Connecting the Dots

Episode 4: **CIO 2025 outlook – and why growth's the elephant in the room**

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Opening soundbite, Fabiana Fedeli, CIO, Equities, Multi-Asset and Sustainability: *Well, the elephant in the room is growth. We have seen strong growth in the US, weaker growth in the UK and in Europe. But as long as we still have some macroeconomic growth and we don't see much more deterioration, then equity markets are well-supported, particularly if we do believe that rates are coming down. However, should we see a worsening of that macro backdrop from a growth perspective, then the relative trade between equities and fixed income would most likely move in favour of fixed income and that is, if you want, from an overall market perspective.*

Romil Patel:

Hello and welcome to *Connecting the Dots*, the podcast brought to you by M&G Investments where each month, experts from across our global network of investors will join us.

My name is Romil Patel and I'm delighted to be joined by Fabiana Fedeli, CIO for Equities, Multi-Asset and Sustainability, Emmanuel Deblanc, CIO for Private Markets, and David Knee, Deputy CIO for Fixed Income. Welcome to you all.

Fabiana Fedeli: Thank you.

David Knee: Thank you.

Emmanuel Deblanc: Thank you.

Romil: Well, the key themes of 2024 were very much around central bank monetary and government fiscal policies as new administrations took office in what was a year of elections around the world.

We'll come back to what that means shortly but first, let's start with what's captured investor attention from a wider markets and asset class perspective as we head into 2025.

Fabiana: The Trump trade is obviously centre of mind right now, particularly for equities, what that means in terms of deregulation, lower taxes, and you've seen it actually manifest not only in a very strong run of the US equity market, but also in a broadening of performance well beyond the 'Magnificent Seven'. There are other considerations to be made, which I will leave to my colleagues, such as what the impact would be of any Trump largesse on the fiscal overall framework and also on inflation.

David: On the macroeconomic story, it has become challenging for markets to find a clear anchor. We've had a year of increased volatility across fixed income assets, and that has followed uncertainty about the path of interest rates. So we've seen the first interest rate cuts finally come around the middle of the year and since then, significant oscillation in terms of how much and how quickly we're going to see further monetary easing.

Part of the uncertainty there is that inflation has proved stickier than perhaps people imagined, and central banks are – particularly the US Fed [Federal Reserve] – having to grapple with the potential for trade tariffs and second round inflation effects coming from that, as well as fiscal policy in the US giving a boost to US growth. So Jerome Powell, Chair of the Federal Reserve, has stepped back in terms of the rhetoric on the pace of rate cuts and we've seen some weakness in in government bond markets as a result of that more recently.

The corollary of that in FX markets has been a return of the stronger dollar. Clearly, Donald Trump has set out a framework in which he'd like to see the dollar depreciate, but in a looser fiscal and potentially tighter than previously monetary framework, it's going to be pretty difficult to let the dollar weaken.

Emmanuel: For private markets, what's most notable is that a lot of investors on the equity side have been sitting on the sideline given the uncertainty that was reflected by the lack of transactions in a volatile macro environment, or base rates environment, or with a lack of visibility on where we were headed. Now it feels like there's more confidence returning as to

where we are headed, in spite of potentially some volatility returning resulting from higher inflation than expected, there is the sense that we are bottoming out in terms of valuation, or at least the real rates are actually stabilising – and that's a major driver for private markets. With that anchoring of the real rates, that means that investors are more comfortable pricing, and so we expect a return of M&A volumes. We've had extremely low volumes in the last 18-24 months and we expect a very strong recovery in 2025 as a result of such renewed stability, or at least confidence.

Fabiana: I think there's an interesting timing dilemma here, because if Trump goes ahead with tariffs and if that flows through to inflation, which it should at the levels of tariffs that we know are possibly being implemented, what does the Fed do?

The Fed, until now, has been looking at past data, but possibly from past data you wouldn't be able to see a rise in inflation. So would they start cutting and then eventually get to that point where inflation starts rising again and then start hiking rates again, which obviously would be giving a lot of volatility to the fixed income market, but in general, overall to all markets. I'd be interested in hearing what David and Emmanuel think.

