Parmenion
Investment Management

2025 Macro Outlook

Peter Dalgliesh
Chief Investment Officer

Summary

Trump's pro-growth policies boost confidence in a 'soft landing'

Pledges of tax cuts, deregulation, and improved government efficiency are spurring investor optimism.

Inflation shock more likely than growth shock

Core inflation remains stubbornly high, with risks of further spikes, making an inflation shock more likely than a growth slowdown.

Central Bank monetary policy expected to diverge

The strength of the US economy is in stark contrast with much of the rest of the world. The ECB is expected to continue interest rate cuts through 2025, while the US Federal Reserve is likely to move towards a pause.

Growing cloud of fiscal irresponsibility

Many Western economies have debt-to-GDP ratios of over 100% and with the US budget deficit set to climb further than the already high 6.4% seen in 2024, this could lead to a straining bond market.

Seek diversification across the US and globally

US mega-cap leadership may cool as earnings growth moderates and valuations look stretched. New opportunities across different regions, sectors, and market caps are expected to emerge later in 2025.

Opportunity for active managers

As market leadership broadens, active managers may have more chances to deliver better results than index-based investments.

Out of favour asset classes offer defence

Concentrated, crowded positioning leaves investors susceptible to sharp swings in sentiment. Unloved, under-owned and undervalued asset classes can help protect against drawdown risk.

For financial professionals only

What's the outlook?

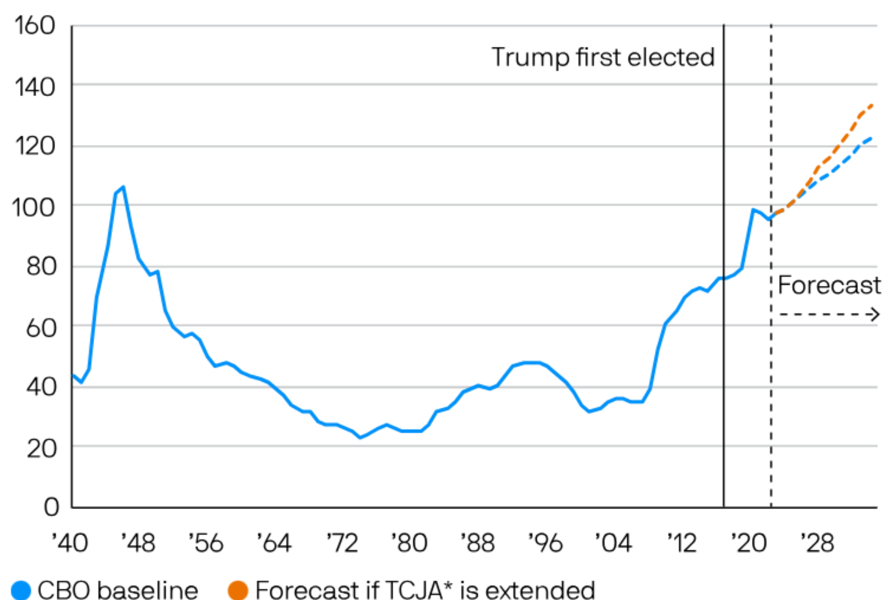
Balance optimism with caution and adaptability

Stronger-than-expected returns in 2024 were driven by resilient US GDP growth, a big boost from the Magnificent 7, central banks easing monetary policy, and fresh optimism following changes in government in a number of countries. That said, with confidence high about a probable soft landing, some key markets look stretched. Inflation is proving stubborn, and geopolitical risk is ever present, so it's worth staying cautious.

US economic and market momentum stood out in 2024. The economy was buoyed by resilient consumers, with a solid labour market driving the savings rate down to 4.4% - below the 2015-19 pre-COVID average of 6.1%.

Coupled with rising equity and property markets positive wealth effects also fed into supportive 'feel-good factors' for many households. But not everyone benefited. Lower-income consumers are struggling with rising cost-of-living pressures, as inflation and higher interest rates on credit cards and other debt eat into their disposable income. Trump's political success could largely depend on how he supports this important segment of the electorate, who are feeling bruised, neglected, and overlooked.

Meanwhile, government spending is loose across several Western economies, with debt-to-GDP ratios topping 100% in many cases. According to the Congressional Budget Office, if the incoming Trump administration follows through on its campaign pledges, US federal debt could hit 130% of GDP by 2030. While bond markets have been pretty tolerant of this to the end of 2024, this is already beginning to change in 2025 as investors demand higher yields, raising volatility and acting as a brake on economic activity, as borrowing costs climb.



Source: US federal debt % of GDP. BEA, CBO, US Treasury, J.P. Morgan Asset Management.

Expect a shift in concentration risk

In equities, concentration risk has intensified. Right now, the top 10 in the S&P 500 make up over 35% of the index, with just two sectors, technology and communication services accounting for over 40%.

The good news? This concentration has been driven by strong fundamentals – impressive earnings growth and cash flow have supported rising valuations.

