

Capital Markets Update

Spring 2025

Global growth forecasts have slipped in recent months as US tariff uncertainty weighs on consumer and business sentiment. Meanwhile, inflation forecasts have drifted higher: partly due to potential supply disruption, but sticky domestic inflation has also contributed.

US stocks had their worst quarter since 2022, with global equities down 1.9% in Q1. In contrast, expectations of greater defence and infrastructure spending helped European equities to outperform strongly. The shift in sentiment was reflected in bond markets, with US yields falling. However, European yields rose in anticipation of higher bond supply and the potential boost to growth from government spending.

Global themes

Consensus forecasts for global growth slipped to 2.3% in March – which is low, even relative to post-GFC standards. Trump has already postponed the implementation of additional ‘reciprocal’ tariffs for all countries except China. However, the newly introduced baseline tariff on all trading partners, along with significantly higher duties applied specifically to Chinese imports, is still expected to substantially increase the overall tariff burden.

The impact of US tariffs, and retaliation by peers, is likely to be extensive as rising costs and weaker demand from the squeeze on consumer incomes weighs on US corporate earnings while other economies see weaker demand for their exports. Heightened uncertainty will also affect consumer and business sentiment as well as investment and spending decisions. Indeed, US growth forecasts were already falling before the recent escalation as post-election optimism over pro-growth policies on tax and regulation gave way to pessimism about global trade. As a result, the risks to economic and corporate earnings growth forecasts look skewed to the downside.

However, the negative impacts may be cushioned by ongoing supportive fiscal policy in the US: even as growth slows, the US is expected to outperform its advanced-economy peers (Chart 1). A more isolationist US is also spurring European governments to dramatically increase defence spending in the face of less certain security guarantees, while emphasising the need to invest more heavily in ageing infrastructure. Chinese policymakers may focus stimulus more directly towards domestic consumers: export-led growth, which has so far offset weak domestic demand, could become harder to deliver as trade headwinds intensify.



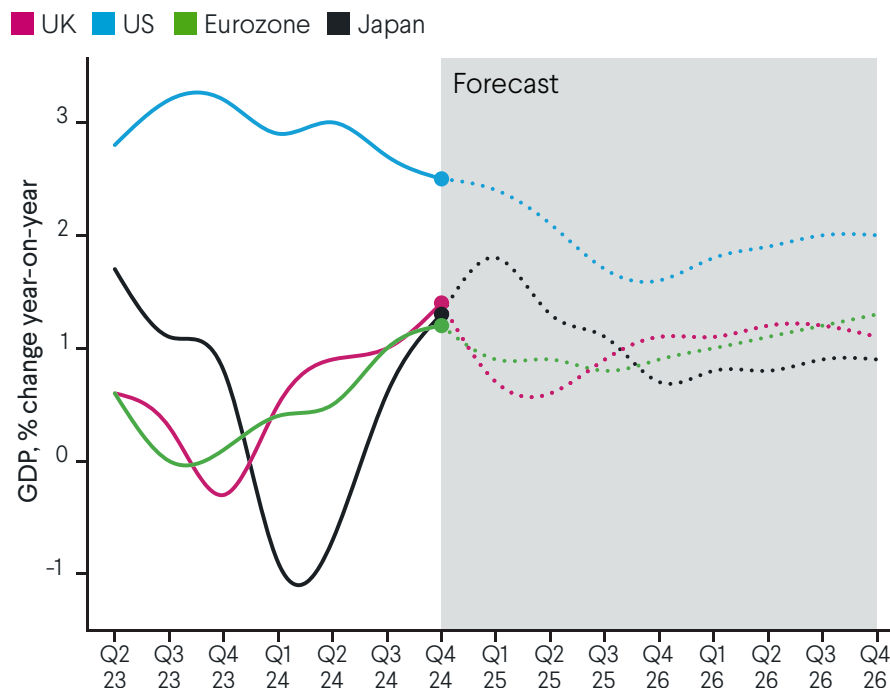
Chris Arcari
Head of Capital Markets

While US tariffs on imports would be near-term inflationary for the US, and negative for global growth, the impact on inflation elsewhere is ambiguous. Disruption to, and the reconfiguration of, supply chains would be inflationary, but exchange-rate movements will depend on relative trade policies and changes in risk sentiment. Meanwhile, weaker US and global demand for exports, and lower prices of exports previously destined for the US, would be disinflationary.

