AVIVA INVESTORS

2025 Outlook

House View

Unsettled new world: plotting a course through extreme policy uncertainty.

Contents

Our House View document is a comprehensive compilation of views and analysis from major investment teams.

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The House View document serves two main purposes. First, its preparation provides a comprehensive and forward-looking framework for discussion among the investment teams. Secondly, it allows us to share our thinking and explain the reasons for our economic views and investment decisions to those whom they affect. Not everyone will agree with all assumptions made and of the conclusions reached.

No one can predict the future perfectly. But the contents of this report represent the best collective judgement of Aviva Investors on the current and future investment environment.

Executive summary

Unsettled new world: plotting a course through extreme policy uncertainty

- The year ahead is likely to be marked by significant policy uncertainty, leading to a wide range of possible outcomes for the global economy.
- Trade policy will be a key factor, with the impact of potential tariffs ranging from benign to highly damaging.
- We expect divergence in pace and scale of monetary easing across countries.
- We prefer to enter 2025 overweight US equities and the US dollar, alongside UK government bonds.

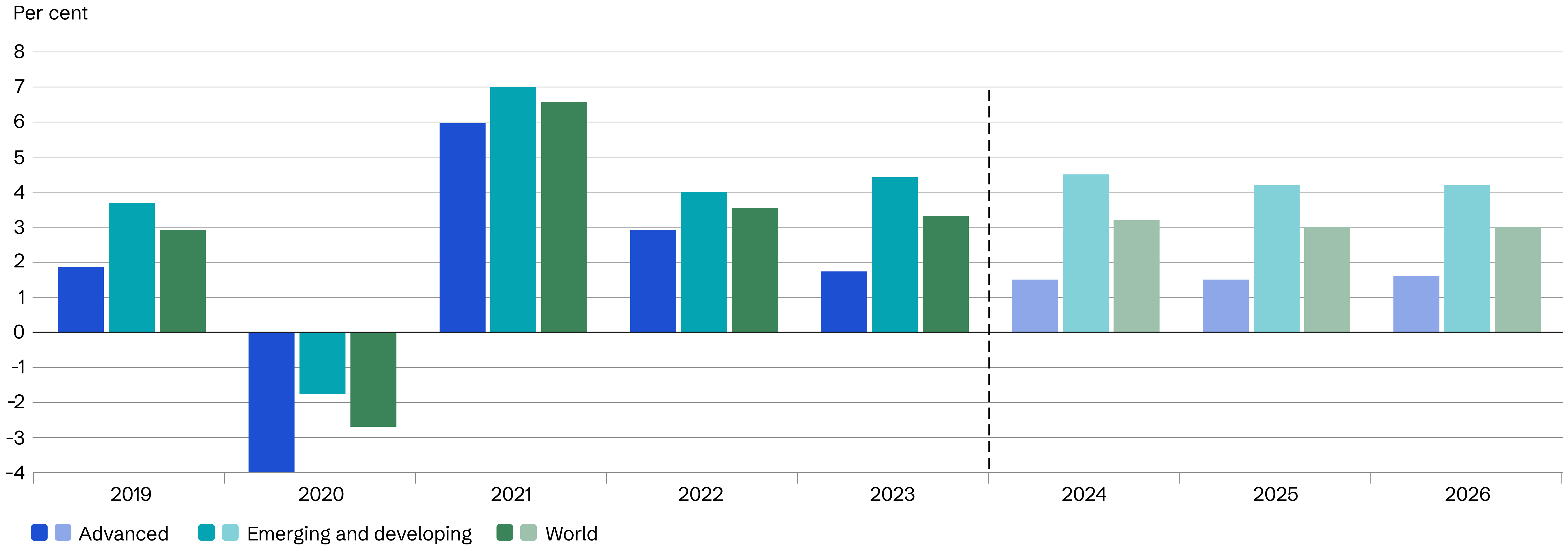
The year ahead shapes up as one of heightened uncertainty. However, it does not have to follow that this leads to recession or a poor environment for risk assets. Instead, the policy uncertainty implies a wide distribution of possible outcomes, both positive and negative. It is likely to feel pretty unsettled. The return of President Trump to the White House is expected to bring with it a host of important changes across the policy spectrum: from trade, to tax and spending, regulatory, immigration and foreign policy. Any one of these would be significant in its own right, so the combination and sequencing of all of them will no doubt prove challenging for markets to digest. Moreover, while the direction of travel is clear for each, the timing and magnitude are not.

> The year ahead shapes up as one with heightened uncertainty

The likely increased use of tariffs is perhaps the best example. Through the election campaign it was suggested that tariffs of 60 per cent could be imposed on all imports from China, with 10 per cent on all other imports. After the election, it was suggested it could be 20 per cent on all others. And then more recently, further threats of 25 per cent on Mexico and Canada and an additional 10 per cent on China (these are the three largest trading partners for the US) if they did not curb flows of illegal immigration and illicit drugs. Whether these threats represent a realistic scenario for tariffs likely depends on what is ultimately motivating them. For example, if they are used in a bargaining process to extract something else (the recent threats against Canada and Mexico probably fit in this camp), then they may not last or may never be implemented. But if they are about trying to de-couple from a trading partner or target specific sectors, then it seems more likely the tariffs would be used, but would not necessarily need to be broad-based. Or alternatively, if they were to be seen as part of a package of broader tax changes, then they might need to be very broad-based to raise sufficient revenue. And this doesn't even take into consideration the legal mechanism through which tariffs might be imposed. The threat and use of tariffs will likely create considerable uncertainty through 2025. Beyond what the US administration decides to do, there will likely then be some sort of response from countries that are impacted, in some cases conciliatory and in others retaliatory. As such, we think trade policy will weigh on global growth.

However, other policy measures could be positive for growth, especially in the US. Extension of the personal tax cuts (due to expire at the end of 2025), in addition to providing some further tax breaks for individuals and corporates, should result in US growth accelerating again in 2026. Regulatory changes could also play a role in helping spur productivity and growth.

Figure 1. Aviva Investors growth projections



Source: Aviva Investors, Macrobond as at 31 December 2024.

The reaction of US equities to the election outcome (they rallied around 5 per cent) suggests that these factors, alongside continuing solid economic performance this year, are more important drivers of the outlook. We broadly agree with that central case, but as noted above, see the range of possible outcomes as wide. That is even more true outside the US, where the policy mix will need to respond to either through trade policy or domestic policy changes. Overall, in our central scenario we expect global growth of 3 per cent in 2025 and 2026 (Figure 1).

Chinese growth has continued to slow, despite their increasing share of global trade, driven through key manufacturing sectors such as renewables and EVs. A more significant de-coupling from the US would undoubtedly hurt growth further – even if some of that trade could be redirected to partners in the "Global South". Policy makers would need to tackle domestic demand challenges more forcefully, even with the property sector expected to remain moribund. We expect there will be further Chinese stimulus measures in early 2025, but it remains to be seen if they will be enough to reverse disinflation.

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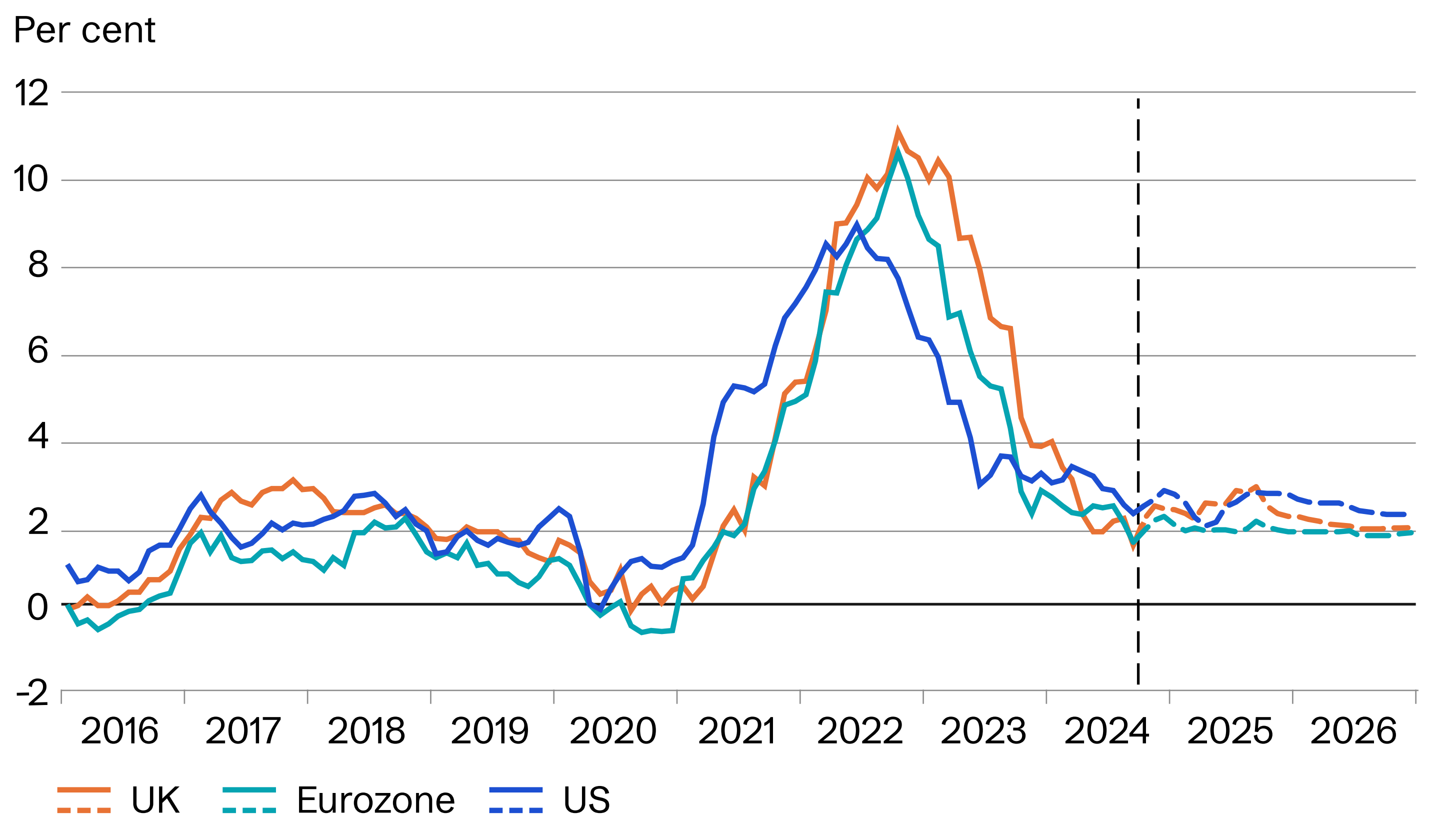
Meanwhile in Europe, there is the prospect of the dual challenge of a more difficult trading relationship with the US, alongside softening Chinese growth (and potential pressure from the US to also reduce reliance on China as a trading partner). While the broader Eurozone has recovered reasonably well from the energy crisis of 2022/23, Germany has not. Industrial production remains weak, with structural cost challenges and fierce competition in autos from the rise of China as a global exporter of EVs. Again, policy makers will need to rise to the challenge, with some easing of fiscal rules likely in Germany following the Federal election in February and potentially new funds to be made available from the EU for defence and other areas.

In the UK, growth and inflation have both been a little better than expected in 2024. The new Labour government has raised taxes and spending – the latter by more than the former – to provide a boost to growth into 2025. But there is uncertainty around how businesses will respond to higher national insurance contributions – with both wage growth and employment likely to be negatively impacted. The UK may also be in the crosshairs for tariffs from the US, at least on some sectors, but will likely have little fiscal room to manoeuvre to cushion industry. We expect growth to be around 1.2 per cent in 2025, with inflation close to the 2 per cent target.

Just as for growth, the range of possible outcomes for inflation next year is also wide, especially in the US where we would expect any tariffs to be passed through to consumer prices. Based on our central scenario, we expect CPI inflation in the US to be in the range of 2.5-3 per cent through to mid-2026. However, a more wide-ranging application of tariffs could push inflation as much as another percentage point higher next year. Outside the US, the inflation picture is expected to be more benign, with the disinflation process of 2024 continuing into 2025, in particular with an easing in service sector inflation. Similarly to the UK, we expect Eurozone inflation to be around the 2 per cent target by the end of next year (Figure 2).

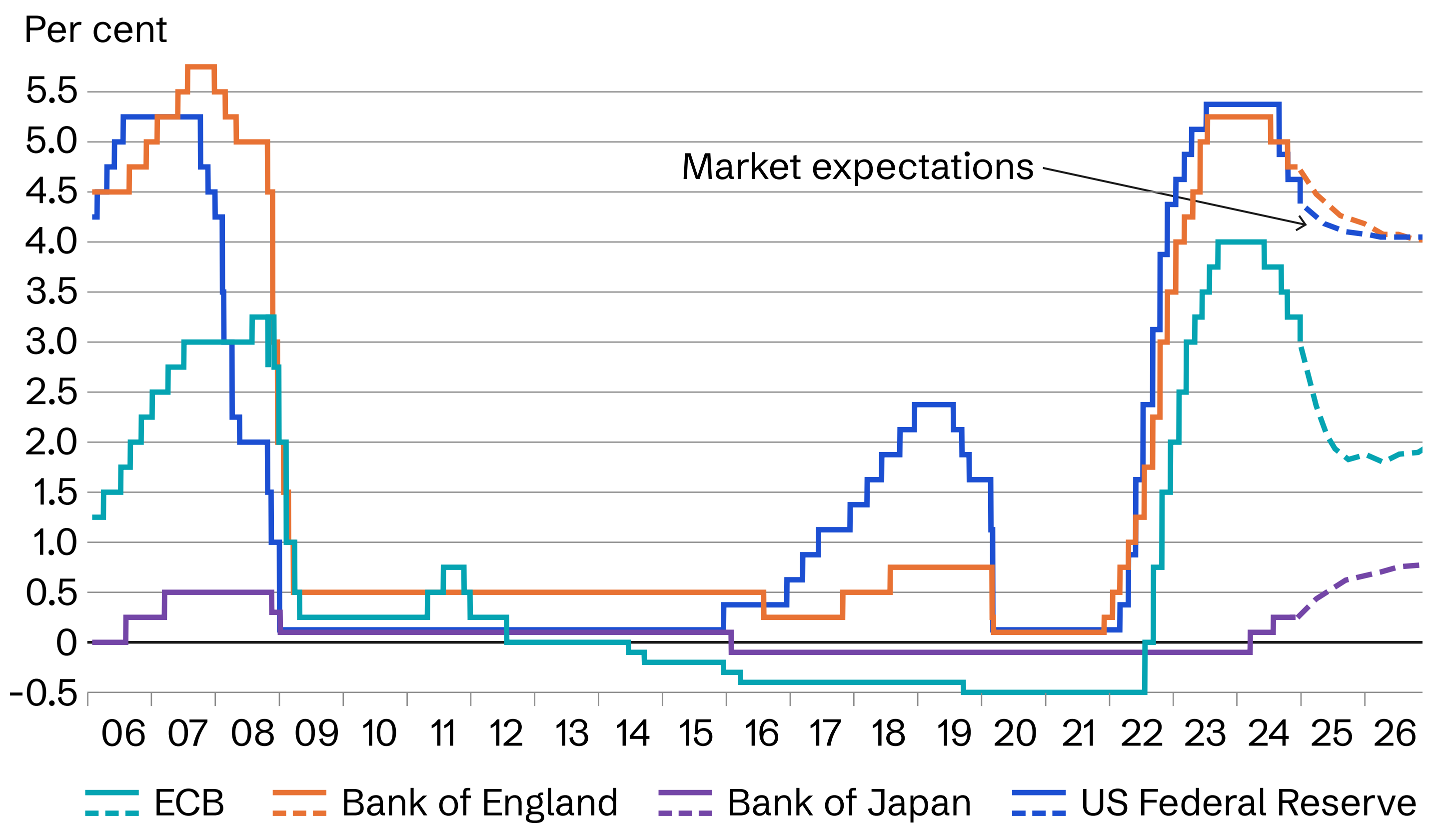
The uncertainty around trade and fiscal policy also creates uncertainty around the outlook for monetary policy. Hence, we think central banks will be cautious in reacting strongly without a clear signal of a change in growth or inflation trends. In the US we think that the Fed will cut rates only gradually in 2025, most likely in March and June, before pausing to see the impact on growth and inflation of other policy measures. Thereafter, the risks become more two-sided for rates, although the skew remains to further cuts. We expect the ECB will continue with rate cuts to 2.25 per cent in 2025 (another 75bp from the current level), as domestic growth remains modest and services inflation eases. We do not see the need for policy to move into accommodative territory unless the impact of trade policies were to push the Eurozone growth materially lower. In the UK we expect the Bank of England will need to cut rates somewhat more aggressively than implied by current market pricing (Figure 3), with cuts accelerating in 2025H2 to leave the policy rate at 3 per cent by the end of the year. We also expect the Chinese central bank to continue to ease policy through 2025 by lowering borrowing rates, reducing required reserves and engaging in quantitative easing. Finally, amongst the major developed market central banks, the one we see most clearly bucking the trend is the Bank of Japan (BoJ), where the outlook for sustained inflation around 2 per cent for the first time in decades should allow the BoJ to continue to steadily raise rates to 1 per cent by the end of 2025.

