HYMANS ROBERTSON

Capital Markets Update

Winter 2025

In Q4, sticky underlying inflation, strong US growth and expectations of an inflationary policy mix under President-elect Trump made markets question how far – and how fast – interest rates will fall.

Sovereign bond yields jumped in Q4, ending the year significantly higher. Meanwhile, hawkish rhetoric from the US Federal Reserve (Fed) tempered equity gains in December. Nonetheless, the FTSE All World Total Return Index still rose over 20% in 2024, while credit spreads ground tighter, ending the year at historic lows.

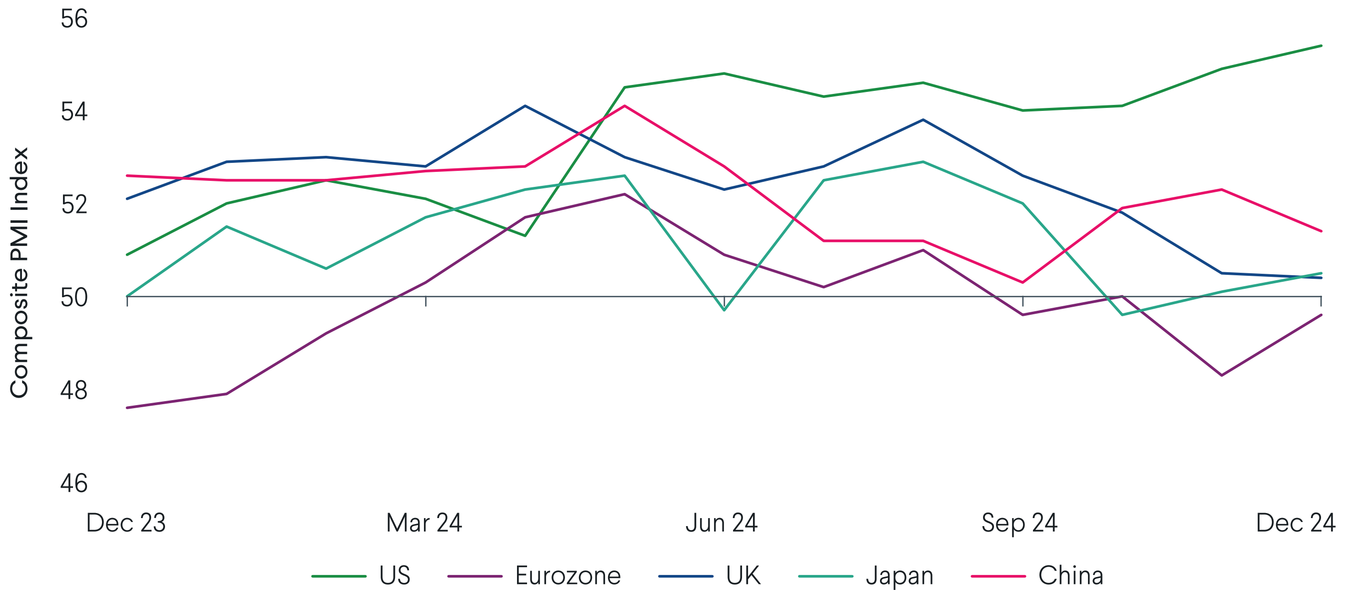
Global themes

Global growth confounded expectations again in 2024. Forecasts for full-year global growth have steadily risen from 2.2% in January to 2.6% in December, only slightly below post-Global Financial Crisis averages.

To an extent, loose fiscal policy has offset tight monetary policy. Nowhere is this truer than in the US, where government spending has supported robust, above-trend US growth, with weaker growth elsewhere. Global manufacturing weakness continues to weigh on the eurozone economy, which has faced the dual threat of tepid Chinese demand for exports and increased competition from low-cost imports due to excess production in China. Meanwhile, UK growth deteriorated sharply in Q3 from the robust pace registered in H1 2024. And Chinese growth was subdued relative to its own standards as ongoing property market weakness weighed on consumer and business confidence.

