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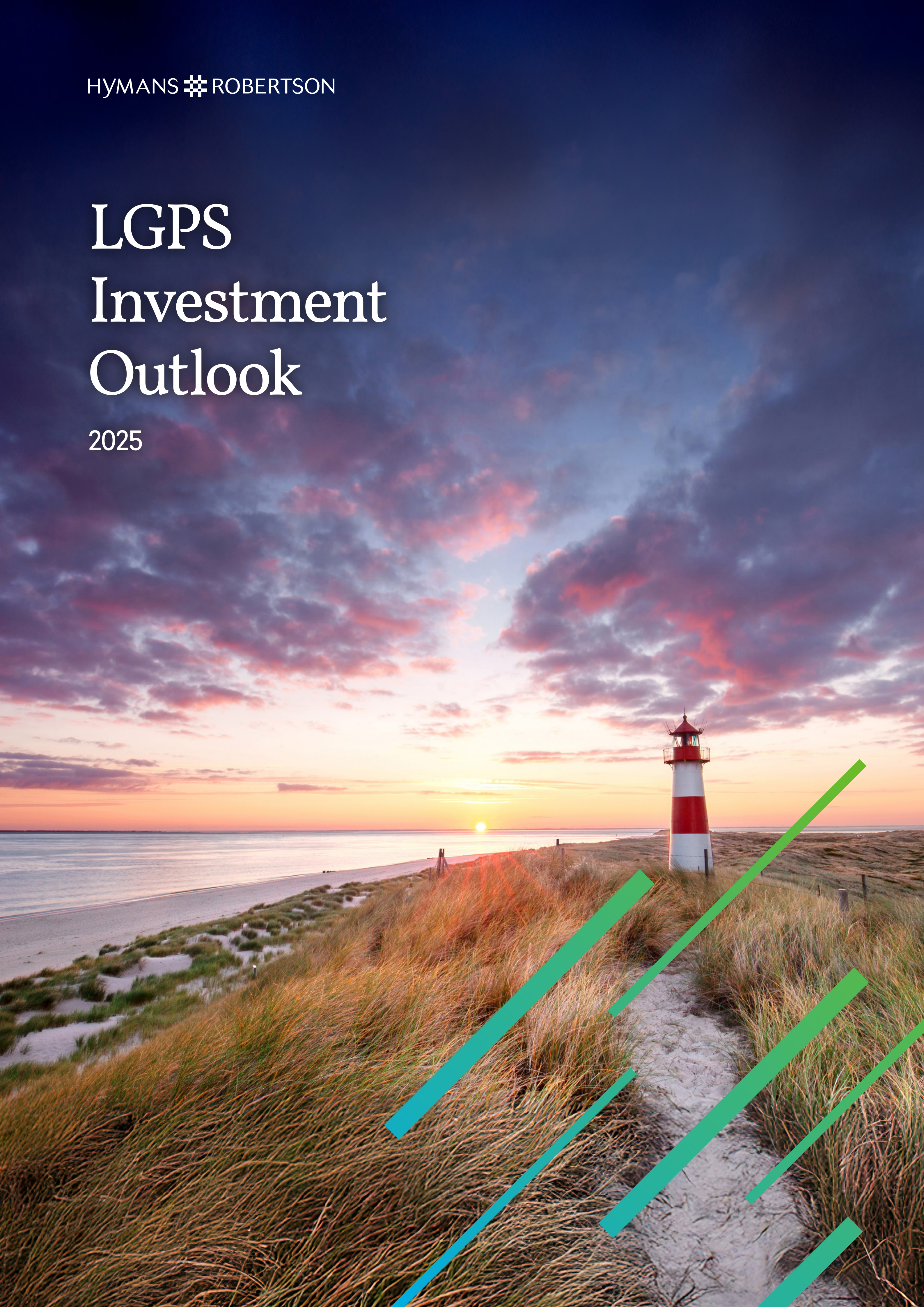

LGPS Investment Outlook

2025

Introduction

Hello and welcome to our 2025 LGPS investment outlook. We decided to delay this year's publication, as the LGPS had quite a busy start to the year with the 'Fit for the Future' consultation.

2024 was a busy year. In England and Wales, we started to get our heads around the 2023 'Next steps on investments' consultation. This explored the expansion of pool services, setting a deadline for pooling assets and mandating minimum allocation sizes to UK 'Levelling Up' investments and global private equity. However, the Conservative government didn't have time to implement this before being replaced by the new Labour government in July, which quickly introduced a vast swathe of new proposals.

In Scotland, funds reviewed and implemented their new investment strategies based on the very strong results of the 2023 actuarial valuations. Lessons can be learned for the English and Welsh funds heading into the same position this year.

