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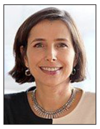
Income, Returns, and Resilience

The economic backdrop is still conducive for returns, but diversification will be essential for building resilient portfolios.

Insight from sub-adviser Schroders Investment Management



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Group Chief Investment Officer

Key Points

- We think there's potential for markets to broaden out further in the US, particularly given the Trump team's focus on deregulation and corporate tax cuts.
- The old-fashioned reason for owning bonds—seeking to generate income—is back, and we continue to argue for their inclusion in portfolios.
- We believe conditions are favorable for good returns in 2025, but there likely will be challenges. A diversified approach across regions and asset classes can contribute to making portfolios more resilient.

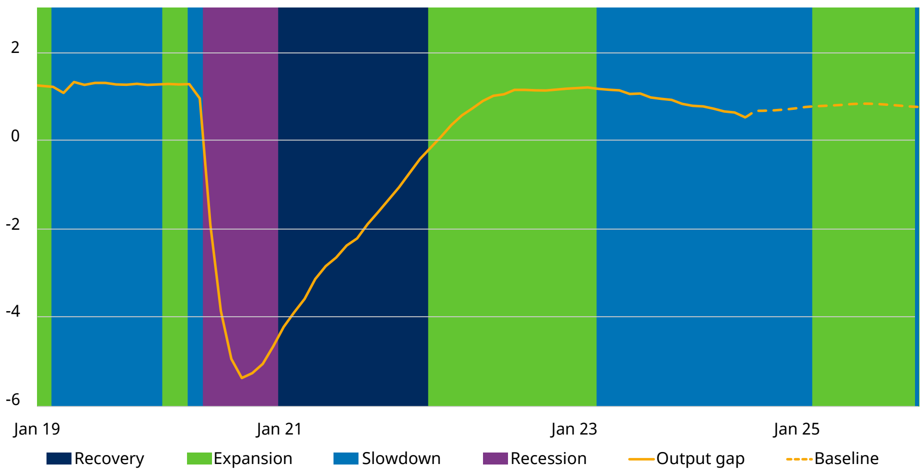
News of Donald Trump's conclusive US election win has led to endless speculation about what his policies might be. In this environment, it's always useful to step back and focus on the bigger picture.

We've written before about the changing investment regime: a shift to a multipolar world, more proactive fiscal policies, and higher interest rates compared to the last decade. The post-Global Financial Crisis (GFC) environment of tight fiscal policy, zero interest rates, and liberalized global trade was not working for the average person in the West, leading to support for more populist policies.

In this context, Trump is more of a symptom than a cause of the political environment. His second term will represent an intensification of trends that were already in place: loose fiscal policy and an ongoing reaction against globalization in the form of higher tariffs (note that President Biden did not reverse the tariffs imposed by Trump in his previous term).

What does this mean for markets in 2025? Leaving aside political risks, the economic backdrop remains benign. Inflation has moved in the right direction and interest rates are falling in the US and Europe. We expect a soft landing, and our expectation is that growth will reaccelerate as we move through 2025.

FIGURE 1
Our Expectation: A Soft Landing for the Economy in 2025
Gross Domestic Product, January 2019-January 2025 (%)



As of 11/11/24. The Schroders Output Gap model assesses the extent to which an economy is operating below its full potential, without generating inflationary pressure. In the slowdown phase the output gap is positive and falling, and in the expansion phase, the output gap is positive and rising as the economy reaccelerates. Sources: LSEG DataStream, Schroders Economics Group.

Look Beyond Recent Winners for Return Opportunities

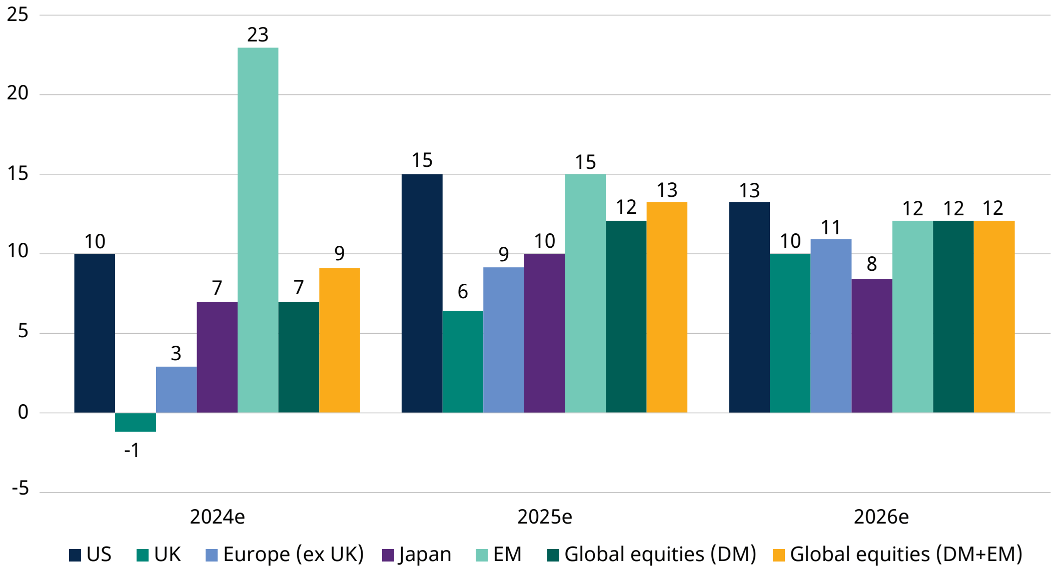
Turning to equities in more detail, the S&P 500 Index[1] is looking expensive, but valuations away from the mega caps and outside of the US appear more reasonable. Equity investors have grown accustomed to a small number of large companies powering the stock market's gains; however, this pattern is already changing.