Looking ahead, we expect earnings growth to accelerate outside the top 10, with a broadening in the market and convergence in relative performance by the S&P 490. While earnings growth among the top 10 is expected to remain robust, it's unlikely to be as exceptional as it has been.

As 2025 unfolds, prevailing pessimism towards Europe, the UK and Emerging Markets is likely to ease as political uncertainty diminishes. We'll start to see clearer, more effective policies take shape. These markets are clearly undervalued, but for that to be translated into returns, we'll need a sustained improvement in the earnings outlook.

Policy divergence ahead

Having been through a period of synchronised monetary policy, we now appear to be heading towards a time of policy divergence.

The Fed is likely to slow, if not pause, its rate-cutting cycle, while the ECB looks set to continue easing to support Europe's structurally challenged economy.

The UK is somewhere between the two, grappling with persistent inflationary pressures, driven by public sector and minimum wage increases, and the recovery hampered by rising taxes imposed by the Labour government. The Governor of the Bank of England has talked of expecting four rate cuts through 2025, but this seems optimistic unless inflation eases towards the 2% target - which appears highly unlikely at this point. By contrast, the Bank of Japan looks poised to continue in its attempts to move interest rates up towards 1%, though progress is likely to be slow and steady.

Opportunities widen

With fiscal and monetary policies tilted to support growth, we anticipate greater breadth and investment opportunities across markets, especially in the second half of the year. A plateauing in the strength of the US dollar will likely reinforce this trend, which is expected as regional growth differences narrow.

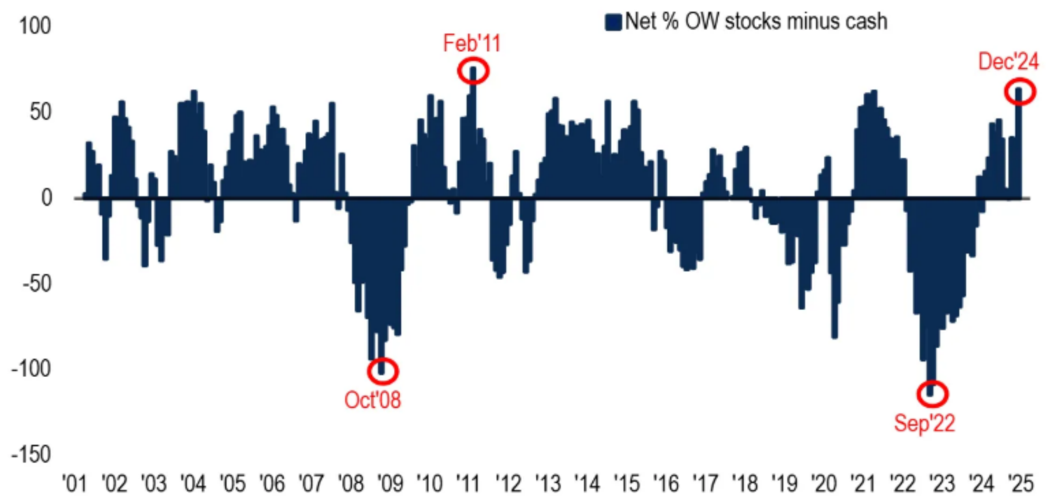
Clearly, a big unknown is the policy prioritisation and aggressiveness of the Trump administration, but much of this is already discounted in the market. Trump himself sees the market as a measure of his success, so he will want to avoid upsetting them wherever possible.

All things considered, we're feeling reasonably optimistic for 2025, but expect market leadership to shift as earnings growth evens out, valuation gaps become more important and concentrated crowded positioning moderates. Volatility is likely to rise, and asset class correlations fluctuate, reiterating the importance of having a globally diversified multi-asset portfolio.

A soft landing is widely anticipated

With central banks easing in 2024 as disinflation came through, fears of a recession have reduced. The lagged impact of higher interest rates from the 2022/23 tightening cycle was less than expected, thanks to a resilient labour market and supportive fiscal policies. This spurred corporate investment activity and helped maintain economic momentum.

Consensus has shifted to discount the risks of a hard landing, with many asset allocators predominantly overweight equities in anticipation of a soft landing, or even no landing at all. Macro trends seem to back this, but when positioning becomes as crowded as this, it often pays to be wary.



Source: Rotation out of cash into stocks. BoA Fund Manager Survey, December 2024

Trump 2.0 – fizz or flop?

The clean sweep by Trump and the Republican party fuelled market excitement around the pro-growth prospects of tax cuts, deregulation, reduced government inefficiency and better border control.

The actual execution of these is key - we've moved from political uncertainty to policy uncertainty. Extreme measures like a 60% tariff on China seem improbable due to congressional hurdles and economic implications. Nonetheless, should the talked about 60% tariffs on China and 10% across-the-board on all trading partners be applied along with proportional retaliation this would be negative for US and global growth as well as inflationary (Franklin Templeton estimates a 0.5% increase to US inflation).

Expect a reasonably rapid flow of policy announcements post-inauguration, though the specifics are unlikely to be as draconian as indicated on the campaign trail.