In this year's outlook, we discuss:

- Our market outlook for 2025
- A LGPS policy update
- Considerations for 2025 investment strategy reviews
- Thoughts on how to tackle local investments

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Investment themes for the 2025 E&W valuation year

As the 2025 England & Wales actuarial valuation date approaches, it's a good time to consider what investment themes might be topping your agendas in the coming months. Investment strategy considerations are likely to be even more important given the need to have a clear trajectory for your strategy ahead of potential reforms in 2026.

Funding and investment

The actuarial valuation always provides an ideal opportunity to consider funding and investment strategy together, as the two must work in tandem to achieve the best outcomes for your fund, employers and members. In general, we would expect funding levels to have improved going into 2025. Despite a period of high inflation, over the last year we have had double-digit returns from equities and strong performance from credit and real assets. Although UK government bond returns have been negative, this also reflects higher yields and interest-rate expectations, reducing liability values.

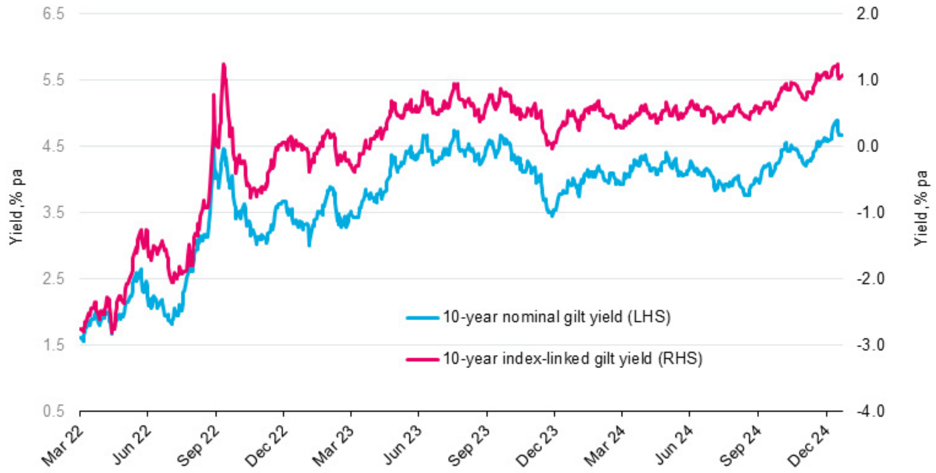
We expect a range of options to be open to LGPS funds, from easing pressure on contribution levels for employers to building prudence to ensure more resilience or taking less investment risk. From an investment perspective, risk management can take a variety of forms and can be addressed through some of the themes we touch on in this article.

If you're not going to buy gilts now...

After advising LGPS funds for over 20 years, I can still recall the start of my career; there was a running joke between my actuarial graduate colleagues that LGPS investment strategies were all 75% equities and 25% bonds... and maybe some property. I would argue that was never the case – and it certainly isn't how LGPS strategies look today. In the last 20+ years, funds have captured a fantastic array of investment opportunities: diversifying risk, increasing resilience and certainty of returns, thinking about income and cashflow, as well as responsible investment and climate considerations. However, we have also been through – and come out the other side of – a decade of falling bond yields. During this period, many funds significantly reduced (or even removed) their allocations to UK government bonds.

2025 kicked off with further uncertainty about the UK economy but also reflections on interest-rate policy, both here and globally, led by the US. This resulted in a rise in bond yields, continuing the moves experienced over the second half of 2024. Ten-year yields on nominal and index-linked gilts now stand at 4.8% pa and 1.2% pa, respectively (Chart 1). Their 30-year counterparts are even higher, at 5.3% pa and 1.9% pa, respectively.

Chart 1: Real yields have risen more than nominal yields, with implied inflation falling as a result