David: From my perspective, putting my economist hat on, the tariff story is pretty complicated because of a number of different macroeconomic effects that are actually at work. It depends on whether companies can absorb the tariff increase, it depends on what's going to happen to the exchange rate. It's possible that you could see a one-off rise in inflation, there's no doubt that that will occur, but will there be second round effects that then filter through as consumers respond to higher prices by demanding higher wages? The Fed's probably going to be concerned about that, especially given that it's going hand-in-hand with looser fiscal policy.

Might that produce opportunities in markets? Volatility is something that active managers like us seek to exploit. If we do see in the medium term higher real rates emerging out of this, then I think that could be good for fixed income investors and private market investors, too.

Emmanuel: On my side, it all depends what kind of volatility. Actually, some volatility is quite good because it creates some uncertainty in public markets, which means, for example, on the credit side more deals happen in the private credit market where there's more inertia, more certainty of execution at a given level, and so borrowers would tend to go more to the private markets than public markets. So that's good news. But within some limits, as you know, a very high level of volatility means low deal volumes in general and everybody is starved of flow. We like a bit of volatility but not too much because of that, and also because primary activity then dies – M&A volumes collapse in a high volatility environment, etc. so a bit of volatility would be good.

Also inflation is not necessarily such a bad thing, again, at some level or a magnitude that is relatively contained in private markets because we tend to be closer to real assets, or we've got products very simply that are indexed to inflation through the floating rate. For example, for credit or real estate, which has some correlation in terms of valuation to inflation or infrastructure, where depending on what type of infrastructure, there is a clear link to inflation for some of the of the assets in the space.

So if one is worried about volatility of inflation, private markets are a good place to be. What the last four or five years has told us is there's been a paradigm shift in the volatility of inflation, and that actually private markets has been a good spot to be in for that for that reason. I, for one, would expect that the uncertainty in terms of policies, tariffs for example, but also the implementation of new rules in terms of immigration may create additional uncertainty as to the outcome for inflation. So maybe just in terms of the complexity that David was mentioning on the tariffs, from our perspective, maybe the ideal scenario is that these tariffs are signalled well ahead so that people can plan around it, assess the impact as opposed to a sudden change which creates that extreme volatility, which then disrupts the whole system.

Romil: So what impact could tariffs have on China, Europe and more broadly speaking, globally?

Fabiana: Certainly they will have an impact if they're actually implemented to the extent that incoming president Trump is announcing, which is not a given.

We know that for him, tariffs are a deal-making negotiating tool. So tariffs could come at any level below where he actually has made some announcements. But clearly, China is the one country that is in his target range. From that point of view, the interesting thing is that Chinese companies are far more prepared for tariffs than they have ever been before, certainly in the first Trump presidency.

You've seen Chinese companies moving some of the manufacturing facilities away from China to other countries, some even to the US and more importantly, you have also seen companies actually changing their target markets when it comes to exports. A large number of exports from China now go to Mexico, actually consumed in Mexico. So on the one hand, yes, that would have an impact. On the other hand, I think it will really be a company by company matter looking at how sensitive they are towards certain markets. But overall, it will be quite, I would say, a volatile issue until we get a little bit more certainty.

Romil: We don't have long to wait then.

Fabiana: We don't have long to wait. We will know more once the president actually is inaugurated and I will be able to give more colour on what happens.

Let's not forget then that there will be a reaction from other countries. We obviously don't want to see much in terms of escalation. But again, for him [Trump] it’s a negotiating tool and I would expect that the rest of the world is more prepared this time than it was last time.

David: It does talk to the challenging environment of a world where the tailwinds of globalisation that were so important in driving growth in the last three decades have significantly diminished, and one might argue in certain cases, going into reverse.

We can see where that leads if we look at the IMF’s recent World Economic Outlook released in October, where growth for global GDP this year through to 2029 is going to bumble along at about 3%, which broadly is about 2% for the developed world and 4% for the emerging world, but there's nothing very exciting happening there.

You might say: ‘Well if that forecast proves to be right, at least we're going to avoid a significant hard landing’. But on the other side, you’re really not seeing evidence yet of an AI-driven productivity boom coming through in a global sense yet. That does create, for bond markets, the challenge that fiscal positions, you're not going to be able to grow your way out of the current deficits that we've seen accumulate – particularly in the post-COVID period. That’s affecting long-dated bond yields where investors are starting to worry that in the long-term, we're going to see challenges coming in terms of governments being able to finance those outstanding levels of debt.