Figure 2. Aviva Investors CPI inflation projections



Source: Aviva Investors, Macrobond as at 31 December 2024.

Figure 3. Central Bank rates and market expectations



Source: Aviva Investors, Macrobond as at 31 December 2024.

Turning to our asset allocation views. We prefer to be overweight US equities, despite elevated valuations (Figure 4). We expect earnings to be the key driver next year, with a clearer case for US corporates out-earning the rest of the world. Moreover, the AI-theme remains a key driver for 2025, as the hyperscalers continue to invest and businesses look to increase adoption. We prefer to be only modestly overweight duration, with a preference for gilts on the view that the Bank of England will cut rates more than the market expects in 2025 on a softer inflation outlook and weaker than expected growth. We prefer a modest underweight in Japanese government bonds, with the inflation outlook there consistent with a further normalisation of rates faster than what is implied by the JGB curve. We are broadly neutral in credit, with overweights in high yield funded out of underweights in investment grade. That largely reflects the relative spread. Both are tight on a historical basis, but with late-cycle dynamics likely to sustain those spreads next year, the pick-up in high-yield is more attractive. Finally, we expect a stronger US dollar in 2025, especially against Asian currencies, as the full effect of US tariffs works through and US out-performance drives flows.

> We expect earnings to be the key driver next year, with a clearer case for US corporates out-earning the rest of the world

Figure 4. Asset allocation summary table

	Underweight -5	-4	-3	-2	-1	0	1	2	3	4	Overweight 5
Equities								2			
Government bonds							1				
Credit						0					
Cash				-2							
Currencies (versus US$)				-2							

Note: The weights in the Asset allocation table only apply to a model portfolio without mandate constraints. Our House View asset allocation provides a comprehensive and forward-looking framework for discussion among the investment teams.

Source: Aviva Investors, Macrobond as at 31 December 2024.

Investment themes

1	2	3	4
The US under President Trump 2.0	Reshaping of global trade, fiscal, and industrial policies	Tech boom: artificial intelligence and beyond	Monetary cycles become unsynchronised

The US under President Trump 2.0

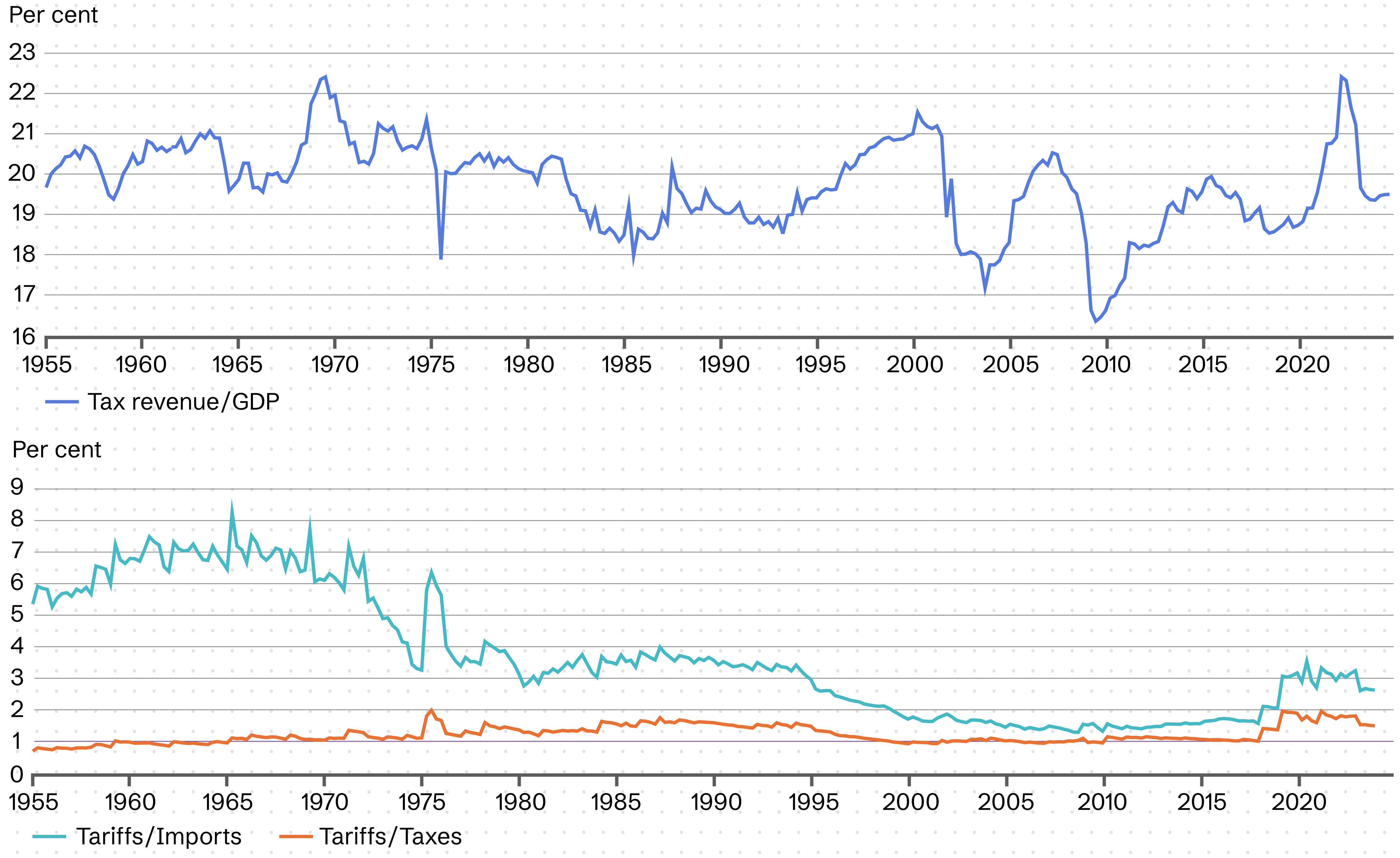
On November 5 2024, the US elected former president Trump for a second, non-consecutive term. The GOP wrested control of the Senate and narrowly retained the House, giving them, as in 2016, control of all branches of government. There will be similarities to Trump's first term, but also some important differences.

"Personnel is policy" was the mantra in the Reagan administration, and has often been a guide to regulation and other government policies. It will be some time before the full roster of appointments is known and confirmed. Thus far, we have a preliminary sense that important positions will be guided, first and foremost, by loyalty to POTUS and ideology. Many are aligned with the ideas espoused in Project 2025, which is neither a definitive set of proposals nor an official manifesto of Trump or the GOP. Beyond the prescriptive policy document, a key aim of Project 2025 and parallel efforts was to provide a pre-vetted set of devoted cadres ready to go on Day One (a normal part of presidential transitions). According to these drafts, this database of trained candidates will be unleashed to deconstruct the administrative state and remould or dismantle parts of it into a socially conservative, economically libertarian vision, with efficiency gains generating trillions in savings while eliminating opposition from the bureaucratic apparatus.

The timing, size, and details of the policies to be implemented are impossible to know precisely, and we wouldn't take catchy talking points like future Treasury Secretary Bessent's 3-3-3 "plan" (3 per cent growth, 3 per cent fiscal deficit, 3 million more barrels per day of oil output) as literal, but they will be significant changes. Some of the broad direction of federal policies we expect to be enacted by President Trump and the GOP Congress in 2025, and their macro impacts, are:

- Sweeping tax cuts, ranging from the extension of the Tax Cuts and Jobs Act (TCJA) to promised, but less certain, elimination of taxes on tips, social security, non-residents, and possible further lowering of corporate taxes – a large fiscal loosening, with 7 per cent deficits much more likely than 3 per cent.
- Immigration reforms: ranging from tighter border controls and modification of Deferred Action for Childhood Arrivals (DACA) to promised deportations and ending birthright citizenship – a potential negative labour supply adjustment, which makes 3 per cent GDP growth more challenging.
- Revenue raising from tariffs (which will also be used to force countries to implement unconnected policies), with the border-adjustment-tax also being mooted – a small offset to tax cuts (Figure 5), but with larger impact on trade and inflation.
- Expanded efforts to promote energy production (even if an extra 3mbpd is unlikely); defence spending by the US and countries which are the industry's customers; deregulation in banking, crypto, and consumer protection – these are all "pro-business" policies, aimed at promoting investment and making the US (even) more attractive relative to other regions.

Figure 5. Tariffs are a tiny part of total tax revenue



Source: BEA, Aviva Investors, Macrobond as at 31 December 2024.

Reshaping of global trade, fiscal, and industrial policies

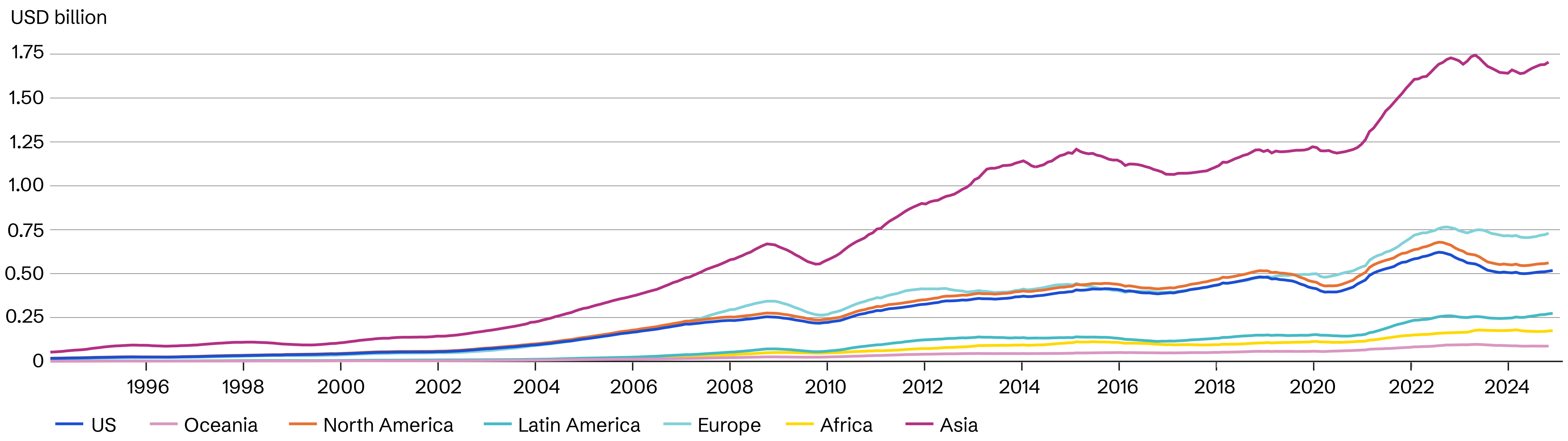
Trade and financial fragmentation: The tension between a rapidly rising and more authoritarian China and the rest of the world, particularly the United States, did not begin during President Trump's first term. Under President Obama, the US made its strategic pivot to Asia to counter China's perceived threat, infuriating Beijing. Anti-dumping measures were used on specific exports, and the TPP was formed to create a bloc that could enforce rules and use collective clout. However, it was under Trump that tensions boiled over, with actions against Huawei and other company-specific bans and sanctions, then moving on to swathes of tariffs. Under President Biden, tariffs were left in place and more targeted technology and military restrictions were added. As with other policies described above, there were a raft of proposals Trump made in the election campaign about tariffs, with 60 per cent levies against imports from China, and a 10 per cent tax on US consumers buying goods coming from all other places.

A variety of laws (Section 301 for retaliation, Section 232 for national security, and IEEPA for national emergencies) will likely be utilised, but the timing, implementation, and eventual negotiation is not yet determined. We expect escalation to be rapid and forceful.

That said, there are at least three competing and not entirely mutually exclusive schools of thought: (i) tariffs are to penalise foreign countries for, and/or protect domestic firms from incorrigible behaviour and encourage broader decoupling and supply-side resilience (ii) they are bargaining chips to extract concessions, e.g. reduce subsidies or unfair competition, or induce actions unrelated to trade such as curbing illegal drug supply, and (iii) revenue raisers to finance other budget measures or deficit reduction. The latter is an unappreciated risk, we think, which would tend to make tariffs large and permanent, if adjustable, which increases risks of a Trade War (see below).

The eruption of war in Ukraine also changed the geopolitical map, with financial sanctions against Russia, the aggressor, including banks and exporters, and the freezing of international reserves. China and Russia have not stood still, but instead strengthened their ties to one another, as well as forcefully projected soft and hard power, and money, in their spheres of influence and beyond. While globalisation is not reversing – quite the opposite (see Figure 6) – it is fragmenting and becoming polarised. Together with the changes to global trade, it is not a stretch to say that the cooperative, rule-based order of the past 35 or so years is largely over.

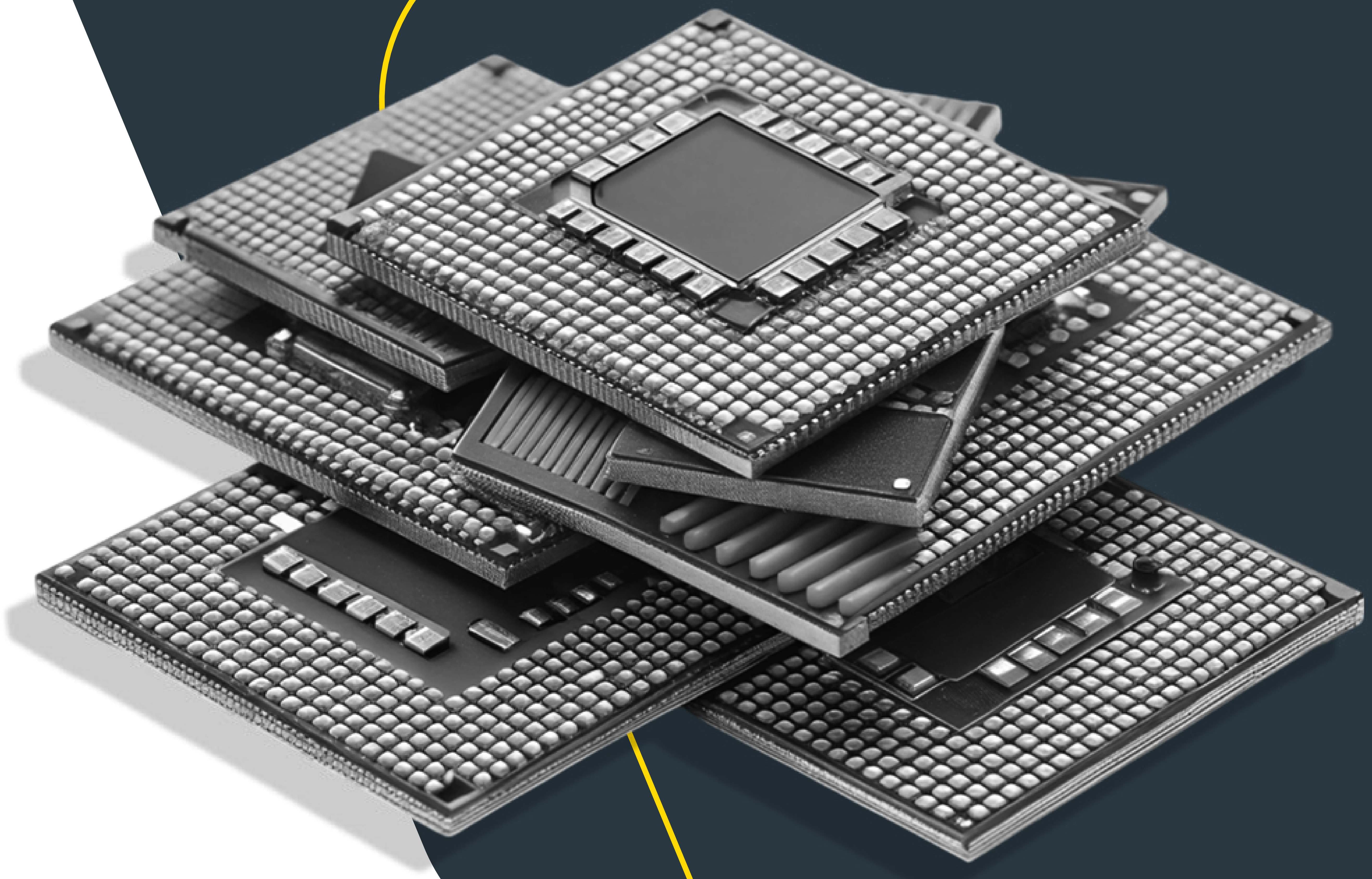
Figure 6. China exports to different regions



Source: China General Administration of Customers; Aviva Investors as at 31 December 2024.