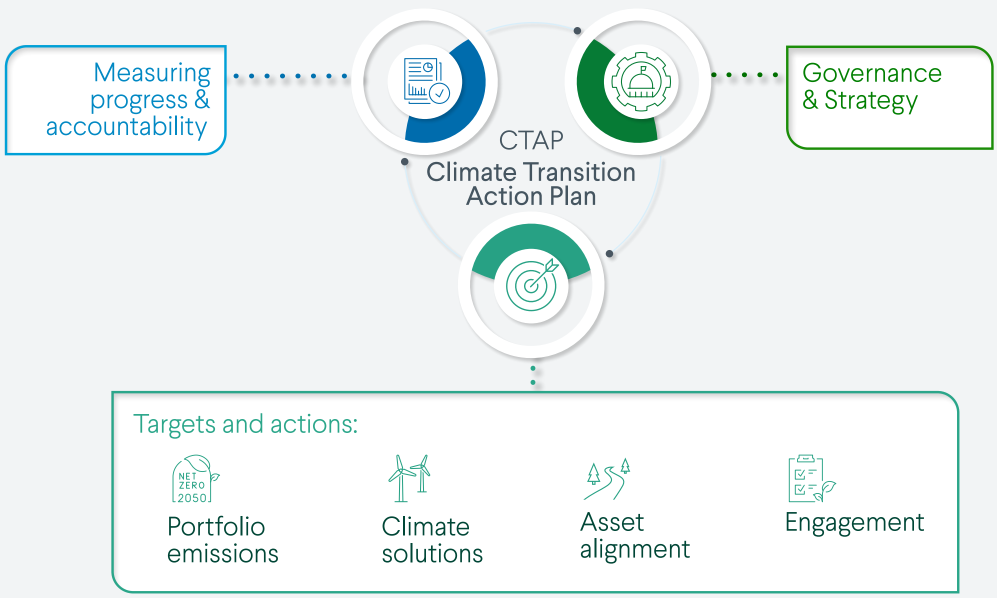


While there remains a lot of uncertainty around supply and demand for UK government bonds and the effect on the future level of yields, these still seem like attractive levels for LGPS funds to be buying long-term secure debt aligned to their pension liabilities. Coupled with potentially improved funding levels at the 2025 valuations, the argument for reducing risk by buying gilts is even more compelling.

Strategy and climate transition action plans

We expect all LGPS committee agendas to include consideration of climate risks and opportunities. This also has the potential to feed through into implementation of investment strategies, as well as capital allocations. More funds are developing climate transition action plans aligned to their agreed net-zero objectives.

These plans are likely to focus initially on a mix of backward- and forward-looking climate analytics to understand both your current and projected trajectory on emissions and how this compares to stated objectives. Having created this foundation, it then allows funds to develop their plans, which could encompass capital allocation, a focus on engagement, and/or plans to collaborate with managers, pools and responsible investment (RI) specialists to drive real-world change.



We're seeing an increasing range of options developed in natural capital, climate opportunities and equities, which allocate capital in a way that provides the right balance of risk and return, offers greater positive exposure to the climate transition, and creates positive impact.

Time to refresh your equity allocation

Equities remain the dominant asset class within LGPS investment strategies. Therefore, it's vital that your allocation is structured and implemented to get the most out of the asset class. Beliefs around equity investing will vary from fund to fund: views on active and passive management and everything in between, style mixes and biases, RI and climate focus, as well as the solutions available through pooling and other arrangements.

Equities have had a strong recent run of performance, but this has been anything but uniform across regions, sectors and individual stocks. The much-talked-about rise of the 'magnificent seven' stocks has resulted in a shift in markets, increasing concentration but also creating potential pockets of opportunity for different equity approaches to manage risk, diversify exposures or target potential opportunities. We think this provides an excellent opportunity to take a fresh look at your equity allocation and ensure it's achieving the best results for your fund.

Thinking locally

Although the latest LGPS consultation only recently closed on 16 January, for funds to be 'fit for the future', one requirement involves setting an approach to local investment, including a target range, and considering local growth plans and priorities. While the legislation isn't yet there to enforce this requirement, funds can get ahead by starting to discuss and agree their approach to local investment.

There's a lot to consider here, so it's important to take the time to be clear on your own plans. Communicating your needs to pools and key stakeholders will help shape the future options ahead of upcoming reforms. This will include overall objectives for a local allocation, target ranges, what local means to you and where it fits within your strategy from a risk, return and implementation perspective. Early engagement should allow funds to be thoughtful about their approach and determine how to have the desired impact on their strategy, as well as achieving local impact.

Risks or opportunities in currency

Currency as an agenda topic seems to come around every so often – sometimes as a risk, sometimes as an opportunity, or even just as a day-to-day issue that needs to be managed or monitored as part of regular cash calls, distributions or performance attribution. However, as with gilt yields, currency markets have also moved significantly over the second half of 2024 and into 2025.

Recent sterling weakness and US dollar strength will have impacted LGPS funds in different ways depending on how your investments are structured and implemented. This could be through equity markets, private market commitments or bond and credit markets. In some cases, this might be considered a part of the active management of a mandate or left as a natural exposure, reflecting the nature of the investment or method of implementation. Whatever the impact, it does provide the opportunity to consider how this risk is reflected in your fund's investment strategy, and the impact it might have on investment outcomes. Once you've taken pause, it's key to think about what actions you might want to take.