More importantly for the Bank of England (BoE), domestic disinflation has stalled. In the UK, disinflation in energy, food and goods prices has accounted for almost all the decline in inflation since its 11.1% peak in October 2022. With this in the rear-view mirror, inflation is forecast to rise in 2025 and could approach 4% (Chart 2). While the increase is expected to be closely linked to energy prices and, therefore, temporary, wage and service-sector inflation point to persistent underlying domestic price pressures.

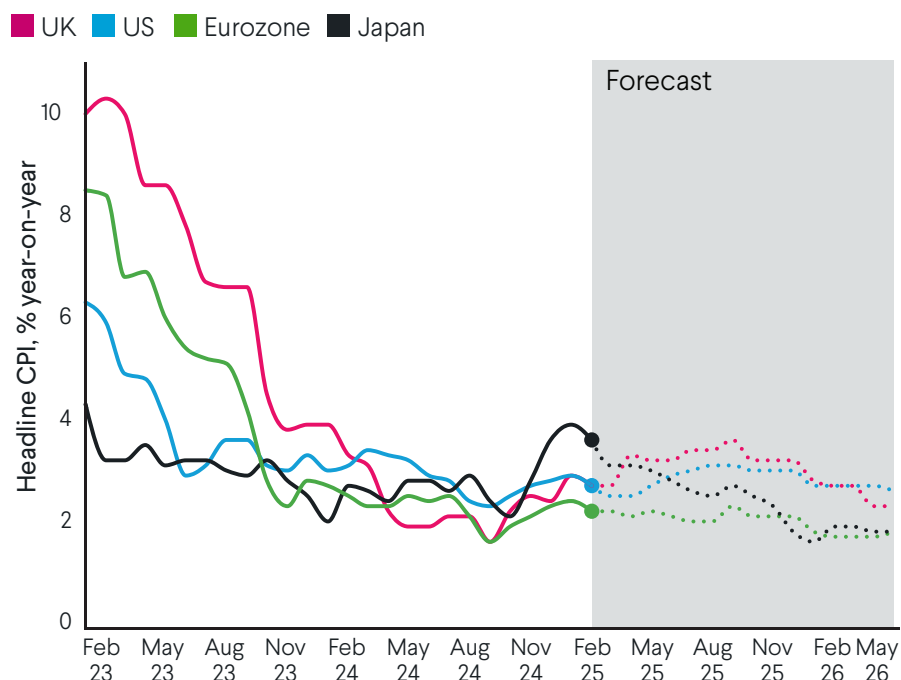
The current level of interest rates should allow for a couple more 0.25% pa interest-rate cuts in 2025, but we expect the BoE to proceed with care. The risks around this outlook are finely balanced – if growth slows, and inflation falls more than expected, interest rates leave ample scope for more aggressive cuts. But sticky inflation will keep policymakers cautious in the near term.

Chart 1: US growth is slowing, but still expected to remain stronger than in other major advanced economies