Fiscal dominance and industrial policy: Alongside these changes, conflicts and the Covid pandemic changed the view that governments should stabilise social and economic progress. Fiscal policy is no longer much of a constraint, with policies like the IRA, the CHIPS act, and the infrastructure bill paralleled in Europe by NextGenEU and the RRF, which the EU may extend if the incoming leadership adopts some of the prescriptions of the Draghi report. In aggregate, governments' policies supporting defence, energy, technology, and social goals are here to stay. These could act as an important counterweight to tariffs and trade uncertainty - if they are scaled up and implemented effectively.

> The cooperative, rule-based order of the past 35 or so years is largely over



Tech boom: artificial intelligence and beyond

In prior House View publications (Q2, Q3), we posited that the breadth and speed of penetration would be a critical question to assess the future benefits of AI. Will the AI adoption curve be as steep as that of the smartphone or as flat as cloud computing?

The latest data on adoption has been promising; household and enterprise engagement with Gen AI models continued to rise in 2024, at an accelerating rate. However, the progress on mass efficiency gains is less clear. Potential AI use cases have expanded, but we have yet to see examples of many “general knowledge” or non-linear tasks being automated. Recent surveys of companies adopting AI offer conflicting reports as to the efficacy of AI within their workflow. A proprietary survey by Morgan Stanley[1] found that 90 per cent of corporate respondents saw the return on investment of GenAI projects either meet or exceed expectations, whilst Boston Consulting Group found that 74 per cent of surveyed companies were not able to generate tangible value from AI programs.[2] The jury’s still out.

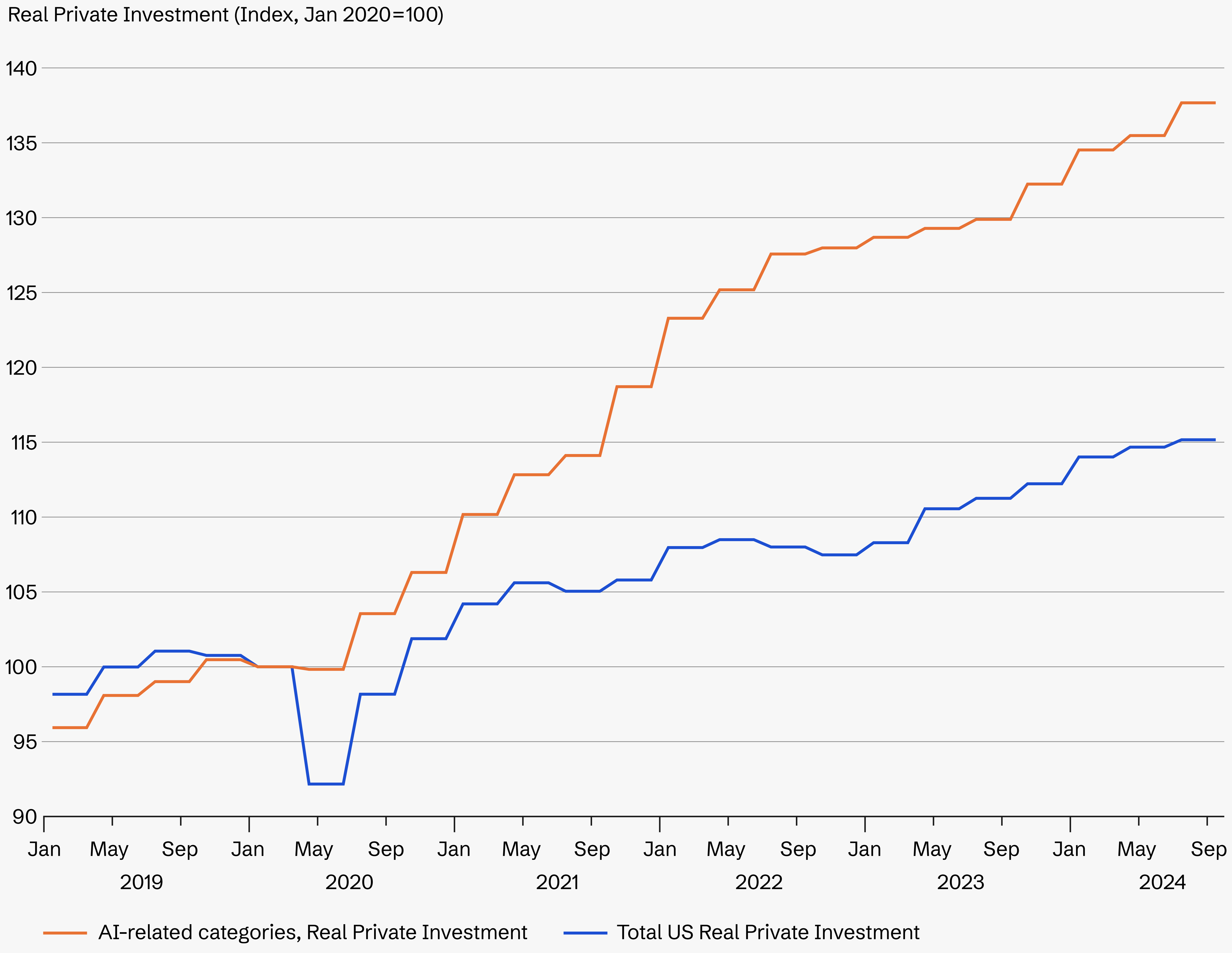
The productivity-enhancing potential of AI is not just about efficiency gains, but also its ability to provide incentives for investment. The capex spend of the mammoth AI “hyperscalers” has and is likely to continue to grow over the coming years (see Q4 2024 House View). Indeed, as of 2024, capex in AI related categories has grown at well over double the pace of wider US fixed investment since the pandemic, and domestic production of computers and electronics has soared too (Figure 7). The visibility of AI-related capex within the national accounts certainly presents tangible signs of the impacts of AI on the broader economy as a driver of growth.

The boom in AI investment has also prompted concerns regarding energy usage. 2023 saw a surge in structures investment, largely due to data centre demand to sustain the training and scaling of Generative Large Language and other data-driven models. According to the IEA[3], these large “hyperscale” data centres have power demands tenfold that of the average previous data centre. Whilst data centre power consumption may appear moderate now, currently accounting for c.3 per cent of global electricity consumption, regional clustering already places large strains upon local power networks. In Ireland, for example, according to the central statistics office, data centres already account for circa 21 per cent of all electricity consumption. Moreover, demand will continue to grow as AI engagement expands: some estimates show energy required to run AI tasks is accelerating at an annual rate of 26-36 per cent![4]

The implications of AI for the energy sector are material and surfaces as the world becomes increasingly fragmented, with concerns regarding the sustainability and security of our energy sources taking centre stage. This has led other “alternative” energy sources to come to the fore, such as nuclear and solar. Global nuclear production, an industry once thought to be in decline, is now forecasted to reach new highs in 2025, whilst Solar and Wind energy are thought to constitute nearly 75 per cent of global electricity production growth.[5] The need for massive grid, battery, and power generation expansion and upgrading is pressing, and with it the costs of commodities and components used in them.

1. Thematics: AI: Adopters Are (Still) Adopting
2. AI Adoption in 2024: 74% of Companies Struggle to Achieve and Scale Value | BCG
3. What the data centre and AI boom could mean for the energy sector – Analysis - IEA
4. The AI Disruption: Challenges and Guidance for Data Center Design
5. Executive summary – Electricity Mid-Year Update – July 2024 – Analysis - IEA

Figure 7. AI-related categories have outpaced broader capital formation...



Source: BEA, Aviva Investors, Macrobond as at 31 December 2024.

...and production of tech goods has surged ahead of other industries

Source: Federal Reserve, Aviva Investors, Macrobond as at 31 December 2024.

Monetary cycles become unsynchronised

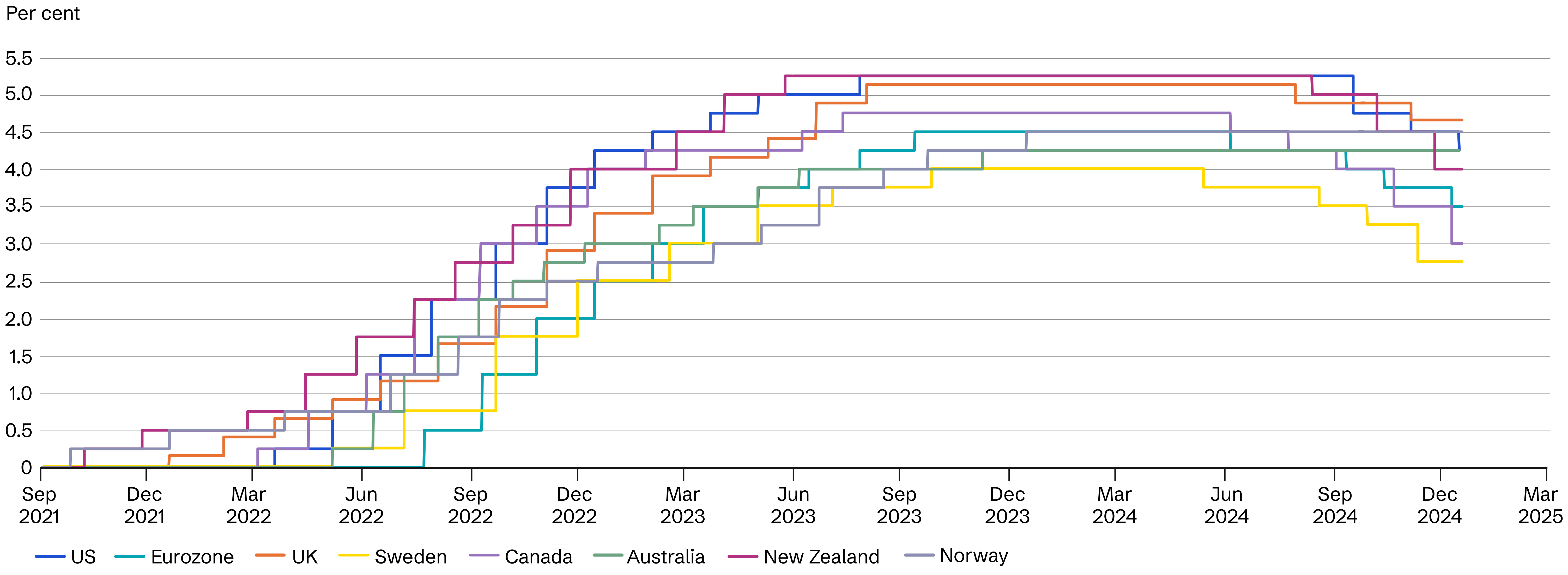
Central bank policy remains topical and will surely be one determinant of financial market and economic results in 2025. But the volatility of inflation has declined, with supply chains, commodity shocks, and fiscal impulse normalising; alongside this recession risks have receded from somewhat elevated levels. Almost every central bank has also cut rates, some sooner than others, so the question marks around 'when' have disappeared; further near-term reduction in monetary restrictiveness is a given, going forward. The reason for 'relegating' it to the fourth of our themes and risks – with growth and inflation not even explicit as dominant matters of discussion – is that the previous three themes, as well as the two risks below, are most likely to be the true drivers of GDP, CPI, and rates. With those factors having heterogeneous impacts on different countries, the paths are more likely to diverge than stay in sync.

Before the outbreak of inflation in 2021-22, central banks were collectively cautious, and tried to guide the market towards gradual hikes and levels that would be "neutral" or even accommodative. Looking back with 20-20 hindsight, it is easy to see how wrong they and markets were; in the face of a series of inflation shocks that was synchronised across countries because it had many common catalysts and drivers, monetary policy went rapidly past neutral, and into varying degrees of restrictive (Figure 8).

From there, some EMs cut early from very high levels, with most DMs following suit in the past year (Australia's RBA and Norway's Norgesbank remaining notable exceptions). Recent Fed commentary has made it clear that despite jumping in late with their 50bp cut, further easing will be patient and may get paused. Meanwhile the ECB remains dovish, as do the Bank of Canada, Sweden's Riksbank, and the RBNZ.

The BoE has remained more cautious (though we think they will eventually get data that eases their inflation anxiety), and many Emerging Markets have halted rate cuts, wary about fiscal pressures and currency weakness. Going forward, absent the global economy going through a very large common shock, central banks will begin to move more and more out of step with one another; this should create some opportunities in fixed income and currencies on the relative value front.

Figure 8. Cumulative change in policy rates – marching to different drummers from now on



Source: Aviva Investors, Macrobond as at 31 December 2024.

"Recent Fed commentary has made it clear that despite jumping in late with their 50bp cut, further easing will be patient and may get paused"

Michael Grady
Head of Investment Strategy and Chief Economist

Risks

Trade war shock leads to slump

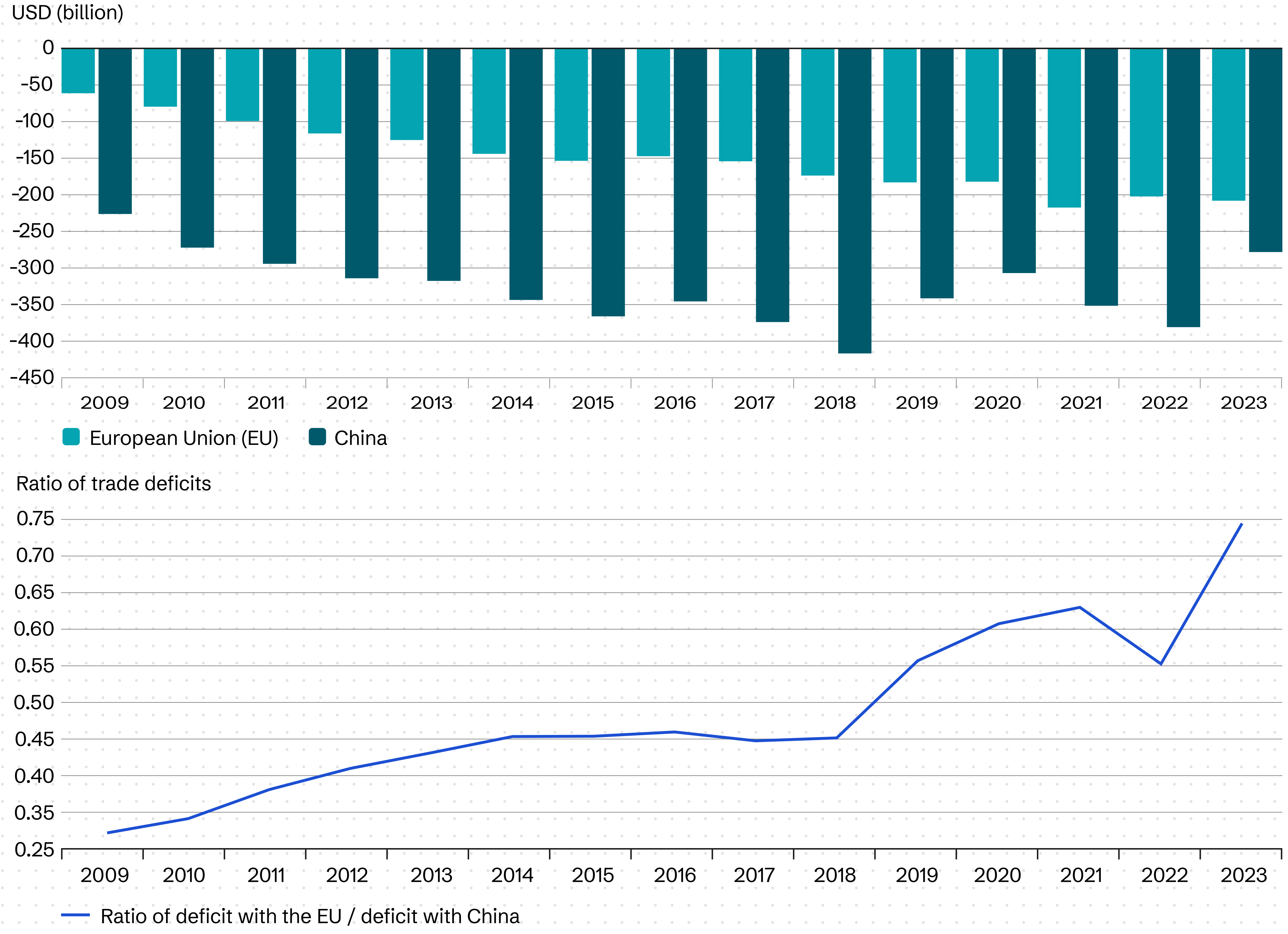
Higher tariffs are a foregone conclusion, and President Trump has signalled a willingness to disrupt the global trade landscape from day one. Tariffs' impact on inflation will be apparent in consumer prices, with the Fed's 2 per cent inflation target becoming even more challenging to achieve. A stronger dollar, particularly versus EM currencies, may cause difficulties to many central banks' cutting momentum across 2025. That will slow growth, at least relative to a less severe baseline.