Cash is king

The principal objective of all LGPS funds is to pay member benefits as they are due – to do this requires cash. It's always been a consideration for funds, but there continues to be a shift in the balance of cash coming in and cash going out to pay benefits. With the potential for employers to gain some relief on contributions during this round of valuations, this could also feed through to net cashflows and the need to generate cash from investments.

This has been something we've flagged regularly in our annual outlooks; however, it's likely to become a more pressing issue – particularly if funds have not previously considered a cashflow management policy, liquidity waterfall or rebalancing framework. We believe that having good insight into net cash requirements and the structure of your investment should be a requirement for all funds in 2025.

Spreading your options in credit

Against a backdrop of rising bond yields, credit markets have held up well – particularly those with lower duration exposures. Credit spreads have tightened to quite extreme levels and, while this is supported by fairly robust credit fundamentals, it does provide the opportunity to think about the options available to credit investors. Could you look beyond the crowded scene of UK investment-grade credit, where many private schemes are vogueing as they await their move to an insurer solution?

One of the attractions of credit investing is the range of opportunities available that can be tailored to meet risk, return and liquidity preferences. Styles to choose from could include: high-quality asset-backed securities, if you want to maintain credit quality but get a kick in spread to bonds; fallen angels, if you're prepared to up the risk and don't want to miss out on some redemption stories; or private asset-backed lending, if you want a change from corporate lending and can take some illiquidity. While the all-in yield on UK investment-grade credit might look reasonable, there are plenty of options to consider that might manage the risk around current spread levels.

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Preparing for policy change

Political interest in the LGPS has been a constant talking point over the last few years. The current wave, driven by a desire to see greater investment into the UK to jumpstart the economy, began in earnest with the 2023 'Next steps for investment' consultation; this suggested that LGPS funds allocate 5% of their assets to 'Levelling Up' projects. Fast forward 18 months: new government, same push. 'Levelling Up' is gone as a term, but there remains a strong push to be investing in the UK and locally.

This has culminated in several proposed changes to how the LGPS invests, principally driven by a large expansion in the role of the pools. Proposed by government, from 31 March 2026, the pools must:

- Onboard all remaining unpooled assets (which government estimate to be over £200bn)
- Transfer and manage legacy private markets investments currently held outside the pools
- Build an investment strategy advisory service
- Develop the ability to implement that advice on a fully delegated basis
- Invest locally

What lies ahead?

There is, of course, more to come this year.

The first is the government's response to the feedback from the latest consultation, as well as clarification of how it intends to proceed. The latest precedent is the 2023 'Next steps for investment' consultation. The conclusion noted the levels of support for the proposals, any subsequent amendments and the confirmed route forward. While the 2023 consultation garnered mixed responses, there was a plan to proceed largely as originally proposed, with the government publishing guidance on the various areas of work – such as reporting on pooling and 'Levelling Up' investment. We await government's feedback on the current consultation and subsequent guidance on how 'local' should be defined; what projects should be prioritised and how fund specific beliefs can be allowed for.

The report for phase one of the pensions review is due to be published this spring. An interim report was received in November, giving some indication of future plans and justifying the proposals in the current consultation.

The final report should provide confirmation of government plans.

Finally, the Pension Schemes Bill, which is expected in the summer, will include any changes that will be enacted using primary legislation.

While we wait, we believe there are several areas that funds should work on this year. These actions will best position funds for the new LGPS pooling landscape.

Pool oversight and scrutiny

Under the government's proposals, the pools will soon have significant power over a fund's investments. While the high-level investment objectives and strategic asset allocation decisions remain with the fund, it's proposed that the advice on these (which typically has a large influence on the decisions made) will come from the pool. From there, the implementation of that strategy is delegated to the pools. This includes decisions on areas like regional allocation, manager selection, tactical asset allocation decisions and stewardship. Government state that a fund's role here is to "monitor" these activities from their pool.

Therefore, funds must have the governance in place to adequately oversee and scrutinise their pool to assess whether they are doing a good job. This can be considered from several perspectives, including operational performance and investment implementation from both high-level and more detailed considerations.

Operational assessments can consider:

- Is the pool adequately staffed with the correct skills and experience?
- Is their business plan aligned to your priorities and are they progressing as agreed?
- Are they building the right capabilities in the areas important to you?

High-level implementation should ask whether your pool has:

- Provided strong advice
- Implemented that advice and your beliefs
- Made strong decisions on tactical asset allocation

The more detailed considerations should include:

- The design and performance of individual investment funds
- Performance of manager and/or stock selection
- Stewardship activities

Now is the time to consider what governance bodies and processes you need in place to properly oversee and scrutinise your pool.