Expected tax cuts and deregulation under President-elect Trump support near-term global growth. Huge fiscal and monetary stimulus in China, as the economy battles chronically weak domestic demand and deflation concerns, potentially lends upside risk to near-term forecasts there too. Indeed, J.P. Morgan's Global Composite Purchasing Managers' Index, which aggregates activity across the global manufacturing and service sectors, suggests the pace of global growth accelerated in Q4 (Chart 1). However, the survey also highlights marked regional and sectoral dispersion: the US has been responsible for much of the recent upturn, while buoyant service-sector activity stands in stark contrast to stagnating manufacturing activity.

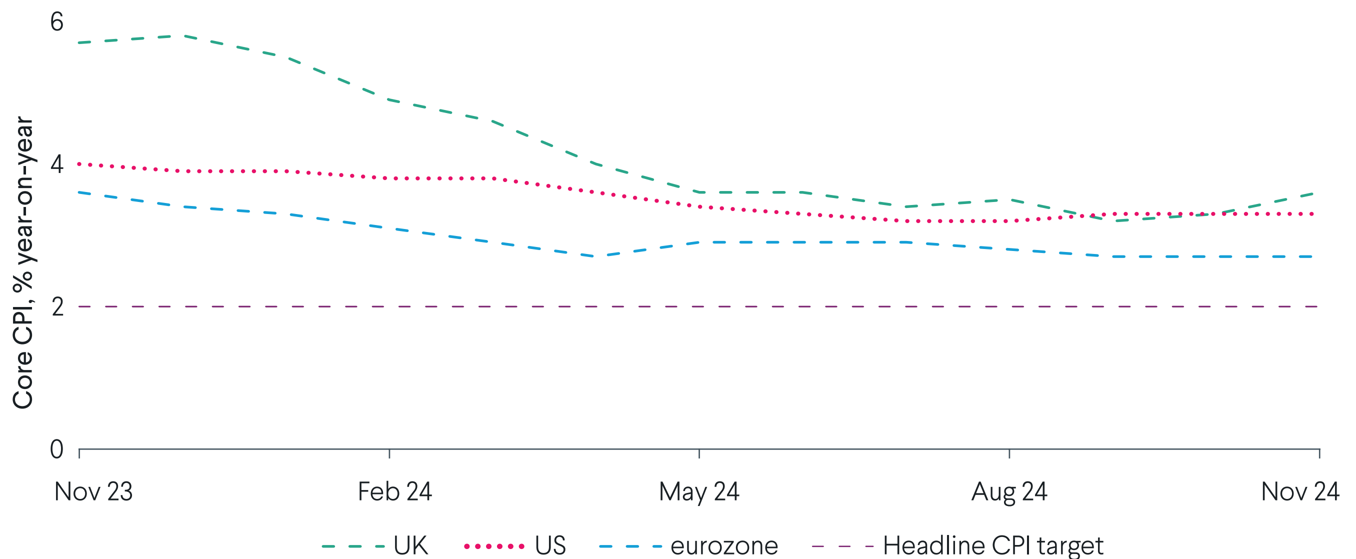
Chart 1: Survey data suggest US economic outperformance will continue in the near term



Source: Bloomberg

Ongoing disinflation prompted interest-rate cuts from the major central banks in 2024. The European Central Bank and the US Fed both lowered rates 1.0% pa, to 3.0% pa and 4.25–4.5% pa, respectively. Amid evidence of more stubborn underlying inflation pressures, the Bank of England (BoE) cut rates a smaller 0.5% pa, to 4.75% pa. With core inflation still running above target (Chart 2), and wages growing strongly, the Fed and BoE are likely to proceed cautiously. Indeed, tax cuts and tariffs lend upside risks to US inflation, while higher energy prices and the effects of fiscal loosening announced in Labour's October budget fed into forecasts for UK headline CPI to rise to around 3% year-on-year in 2025.

Chart 2: Core inflation, which excludes volatile energy and food prices, remains stubbornly above target



Source: Datastream

However, real interest rates above long-term real growth forecasts look restrictive, leaving scope for policymakers to lower rates. Market expectations have also shifted to anticipate a gradual approach from central banks, pricing in barely two 0.25% pa cuts from the Fed and BoE in 2025 – much more reasonable than the six to seven cuts expected at the start of 2024.