There is confusion as to whether tariffs are a revenue tool to reduce deficits or allow for lower income tax, or if they are a way to punish wayward behaviour, reduce bilateral trade deficits (which would make the EU as well as China prime targets, as shown in Figure 9) or derisk and decouple from China in particular. To achieve meaningful deficit reduction alongside tax cuts, levies at the higher end of speculated levels may be needed. Consumer purchasing power and confidence could be damaged by vast changes in trade and tariff stances globally. China, Mexico, and Canada account for the largest share in goods imports to the US, but the GDP hit for many other nations may be larger – particularly those with smaller open economies, and modest fiscal buffers.

One of the biggest downside risks to growth is that trade policy uncertainty might deter investment and induce market volatility. The US' policies under Biden have spurred domestic infrastructure and manufacturing capital expenditures, in the name of 'reshoring', but this positive would be overwhelmed by negative business sentiment in a trade war.

The European Commission likewise has highlighted a need for greater EU public investment. The risk is that these efforts too become overpowered by a 'sudden stop' in FDI and private investment caused by a trade war.

Figure 9. US bilateral trade deficits make the EU as well as China prime targets



Source: US Census Bureau, Aviva Investors as at 31 December 2024.

Tariffs' impact on inflation will be apparent in consumer prices, with the Fed's 2 per cent inflation target becoming even more challenging to achieve

Geopolitical conflicts (or resolutions)

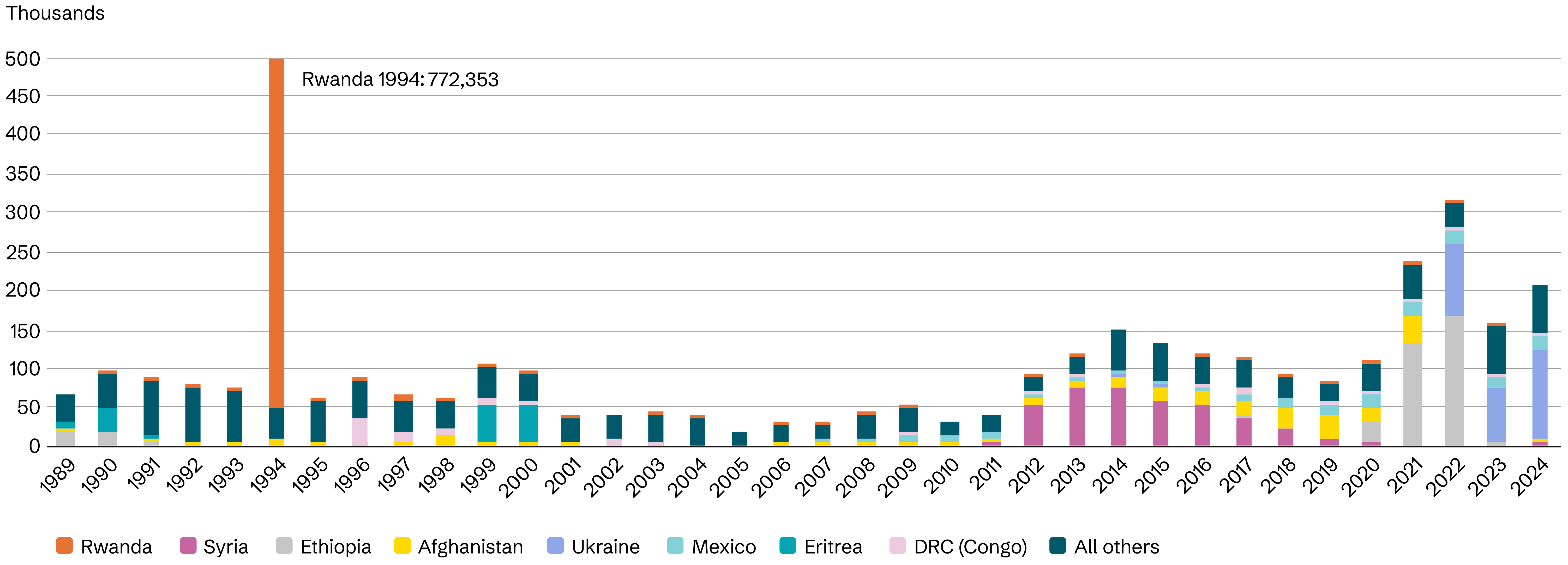
Is the world safer, healthier, and more prosperous than in the past? In many ways it is, particularly in the developed world, but the decline of large international conflicts involving major powers is not the only measure to use. For many parts of the world, peace and stability cannot be taken for granted, and the cheery predictions of many professional and armchair historians around 2010 have proven premature. Since the last decade, conflicts have been on the increase, despite the end of the Cold War and the conclusion of wars in Afghanistan and Iraq (Figure 10).

While those wars did have a major impact on global sentiment, it was not until Russia's invasions of Ukraine in 2014 and again in 2022 that markets were significantly impacted by sanctions, bond defaults, commodity disruptions, and widespread suffering. The rise of tensions in the Middle East has not disrupted oil flows significantly, but the Oil Crises of the 1970s were directly tied to conflicts there, with inflation also caused by the Vietnam war and other Cold War conflicts. The list of worries is long, from the "live" conflicts in Ukraine and the Middle East, to potential clashes in the South China Sea, India's border disputes, Taiwan, and numerous internal struggles with non-state militias, particularly in Africa, Asia, and Latin America. Iran in particular is likely to be in the crosshairs, with its 4 million barrel-per-day production likely curtailed to the roughly 2.5 mbpd pre-Covid level – though OPEC+ will be willing and able to make up the slack, in theory.

There are high hopes for peace, or at least ceasefires, too – but the evidence shows we have entered a more dangerous geopolitical regime that shows little signs of reverting to the brief interregnum. The impacts of large conflicts on markets are not obvious – often wars lead to excellent commodities and equity performance – but in the build-up to high uncertainty, or if capital flows or supply chains are affected, our benign growth and inflation baseline expectations could be challenged.

The rise of tensions in the Middle East has not disrupted oil flows significantly

Figure 10. Deaths in armed conflicts rising after post-Cold War halcyon period



Source: Our World In Data; Uppsala Conflict Data Program, Aviva Investors as at 31 December 2024.

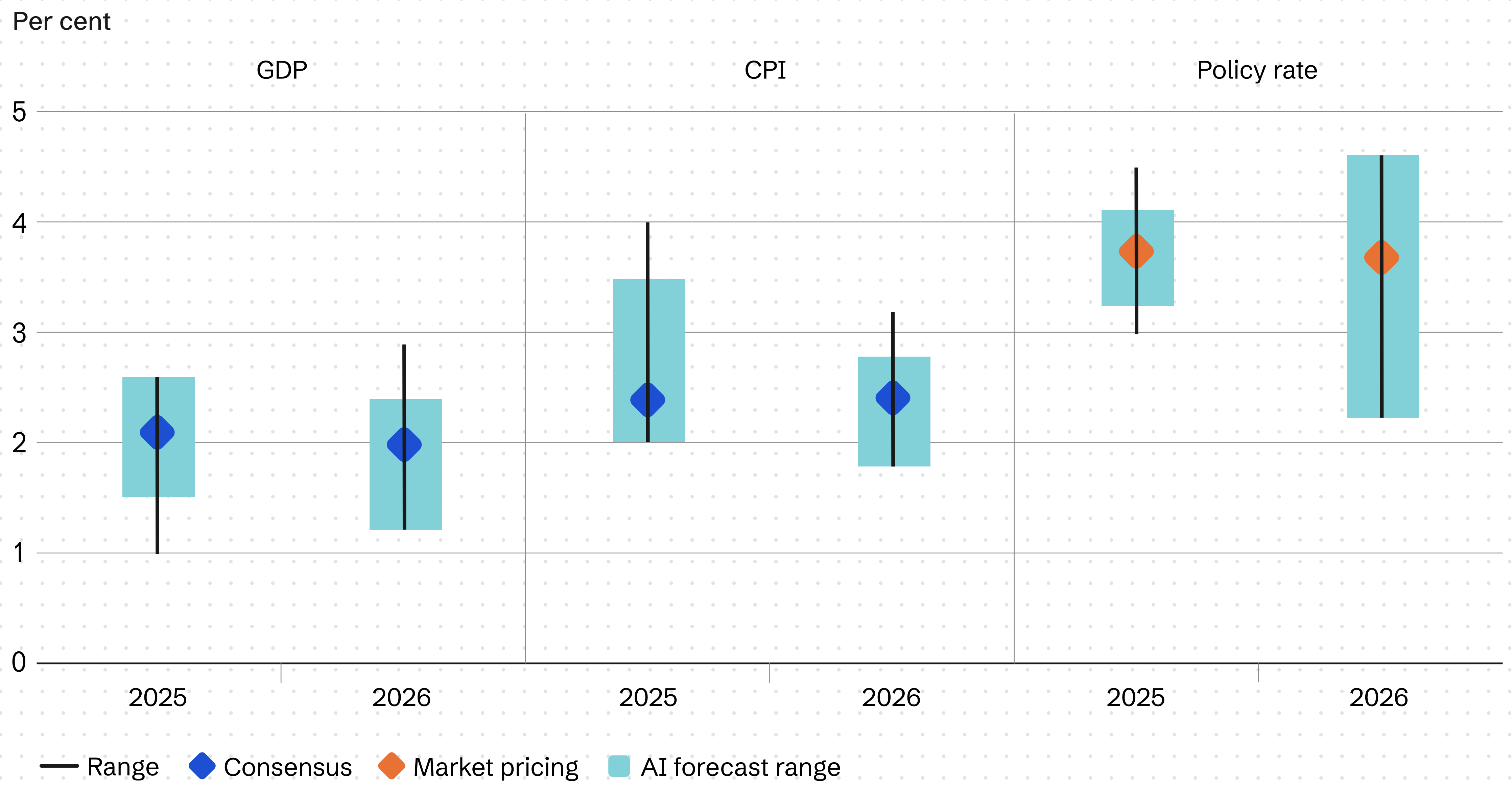
Macro forecasts charts and commentary

US

Growth in the US is expected to slow from above-trend rates seen in recent years to below trend in the second half of 2025, before re-accelerating in 2026. The slowdown largely reflects an expected softening in consumer spending, as real disposable income growth eases as the impact of ongoing restrictive monetary policy weighs on activity. The prospect of trade policy uncertainty and likely tariff measures are also expected to weigh moderately on growth H2. On the supply-side, the rapid increase in population growth seen in 2023 and 2024 is likely to also slow, as immigration declines, bringing trend growth lower as well. The recent surge in measured labour productivity is expected to abate, as growth slows. The potential impact on growth of policies under President Trump is likely to be wide-ranging. We assume that significant tariffs are imposed on China, but that they are more limited in other specific product areas. We expect that corporate tax cuts are delivered in the 2025 budget (likely Q3) and that the existing personal tax rates are maintained. There is likely to be some additional easing in income tax burden. The boost from tax changes, alongside a deregulation drive leads to the reacceleration in growth in 2026. The deficit is expected to widen moderately in 2026 from the already wide 6.5 per cent of GDP.

CPI inflation has proven to be somewhat sticky around 2.5-3 per cent on headline and 3-3.5 per cent excluding energy and food. That reflects service sector inflation (shelter and non-shelter) remaining high, with core goods contributing very little. We expect core services inflation to ease somewhat over the next 12 months, reflecting slower wage growth and some tightening in margins.

Figure 11. **US**



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.

Source: Aviva Investors, Bloomberg as at 31 December 2024.

However, the assumption on tariffs (which are assumed to be only partly offset by a stronger dollar) mean that core goods inflation picks up, leaving headline inflation in the 2.5-3 per cent range through 2025 and early 2026, before easing in late 2026 (Figure 11). That is an upward revision on our projection at the time of the last House View.

We expect the Fed will cut rates again in March and June 2025, but thereafter will be cautious in cutting further or faster given the mix of likely policies from the Trump administration and the underlying strength of the US economy.

The risks around the US outlook are considerable. They range from the potential breadth and magnitude of tariffs to the extent of tax cuts and regulatory measures. Overall, we judge the inflation risks to be skewed to the upside. The growth risks are more balanced (with a wide range of possible outcomes). If the upside supply risk dominates, then the Fed would once again be in a difficult position of having to balance higher inflation and lower growth. If demand shocks more than offset, then it is more straightforward, policy is unlikely to loosen much from here and they could be raising rates again by 2026.

Growth is expected to slow from above-trend rates seen in recent years to below trend in the second half of 2025, before re-accelerating in 2026

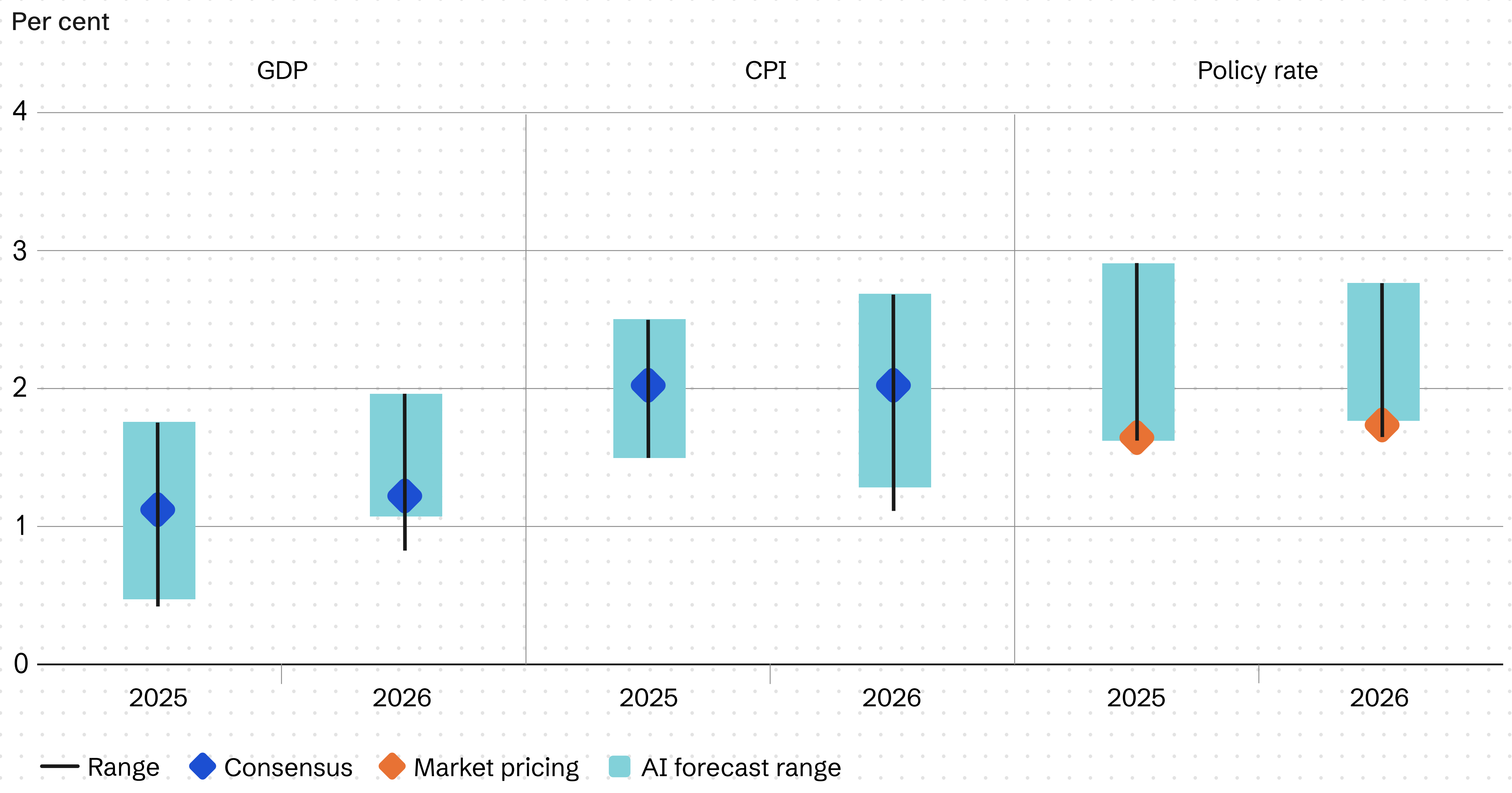
Eurozone

It will be a very challenging year for the euro area: potential trade disruptions will affect Eurozone growth directly and indirectly via externalities stemming from lower global trade; negotiations on Ukraine-Russia will heat up and a potential withdrawal of US support would have implications on the broader EU defence spending; Germany will also be heading to the polls in February and the result – a likely coalition led by the CDU – could trigger some fiscal expansion; finally, the EU is racing to issue record amounts of EU bonds so that it builds its necessary stock for NextGen fund disbursements, potentially even beyond the end of the programme in 2026. On balance, we expect growth will approximate 1.1 per cent in 2025 (with downside risks), about 0.3ppts lower than we anticipated before, while inflation should fall closer to target with the ECB cutting rates to 2.25 per cent (Figure 12).

