HYMANS ROBERTSON

Capital Markets Update

Summer 2025

Global growth forecasts for 2025 have slipped since April's 'Liberation Day' tariff announcements. Despite subsequent delays and trade deals, the US effective tariff rate is much higher than it was. Meanwhile, US and UK inflation is expected to rise in the near term.

Global equities rebounded from an early-April sell-off, rising strongly in the second quarter (Q2). Credit spreads retraced their earlier widening to end the quarter tighter, close to historic lows. UK 10-year gilt yields fell amid slowing growth and interest-rate cuts, but concerns over higher bond issuance and waning demand kept long-term yields elevated.

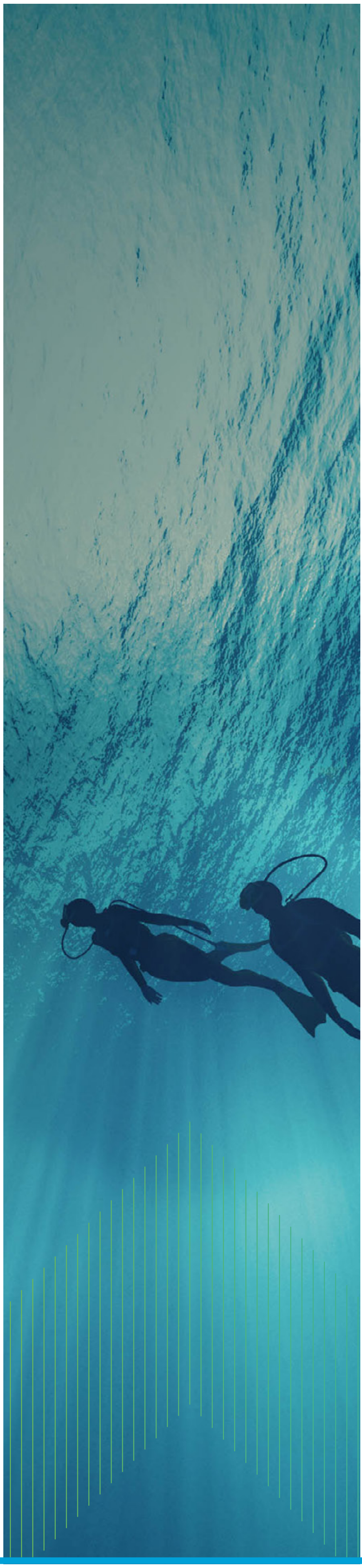
Global themes

Full-year global growth forecasts fell in June. If realised, these would mark a sharp slowdown from the growth registered in 2024. While a global recession is not the base case, risks are skewed to the downside.

Despite bilateral trade agreements (notably with China) and a temporary pause on tariffs for most countries, the US effective tariff rate has risen from low single digits to the high teens. New sectoral tariffs affecting steel and aluminium are also being applied across trading partners. This is expected to weigh on both US and global growth in the years ahead. Trade-policy uncertainty is also dampening business and consumer confidence, curbing spending and investment decisions.

Trump's budget reconciliation bill, which enacts sweeping tax cuts and increases federal debt, might provide a modest short-term boost to US growth, but it's unlikely to fully offset the tariff headwinds. The bill adds to concerns about US debt and places upward pressure on longer-term bond yields, both domestically and globally. Government spending may also help offset these effects in Europe, where, unlike many major advanced economy peers, Germany has ample space to increase defence and infrastructure spending.

Chris Arcari
Head of Capital Markets



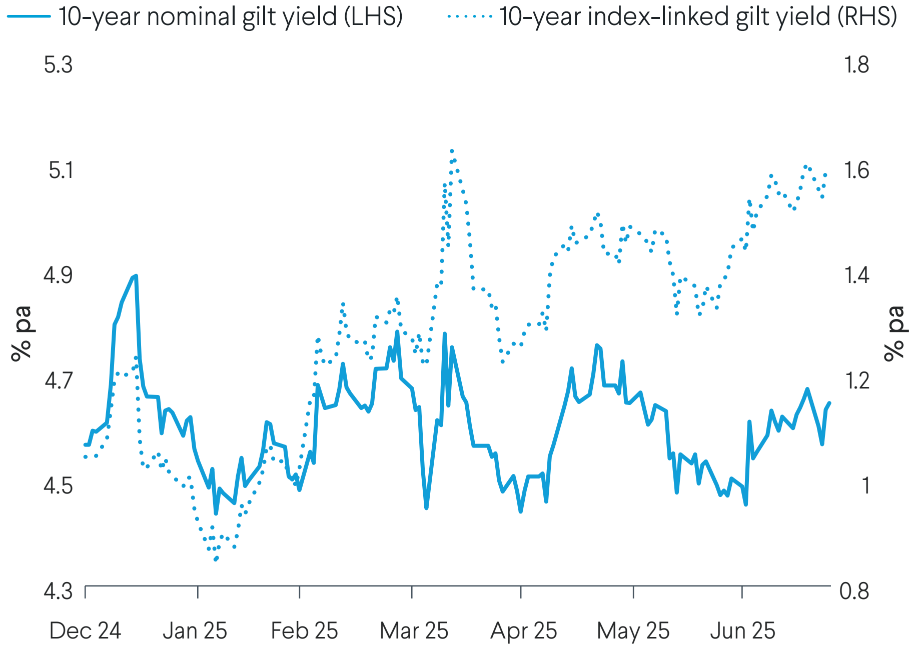
Meanwhile, US and UK inflation forecasts have risen, reflecting anticipated supply disruption and persistent domestic price pressures. Inflation in both regions is expected to stay above target until at least 2026. The US is being hit with both supply and demand shocks, which will raise near-term inflation, but the direct tariff impact on inflation elsewhere is more uncertain. Falls in commodity prices and currency appreciation against the dollar might lower headline inflation, while some imported goods could become cheaper if exports previously destined for the US enter non-US markets. On the other hand, damage to global supply chains could raise inflation.