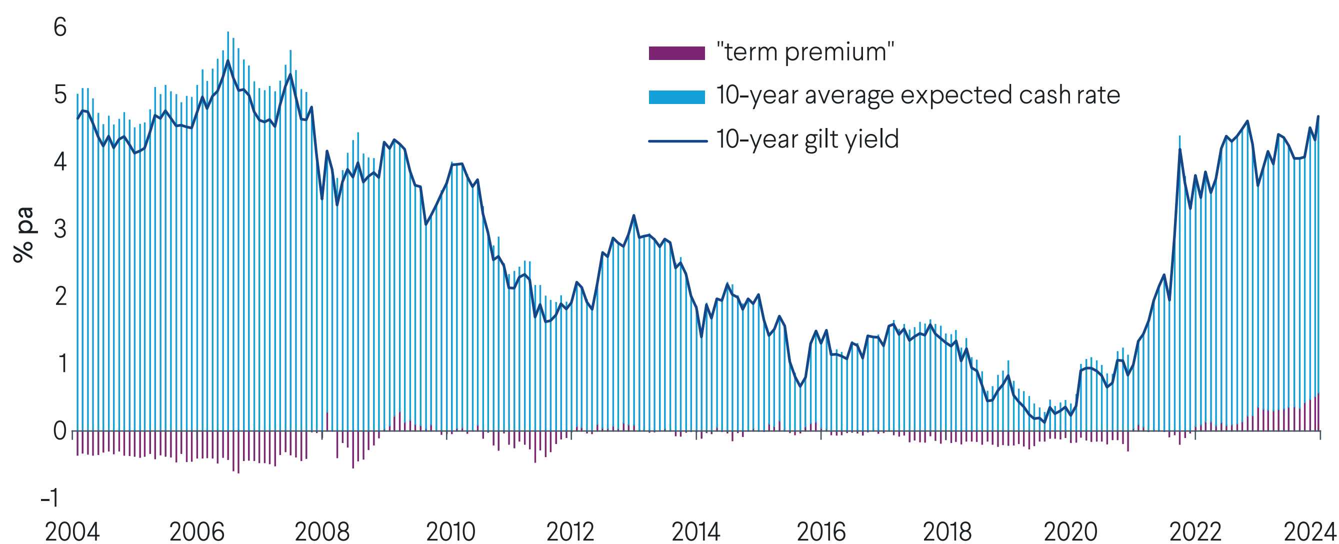
In summary, global growth is expected to maintain its solid, albeit unspectacular, pace of 2.6% in 2025, remaining around that mark over the next few years. And US economic outperformance is expected to continue among the major advanced economies. However, stronger US growth, alongside tariffs and lower migration, may stoke inflationary pressures, resulting in a slower pace of rate cuts. Uncertainty has increased, and rising trade tensions, higher US treasury yields and a stronger dollar could pose headwinds to global growth over the medium term.

Government bonds

Gilt yields rose significantly in Q4, in tandem with global yields, but the UK Autumn Budget added further impetus. The larger-than-expected increase in borrowing announced in the budget adds to an already challenging technical backdrop for gilt markets. Issuance is increasing at a time when the BoE is selling gilts acquired through its Asset Purchase Facility (APF), while demand from private sector defined benefit pension schemes is waning.

And while the shift in the government's debt target to Public Sector Net Financial Liabilities is a positive step, allowing greater borrowing to fund investment, the government used far more of the headroom created than markets expected. This leaves little room for slippage against forecasts and raises the risk of higher gilt issuance in the future. As a result, term premia (the additional amount required by investors to hold a long-term instrument versus a short-term deposit) have risen (Chart 3).