We think there's potential for markets to broaden out further in the US, particularly given Trump's focus on deregulation and corporate tax cuts.

FIGURE 2

Consensus Expectations: Improving Earnings Growth in Most Regions in 2025

Year-on-Year Corporate Earnings per Share (EPS) Growth Forecasts (%) (e=estimate)



As of 10/31/24. **Past performance does not guarantee future results.** Japan EPS represents a 4-quarter sum of the next calendar year through 6/30/25, e.g. 2024 = 3/31/24–3/31/25. DM: developed markets, EM: emerging markets. Sources: LSEG DataStream and Schroders Strategic Research Unit.

Beyond the US, trade will be an important area of focus if Trump fully implements the tariffs he announced during the campaign. In practice, such widespread tariffs might be hard to implement into law, but the uncertainty will encourage US companies to reshore in any case. This could boost US growth at the expense of its neighbors, but we would also expect more monetary stimulus outside of the US to offset this.

So, all in all, we see scope for positive returns from equities in 2025, but investors may need to look beyond the recent winners.

We also need to recognize that the risks are increasing as positive expectations get baked into market valuations. In particular, given an approximate 4.5% to 5% yield on the US 10-year Treasury bond, we'd judge that comparisons with bond valuations would pose a speed limit to equity returns (this arises because higher bond yields can draw money away from the stock market, as well as increasing borrowing costs for corporates).

As mentioned previously, we remain positioned for a soft landing, which is a benign outcome. But, as we consider the risks around this scenario, our bias is still to worry that the US growth environment might be "too hot" rather than "too cold." Curbs on immigration and policies to boost the corporate sector could increase the risk of domestic inflation, curbing the Federal Reserve's (Fed) abilities to deliver rate cuts.

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Bonds Can Offer Attractive Income

Which brings us to bonds. As I've outlined previously, we believe that we're in an environment that's very different from the deflationary, zero-rate regime of the 2010s. As a consequence, bonds don't offer the same negative-correlation benefits that they did in the last decade.

However, the old-fashioned reason for owning bonds—seeking to generate income—is back, and we continue to argue for their inclusion in portfolios. Divergent fiscal and monetary policies around the world will also provide cross-market opportunities in fixed income and currency. Strong corporate balance sheets support the yields offered by credit markets.

To the extent that investors are seeking diversifiers, we continue to like gold as it can provide a hedge against recession risks such as bonds. It's also a good store of value in the event of more stagflationary outcomes and geopolitical events.

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Diversification Holds Key to Portfolio Resilience

And that brings us to the importance of portfolio resilience. While the economic backdrop generally looks favorable for returns, we can't gloss over the fact that there are many risks to markets. We're facing disruption on an unprecedented scale and it's taking various forms.

We've already mentioned the potential disruption from tariffs and trade wars. There are also the ongoing conflicts in the Middle East and Ukraine, where the risks of political miscalculations can't be ignored.

The transmission mechanism of geopolitical events to markets is typically through commodities. As an asset class, commodities have been out of favor due to global-growth worries, but they have an important role to play in offering diversification and creating resilient portfolios. Energy is one way to play this, while gold is still the ultimate safe-haven asset.

Private markets can also help provide resilience via exposure to different types of assets that are typically more insulated from geopolitical events than listed equities or bonds. Examples include real estate and infrastructure assets that offer resilient long-term cash flows, as well as assets such as insurance-linked securities, where weather is the key risk factor.

Overall, we think conditions are favorable for good return potential in 2025, but there will likely be challenges to navigate. A diversified approach, looking across regions and asset classes, can contribute to making portfolios more resilient, no matter what the year ahead brings. Keep in mind that diversification does not ensure a profit or protect against a loss in a declining market.

Talk to your financial professional about how to position your portfolio amid a changing economic landscape.

[1] **S&P 100 Index**, a sub-set of the S&P 500®, measures the performance of large cap companies in the United States. The Index comprises 100 major, blue chip companies across multiple industry groups. Indices are unmanaged and not available for direct investment.

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