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Aligning investment strategy to current beliefs

The starting point for the pools will be the investment strategy, priorities and holdings that you hand over. This will then become something the pool needs to manage and take active decisions to change and move away from. As a result, it's prudent to ensure your portfolio is fully aligned to your aims and beliefs – and to make this clear to your pool. Without this, the pool may find it challenging to implement the strategy you want, and you may have a harder time assessing whether they have done a good job.

We believe funds should use this upcoming investment strategy review to reassess beliefs; set objectives around risk, return and responsible investment; and consider how to adapt current strategies to reflect this.

There is also the opportunity to review your remaining unpooled assets. Are there acceptable options within the pool? Or do you need to make the case for continuing to hold it – and for the pool to explore launching a solution? Similarly, are there any further investments you wish to make and hold post-pooling that your pool doesn't currently have solutions for?

Local investment beliefs and ambitions

Reviewing existing core and responsible investment beliefs should be supplemented with an assessment on what investing locally means for the fund. Given it's such a new method of investing for most funds, training will be needed for committees to adequately understand the area. Once achieved, beliefs can be set on important areas: definitions of local, the types of investments to be considered, and the impacts to be aimed for. This can then be used to inform the pool's investment activity on behalf of your fund.

Fail to prepare...

A lot of work is needed to prepare for the pooling deadline of 31 March 2026. While we are still waiting for the final details from government, the overall trend is clear. Don't let it stop you from getting started on this all-important preparation.

Bringing Mansion House home – what ‘local’ investment means for funds

For some weeks now, we have been digesting the government’s radical Mansion House reforms and attendant ‘Fit for the future’ consultation. A central pillar of the proposals is the imperative to consider local investment. But what does that mean for funds and pools, and what action should be taken this year to ensure the goals of all stakeholders are met?

Recap: the policy goal and consultation requirements

Government has drawn a clear line between LGPS assets and economic growth, remarking that “as an institutional investor, the LGPS can make a distinctive contribution to UK and local growth”. This has been well signposted by Labour and builds on the ‘levelling up’ ambitions of the previous government. Nonetheless, several aspects will be substantially new for most funds, and there will be a significant effort for funds to fulfil the government’s requirements.

The consultation requires funds to set out their approach to local investment, detailing a target allocation range in setting investment strategy. It will also be incumbent on funds to work with local authorities to identify local investment opportunities.

Local authorities, in turn, are expected to create a local growth plan, which will be informed by the needs and opportunities in their regions. The government has proposed a deadline of June 2025 for completion of these local growth plans, and expects them to be reflected in the local investment strategies that funds build.

Reporting will also be required. Funds will need to record the size and impact of their local investments in their annual reports. Meanwhile, pools will be responsible for conducting due diligence and deciding whether to invest. While these requirements may be amended to reflect the outcome of the consultation, we expect local investment to remain a requirement for funds.

Building the link between local growth and local investment

Local growth plans are likely to differ depending on the region's needs. However, the ambitions will create a potential imperative to act in different ways, which will help identify where capital may be needed. Growth goals, and the type of investment they may support, could include:

LOCAL GOAL	REQUIRED INVESTMENT
Regeneration of local commercial centres to encourage trade and redirect footfall.	Real estate investment, including the revitalisation of high-street shopping, the repurposing of surplus office space and the provision of better industrial facilities to support local businesses.
Developing local 'skills hubs' and encouraging the creation of businesses that exploit emerging skill sets.	**SME Finance**: The provision of debt and/or equity finance to innovative, high-growth companies. **Local banking**: Supporting the providers of capital to individuals who are building businesses.
Green growth. Ensuring the local economy has the capacity to transition quickly and effectively.	**Infrastructure**: Smaller-scale projects focused on regional energy generation and storage, and the deployment of associated capital.
Job creation, especially in areas of low employment.	**SME Finance**: Supporting the creation of manufacturing facilities to build local employment opportunities.

To be most effective, local investment strategies should be informed where capital is required to support growth ambitions. In decision-making, funds will need to spend time understanding what is needed and consulting with different stakeholders to ensure they are targeting their investment appropriately.

How new is this for funds?

Local investment is not new for the LGPS; the concept has been around for a long time, with some believing that a fund's duty to its local area is to invest. Some LGPS funds do invest locally, though allocations are typically small (due to the complex nature of these types of investments) and are done through professionally managed investment funds, rather than directly. However, most do not explicitly invest in their local area.

The consultation defined "local" to mean a fund's region (though "region" is not defined) or their pool area, but this definition could evolve. Key drivers of each fund's definition of local will need to be your beliefs about how strongly you wish your fund to aim for a positive impact on your local area, and the opportunity set within your fund's area.