Chart 3: The market is pricing in cash rates staying higher for longer, and term premia have risen



Source: Bank of England, Hymans Robertson

That said, gilt yields already discount a degree of risk posed to inflation and issuance by higher government spending. At 4.6% pa at the end of December, 10-year nominal gilt yields are over 1.0% pa higher than at the start of 2024 and well above long-term consensus forecasts for UK nominal growth, which inform our assessment of long-term fair value. Furthermore, 10-year gilt-implied inflation of 3.5% pa versus 10-year forecast inflation of 2.5% pa, based on RPI till 2030 and CPI thereafter, suggests there is a substantial inflation risk premium already embedded in market pricing.

Credit

Credit spreads continued their year-long grind tighter in Q4, ending 2024 close to historic lows in both investment- and speculative-grade markets. Amid strong yield-driven demand, we think spreads already more than reflect the decent fundamental backdrop. Interest coverage – or the number of times earnings cover debt interest, a key debt affordability metric – has fallen from post-pandemic highs, but it is healthy in both the investment- and speculative-grade fixed-rate credit market. However, it's likely to come under further pressure as debt is refinanced and effective interest rates move higher. In the leveraged loan market, where higher rates were passed on more quickly to highly indebted borrowers, defaults reached 7.4% in the 12 months to end November, as high as they have been since the Covid-19 pandemic.

Chart 4: ABS bonds continue to offer a premium versus similarly rated corporate credit

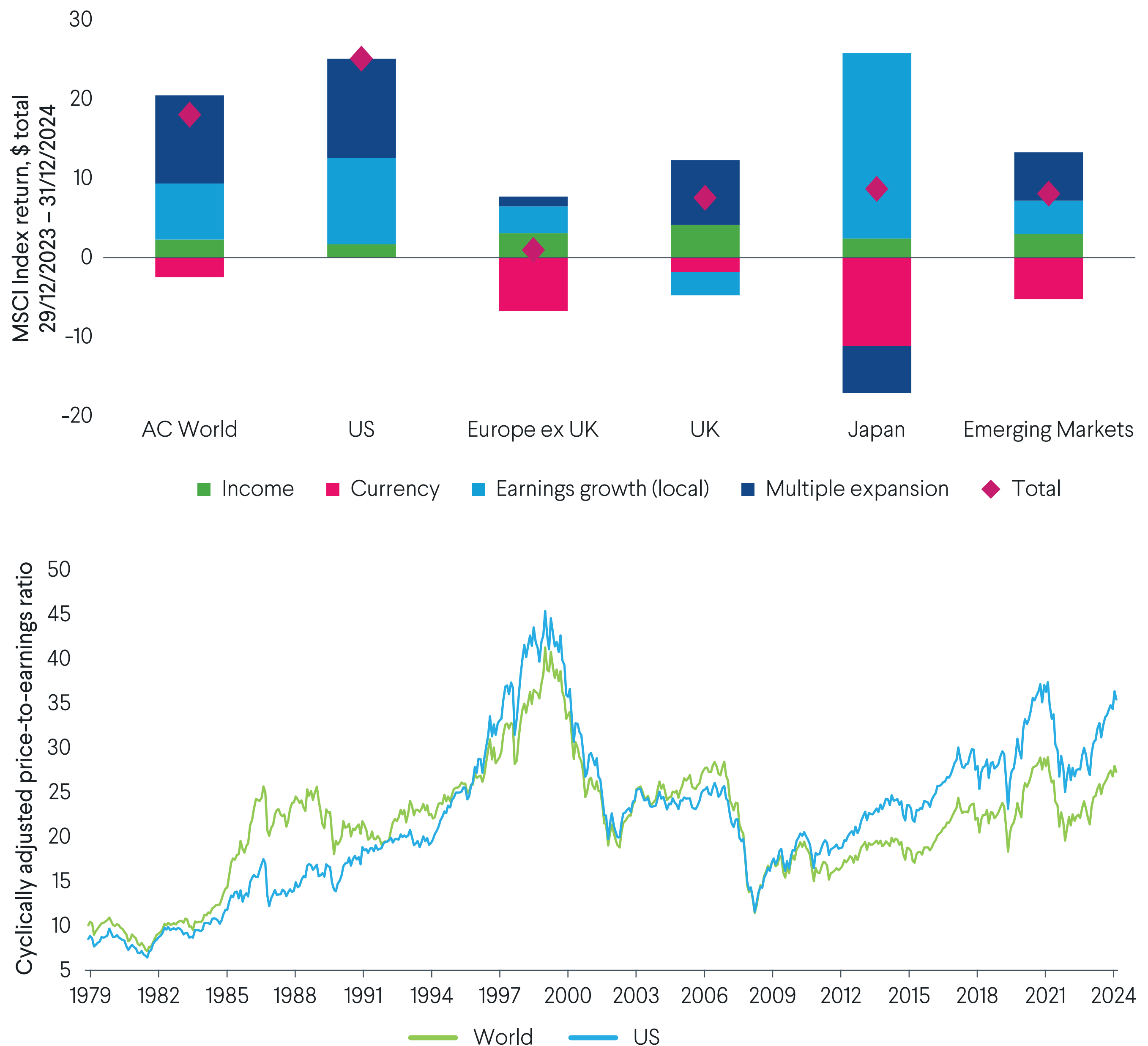
Source: Citivelocity, ICE Index Platform