Eurozone growth will be subject to downside pressure due to potential tariffs and the region's exposure to global trade. It is difficult to estimate the likely impact absent concrete measures, but the 2018 precedent suggests a hit to 2025 GDP growth of around 0.5ppts. However, underlying dynamics are not as weak as sentiment surveys suggest and the reduction in interest rates together with still positive real income growth and significant excess savings suggest that part of the hit will be absorbed. In sum, we reduce our 2025 real GDP growth forecast to 1.1 per cent from 1.4 per cent previously (assuming a hit of 0.5ppts due to tariffs and a cushion of c.0.2 per cent due to still low unemployment, positive real income growth and drawdown from savings).

Inflation will broadly fall over the course of 2025 as services inflation eases. However, (1) the trend in services inflation has stalled suggesting that the decline will be gradual; and (2) aggregate demand will not be as weak as generally assumed. Further complicating the picture are natural gas prices which have soared in 2H24. We see inflation returning sustainably to target in early 2026.

Figure 12. Eurozone



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.

Source: Aviva Investors, Bloomberg as at 31 December 2024.

The ECB has a clear dovish bias, and the likelihood of global trade disruption may be an additional catalyst to proceed with further rate reductions more rapidly. We have lowered our terminal rate to 2.25 per cent from 2.5 per cent previously due to weaker growth but we still push back against the terminal rate market pricing of 1.7 per cent. At such a level, real policy rates would return firmly into negative territory, which historically has been consistent with deeply negative output gaps, something unlikely to play out this time, absent a major shock.

On the fiscal front, the Eurozone budget deficit is forecast to be 2.8 per cent of GDP in 2025 from 3.1 per cent in 2024 and 3.6 per cent in 2023 - hence there is likely to be a modest fiscal drag, although part of it will be offset by lower borrowing costs. However, there is a great deal of uncertainty on (1) Germany's budget following the election of the new government (which appears likely to adjust the debt break); (2) defence spending; and (3) any potential response to trade policies. On balance, risks are skewed towards higher-than-forecasted deficits which would remove part of that modest fiscal drag. In addition, the EU plans a record-issuance for EU-bonds (around EUR150bn) for 2025 as it tries to build its stock of cash reserves for (later) distribution to member states via the Recovery Fund channel (NextGenEU).

Risks to growth and policy rates are skewed to the downside: trade barriers could be bigger in magnitude or scope and dent activity/aggregate demand by more than we expect; the complicated political landscape could result in Germany failing to raise fiscal support and/or the economy's industrial cycle not bottoming out in 2025 due to domestic or global factors; increasing uncertainty could "prevent" consumers from utilising their (excess) savings resulting in flat or declining household consumption growth. If so, then policy rates would be cut by more than in our baseline scenario.

Eurozone growth will be subject to downside pressure due to potential tariffs and the region's exposure to global trade

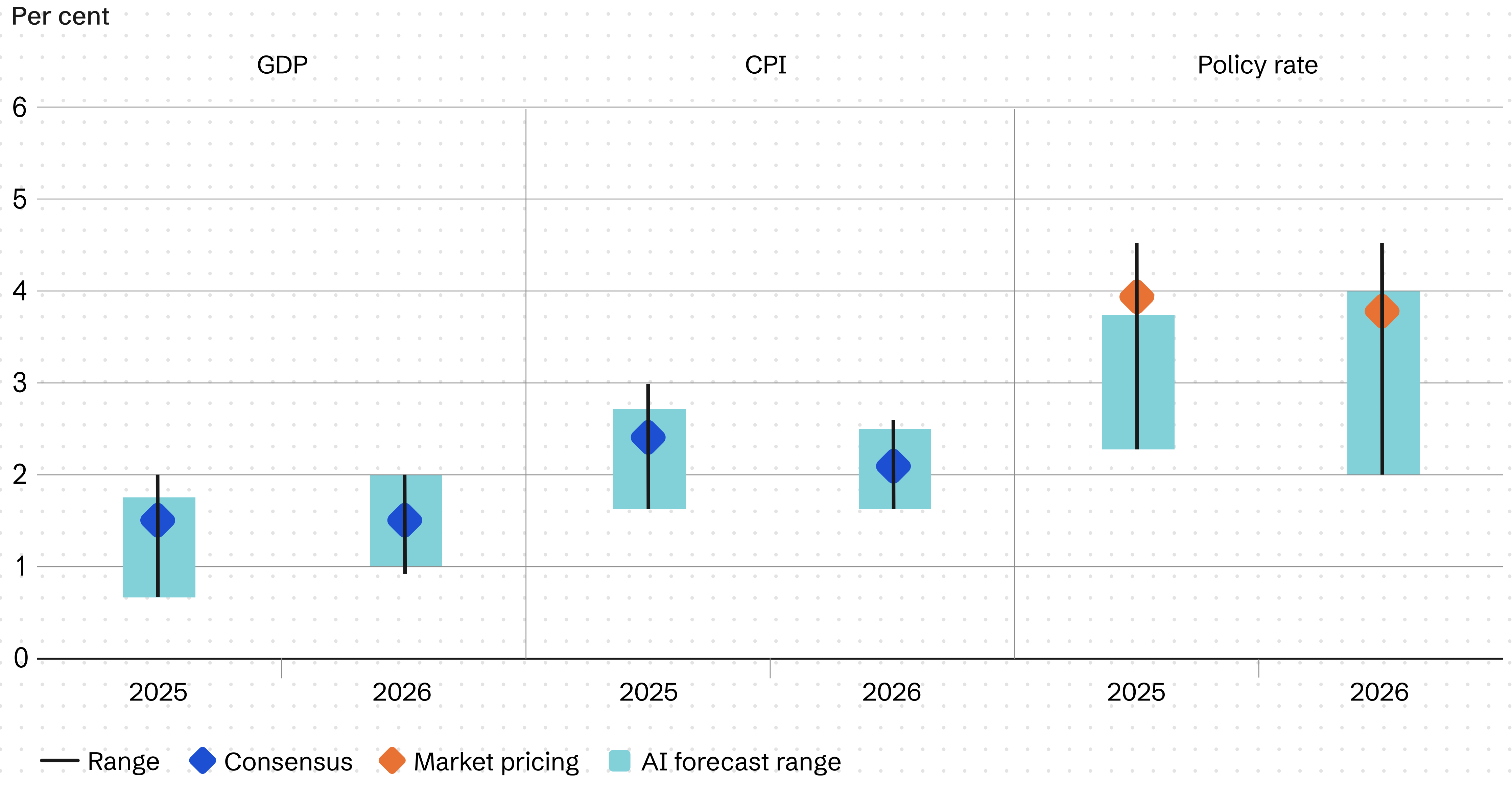
UK

The UK will find itself at crossroads this year: on one hand, domestic developments are clouded with uncertainty on the growth and inflation impact of the new budget and the monetary policy response. On the other hand, the new US administration poses considerable challenges to policy makers including direct and indirect impacts from potential tariffs and the role the UK will play in negotiations with the US over Ukraine-Russia talks and more broadly, as the government is entering a phase of resetting relationships with the EU and China. On balance, we expect growth will settle around 1.2 per cent in 2025 – much lower than the OBR and BoE forecasts. Uncertainty and initially high borrowing costs suggest a revival of private consumption is not in the cards. As a result, we expect the Bank of England to maintain a cautious stance early in the year but eventually be forced to slash rates towards 3 per cent (Figure 13).

Growth should pick up slightly to 1.2 per cent due to a materially lower fiscal drag (budget deficit as a share of GDP will likely be c.0.5 per cent higher than initially projected) but we see it as highly unlikely to achieve the forecasts produced by the OBR (2 per cent) and BoE (1.5 per cent). This is because of wage growth downside risks, further rises in unemployment and – at least, in the early part of next year – higher borrowing costs than previously assumed. Tariffs, global growth/trade deterioration and higher uncertainty will likely compound downside pressures.

We have revised higher our inflation projections to 2.0 per cent YoY for year-end: increased public spending adds upside inflationary impulses alongside potential tariff impact (in case of retaliation) but downside risks to wage growth, higher unemployment, and higher yields initially will offset part of the move. Businesses' National Insurance Contributions (NICs) will increase employment cost but profit margins are falling, signalling increasingly reduced pricing power by firms: wage growth and employment are likely to absorb most of the impact.

Figure 13. UK



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.

Source: Aviva Investors, Bloomberg as at 31 December 2024.

As a result of the initial budget uncertainties, the BoE will likely remain cautious in the early part of 2025. In line with consensus, we see two more cuts by May 2025 (to 4.25 per cent) but then believe the BoE will accelerate its easing cycle, bringing rates to 3 per cent by the end of the year.

The budget announcements now suggest a materially lower fiscal drag in 2025, while the surge in yields puts upside risks to the budget deficit – as well as having wiped out the government's headroom. All this complicates fiscal management and should be one of the key risks to watch in 2025.

On the international scene, it is becoming increasingly apparent that the UK will have to make a choice of either resetting its relationship with the EU (and maybe China) and subject itself to potential tariffs for exports to the US or align with the US to minimise erection of trade barriers and distance itself further from its major trading partner. In our base case, we think the UK will opt for the former, something which has been part of the Labour government plans.

We see risks to our baseline scenario as tilted towards a mix of lower growth and more persistent inflation: if firms manage to pass on some of the higher employment costs to prices, price growth will remain sticky but this in turn will exacerbate pressure on (hand-to-mouth) consumers, amidst lower wage growth and rising unemployment. This would put the BoE between a rock and a hard place: in all likelihood it would delay further policy easing but ultimately would result in deeper and faster cuts later.

We expect the Bank of England to maintain a cautious stance early in the year but eventually be forced to slash rates towards 3 per cent

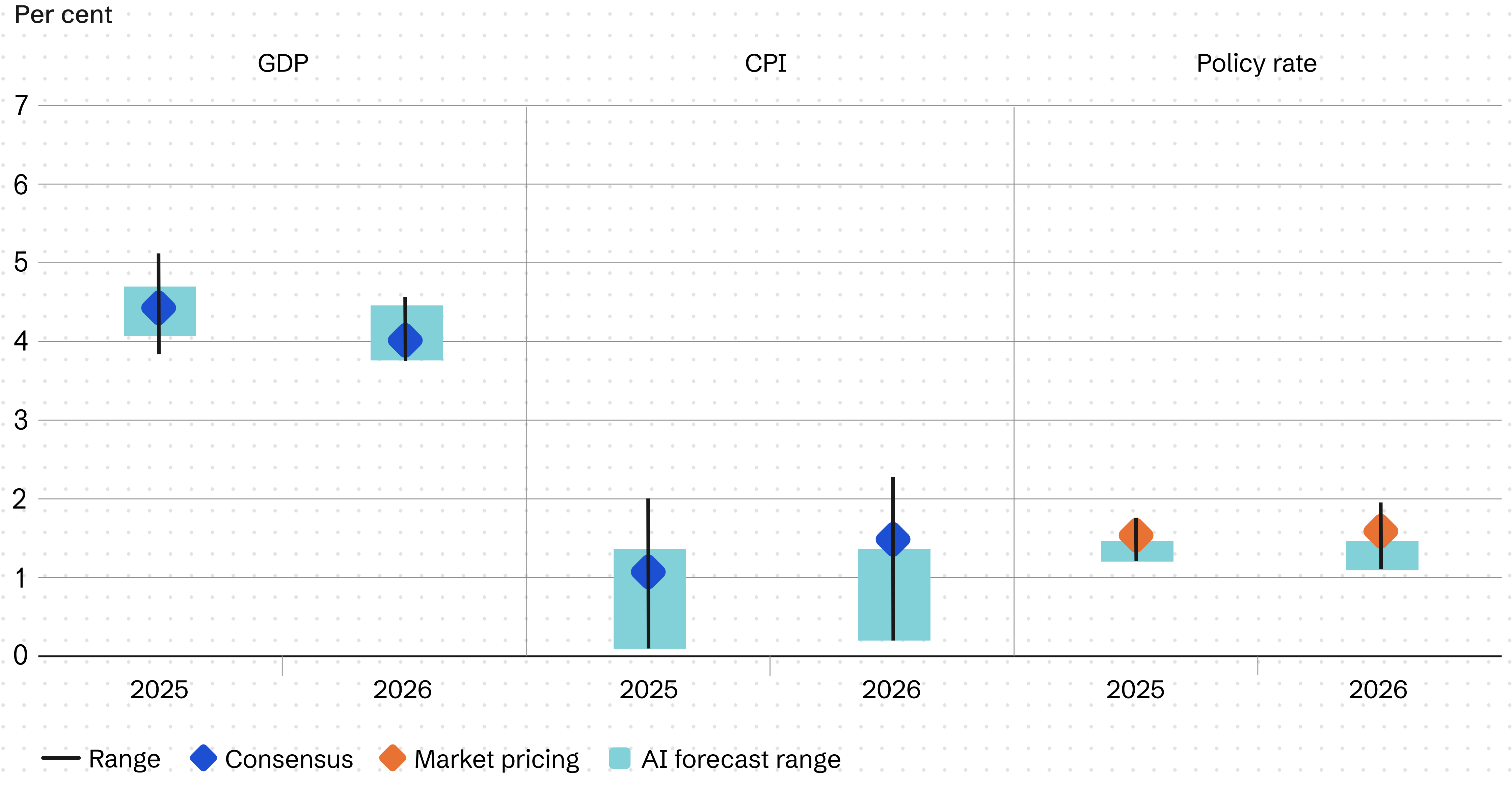
China

After a difficult year economically for China, things are about to become even more challenging. The election of Donald Trump for his second term as US president makes a storm of sanctions, restrictions, quotas, and of course, tariffs a certainty. What remains less clear is the exact sequencing and size of those attacks on China's trade with the US, as well as Beijing's response. The direction is clear: China's exports and growth will be hurt, even if some can be rerouted or sold to other nations, while growth will decelerate further from the already weak (for China!) starting point (Figure 14).

The varied "stimulus" announced by policymakers in Q3 was more than a damp squib, and activity picked up slightly going into Q4. This will help 2024 GDP approach the "around 5 per cent" goal, but it is not a hard target and we, and consensus, expect the reality to fall a little short. December's Politburo meeting and Central Economic Work Conference delivered announcements of "moderately loose" monetary policy and "more active" fiscal policy. This indicates that President Xi and other senior officials are responding to continued slowdown, and will continue to respond to and cushion the deteriorating macroeconomic situation. In 2025 and 2026 GDP will continue to grow, but decelerate towards 4 per cent. Some exports may be brought forward ahead of tariff risks, but this will likely mean exports are challenged in coming quarters, and investment may also face a chill. That said, manufacturing – including tech broadly and EVs, batteries, and solar panels – is roaring, with industrial production growth around 5 per cent y/y, causing disinflation pressure and protectionist reaction abroad.