Source: Datastream and Consensus Economics

Chart 2: UK and US inflation is expected to rise and remain above target in 2025



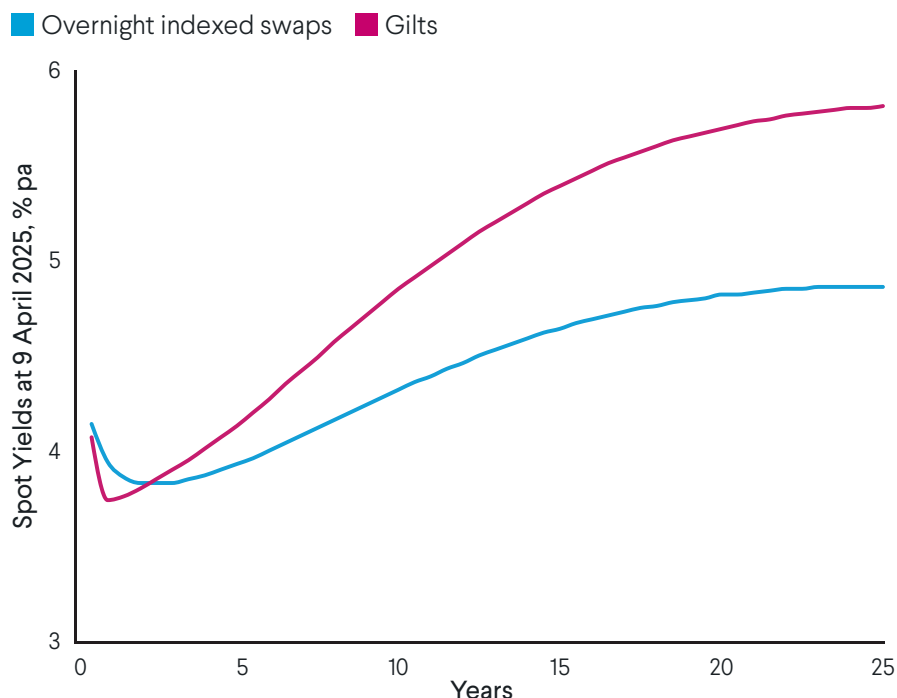
Source: Datastream and Consensus Economics

Government bonds

However, swaps markets may already be pricing in a higher-for-longer interest-rate environment: as of 9 April, overnight index swaps (which we would suggest are a better gauge of market-based interest-rate expectations than gilts) indicate the BoE base rate will average 4.3% pa over the next 10 years.

Furthermore, term premia (the additional amount required by investors to hold a long-term instrument versus a short-term deposit) have, perhaps surprisingly, risen further since the global equity sell-off at the start of April. Commentators suggest margin calls on levered equity and credit positions forced collateral sales (US treasuries and other major sovereign bonds), as credit and equity markets weakened, putting pressure on US – and global – bond yields. 10-year gilt yields, at 4.9% pa, are arguably reflective of the weak technical backdrop of anticipated heavy issuance and risks to inflation. As a result, we think yields are attractive relative to long-term growth and inflation forecasts.

Chart 3: The yield spread between gilts and swaps suggests a reasonable term premium is priced into gilt markets



Source: Bank of England, Consensus Forecasts

The recent rise in UK inflation forecasts, coupled with a fall in real GDP forecasts, increases the fundamental attraction of index-linked gilts. Meanwhile, the Debt Management Office's tabling of a lower proportion of index-linked gilt issuance makes for a slightly better supply-demand dynamic for index-linked than nominal gilts. As a result, we have a balanced view between index-linked and nominal gilts, despite nominal gilts being more attractive from a valuation perspective.

