Outlook 2025

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Key points

- **US consumption is weakening, and we are keeping a close eye on this area because consumer spending accounts for around 70 per cent of GDP.**
- **Given the slowdown scenario we are anticipating, we are relatively defensively positioned with US Investment Grade (IG) credit markets arguably priced to perfection.**
- **At a sector level, we favour shorter dated senior financials, where we still see pockets of value. We are steering clear of the longer end of credit curves across sectors given rich valuations.**

What is your outlook for your asset class?

Our base case into 2025 is that of a slowdown scenario materialising in the US, driven largely by US consumer weakness, a labour market under pressure and a more aggressive US Federal Reserve (Fed) rate cutting path than currently expected by the market. US consumer spending constitutes almost 70 per cent of GDP and we are keeping an eye on signs of weakness that is already emerging in consumer facing sectors. Pandemic-era savings have also largely been depleted and data shows up to 40 per cent of American credit card holders have maxed out limits.

Whilst the labour market has remained relatively robust in 2024, hiring rates have fallen materially and unemployment is rising, and this is indicative of pressure to come. This is against a backdrop of inflation on track to fall to 2 per cent, with services disinflation already ingrained and housing driven costs - which have accounted for the bulk of recent consumer price index (CPI) - on a slowing trajectory. We also question the effectiveness of rate cuts in the near-term given consumers are now less sensitive to changes in rates, with mortgages a case in point.

These factors are combined with extremely expensive valuation levels in US IG credit markets, which are arguably priced to perfection with spreads the tightest they have been since 1998. We are keeping a keen eye on any reversal in the yield-buying demand technical factors which have proved to consistently drive spreads ever tighter.

How are you looking to position your portfolio against this backdrop?

From a top-level perspective, we prefer to be defensively positioned against this backdrop. Historically tight spread levels do not provide adequate compensation for the additional credit risk, particularly in the face of the slowdown scenario we are

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anticipating. Given that IG credit spreads have largely been supported by consistent buying demand, attracted by the high all-in yield levels still available, there is also some detachment from fundamental valuations. We view any withdrawal of this buying demand momentum as a potential risk factor. If supply increases materially in 2025, either through corporate refinancings, with issuers drawn by attractive spread levels, or a wave of merger and acquisition (M&A) activity, this could alter the demand driven balance we have been seeing.

For these reasons, we are underweight US IG credit. This gives the strategy a defensive base, where in the event of market volatility we will be in a strong position to add credit exposure to names we like at more attractive valuation levels. In terms of sector positioning, we maintain an overweight in shorter dated senior financials, where we still see pockets of value, but we are steering clear of the longer end of credit curves across sectors given valuations here are even richer. We also maintain an overweight in healthcare, an expression of our defensive bias given the sector should outperform the wider corporate universe when our anticipated slowdown scenario materialises. Additionally, we are underweight cyclical and higher beta sectors which will be most impacted in a risk-off environment.

In terms of duration positioning, we maintain an overweight in US duration in light of our view that the Fed will have to cut more aggressively than anticipated by market pricing going into year-end. We also still see US Treasury yields as too high given our growth outlook and the fact that US population growth levels of 0.5 per cent are not supportive of longer end US Treasury yields above 4.5 per cent.

Elsewhere, we maintain some small off-benchmark overweight duration positions in Bunds and Gilts, given these markets are already struggling with growth at lower levels of inflation, making current yield levels attractive. A slowdown scenario in the US would also read across to these markets given historical correlations with US yields, as well as potential headwinds from a more US-centric policy agenda expected from the Trump administration.

All information is current as at 3 December 2024 unless otherwise stated.

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