The property downturn that began in 2021 is set to continue through this decade, after years of overbuilding peaked just before a long decline in an ageing population; the supply overhang is deflationary and dampening everything from consumer sentiment to the land sales that were, for decades, the main cash cow for local governments. This source is permanently damaged, as are household balance sheets, with property prices falling.

Figure 14. China



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.

Source: Aviva Investors, Bloomberg as at 31 December 2024.

Local entities were failing to pay workers and suppliers in full or on time, and could not keep up the infrastructure push that was required to meet the arbitrary growth targets; the central government finally relented and allowed for bond issuance and swaps to supply fresh funds. The losses and non-performing loans will be cleaned up at a future time, at a greater cost than previous restructurings.

We expect CPI to remain close to zero, and PPI is likely to stay in negative territory amidst fierce competition. Tariffs imposed by the US, and anti-dumping measures and other protectionist or geopolitically motivated sanctions will hurt exports and terms of trade, and also result in continued negative net FDI; this will pressure the currency. The war in Ukraine may be paused, but China's support for Russia will continue to be costly, and the US is likely to ramp up restrictions unilaterally, and pressure others to follow – as they have under President Biden. With an immense (nearly $1 trillion annual) trade surplus, and burgeoning foreign assets (over $3 trillion), the PBOC should be able to keep a handle on the FX rate even as it provides liquidity, cuts rates further to 1.5 per cent or below, reduces required reserves, and weakens the CNY (probably to 7.6-7.8 by end-2025 against the dollar) to retain competitiveness against more flexible DM and EM currencies, against which it will in fact appreciate.

After a difficult year economically for China, things are about to become even more challenging

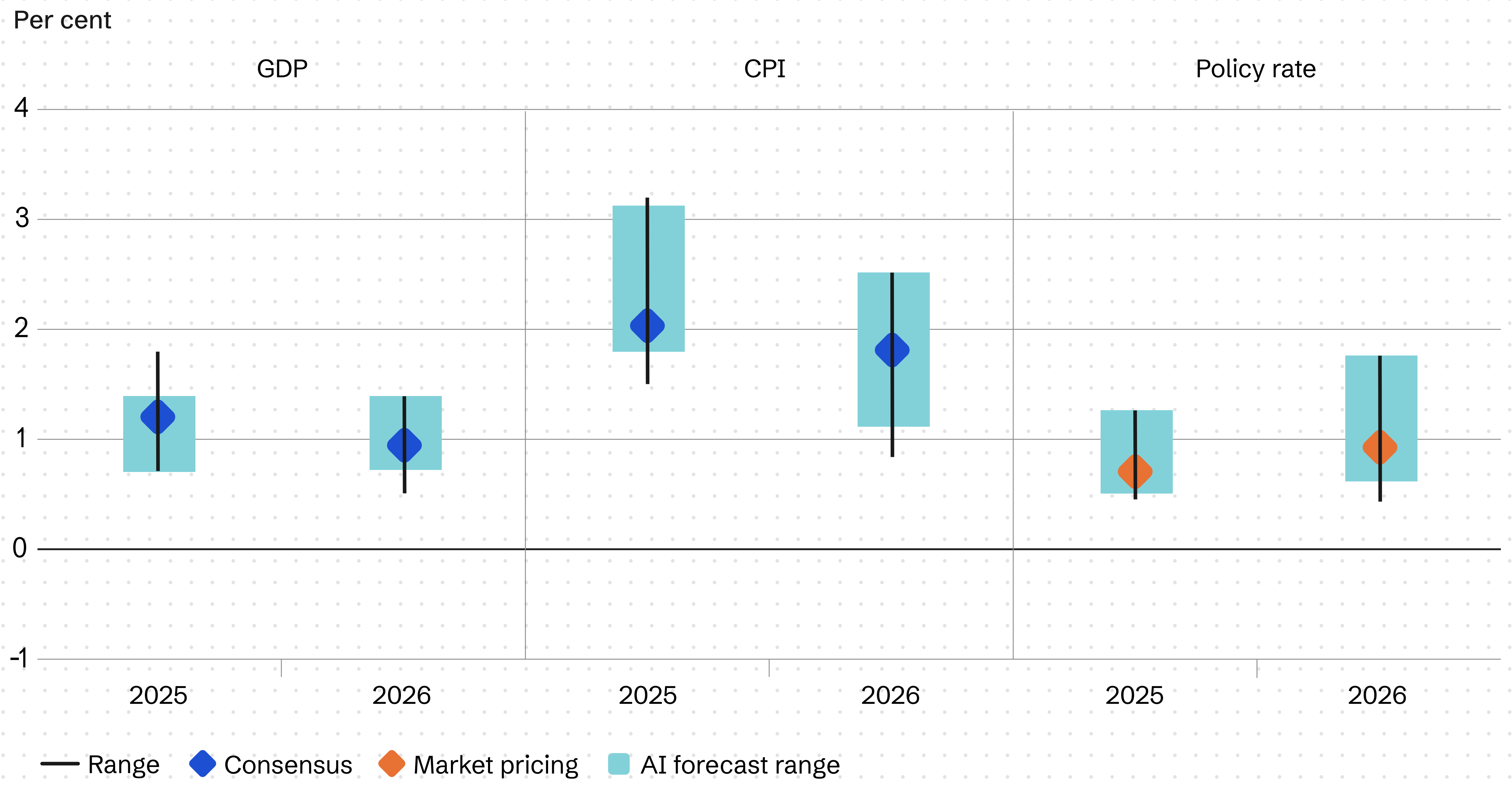
Japan

Following a surprise outcome in the snap election that saw Prime Minister Shigeru Ishiba and his LDP lose a majority, the economic outlook for Japan is surprisingly bright. This is in part because the coalition partner will push his minority government to add fiscal stimulus via tax cuts. Along with wage rises that have continued to push inflation to 2 per cent or above, and extremely low BoJ rates, we see GDP improving to above a 1 per cent growth rate in coming years (Figure 15).

There are two-sided risks: sharp yen weakness and inflation did cause consumption to weaken temporarily in 2023, and China and EU economic weakness and trade tensions could hurt exports, which have been a bright spot – rising around 3 per cent y/y in real terms. Yet Japan's economy is not all that dependent on trade, even though it has many world-class multinationals. Domestic consumption should be helped by wage increases and post-tax disposable income, although this will face the chronic headwinds of ageing and a shrinking population. Domestic cap-ex is also a bright spot, as the labour shortage forces firms to seek efficiency gains through digitalisation, artificial intelligence and automation. Income from foreign assets, which total ¥1.7 quadrillion ($11 trillion), and a net international investment position of $3.6 trillion, are additional supports for both corporate earnings and household incomes.

While reflation is a success story, higher prices are never popular and the government is once again likely to reduce utility and other regulated prices through subsidies. These have come on and off since Covid and the energy inflation of past years, and make exact forecasting of CPI impossible due to base effects.

Figure 15. **Japan**



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.

Source: Aviva Investors, Bloomberg as at 31 December 2024.

Nonetheless, core CPI is sustainably above 2.0 per cent, giving the BoJ confidence to hike slowly. With little priced into the curve and recession risk low, JGB yields should face upward pressure and rates should reach 1-1.5 per cent in the next 12-18 months; getting to a rate of 2.0 per cent will require inflation to stay above 2 per cent afterwards. Yen weakness is most likely structural, but bouts of strength can occur, as the July-August carry unwind episode showed; the catalysts of such flareups will most likely be a mix of positioning and Fed dovishness, though MoF intervention may play a role again, too.

> Following a surprise outcome in the snap election that saw Prime Minister Shigeru Ishiba and his LDP lose a majority, the economic outlook for Japan is, surprisingly brighter

Canada

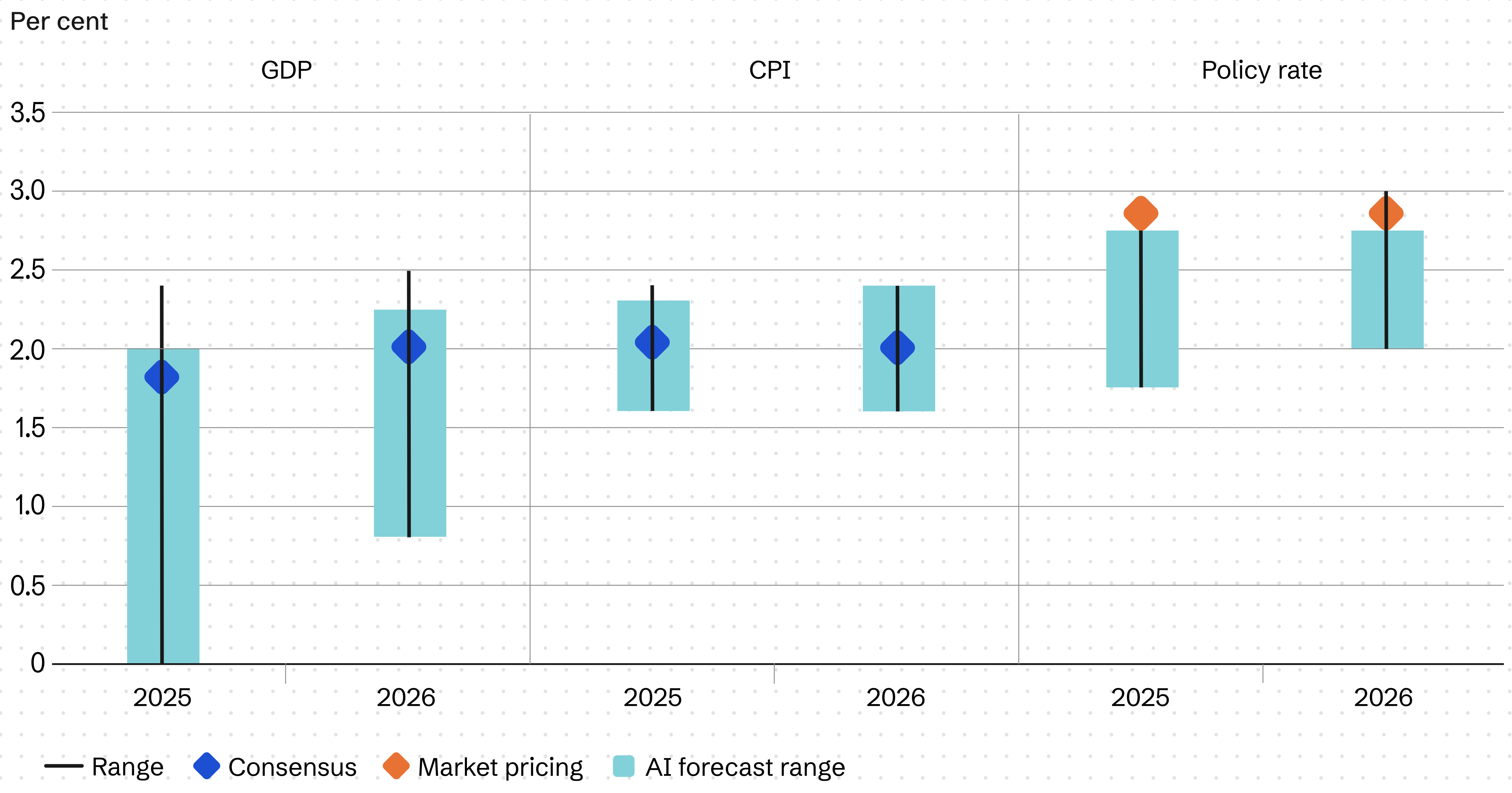
2024 has arguably seen the balance of risks around inflation shift to the downside. Quarterly annualised real GDP growth has averaged c.2 per cent thus far this year, an improvement upon 2023 but still well below the BoC's estimates of potential growth. As of October, prices rose at a 2 per cent YoY – a pace that is comfortably within the BoC's target range. Whilst the BoC have not been idle, lowering the policy rate by 125bps to 3.75 per cent, we still expect further easing in 2025 (Figure 16).

Much of Canada's growth in 2024 has been driven by government expenditure, growing at a 4.2 per cent quarterly annualised pace thus far this year. Whilst, thanks to recently announced measures, this support may continue in the short term, we expect this tailwind to fade in the latter half of 2025. On the supply side, recent shifts in immigration policy from the incumbent government, should curtail population growth next year. Given that per capita growth has been negative, on average, since 2022, there will be significant pressure upon policymakers to revive the currently anaemic business investment and productivity in Canada.

Canadian labour markets have continued to loosen, with the unemployment rate rising to 6.53 per cent from 5.77 per cent at the start of the year. This increase in unemployment is more than just a "supply story", given the softness seen in employment growth as well as the weakness evident in end demand. In other words, the slack we have seen in the national accounts is being reflected in the labour market.

Yet wages, whilst having softened, remain sticky; however, we continue to expect wage growth to decelerate into the first half of 2025. We expect an elevated volume of mortgage renewals in 2025; this should continue to constrain discretionary spending and keep the savings rate elevated, as it has done thus far in this cycle. Should wage growth endure, this would likely mitigate the drag on consumption from the ongoing mortgage resets, as opposed to causing any reacceleration in inflation.

Figure 16. Canada



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.

Source: Aviva Investors, Bloomberg as at 31 December 2024.

As has been the case throughout the year, shelter remains the main source of upward inflationary pressure. Yet the outlook for shelter is now relatively sanguine; house prices seem to be decelerating, whilst the new immigration policies should add to the cooling of the rental market. Removing the shelter component reveals the downside risks to inflation, with CPI ex Shelter currently running at a sub-1 per cent YoY pace.

As of Q3 there remains a negative output gap in Canada. This, until closed, will continue to place downward pressure upon inflation - which is already at target. Given that inflation expectations appear anchored, the BoC should have considerable room to lower its policy rate further. The BoC have arguably indicated their tolerance for divergence from the Fed over the course of the year, whilst we believe the currency has much further room to depreciate before it becomes a constraint on policy via imported inflation. The prospects of tariffs may complicate the near-term cadence of the easing cycle, but we nonetheless envisage the BoC cutting to a terminal rate of 2.25 per cent by 2025 with risks skewed to the downside.

Much of Canada's growth in 2024 has been driven by government expenditure, growing at a 4.2 per cent quarterly annualised pace thus far this year

Global market outlook and asset allocation

- US equities seem well positioned, with a robust earnings growth outlook amidst resilient economic activity. Absent a major shock, we expect the US to keep outperforming.
- In rates, we think there is an increased risk of higher long-term rates and steeper curves owing to US solid economic performance and some higher fiscal premium.
- In FX, we expect a stronger dollar – especially against Asian currencies – at least in the first part of 2025.
- Credit spreads have tightened considerably and the odds are low for a repeat performance in 2025, but unless the negative risk plays out, bouts of widening may prove temporary and should retrace.

Global market outlook

2024 was a year of strong equity returns but with dispersion across regions. Developed markets outperformed EM and the US led across DM. In parallel, the year saw: (1) higher longer-term yields and steeper curves as central banks began the process of monetary policy easing; and (2) the dollar strengthening by c.5 per cent. Policy normalisation is now entering a more mature phase, where discussions about the range of neutral rates will become more prominent, while political shifts in all major economies are likely to result in even slower fiscal consolidation.

While equity valuations look elevated, especially in the US, it is also hard to make a compelling argument for valuations to move lower. This suggests that earnings take over from multiple expansion and become the major contributor to returns in 2025. If that scenario is correct, US equities seem still well positioned, with a robust earnings growth outlook amidst resilient economic activity. Absent a major shock, we expect the US to keep outperforming, especially relative to European peers where EPS forecasts are weaker and external headwinds to growth are rising owing to potential global trade disruptions.

In rates, we think there is an increased risk of higher long-term rates and steeper curves as a result of solid economic performance and some higher fiscal premium. We think Fed pricing (65bps of cuts in 2025) is broadly fair; however, the path of rates in Europe is very uncertain: on the one hand, market pricing of monetary policy easing appears aggressive, and core European yields have undershot their fair value levels but, on the other hand, a significant slowing in global growth trade would be suggestive of lower yields.

We expect some upside in European yields but see this as capped due to the weakening external backdrop. In the UK, we still expect the BoE to cut rates more than markets have priced and see further curve steepening reflecting some fiscal premium at the long end of the curve. Finally, Japanese rates should continue to (gradually) increase as the BoJ proceeds with tighter monetary policy.

In FX, we expect a stronger dollar – especially against Asian currencies - at least in the first part of 2025 due to potential tariffs, weaker global growth/trade, and flight to safety.