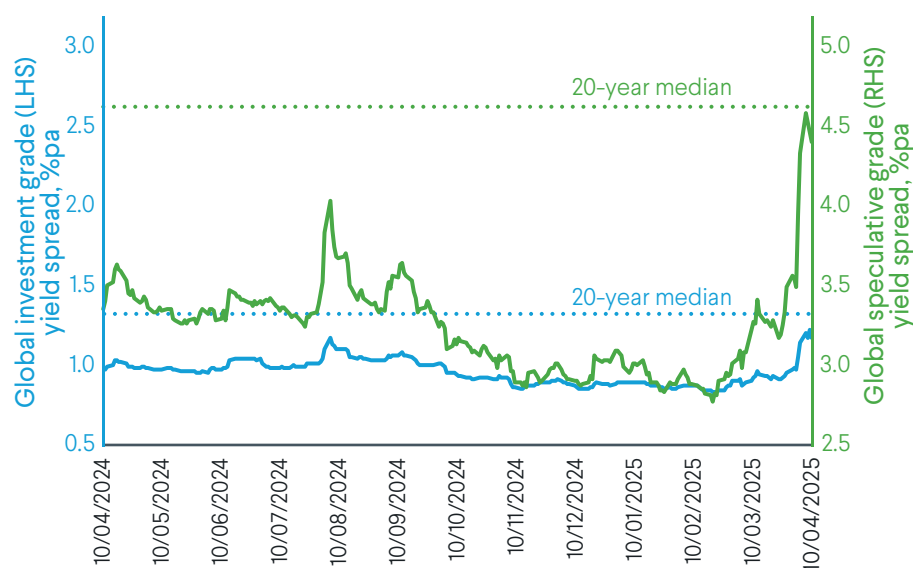


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Credit

Credit spreads drifted higher in Q1 as concerns mounted over tariffs and slowing growth. They subsequently rose more dramatically following the intensification of trade hostilities on 2 April. At the time of writing (10 April), global investment-grade credit spreads are up 0.3% pa since the start of the year, at 1.3% pa. Global speculative-grade credit spreads have risen more, by 1.4% pa, to 4.5% pa. Credit spreads started their ascent from historically low levels but are now only a little below long-term median levels (Chart 4). Credit is not necessarily cheap, and credit spreads tend to overshoot to the upside in a risk-off environment, but long-term investors who had been underweight relative to their strategic benchmark on account of low spreads might be considering moving back towards a more neutral position.

Chart 4: Corporate credit spreads are now only slightly below long-term median levels



Source: ICE Index Platform

Debt affordability metrics, such as the number of times interest payments are covered by earnings, remain relatively healthy in fixed-rate corporate bond markets. Indeed, ratings agency Moody's suggests corporates will be able to weather the ongoing rise in effective interest rates, as maturing debt is rolled over at higher yields. The ratings agency forecasts the 12-month trailing default rate will fall to 2.2% by the end of 2025, well below long-term averages. However, with economic and earnings growth slipping in recent months, and the risks to those forecasts skewed to the downside, the default forecast may be more likely to rise than fall in 2025.



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Equities

Global equity markets lost ground in Q1 (-1.9%), ending a streak of 10 consecutive quarters of positive returns for sterling-denominated investors. US markets underperformed as growth forecasts fell and inflation forecasts rose amid concerns over trade policy. The quarter saw a reversal of many of the trends that have dominated markets in recent years. 'Value' far outperformed 'growth' as sentiment soured towards relatively expensive technology stocks, driven by the potential impact of trade barriers on the highly globalised sector and the emergence of DeepSeek, a Chinese AI company that could provide a cheaper alternative to US offerings. This, alongside commitments to defence spending and a larger-than-anticipated infrastructure package announced in Germany, led the US to significantly underperform more value-oriented European markets.

Recent equity market weakness has taken a little heat out of global valuations. Trailing price-to-earnings multiples do not look particularly high relative to long-term median levels. However, earnings look extended relative to trend – ie the denominator is making multiples look a little lower than they are. As a result, cyclically adjusted valuations are still on the expensive side (Chart 5). Furthermore, the risks to earnings, and hence likelihood of reversion in earnings, have perhaps risen: 2025 full-year earnings forecasts for the MSCI World stand at a healthy 9.5% year-on-year. But this forecast has fallen from 12% at the start of the year, and earnings momentum – the extent to which analysts' upgrades exceed downgrades – is negative. It should also be noted that, despite rotation of favoured areas of the market, US equity market concentration is elevated relative to history, and the US market still trades at a premium to both global equities and its own history.