There is a balance to be struck here. Narrower definitions of local may mean capital is not allocated, whereas broader definitions will see capital allocated away from the fund's immediate locality, meaning that accepting some level of trade-off will be vital.

The government's proposals indicate a push for all funds to do this. Moreover, there is a need to invest in a manner very different to the past – working with local bodies to find direct investment opportunities. Therefore, funds must understand this important area before determining the types of investments and impacts they would like to make.

Taking steps to prepare for local investment

Local investment needs to be a considered element of funds' investment strategies – not something that is bolted on as an afterthought. As funds work through their actuarial valuations and reconsider strategy, there are three areas of focus:

- **Education** - Local investment is likely to be new to many and there are several factors, some of which we have highlighted above, that need to be considered. This will include risk/return considerations, how different types of assets could achieve different goals and how to understand and measure local impact.
- **Engagement** - Dialogue with different stakeholders is going to be vital, both to build an understanding of needs and to understand how they may be funded. While these discussions may be undertaken locally, there may also be external investors with capital to deploy that could be considered.
- **Setting strategy** - Funds will need to create a strategy that can be delegated to their pools for implementation, which needs to be written into their Investment Strategy Statement. There are several factors that this strategy will need to reflect, including the objectives, target range and focus of the local strategy, all of which will be informed by dialogue with other stakeholders.

With pools expected to take on responsibility for the implementation of local investment strategies, it's key that each fund can state its requirements and exercise influence. In that way, funds become the makers of local investment strategies, rather than the takers of it.

We can help funds understand these myriad considerations and work with you to build your local investment strategy. To find out more about local investing and its effect on funds, please contact me directly or via your usual Hymans Robertson consultant.

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Net zero in the LGPS

Climate-change progress five years into the 2020s...

The decade so far has been one of commitment and promise by global leaders to tackle climate change – with insufficient action to back up their pledges. But this will be a pivotal year in the transition, as we reach the five-year milestone towards 2030 and the signatories to the Paris Agreement reset their Nationally Determined Contributions in February.

While it's an emotive question, is the 1.5-degree target now out of reach? Almost certainly, is the answer. Nonetheless, below 2 degrees is still both achievable and affordable. Renewables are now cheaper for many than fossil fuels, which is a positive tipping point in the transition. And momentum is likely to continue with clean, cheap, local energy addressing many problems, particularly energy security.[1] Private capital will play a critical role here. However, policy to date remains inadequate, putting the world on track for a 2.6–3.1-degree outcome.[2]

...with the next five years to be driven by geopolitics

Following the record number of global elections in 2024, the landscape has shifted. With President Trump back in the White House, the disputes between the US and China are likely to heat up alongside other contentious climate-related topics. (To quote the re-elected president: "Drill, baby, drill".) The impact of the Republicans' governmental trifecta – ie control of the White House, the Senate and the House of Representatives – is yet to be felt but will affect how the pivotal Inflation Reduction Act is implemented. In contrast, the new UK government has been clear in its commitment to the energy transition and tackling climate change, so we can expect policy support for the rest of the decade. Meanwhile, we shouldn't forget that climate change has long been cited as the biggest risk to national security. Inaction, or a lack of concerted action, means that risk will only increase.

What does this mean for LGPS investors?

Even without Trump's re-election, one of the biggest challenges for the rest of this decade is the pace of decarbonisation, which was already expected to slow. For example, listed US companies' emissions are now forecast to fall 1.8% pa from 2023 to 2030, compared with 3.7% pa over the six years to 2022.[3] From an LGPS investment perspective, this means it will be progressively harder to reduce emissions in investment portfolios without running into portfolio construction issues and potentially negative impacts on the push for real-world change. On-paper decarbonisation by removing allocations to high-emitting regions, sectors or even companies is not how we'll collectively reach net zero.

Invest in reducing, not reduced, emissions...

We have one key message for the year, and that's to invest in *reducing* emissions rather than *reduced* emissions. In other words, shifting the investment focus from current emissions to the low-carbon transition. We've reached this conclusion for two reasons:

- There's potential for enhanced investment returns by taking assets that are 'brown' today and financing their decarbonisation to 'green'.
- To drive the real-world outcomes required, there's currently no place to invest solely in assets that are already low carbon. Given the outcomes of COP29, investments by private asset owners will be key to the transition.

This approach applies across all asset classes. For listed equities, the key to investing in the transition is financing all sectors and regions to decarbonise, including the highest emitting sectors and regions. This includes both fossil-fuel companies and emerging markets.