Finally, in credit, we note that spreads have rallied across IG and HY and ended the year at historically tight levels; this is supported by strong demand absorbing supply easily and the monetary and business cycle. We think the odds are extremely long for a repeat performance in 2025, but unless the negative risk plays out, bouts of widening may prove temporary and should retrace; in the medium term, more risk premium would be needed to recommend a meaningful allocation.

Equities: All about earnings

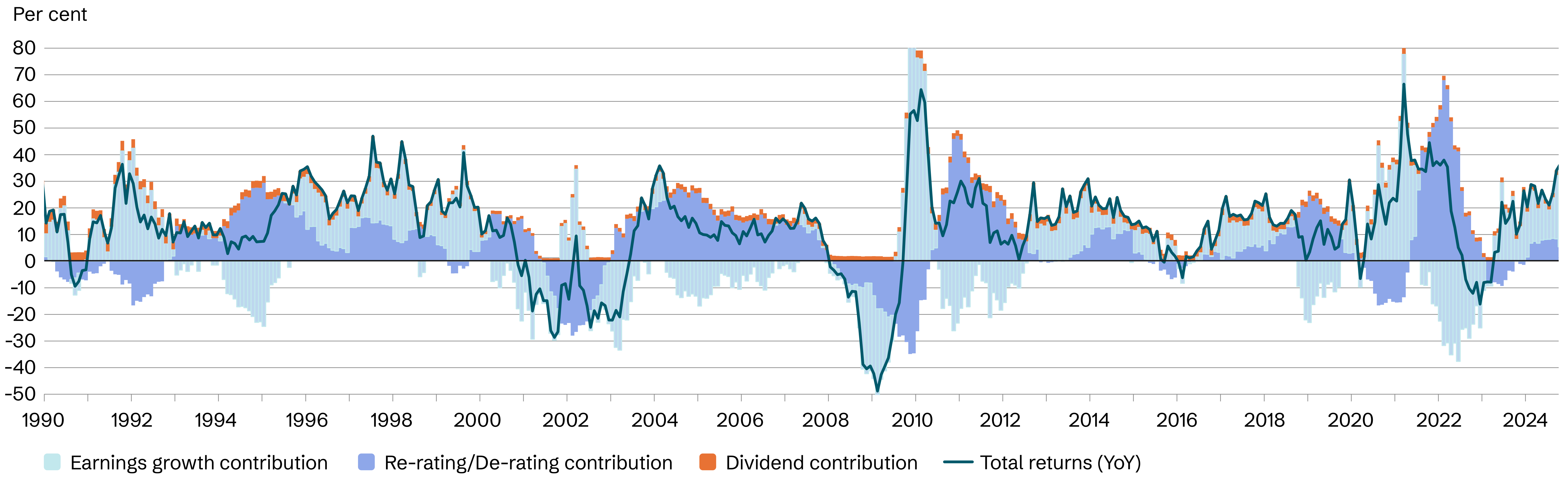
The strong performance of equities over the last two years has been by and large a story of valuation expansion. P/E re-rating has been the major contributor to equity returns with earnings growth having a negative contribution to returns through most of 2023. Only when we moved into 2024 did earnings growth start to account for a more significant component of total return, especially in the last six to nine months of the year. But even then, multiples continued to be by far the largest contributor (Figure 17).

After such a prolonged period of re-rating, it should come as no surprise that equity valuations look elevated. It is widely understood that the US is the main driver of those high valuation multiples, but what gets less attention is that other regions also fail to offer depressed valuations (to put it simply: other regions only look "cheap" when analysed in relative terms compared to the US; they do not look "cheap" in absolute terms). Forward P/Es in Asia ex-Japan trade at high levels compared to their own history (circa 1 std deviation above long-term average). Japan, Europe and EM trade broadly in line with their respective historical averages.

With all that in mind, it is hard to make a compelling case for continued valuation expansion into 2025 for any region. However, in our base case we also see no clear reason for valuations to move significantly lower. The environment suggests we should see minimal change in valuations. Hence, the earnings contribution and multiple expansion contribution to equity returns are likely to trade places, with earnings becoming the major contributor to returns this year. That is true for the US where valuations are historically elevated, as well as for Europe or EM where valuations are more in line with historical average.

> After such a prolonged period or re-rating, it should come as no surprise that equity valuations look elevated

Figure 17. Decomposition of S&P 500 total returns - Multiple expansion has been the driver of returns



Source: Aviva Investors, Refinitiv Workspace as at 31 December 2024.

And when it comes to earnings, the US still appears to have the upper hand

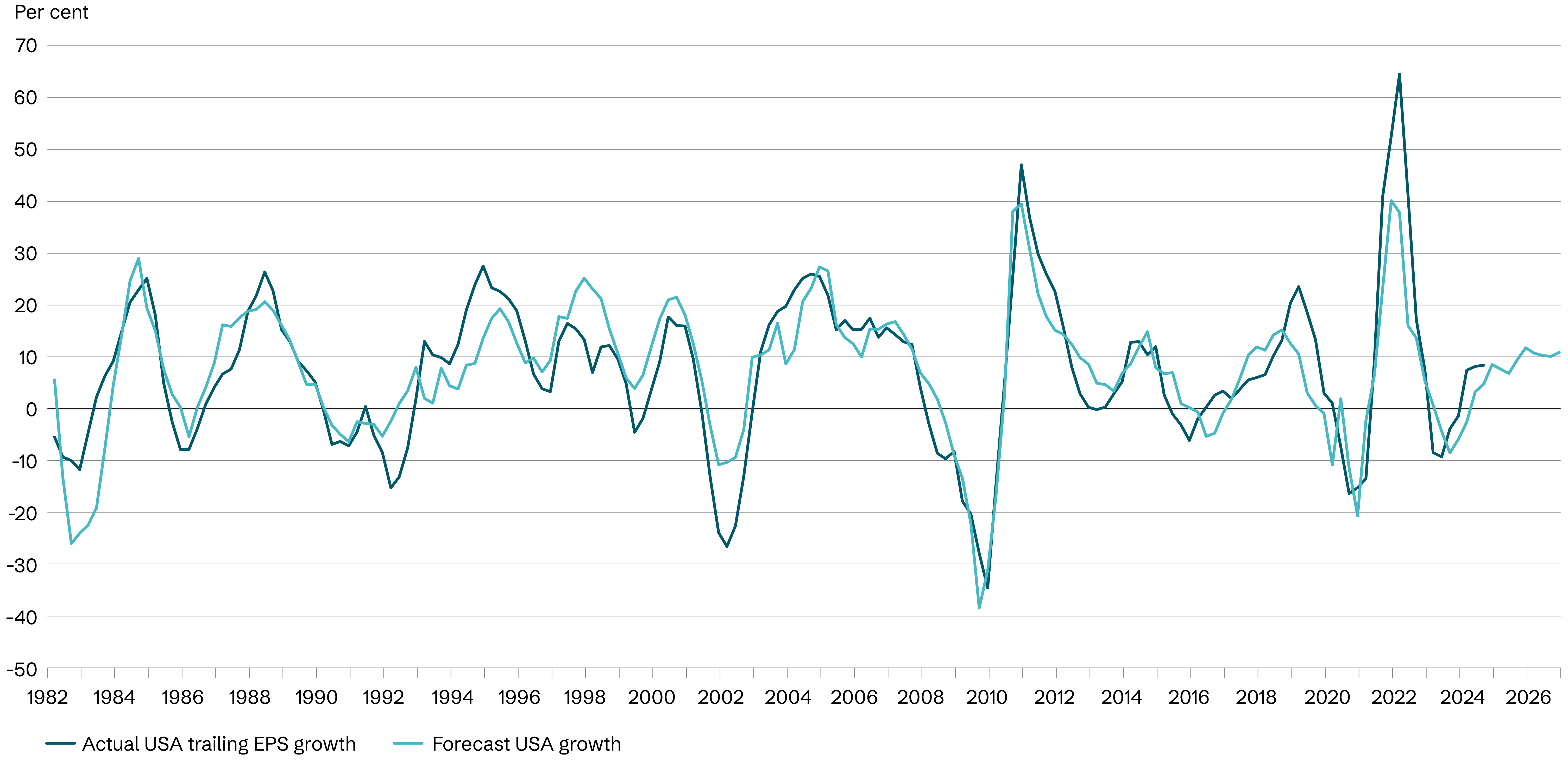
When building our equity expectations for the year, we use our House View macro forecasts as inputs into our quantitative US earnings model. If our economic base case is correct, our model (Figure 18) suggests 11.7 per cent EPS growth in 2025 for the S&P 500 (somewhat below current consensus expectations of c.14 per cent). EPS growth then broadly plateaus from there, ending 2026 at 10.9 per cent (again below current consensus of c.13 per cent).

Clearly there are many external factors at play, such as potential tariffs, tax cuts, productivity changes (driven by artificial intelligence or otherwise), etc. None of these variables can be comprehensively captured by a quantitative model based on economic indicators, even if predicted policy changes are incorporated into GDP, rates, profits, and valuations. That being said, the model's outcome seems reasonable to us. US earnings are in a process of broadening out, where the "magnificent 7" contribution to overall earnings growth is contracting from high levels while the remainder of the index (especially mid and small caps) is recovering from a period of weak growth.

All in all, there appears to be reasonable visibility on US earnings and growth is likely to be robust this year. In a scenario where valuations are likely to play a reduced role in returns, that puts US equities in a strong position in 2025.

> There appears to be reasonable visibility on US earnings and growth is likely to be robust this year.

Figure 18. US earnings model - the US earnings outlook appears robust



Source: Aviva Investors, Refinitiv Workspace as at 31 December 2024.

What about Europe? Can equities catch up?

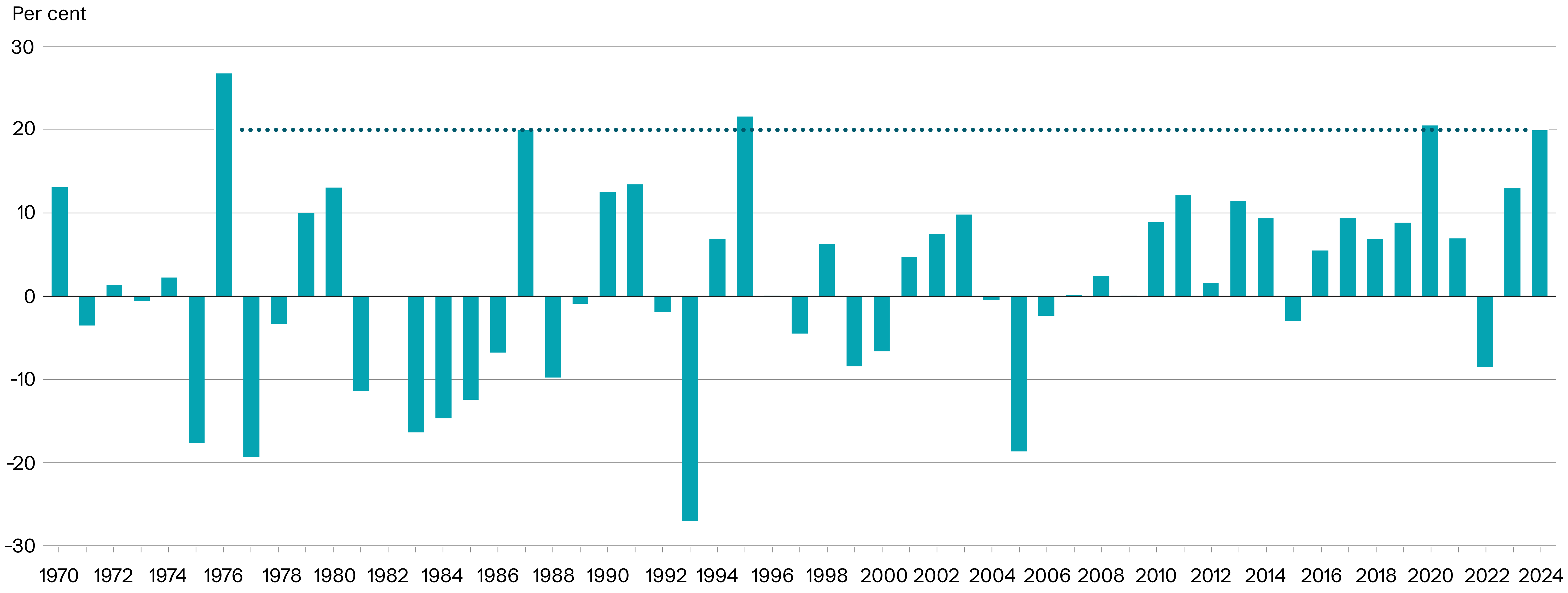
European equities appeared to have a window of opportunity to recover some lost ground vs the US earlier in 2024 and European stocks outperformed their US counterparts between February and May. However, following the European parliament elections and the announcement of snap elections in France, that outperformance reversed and over the whole year the US has shown one of the strongest outperformances over Europe since 1976 (Figure 19).

The sharp US gain might suggest an element of reversal (that happened in two of the last four years when US outperformance was of similar or greater magnitude – 1976 and 1987 – however, in 1995 US and European stocks performed in line the following year and in 2020 US equities continued to outperform in 2021). It is key to highlight here that 2024 European returns were actually very healthy; total returns in Europe were c.11 per cent and the outperformance came from US strength, rather than European weakness, suggesting there is no "trough" from which Europe would bounce back from. That, in addition to an environment where earnings growth is likely to drive returns and US earnings appear more robust, suggests European equity outperformance is unlikely.

Applying our central scenario to the European version of our EPS model points to 3.6 per cent EPS growth in 2025 (vs consensus 8 per cent) and 6.8 per cent in 2026 (vs consensus 11 per cent). That implies not only weaker growth in European earnings than in the US but also a bigger gap to consensus and hence sharper earnings downgrades.

All in all, for European equities to reverse the underperformance of 2024 we would need to see a shock which changes the scenario described above. This could come either via a negative surprise that knocks down US earnings expectations and with that US valuations (e.g. US yields rise too much, too fast or the artificial intelligence growth driver disappoints greatly) or via a positive development that significantly boosts European earnings expectations and leads to European equities re-rating to historically high levels (e.g. a "bazooka" China stimulus). Outside of a large magnitude shock, the baseline scenario is one that supports a continuation of US outperformance at a slower pace, rather than a reversal.

Figure 19. US vs Europe annual equity performance - 2024 was one of the strongest years of US outperformance in history



Source: Aviva Investors, Refinitiv Workspace as at 31 December 2024. NB – Returns in local currency.

Fixed income: Active fiscal policies shift the focus to the long end

While 2024 marked the beginning of major central banks easing policy and precipitated steeper curves, it also saw a material rise in longer-dated yields, mostly in the UK. Japan was the “exception” with higher yields against a backdrop of gradually tighter monetary policy.

Before looking into regional dynamics for 2025, it is worth making an observation on a global scale which we think will dictate fixed income market developments over the next year or two: the pandemic has created a precedent for more active fiscal support, irrespective of the phase of the business cycle; and President Trump policies look likely to add to this trend. One needs to look no further than revisions in consensus expectation for budget balances of G3 economies (Figure 20): the initially slow fiscal consolidation envisaged is very likely to be even slower or halted over the next two years, sustaining budget deficits at 5 per cent of GDP – this does not take into account likely increases in defence spending as well as potential tariff-related fiscal responses.

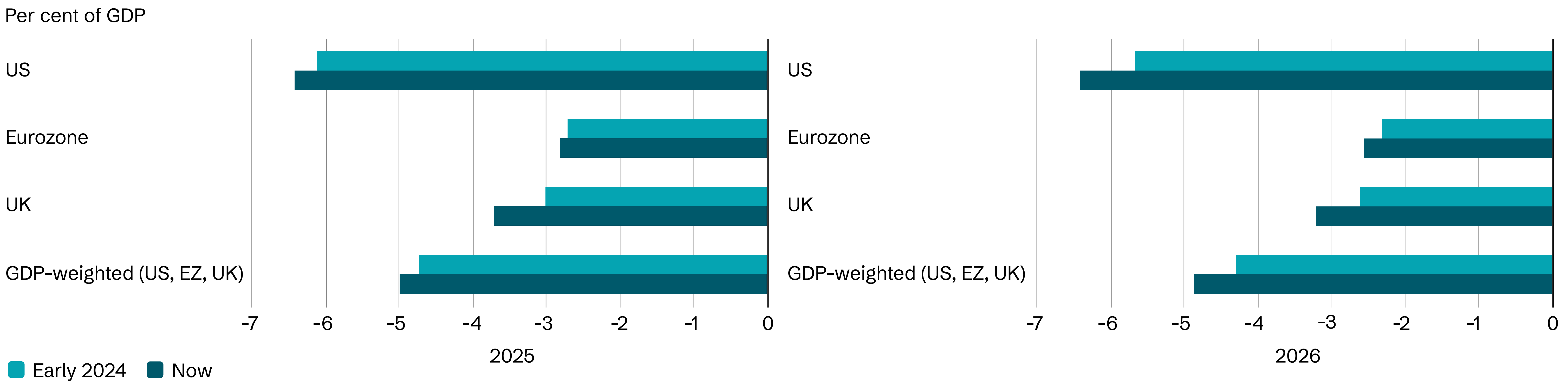
Hence, while monetary policy easing will maintain focus on the short-end of the curve, we think there will be an increasing focus at the long-end with the pricing-in of higher risk premia. Notwithstanding individual economy idiosyncrasies, on balance we expect higher long dated yields and steeper curves.