Chart 5: Global markets remain on the more expensive end when compared with history



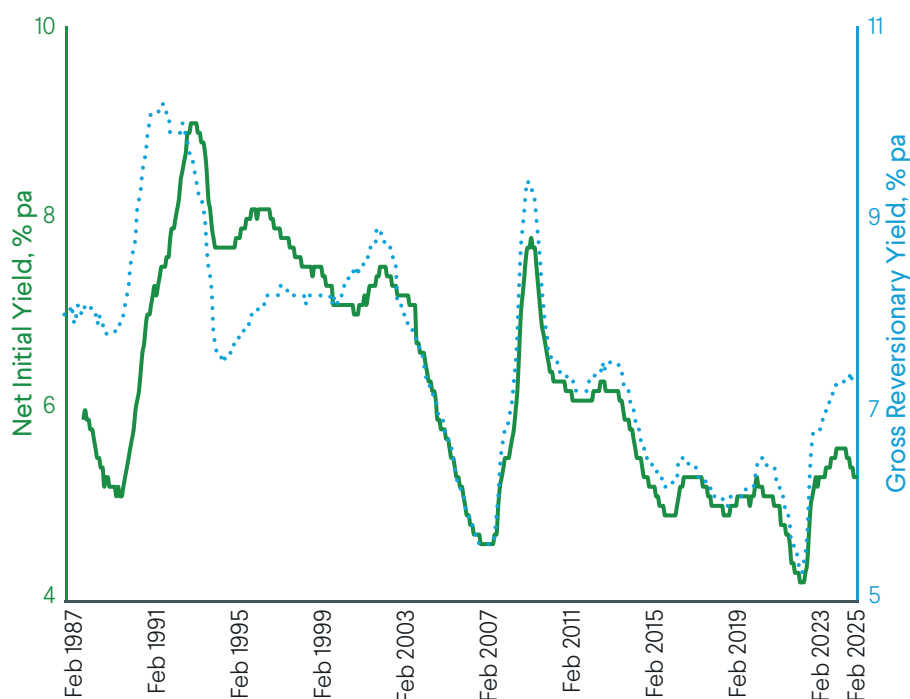
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Property

Strong rental value growth in recent years has been driven by demand for better quality, more energy-efficient buildings, particularly in the industrial and office sectors. This trend has been exacerbated by a lack of supply of prime quality space, as development activity has slowed amid high financing and construction costs. This has supported robust income growth, which contributed 5.9% of the 8.1% rise in the MSCI UK Property Total Return Index in the 12 months to the end of February. Rental growth expectations have been slipping more recently, though, as tenants contend with rising inflation and a weak growth outlook. We anticipate further divergence between market average/sub-prime and prime quality property rental growth.

Chart 6: UK commercial property reversionary yields suggest there may be scope for further capital appreciation



Source: MSCI IPD Monthly

Net initial yields (based on current rents) of 5.2% pa are below gross reversionary yields (based on future estimated rent when leases expire or are renegotiated) of 7.3% pa. This suggests scope for further capital appreciation. However, MSCI data suggest transaction activity is still sluggish in 2025 and below the levels of 2024. There is also continued redemption pressure on several UK pooled funds, underscoring the challenging technical landscape of the past few years.



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Conclusion



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While cracks have started to appear in the economic outlook, equity valuations are less stretched than they were, and credit spreads have risen from historic lows.

Equities are less expensive than they were but still not cheap. Trailing price-to-earnings multiples now look close to the long-term median, but these appear artificially low, given earnings look elevated relative to trend. In other words, the likelihood of earnings reversion has increased, and valuations have not yet fallen enough to offset this risk.

Credit spreads have risen rapidly in 2025, but spreads have a history of overshooting in risk-off environments. However, there may be some opportunities for longer-term investors who have been underweight strategic targets on account of the historically low spreads in 2024 to revisit those positions.

UK sovereign bonds may be in for a bumpy ride given heavy supply, ongoing BoE asset sales and waning institutional demand. But forward yields, which are elevated relative to longer-term economic fundamentals, provide an attractive entry point for long-term investors.

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