In Q2, the Bank of England (BoE) cut rates a further 0.25% pa, to 4.25% pa. To some extent, the BoE is expected to look through the near-term uptick in inflation, as it's at least partly due to supply-side developments and therefore likely to be temporary. Given the BoE estimates that interest rates are slightly restrictive, further rate cuts are likely. However, the central bank will proceed cautiously amid persistent domestic price pressures. Markets expect a couple more BoE cuts in 2025 and one more in 2026, which would take the base rate to 3.5% pa.

Government bonds

Despite high near-term inflation, slightly weaker real GDP growth means that average forecast nominal GDP growth is within our 'neutral' band. Downside economic surprises and rate cuts pulled shorter-term yields lower in Q2, but longer-dated yields were little changed over the quarter. They remain elevated, given a challenging technical backdrop characterised by rising issuance and waning institutional demand. We think 10-year gilt yields are attractive relative to longer-term growth and inflation forecasts – even when adjusting our assessment of fair value to account for persistence in a positive 'term premium'.

Chart 1: A larger rise in real than nominal yields means 10-year implied inflation is no longer particularly expensive



Source: Bloomberg

Weaker growth and higher inflation, meanwhile, make a slightly more supportive fundamental backdrop for index-linked gilts. Ten-year real yields have risen to around 1.5% pa, becoming more attractive from a valuation perspective too. The rise in real yields relative to their nominal counterparts also means that 10-year gilt-implied inflation has cheapened significantly in 2025. However, long-term implied inflation protection is still slightly expensive. Moreover, a lower proportion of index-linked gilt issuance and ongoing demand for real exposure contribute to our more constructive technical view. As a result, we have a balanced view between nominal and index-linked gilts, despite a slightly better valuation assessment for nominal bonds.

Robert Kotlar
Senior Investment Research Analyst

Credit

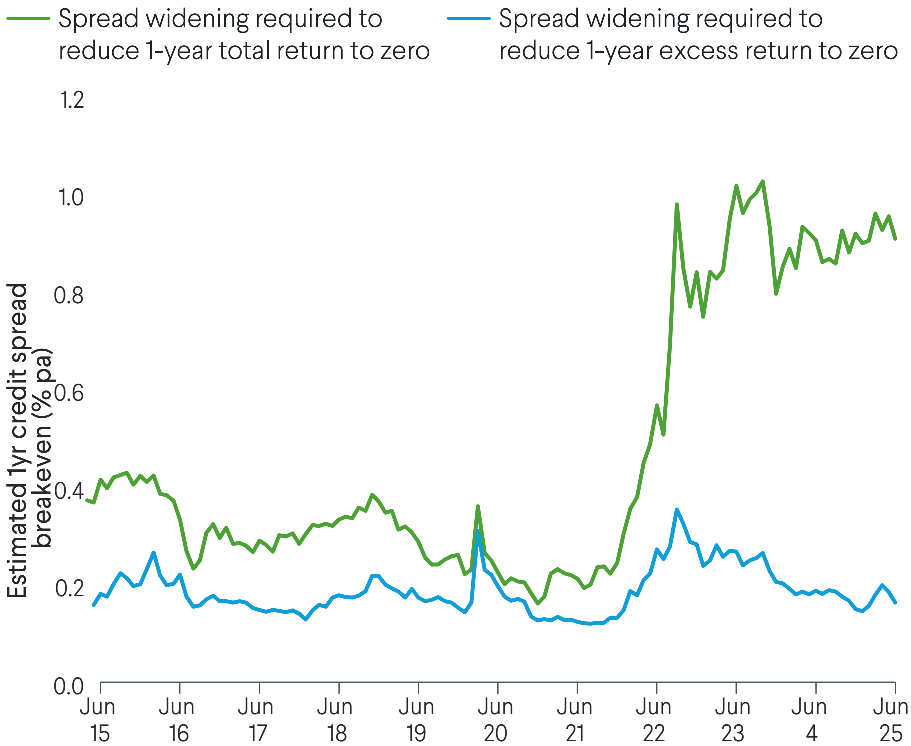
Companies are more indebted than when yields were last at these levels, and interest coverage has continued to fall towards long-term averages. However, interest coverage remains healthy, providing support amid ongoing rises in effective interest rates. This, alongside low spreads and solid earnings forecasts, suggests that companies can navigate the gradual decline in debt affordability.

