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Looking ahead to 2025: expect the unexpected?

2024 has been a special investment year with a lot of unexpected twists and turns. Not only in the financial markets, but also from a macro-economic and geopolitical perspective. Will 2025 at last be business as usual again for investors, or should we continue to expect the unexpected?

Review of 2024: the economy

With growth of around 3%, the global economy performed more or less as expected in 2024. However, the variations in regional growth were greater than expected. The US economy performed significantly better than expected, with an estimated growth of over 2.5% in 2024. US growth was also broadly supported, with business investment leading the way. With growth of less than 1%, the eurozone economy had another disappointing year, with higher exports and public spending but held back by low consumer spending and business investment. Lastly, China's economy grew by less than 5%, slightly below the authorities' growth target and well below the average in recent decades.

The wave of inflation in 2021-2022 gradually subsided in 2023-2024, with inflation in both the US and the euro area approaching the 2% targets of the central banks by the end of 2024. However, core inflation has remained high, partly due to the historically strong labour market in both the eurozone and the US. This mainly affects services inflation, with a lesser impact on goods inflation. With the improved inflation picture, central banks started to

change course in 2024 by reducing base rates, with cuts ranging from 50 (Bank of England) to 75 (Fed, ECB) to 175 (Bank of Canada) basis points so far. Unlike most central banks, the Bank of Japan raised its base rate for the first time since 2007, finally abandoning its zero-interest policy.

Review of 2024: the financial markets

The financial markets can look back on a good year in 2024[1]. Mainly on the stock exchanges, and in particular the US stock market. The broad composite S&P 500 index is up more than 30%, while the Nasdaq technology index was up as much as 40%. Outside the US, returns on equity markets remained 'limited' to 10-20%, which is still well above average. Bond investors achieved less pronounced positive returns, but have little to complain about with annual returns of more than 3% on European government bonds to 5-10% on European high yield corporate bonds. Only European listed real estate lagged behind, with prices remaining close to flat on balance since early 2024.

1 Data based on closing prices on 11 December 2024

Outlook for 2025: economic growth prospects

- **World:** the global economy is expected to grow by around 3% in 2025, i.e. at a fairly similar pace to 2023 and 2024, but well below historical average growth rates. The US was once again the driving force behind global economic growth in 2024, and is expected to continue to do so in 2025, but probably to a lesser extent than in 2024. Geopolitical risks continue to pose a serious threat, and the recent re-election of Donald Trump as US president adds to uncertainty, resulting in significant downside risks relative to our baseline scenario of moderate but positive global economic growth.

- **United States:** it is unlikely that the US economy will continue to grow as strongly in 2025 as it did in 2023-2024. The strong US dollar and still high interest rates have an adverse effect on growth forecasts. Consumer spending may show a downturn, as savings accumulated during the Covid pandemic have been depleted and the household debt position has deteriorated. Fiscal stimulus from the incoming Trump administration could pose an upward risk to growth, albeit most likely temporarily.

- **Europe:** the eurozone economy is not expected to perform exceptionally well in 2025, but growth is likely to pick up somewhat after a disappointing 2024. Business investment is expected to recover and consumer spending could benefit from lower interest rates and low unemployment. High government debt, geopolitical uncertainty and the absence of structural reforms (e.g. in Germany and France) are major risk factors.

- **Emerging markets:** generally, the recovery in emerging markets since the end of the Covid crisis has been disappointing. Especially in emerging Asia, China's over-indebted real estate and banking sectors remain a significant risk, while geopolitical risk (e.g. Russia/Ukraine, Middle East) has significantly increased. The threat of higher import tariffs imposed by the new US administration could negatively affect emerging markets' growth prospects, albeit to varying degrees.

Outlook for 2025: inflation and interest rates

The inflation outlook is expected to improve further in the course of 2025, with core inflation in both the eurozone and the US expected to converge towards headline inflation, at or near the ECB and Fed targets of 2%. Upward inflation risk however remains high, as strong labour markets still allow for higher wages, which is reflected in core inflation, especially in the services sector. The inflation picture could be further complicated by a possible trade war at the instigation of the Trump administration, a possible increase in the supply of oil in the US (which could lead to lower oil prices) or a further escalation of geopolitical conflicts, for example in Ukraine or the Middle East (which could lead to higher energy prices).

After starting its first easing cycle since the euro crisis in early 2010 in mid-2024, it looks as though the ECB has enough room to cut interest rates further in 2025. A further easing of 100-150 basis points would bring the ECB base rate to or below 2% (currently 3.25%), which seems reasonable given the current conditions and prospects. However, the risks surrounding this base scenario have greatly increased, as uncertainty with regard to policy is unusually high. This may force the ECB in a different direction than currently envisaged, but the upside and downside risks seem to be roughly balanced.

As the US economy is performing better than the eurozone economy and inflationary pressures are higher there, the Fed has had less incentive to cut interest rates than the ECB. The Fed accordingly started its easing cycle later and is also expected to end this process earlier than the ECB, with a base rate of around 3.5-4% (currently 4.75%). For the Fed, policy uncertainty may be even greater than for the ECB, depending in part on the actions and policies of the new Trump administration.

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Outlook for 2025: financial markets

At current valuations and given the highly uncertain geopolitical and policy outlook (both monetary and fiscal), no asset class is particularly attractive at this time. The motto 'cash is king' may thus still apply for the time being, even if short-term interest rates fall further. At some point however, more attractive entry points for asset classes besides cash may arise as the economic outlook and/or the interest rate environment change. This will require a more proactive attitude by investors towards tactical asset allocation than usual.

- **Government bonds:** with higher capital market rates (relative to pre-pandemic levels), the state of public finances and sovereign debt is once again becoming a focus for investors, especially in the US, where the incoming Trump administration is expected to create additional policy uncertainty. However, the scope for (much) higher capital market rates does seem limited, at least without causing unrest in the bond market. In this case, eurozone bonds could also be affected. Yield curves steepened slightly in 2024, but could continue to steepen as central banks continue to cut base rates in 2025.

- **Corporate bonds:** credit spreads have remained fairly flat lately, but higher interest rates are negative for corporate bonds from both a fundamental and a total return perspective. Additional quantitative tightening (QT) by central banks is another monetary risk factor for corporate loans. In general, corporate bonds seem fairly valued given the economic outlook, but high interest rates and other (including geopolitical) risk factors pose different challenges for the various bond categories, such as corporate versus financial institutions and investment grade versus high yield corporate bonds.

- **Equities:** equity markets (especially in the US) have performed very well over the past two years and can continue to benefit from a growth-enhancing policy (again, especially in the US), at least in the short term. But even if corporate profits continue to surprise in a positive sense, valuations already seem to be stretched. This makes equities vulnerable to economic headwinds or an external shock.

- **Real estate:** listed real estate was among the most affected asset classes in the post-Covid stagflation environment. Higher interest rates will remain a challenge, but the valuation of listed real estate already seems to have priced in much of the downside risk. It is quite possible that direct real estate will undergo even more negative revaluations in the coming period, but with significant differences at sector level, for example residential versus offices..

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