We believe attractive credit yields reflect elevated underlying risk-free rates and would currently be overweight gilts versus investment-grade corporate credit in our high-quality bond portfolio. At current levels, the risks to spreads, and excess credit returns, look increasingly asymmetric. Within credit, we would be overweight short-dated credit and asset-backed securities (ABS) versus benchmark investment grade, as ABS bonds continue to offer a reasonable spread premium over similarly rated corporate credit. Also, the capital values of shorter-dated assets, with lower spread duration, are less susceptible to spread widening. Should spreads widen, maturing cashflows from short-dated assets can quickly be re-invested at attractive levels without having to realise negative mark-to-market moves.

Equities

Hawkish comments following the Fed's December rate cut caused global equities to hand back some of their Q4 gains in December, but the FTSE All World Total Return Index still ended the year up 20.6%, in local-currency terms. While some of that gain owes to earnings growth (Chart 5), share prices have risen by far more than earnings, causing price-to-earnings multiples to increase. Meanwhile, above-trend earnings mean cyclically adjusted price-to-earnings ratios are even higher, particularly in the US (Chart 6). We do not suggest a slump is imminent. Indeed, forecast real earnings growth for the MSCI World of 12% in both 2025 and 2026 points to a solid fundamental backdrop. However, lofty expectations leave scope for greater disappointment, and the tailwind of multiple expansion may become a headwind for medium-term returns.

Chart 5 & 6: Share prices have risen by more than earnings, and valuations are elevated versus history