[1] The energy transition will be much cheaper than you think | The Economist
[2] UN Environment Programme Emissions Gap Report 2024
[3] MSCI Sustainability Institute

... while mixing green and brown investments

LGPS funds can take a more nuanced approach to net zero by striking a balance between green and brown assets. For example, by prioritising green investments like renewable energy or climate mitigation via natural capital assets, LGPS funds can align with their own climate strategies while taking advantage of growth opportunities. But instead of entirely avoiding investment in carbon-heavy brown assets, LGPS funds can focus on engagement, pushing for change in critical industries like fossil fuels, to factor in the long-term benefits of the transition to a low-carbon economy. This way, LGPS funds can influence real-world outcomes.

Conclusion

The geopolitically unstable backdrop for climate policy will make navigating the low-carbon transition more difficult. And with that, the increasing manifestation of physical risks will most likely increase transition risks, too. However, with risk comes investment opportunity in both climate mitigation and, increasingly, in adaptation solutions. Ultimately, this means that deeper understanding is needed of the drivers of future change and their impact on investments.

Meanwhile, LGPS funds are likely to face stricter disclosure requirements to comply with the Task Force on Climate-related Financial Disclosures (TCFD). The government could make TCFD reporting mandatory, while the need to create transition plans was a manifesto commitment that we expect to be implemented. We recommend clearly mapping out an effective net-zero investment strategy through Climate Transition Action Plans (CTAPs) as a significant step forward.

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Market outlook

Global growth in 2024 is proving resilient

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

To an extent, loose fiscal policy has offset tight monetary policy. Nowhere is this truer than in the US, where government spending has supported robust, above-trend US growth, offsetting weaker growth elsewhere. Global manufacturing weakness continues to weigh on the eurozone economy, which has faced the dual threat of weak Chinese demand for exports alongside increased competition from low-cost imports due to excess production in China. Meanwhile, UK growth deteriorated sharply in the third quarter, from the robust pace registered in the first half of 2024. Strong manufacturing and export growth in China stood in stark contrast to weak domestic demand and deflation pressures as ongoing property market weakness weighed on consumer and business confidence.

Expected tax cuts and deregulation under President Trump are supportive of near-term global growth. And while lasting improvement in Chinese domestic consumption might require more fundamental shifts in the labour and property markets, fiscal and monetary stimulus unveiled in late 2024 may at least prevent a more pronounced slowdown there. Indeed, J.P. Morgan's Global Composite Purchasing Managers' Index, which aggregates activity across the global manufacturing and service sectors, suggests the pace of global growth accelerated in the fourth quarter. However, the survey also highlights marked regional and sectoral dispersion: the US has been responsible for much of the recent upturn, while buoyant service-sector activity stands in stark contrast to stagnating manufacturing activity.

In summary, global growth is anticipated to maintain its solid, albeit unspectacular, pace of 2.6% in 2025, remaining around that mark over the next few years.

US economic outperformance is expected to continue among the major advanced economies. However, stronger US growth, alongside tariffs and lower migration, may stoke inflationary pressures, resulting in a slower pace of rate cuts than initially expected. Uncertainty has increased, and rising trade tensions, higher US treasury yields and a stronger dollar could pose headwinds to global growth over the medium term.

What about inflation and interest rates?

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

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

Asset-class considerations

The deterministic returns shown in this section are fundamental, or structural, in nature. They are central expectations of returns from asset classes derived from income, and changes in income and prices. These are prepared separately from our Economic Scenario Service (ESS), which generates returns in a fundamentally different way. All ESS returns are essentially a combination of risk-free rate, or cash, plus a risk premium, arrived at via stochastic simulations based on key inputs and variables determined by their underlying statistical distributions.

Government bonds

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

And while the shift in the government's debt target to Public Sector Net Financial Liabilities is a positive step, allowing greater borrowing to fund investment, the government used far more of the headroom created than markets expected. This leaves little room for slippage against forecasts and raises the risk of higher gilt issuance in the future.

As a result, term premia (the additional amount required by investors to hold a long-term instrument versus a short-term deposit) have risen.

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

10-year expected returns, % pa	31 December 2024		31 December 2023	
	Index-linked gilts	Nominal gilts	Index-linked gilts	Nominal gilts
10-year spot yield	1.1	4.7	0.2	3.6
10/10 forward yield	2.4	5.9	1.5	4.9
Neutral 10/10 forward	1.3	3.8	1.3	3.8
Yield uplift	-0.6	-1.1	-0.1	-0.6
Capital gain/loss	1.2	2.1	0.2	1.2
Real return	**1.7**		**0.3**	
Inflation[1]	2.5		2.5	
Nominal return	**4.2**	**5.7**	**2.8**	**4.2**

[1] Consensus forecasts for UK inflation, RPI until 2030, CPI thereafter.

