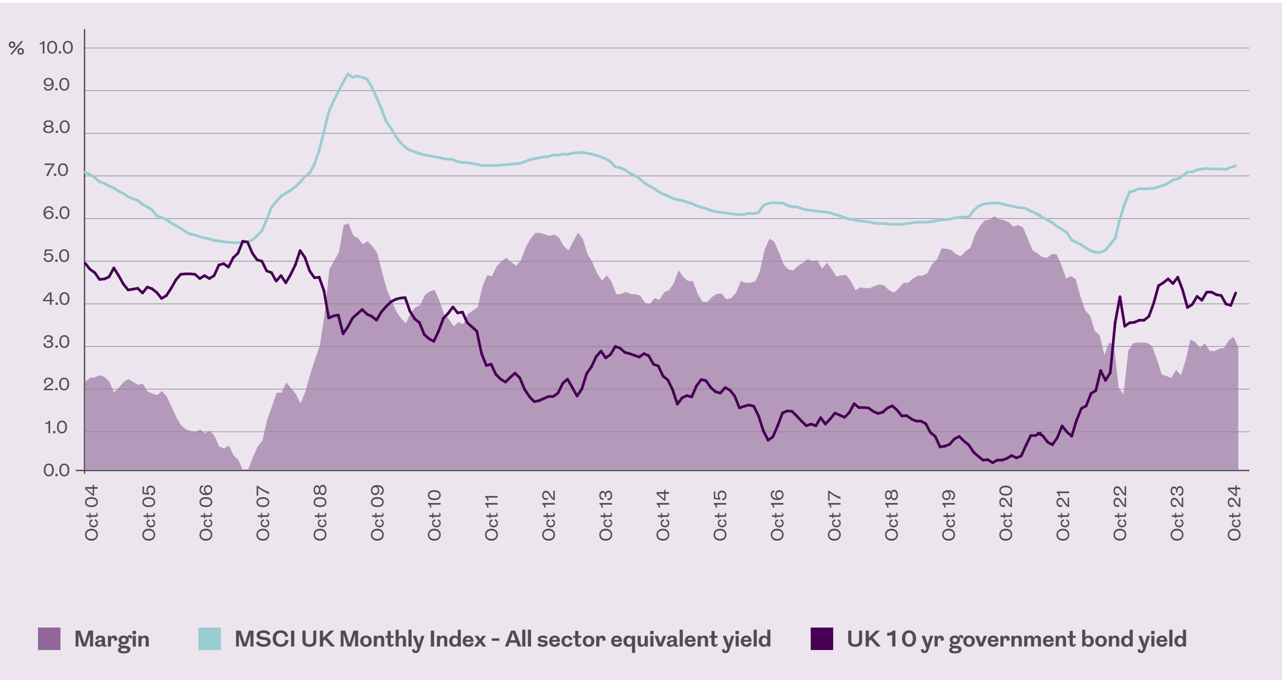
Interest rate tightening cycle has ended

August saw the first drop in borrowing costs for more than four years, with a further cut in November to 4.75%. However, the pathway to more cuts in 2025 has been complicated by an expansionary budget compared with previous plans, which financial markets have interpreted as potentially inflationary. With the gap between the risk-free rate and property yields relatively narrow, if gilt yields remain high, it could impact or slow the recovery in capital values.

Support offered by the improving economic backdrop

Property has had to contend with a relatively weak economic environment in the past two years with estimated growth of 0.3% and 1.0% in 2023 and 2024 respectively. As a sector extremely sensitive to changes in the economic cycle, it has been surprising to see the occupational market so strong, with many sectors seeing occupational demand close to long-term averages. Having rebounded in 2024, the UK economy is forecast to grow more robustly in 2025 with Oxford Economics latest forecast suggesting around 1.5%. We anticipate this will translate into stronger occupational demand and higher rental growth in 2025 and beyond.

The gap between property yields and the risk-free rate has narrowed



Source: MSCI Monthly Index October 2024 and Macrobond

Watch property market fundamentals

In a typical property market cycle, weak economic growth leads to reduced leasing activity. Due to the inherent delays in the development cycle, this situation results in an increase in supply as new space becomes available precisely when demand is at its weakest.

This has occurred to some degree this cycle. For instance, in the logistics sector, an increased number of speculative developments were completed as interest rates rose and leasing demand weakened, resulting in higher supply. Conversely, while supply has also risen in the office and retail sectors, the main contributing factor has been the return of second-hand space to the market.

The limited supply of new, high-quality space has driven significant rental growth. For instance, prime West End office rents have increased by 14.8% over the past two years and 47.6% over the past four years. High construction costs and elevated interest rates have curtailed speculative development, preventing the usual response to rising rents, namely development starts. We expect strong rental growth to continue until this situation changes.

Net zero carbon stays centre stage

In terms of investors and occupiers, we are seeing differentiated demand characteristics. They are now focusing on a building's lifecycle carbon footprint, including embedded carbon, energy and water efficiency, potential for on-site renewable energy, and end-of-life carbon impacts. This is notably challenging for the office sector, where retrofitting buildings for net zero carbon is being scrutinised for cost-effectiveness. As a result, there is increased obsolescence and a reduction in property values to account for this. Additionally, the demand for office space is declining outside the central business districts of major UK cities, which is accelerating the falls in capital value.

Implications for our strategy

In our view, the outlook for property in 2025 remains positive. Economic growth is expected to sustain occupational demand, which is having a strong end to 2024. Combined with a shortage of quality space, we think this will likely drive rents higher. A cutback in speculative development starts will ensure that there is not much additional supply of new space adding to the upward pressure on rents.

Investor demand and risk appetite have risen, boosting competition for assets and is starting to drive prices higher albeit slowly. We expect this trend to intensify in 2025. Following the general election, the UK is considered relatively more stable than other large European economies, which will appeal to investors. As a result, we expect international investors to renew their appetite for UK property.

We anticipate that all property total returns will average 7.0% annually over the next five years, driven by some yield compression and rental growth. Certain sectors are expected to outperform this average. Among these are the industrial and living sectors, which are supported by strong fundamentals, particularly a limited supply. This suggests a strategy to focus investment on build-to-rent, healthcare, and industrial sectors.

Following the challenges of the pandemic and the disruptions caused by ecommerce, the retail sector is anticipated to exhibit robust total return performance. As consumer confidence improves, low inflation and high earnings growth are expected to enhance spending power, subsequently boosting retailers' sales. Retail parks and shopping centres, particularly those of higher quality and with dominant catchment areas, are poised to benefit from this recovery.

The office sector outlook is mixed. We expect values to decline until late 2024, potentially into 2025, then stabilise. Central business districts in major UK cities are likely to perform best due to limited development and renewed investor interest. Outside major cities, we anticipate continued value declines and repurposing of office space for residential, hotels, and self-storage uses.

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.

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