Global investment-grade credit spreads have recovered from the widening sparked by the Liberation Day announcements at the start of April, ending Q2 marginally tighter. They also tightened further through the first half of July, with spreads returning close to historic lows.

That said, investment-grade credit markets continue to offer a spread premium over long-term losses due to defaults and downgrades. But investors with shorter time horizons run the risk of underperforming gilts, should spreads widen even modestly. While investment-grade credit spreads are low by historical comparison, high all-in yields mean medium-term risk-adjusted returns look relatively attractive to an absolute-return investor and provide a cushion from the prospect of negative total returns due to spread widening (Chart 2).

The same is not entirely true of speculative-grade markets. Global speculative-grade spreads, which more than recovered from April's widening over the rest of Q2, are more vulnerable to downside risks. The greater risk of credit losses in speculative-grade markets warrants a degree of caution.

Chart 2: Investors with shorter time horizons should be cautious on credit spreads at these levels, but spreads still offer compensation versus long-term default and loss, and all-in yields are attractive



Source: ICE Index Platform. Sterling Corporate Index

Chiara Beaton

Investment Research Analyst

Equities

Global equities rebounded strongly from their early-April tariff-induced sell-off in Q2. However, dollar weakness stemming from policy uncertainty reduced returns for an unhedged sterling investor. After underperforming in Q1, growth stocks fared well as mega-cap tech stocks drove the US to ultimately outperform in Q2.

Cyclically adjusted global equity valuations have returned to high levels relative to history and are approaching their 2021 peak. But the US market, which was around 72% of the MSCI World Index at the end of June, is primarily responsible for this apparent expensiveness. US equities have performed well in recent years. Earnings growth has been strong, but share prices have risen even faster. As a result, US equities have become expensive. This can be informative for medium-term returns, as the cyclically adjusted earning yield is often interpreted as a proxy for the expected real medium-term market return. Furthermore, given rises in real yields since 2022, the excess earnings yield, which can be interpreted as an implied 'equity risk premium', looks low relative to history. As a result, we are a little more cautious on global equities, particularly the US.

Andrew McCollum
Investment Research Analyst

Property

Nominal rental growth remains positive but has eased in recent months. Meanwhile, a rise in inflation means that real rental growth is negative in UK commercial property markets. There's an increasing divergence between market average rental growth and rental growth of prime quality assets across the retail, office and industrial sectors. Better-quality and more energy-efficient buildings continue to drive positive rental value growth. Vacancy rates, however, are increasing and are high relative to historic averages, particularly in the office sector, where they're more than double their long-term average. Vacancies in the industrial sector have also been rising, albeit from a much lower base, but are also above their historical average.

Net initial yields (based on current rents) are below gross reversionary yields (based on future estimated rent when leases expire or are renegotiated). This suggests that there is scope for further capital appreciation. We continue to see signs of technical factors improving, but redemption queues on some of the pooled funds are quite high, which indicates that selling pressure persists. Furthermore, elevated economic uncertainty and a narrow gap between property and gilt yields, which deters leveraged buyers, are weighing on sentiment.

Viran Patel
Investment Research Associate Consultant

Conclusion

While the outlook is not terrible, growth is slowing, and forecasts are lower than they were. Higher government spending has scope to provide near-term support. However, this spending, alongside lingering inflation pressures, will make it more difficult for central banks to lower interest rates.

That said, we find attraction in positive real sovereign bond yields, which look high relative to longer-term growth and inflation forecasts. Moreover, recent downgrades to real UK growth forecasts, alongside upgrades to inflation forecasts, improve the relative attraction of index-linked gilts. Implied inflation is also cheaper.

Investment-grade credit spreads are very low relative to history, which should make short-term investors cautious, but they still provide a premium relative to longer-term expected default and loss. Furthermore, high all-in yields mean potential medium-term absolute risk-adjusted returns look relatively attractive. We are more cautious on speculative-grade credit, where spreads are tighter relative to history and the risk of actual loss is greater.

Cyclically adjusted global equity valuations have risen and are high relative to history. Moreover, materially positive real yields mean the excess earnings yield, which can be interpreted as an 'equity risk premium', looks very low. This indicates that equity risk does not look particularly well rewarded at the moment.

It's important to focus on longer-term strategic objectives and the assets that are most likely to achieve them. But it may not be unreasonable to be underweight risk markets, given a backdrop of materially positive real bond yields, elevated equity valuations and thin credit risk premia.

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