Romil: So as we look ahead into 2025, which themes sectors and regions are looking attractive and why? And Emmanuel, with rates declining, are you expecting an uplift in deal activity? You mentioned the return of M&A volumes a moment ago.

Emmanuel: The most interesting thing from a private markets perspective is a stabilisation of the real rates. The nominal yields are dropping, but the real rates, I believe, are forecast to be relatively stable and that's actually the most important thing from our perspective, because that means investors can price deals, and then the wheels start to churn. So we're seeing private equity investors coming in, pricing, and LPs [Limited Partners] receiving distribution, which means they're ready to plug back money into the system and we're on our way to a normalisation after what have been very low levels of M&A.

2023 was the lowest level of M&A activity in 30 years in nominal terms, so you can imagine in real terms, we're even beating that record. That's really what that means, these lower nominal yields for us. Underlying that, yes, inflation is looking like it's getting tamed, albeit still somewhat volatile and a bit stickier. But the real yield stability is really what matters and what we sense is what we've been expecting for many quarters is about to happen and that is a reversion to the mean in terms of deal flow. If anything, there probably will be a catch-up effect after the low levels we've experienced.

Fabiana: Well, the elephant in the room is growth. We have seen strong growth in the US, weaker growth in the UK and in Europe. But as long as we still have some macroeconomic growth and we don't see much more deterioration, then equity markets are well-supported, particularly if we do believe that rates are coming down. However, should we see a worsening of that macro backdrop from a growth perspective, then the relative trade between equities and fixed income would most likely move in favour of fixed income and that is, if you want, from an overall market perspective.

But one of the things that we said at the last outlook, the mid-year outlook, was that this is not a market to make overall index, country, sector trades. This is more of a market to be selective and to literally look company by company.

You've also seen that in the MSCI All Country World [Index], the overall dispersion of performance from a stock-to-stock point of view actually has stayed consistently above the 10-year median, which really is there to show that investors are going well beyond the big cap names, the best known names and are trying to look for performance where they can find it and also based on fundamentals.

We think that's a strategy that from a trading perspective in equities, you have to continue to follow. So we do like the US, we like particularly innovation in the US but there are other areas in the world where we find some compelling opportunities. Think about Europe, where we find opportunities for example, in industrial names, in utilities, anything that is linked to infrastructure investment, and also look at innovation in healthcare, and that's really around the world. Last but not least, Asia, where there is a significant amount of innovation, but also in China, where you're seeing services, for example, such as hotels representing some compelling investment opportunities. So it's really a matter of looking for the right companies all around the world.

David: I think in fixed [income], the picture that Fabiana has painted for equities, there's a lot of commonality that feeds through, particularly into the corporate bond market where the valuations that are on offer relative to government bonds don't look that appealing. In credit spreads the additional yield from the corporate bonds relative to governments are at the lowest levels for 15 or 20 years, and that has followed on from investors continuing to allocate capital into the corporate bond market on the back of relatively high absolute yields. So if we just take, for example, the US investment grade market, that's all bonds that are rated BBB and above, then the yield on that overall group is currently around 5.2%.

Now the 25-year average is 4.8%, so we are seeing investors who are still prepared to buy on an absolute basis, but you are not being very compensated for the additional risk that you're taking in the credit. So for us, this is a time to be pretty selective as Fabiana talked about in equities, and discerning around which bonds you buy.

It's a time to be defensively positioned and to have a generally higher-quality portfolio than I think you'd get if you just bought the index overall. In the 15 years since the Global Financial Crisis, you've had at least four very significant episodes where you've seen corporate bonds significantly underperform.

Whilst we can't see the catalyst for what that might be going forward, the probability is that in the next two or three years we will have another event, be that a geopolitical event or economic event, which sees some volatility and weakness within the public corporate bond markets. So defensiveness, I think being there and being pretty selective about where you actually deploy your capital.

Romil: So remaining selective in precarious growth conditions is key. But how do you assess the conditions for growth itself? Is it sufficient heading into next year?

David: If Trump delivers on his tax cut agenda, then the general expectation in the market consensus is obviously that is going to be growth positive.

On the flip side, clearly, tariffs are generally regarded as being growth negative. Probably the most important vector there is going to be his ability to implement an anti-immigration policy. You've had a surge in immigration into the US in the last three years and that expansion of the US labour force has definitely been a positive growth driver.