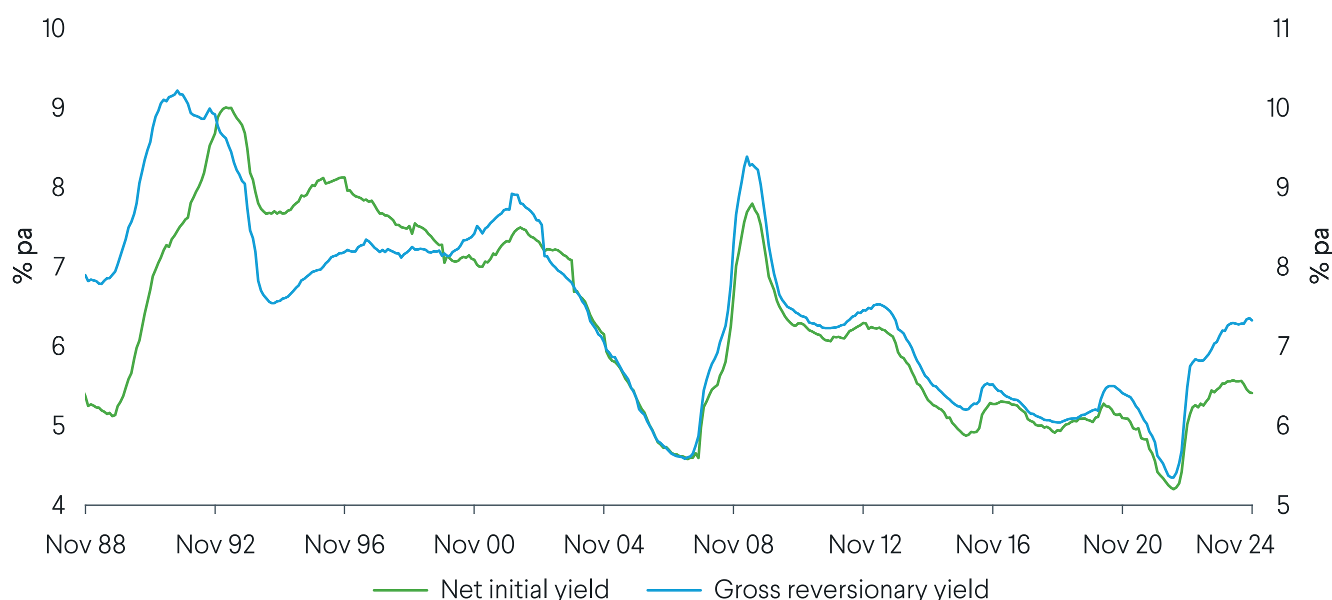
Source: Datastream

US outperformance in recent years, particularly that of the 'Magnificent Seven' tech stocks, means the concentration of global equity markets has increased: the US makes up almost 70% of global market capitalisation and, given the relatively narrow market leadership within the US, the top 10 stocks make up almost 40% of the S&P 500. Relatively strong economic growth, alongside tax cuts and deregulation under Trump, might be fair challenges to being underweight the US in the near term, but, historically, steep rises in concentration have tended to unravel, with equal-weighted indices subsequently outperforming their market-cap comparators. We think now is a good time for investors to revisit their equity exposures and consider the role alternatives to market-cap-based exposure, such as equally weighted or multi-factor approaches, can play in their global equity portfolio.

Property

The 12-month change in the MSCI UK Property Total Return Index edged up to 5.4% in November as declines in capital values moderated. Capital values continue to fall in the office sector month on month, but, given rises in industrial and retail capital values, the aggregate decline eased to 0.5% over the 12 months to end November. The redemption pressure on several UK pooled funds highlights how challenging the technical landscape has been over the last couple of years. Investment volumes have been improving but remain below 5- and 10-year averages, which themselves have been weighed down by the pandemic and the sharp fall in transaction activity that followed.

Chart 7: UK commercial property reversionary yields suggest there may be scope for further capital appreciation



Source: MSCI UK IPD

Nonetheless, we've become less cautious on commercial property over the last couple of quarters. UK commercial property market fundamentals have improved. The latest survey by the Royal Institute of Chartered Surveyors cited improvement in occupier demand as well as rent- and capital-value expectations, while availability and inducements declined. And decent, if unspectacular, economic growth is likely to support slower but still-healthy real rental growth, which has been positive for the last 10 months. Furthermore, property yields are substantially above their June 2022 low, and reversionary yields suggest there is scope for capital value appreciation ahead.

Conclusion

Global growth confounded expectations in 2024, and the prospect of more fiscal stimulus in the US and China could support growth in the near term. However, rising trade tensions, slower interest-rate cuts and a stronger US dollar might weigh on medium-term growth.

The supply-demand imbalance has deteriorated in the UK gilt market, but term premia have risen, and nominal gilts offer a reasonable inflation risk premium. If growth and inflation were to weaken more than expected, gilts could provide substantial upside, given current yields.

Historically low credit spreads make us cautious on credit. In high-quality bond portfolios, we would be underweight investment-grade credit versus gilts. We're even more cautious on speculative-grade bonds, where spreads are still tighter relative to their own history.

Strong earnings growth is supportive of equities in the near term, but elevated valuations already reflect a lot of good news. Given wide dispersion in valuations by region, sector and factor, however, there may be opportunities to diversify exposure within equity markets.

Despite a still-challenging technical backdrop, the outlook for property has improved. The correction in capital values looks well advanced, growth should support slower but still-positive real rental growth, and yields have risen towards our assessment of neutral.

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