On a more granular/geographic level:

- With a strong economy, we find Fed market pricing broadly fair, though fiscal/trade policy uncertainties pose some risks for fewer cuts. We expect upside pressures on the long-end of the curve: our Fair Value (FV) framework shows the current US10Y yield at equilibrium, while future economic performance and fiscal policy suggest potential for moves higher. Consequently, we anticipate higher longer yields and a steeper curve; 30s10s looks more attractive relative to 10s2s, given its historically low level.

- The path of EA rates/yields is challenging to assess: low growth, potential trade barriers, and rising political risks in France and Germany suggest lower policy rates and long-dated yields. However, ample consumer savings, a likely increase in German fiscal spending, and record EU bond issuance for 2025 could support growth. Resilient consumption and sticky services inflation imply the market’s terminal rate of 1.75 per cent is too low. Our FV model shows 10Y Bund yields are at present undershooting by nearly 80bps. Hence, we expect some upside in longer-dated core European yields, but growth headwinds may limit this, keeping the spread with US yields wide. We do not foresee significant steepening in the yield curve because we anticipate the ECB will ease by less than the market expects, though 30s10s could rise due to global steepening.

Figure 20. Consensus forecasts for budget balance

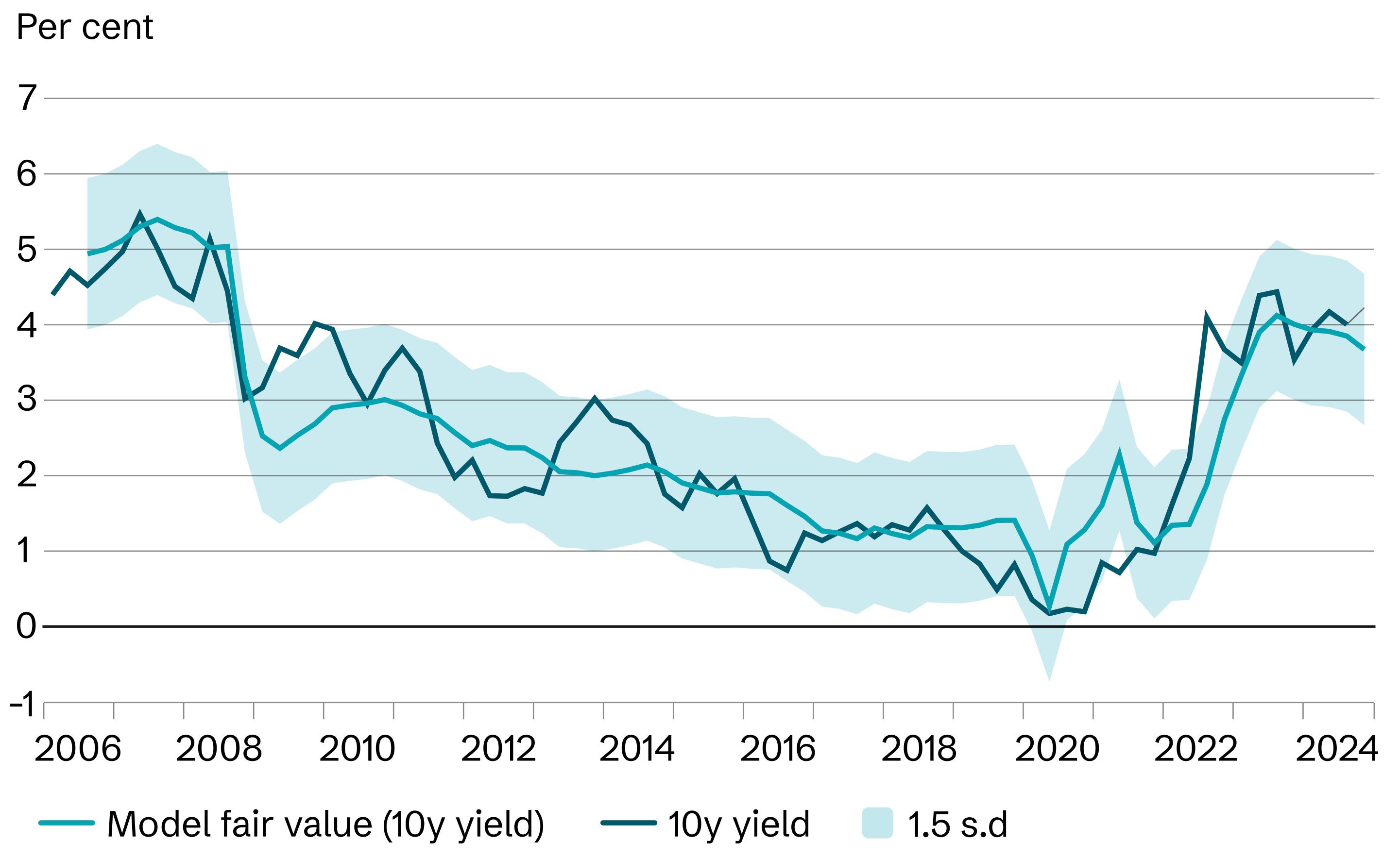


Source: Aviva Investors, Macrobond as at 31 December 2024.

While 2024 marked the beginning of major central banks easing policy and precipitated steeper curves, it also saw a material rise in longer-dated yields

- The UK has seen the sharpest increase in 10Y yields among major developed market economies and a strong steepening of the 10s2s curve. The BoE's cautious stance early in 2025 will likely keep policy rate expectations and longer-dated yields elevated. However, we expect the BoE to cut rates close to 3 per cent later in the year as growth falls short of officials' forecasts, employment declines, and inflation nears target. The two vulnerabilities we see are: (1) anaemic household consumption on the back of rising yields/mortgage rates in 2024; and (2) the NICs increase in April 2025 will be mostly absorbed by lower employment and lower wage growth. We expect longer-dated yields to be supported at higher levels early in the year, declining later as the policy rate reprices lower and 10Y yields close the gap with our estimate of FV (see Figure 21). Higher risk premia will further steepen the curve, though forwards (in 10s2s) have already moved ahead of spot by 70bps. We also expect UK-US yield spread compression during the year.
- Japanese bonds performed poorly in 2024, with yields rising by 50bps in the 10Y tenor; however, the curve flattened due to the beginning of BoJ's hiking cycle. On the inflation front, both headline and core appear to be sustaining above the 2 per cent YoY level, while cash earnings growth – while having declined recently – remains firmly above the 2 per cent annual level. Notwithstanding some political hurdles, all this should strengthen the central bank's confidence to normalise policy further. The market is pricing close to 50bps of tightening for 2025, which we think is likely to be surpassed. Consequently, we expect higher yields across the board and further flattening of the curve.
- Elsewhere, we believe in owning duration in countries with weak economic performance and/or low odds of upside activity into 2025 such as Canada, New Zealand and Switzerland as well as Australia, where growth is subdued but yields remain historically high. Finally, we expect that persistent disinflationary forces and the threat of tariffs is likely to result in even lower Chinese yields.
- Turning to credit, what has been a rocky year up until August has transformed into a very solid performance, with spreads ending 2024 at historically tight levels. Creditworthiness has improved, with upgrades in the US in particular; in Europe spreads have weathered the German industry malaise and French political turmoil. Although IG has underperformed cash YTD, that is mainly because yields started "too low", with the market erroneously pricing in rapid Fed cuts; excess return to treasuries has been an impressive 2.5 per cent, through December; spreads are sub-100bps in both Europe and the US. HY benefits from lower duration, with total return of nearly 9 per cent and excess return approaching 5 per cent; spreads compressed during 2024 from a low 325bp to a miserable 260bp. That is usually a poor risk-reward, yet prefunding and good market technicals (large prefunding, and sizeable inflows including retail attracted by headline yields), along with BoE, Fed, and ECB cuts can keep spreads in check. The odds are extremely long for a repeat performance, but unless the negative risk plays out, bouts of widening may prove temporary and should retrace; in the medium term, more risk premium would be needed to recommend a meaningful allocation.

Figure 21. UK yields are below fair value



Source: Aviva Investors, Macrobond as at 31 December 2024.

Our expectations of higher longer-dated yields and steeper curves are based on strong economic performance (mainly in the US) and active fiscal policies. The main risk to our view is a reversal of these forces, either through policy inaction (relative to announcements) and/or a significant deterioration in the US labour market. Outside the US, EA rates/yields risks are two-sided: tariffs or rising political risk premia could lead to more ECB cuts and lower yields by dampening activity further, while faster consumer spending (financed by savings) could support growth more than we expect. In the UK, persistent inflation/ wage growth could delay rate cuts, but – if so – we would still expect faster and deeper policy easing later.

FX: The dollar rally has further to run

The trade-weighted USD appreciated by c.5 per cent Q4 24 and c.2.8 per cent since the US elections. By our estimates, only about 0.4ppts of the 2.8 per cent gain can be attributed to “Trump policies premia” with the rest accounted for by solid US data and rate differentials.

In our baseline scenario which envisages further US fiscal expansion and tariffs, we think that the dollar rally is far from over.

There are two main channels that USD appreciation can operate:

1. Wider US-RoW interest rate differentials due to US inflationary impulses from import tariffs.
2. Weaker sentiment and a re-rating lower of global growth/trade expectations which historically is linked to dollar strength (flight to safety). Empirics suggest that there is a clear negative relationship between world trade volume growth and USD appreciation (see Figure 22).

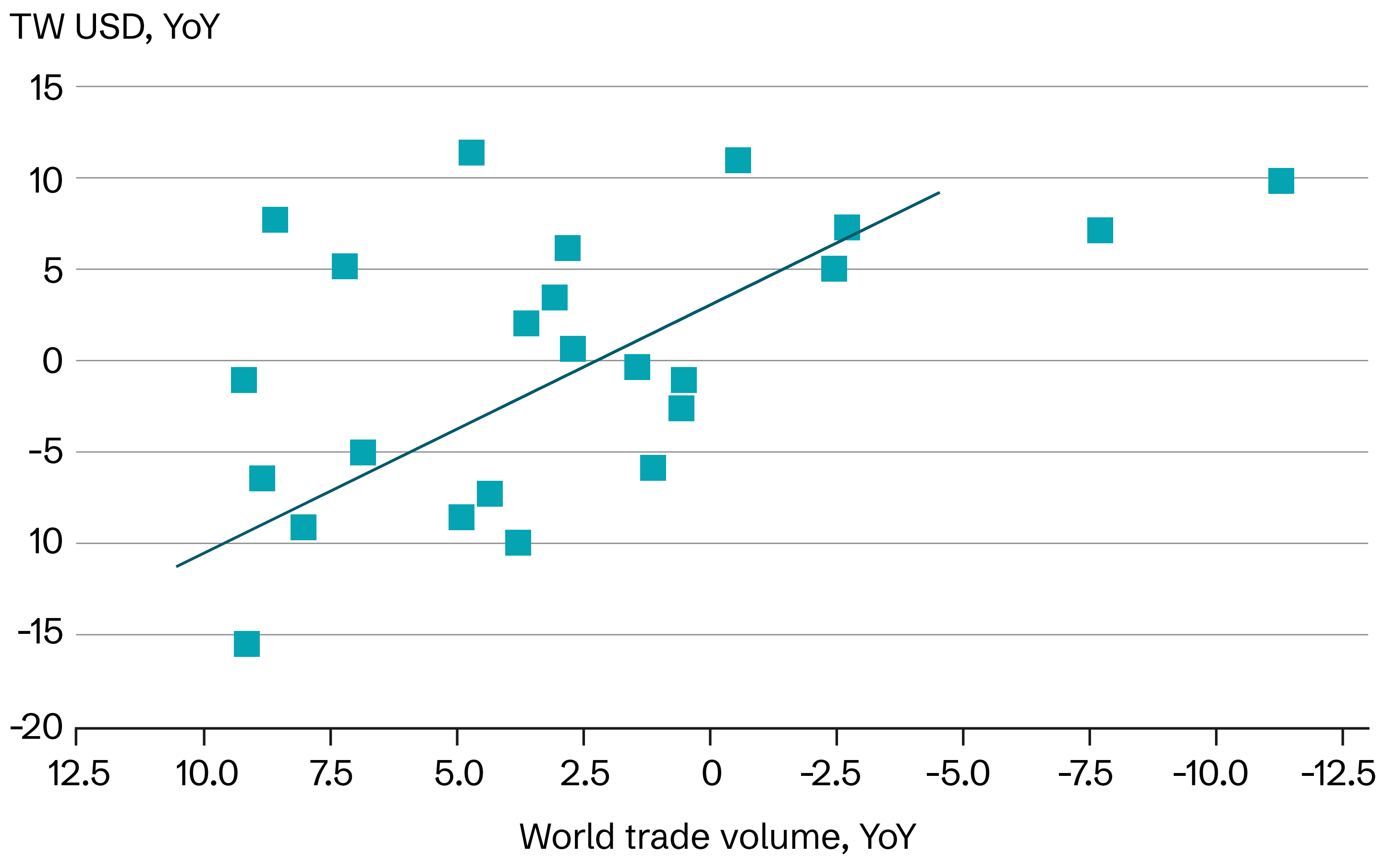
Within G10, the EUR would be vulnerable although part of the hit may be cushioned by the ECB cutting rates less that the market expects (our base case). However, we think GBP will be particularly pressured to the downside, both through externalities from weaker global growth, high beta to the dollar and more easing by the Bank of England. However, we expect this will play out later in the year (from late Q2 onwards) as the BoE will likely stay cautious until it has more visibility on the impact of the Budget. The Swiss franc should continue to underperform, while JPY remains a wild card, since the BoJ remains firmly in the process of tightening policy.

Within EM FX, we think EEMEA’s links to developed Europe will prove a material vulnerability, while in Asia we think the PBoC will let the Renminbi depreciate to absorb the tariff shock but also stem disinflationary pressures. This should also put pressure on the rest of the Asian FX bloc.

Needless to say, uncertainty over the magnitude, scope and sequencing of US policy measures is very wide. If, for example, fiscal boost is restrained, and tariffs prove to be more moderate, then the dollar rally would be much shorter lived as global growth and trade would avoid a significant decline and the Fed would not have to fight renewed inflationary pressures. If so, we would expect EUR and JPY to outperform beyond Q1 25, alongside select EM currencies like the INR.

> In our baseline scenario which envisages further US fiscal expansion and tariffs, we think that the dollar rally is far from over

Figure 22. Dollar strengthens in periods of global trade weakness



Source: Aviva Investors, Macrobond as at 31 December 2024.

Figure 23. **Asset allocation**

	Underweight										Overweight
	-5	-4	-3	-2	-1	0	1	2	3	4	5
Equities								2			
US								2			
Europe						0					
UK						0					
Japan						0					
Pacific Basin ex-Japan						0					
Emerging Markets						0					
Government bonds							1				
US						0					
UK								2			
Eurozone						0					
Japan					-1						
Australia						0					

	Underweight										Overweight
	-5	-4	-3	-2	-1	0	1	2	3	4	5
Credit						0					
US Investment Grade					-1						
European Investment Grade					-1						
UK Investment Grade						0					
EUR High Yield								2			
US High Yield								2			
Emerging Govt (Hard Currency)						0					
Emerging Govt (Local Currency)						0					
Cash				-2							
Currencies (versus US$)				-2							
GBP						0					
EUR					-1						
JPY						0					
AUD						0					
EM FX				-2							

Note: The weights in the Asset allocation table only apply to a model portfolio without mandate constraints. Our House View asset allocation provides a comprehensive and forward-looking framework for discussion among the investment teams.

Source: Aviva Investors, as at 31 December 2024.

Webcast

House View 2025 Outlook

14 January 2025 | 15:00 GMT | 45 MINS

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