If he succeeds in deporting millions of immigrants south of the border, then I think that is going to be another headwind to growth. Net, it pretty much remains in the balance depending on exactly the way the policy agenda is delivered and the Trump administration's efficiency in actually implementing the policies which have been so much in the public eye.

Elsewhere in the world, when we look into emerging markets the story is somewhat better, as I mentioned, the IMF sees emerging markets overall able to grow at 4%. Fabiana and I were recently in the Middle East, you go to Riyadh – there's a massive amount of construction happening there. They've got a huge infrastructure and growth agenda driving the level of activity and that region, certainly within the IMF forecast, is expected to outperform peers. So there will be some winners as a result of their own idiosyncratic stories as they unfold. But overall, it looks to be a pretty lacklustre growth story, which might be challenging for assets where a lot of optimism is already priced into valuations.

Romil: Well, finally, before we go, let's have a quick fire round. If you had $100 million to invest today, where would you put it?

David: Certainly one opportunity that we haven't talked about is local currency emerging market debt. The strong dollar that we've seen over the last 15 years has been a distinct headwind for a lot of emerging markets and they were also badly affected by COVID and the supply disruptions there.

So we saw a requirement for many of them to significantly tighten interest rates in response to much higher bouts of inflation and, consequently, local market yields elevated. That would definitely form part of a portfolio that I'd invest in as part of that 100 million.

Emmanuel: Well, the first 50 [million] of that I would go for the value add part of real estate. I think this is well positioned to pick up on the GDP bounce back. And the second part of that 100 million pot, I would go for core real estate, as I would expect that investors come back. The entry points, broadly speaking in the estate sector are very attractive right now and I think it plays to the medium term for the value add investor and, for the long-term, for the core investor.

David: I'm sure that people listening will be interested in your view on whether real estate valuations now have washed through all of the difficulties? That has been an area that people have been concerned about. Have we seen the worst for office space, and how is that opportunity reflecting in the market values?

Emmanuel: So what's interesting is we've seen the discounts in the secondary markets really compressing or reducing, and that usually is a sign of a better market to come. We're also seeing inflows, which is another sign. And then the third thing that flows from the inflows we're seeing – and I assume some of our peers do – is the M&A volume, all the acquisitions, volumes, transactions are starting again.

So all signs are there to tell us that the market is really on a firm footing finally after some very tough years, obviously. Finally, the public markets also tell us a story and usually is a bit of an early signal of a bounce back, or the other way around. In this case, a positive story for 2025 and following years.

Fabiana: Well, first and foremost, I need to determine what my investment horizon is and assume that it is until the end of 2025. From an asset allocation standpoint, I would like to be quite diversified because I don't know what's going to happen with growth and so I would expect perhaps part of my portfolio to be invested in fixed income markets, part to be invested in equities and some part, assuming that I am willing to take a longer time in terms of liquidity, also in private assets.

When it comes to equity markets, I really would like to be diversified also within equity markets. The United States is likely to see a more sustained growth than the rest of the world on a relative basis, because we don't know what happens from an absolute standpoint, there's always a risk, of course. And so I would like to have a good allocation to the US, but also not forget other markets such as Asia, for example, including Japan, which we like very much as a structural story and also areas of Europe where there is a significant degree of low valuations that are probably completely separated from fundamentals.

In terms of areas that I like, those three areas that for a very long time we've said, these are the long-term secular growth areas: it is infrastructure, it is innovation – whether it is in technology, whether it is in healthcare – and then the low carbon economy. Even if President Trump doesn't like renewables, even if he wants to repeal the Inflation Reduction Act [IRA], the truth is companies will have to continue to invest in that area and so will governments.

Right now, with rates coming down there are areas of the market, such as utilities and real estate, I very much agree, that are clearly seeing an easier path forward.

Romil: Three ways to allocate $100 million. Well, that's been very, very fun. But sadly, that's all we have time for in our final episode of 2024. Fabiana, Emmanuel, David, thanks indeed for peering into 2025 with us. It's been a real pleasure connecting the dots with you here today.

David: Thank you.

Fabiana: Thank you.

Emmanuel: Thank you.

Romil: And thanks to you, our audience, for tuning in. Don't forget you can subscribe to our podcast and we look forward to welcoming you back, but it's goodbye for now.

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