Corporate bonds

Credit spreads continued their year-long grind tighter in the fourth quarter, ending 2024 close to historic lows in both investment- and speculative-grade markets. Amid strong yield-driven demand, we think spreads already more than reflect the decent fundamental backdrop. Interest coverage – or the number of times earnings cover debt interest, a key debt affordability metric – has fallen from post-pandemic highs, but it is healthy in both the investment- and speculative-grade fixed-rate credit market. However, it's likely to come under further pressure as debt is refinanced and effective interest rates move higher. In the leveraged loan market, where higher rates were passed on more quickly to highly indebted borrowers, defaults reached 7.2% in the 12 months to end October – as high as they have been since the Covid-19 pandemic.

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

	31 December 2024		31 December 2023	
10-year expected returns, % pa	**Sterling investment grade**	**US high yield**	**Sterling investment grade**	**US high yield**
Initial spread	0.9	2.9	1.3	3.4
Neutral spread	1.5	4.4	1.5	4.4
Average spread	1.2	3.6	1.4	3.9
Revaluation	-0.4	-0.6	-0.1	-0.4
Credit losses	-0.2	-2.0	-0.2	-2.0
Excess return	**0.6**	**1.1**	**1.1**	**1.5**
Risk free return[2]	5.7	4.3	4.2	3.4
Nominal return	**6.3**	**5.4**	**5.3**	**4.9**

[2] Ten-year gilt return for investment grade, five-year gilt return for high yield, and cash return for loans.

A strong year for equity markets, but what lies ahead?

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

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

10-year expected global equity returns, % pa	Assuming reversion in earnings and valuations		No reversion in earnings and valuations	
	31 Dec 2024	31 Dec 2023	31 Dec 2024	31 Dec 2023
Dividend income	2.1	2.2	1.7	1.9
Trend earnings growth	2.3	2.3	2.3	2.3
Reversion to trend earnings	-0.6	-0.4	0.0	0.0
Revaluation	-1.9	-0.8	0.0	0.0
Real return	**1.9**	**3.2**	**4.0**	**4.2**
Nominal return[3]	**4.1**	**5.7**	**6.2**	**6.7**

[3] Consensus forecast for 10-year average US CPI inflation = 2.2% pa.

Glimmers of improvement in UK property

The 12-month change in the MSCI UK Property Total Return Index edged up to 7.0% in December. While capital values in the office sector were still 5.7% lower year-on-year, they have stabilised in recent months, and recent rises in industrial and retail capital values contributed to a 1.1% rise, in aggregate across sectors, over 12 months. The redemption pressure on several UK pooled funds highlights how challenging the technical landscape has been over the last couple of years. Investment volumes have been improving but remain below five- and 10-year averages, which themselves have been weighed down by the pandemic and the sharp fall in transaction activity that followed.

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

10-year expected UK commercial property returns, % pa	31 December 2024	31 December 2023
Income yield	6.0	6.1
Underlying income growth	-0.5	-0.5
Depreciation	-1.0	-1.0
Management costs	-0.5	-0.5
Revaluation	0.3	0.2
Real return	**4.3**	**4.3**
Nominal return	**6.4**	**6.4**

Private markets – looking beyond primary investments

High interest rates have led to a marked slowdown in private equity transactions in recent years and are likely to continue weighing on highly levered buyout activity. The low-rate environment of the past 15 years helped companies generate strong revenue growth, but we expect to see increasing focus on improving profit margins.

In this environment, we believe sector specialist strategies and secondaries/co-investments are likely to perform better than primary investments. The former areas could benefit from managers looking to deliver value through operational business improvements, investors trimming overweight funds from their portfolios (potentially accepting discounts in exchange for liquidity) and primary managers looking to replace expensive debt finance with co-investment.

The first line of defence against changing economic conditions is having a mix of diversified managers and investments across different vintage years, but the optimal mix of strategies has shifted in the current environment.

The higher returns that elevated financing costs offer private debt investors, and the challenge they pose to parts of the private equity market, mean we would be slightly overweight private debt versus equity. Direct lending managers are fundraising for new vintages on the back of significant flows of capital into the asset class, which has increased competition for deals. Along with the reopening of the broadly syndicated loan market, we have seen spreads compress significantly over the year.

Despite speculation about a potential lighter-touch approach to banking regulation on both sides of the Atlantic, the retrenchment of commercial banks from these markets is well advanced, with direct lending managers likely to retain a large portion of the market share gained over the last decade or so. Borrowers are still willing to pay a premium for certainty of finance and the flexibility of private debt. We expect recent vintages to yield better returns than in prior years, and also see increasing opportunities for investors to diversify away from corporate credit within private debt markets.

In summary

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

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

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

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

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

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