The Tax Cuts and Jobs Act, set to expire at the end of 2025 will likely be extended, but this only keeps tax rates the same – it doesn't put extra income in households' pockets. Trump plans to lower corporate taxes to 15% for US-derived revenues and make tips and overtime tax-free. However, the size of a corporate tax cut may end up closer to 18% due to budget concerns. The greatest beneficiary of this will be smaller, US-focused companies (SMID caps), which have greater domestic revenues.

Can Musk deliver?

Since the election, investors are optimistic about deregulation and government efficiency. This is expected to drive increased M&A activity, which tends to be good for growth, jobs and corporate profits. The downside, however, is that this could increase financial risks over time – so something to keep an eye out for.

The newly formed Department of Government Efficiency (DOGE) under Elon Musk and Vivek Ramaswamy aims to cut $2 trillion in federal government spending in the Trump administration. This represents about 29% of federal government spending, which is more than Congress spends annually on government agency operations, including defence. If successful, this may hurt job creation, particularly in the public sector where in the last 12-18 months the bulk of new jobs have been created. It could lower inflation but might weaken domestic consumption, which has been the mainstay for US growth in recent years. So again, something to be watchful of.

A tightening of border control is expected to be swiftly rolled out by Presidential executive order, but mass deportations are unlikely. Foreign-born workers in the US as a percentage of the workforce has risen 1.5% in the last four years to 19.4%, amounting to 5.3m people. That's one-third of the total increase in employment, boosting labour supply, aggregate demand, and tax revenue for the government. Mass deportations would harm sectors like construction and hospitality, which are close to Trump's personal interests.

The key to consumption

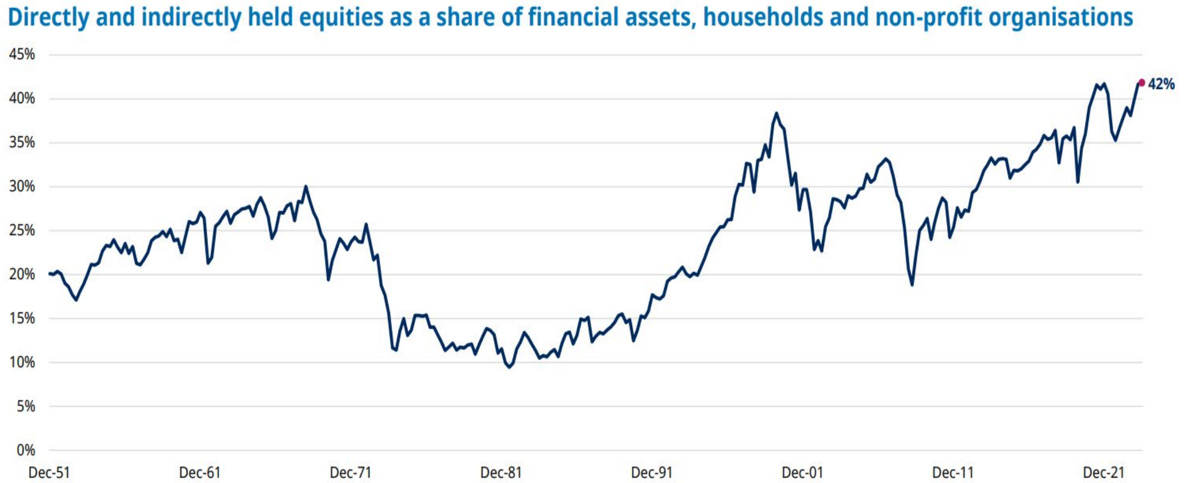
Private consumption in the US represented just under 68% of US GDP in the year to September 2024, making it a critical driver of economic stability and growth.

Strong job creation since the pandemic has helped support spending. However, with the unemployment rate edging up, wage growth moderating, and the savings rate beneath the historical average there are signs of strain.

The Sahm Rule of an imminent recession was triggered in 2024, which is when the rise in the rolling 3-month unemployment rate exceeds 0.5% above the low point in the last 12 months. But this was due to a rise in the labour force rather than an increase in layoffs. However, that increase in the labour force has meant that the monthly breakeven level of job creation is now estimated by the San Francisco Federal Reserve Bank to be around 230,000. This looks a challenging level of job creation to maintain, especially since small businesses, which make up close to half of private sector employment, are feeling the pinch of high debt servicing costs with the average cost of loans now sitting at over 9%.

But having experienced recruitment challenges in the post-pandemic tight labour market, businesses have been hesitant to lay people off, resulting in labour hoarding. If economic activity softens and corporate sales slow it is likely that redundancies will pick up raising doubts around the durability of the consumer.

An equally important recent driver to consumption in the US has been the positive wealth effects from rising equity and property markets. Household allocations to equities are at an all-time high and with the S&P 500 close to a record level has created a positive "feel-good factor". But there's a risk that if the market experiences a setback, then the reverse should be assumed. As such, we believe Trump and his administration won't want to upset capital markets, both bonds and equities alike.



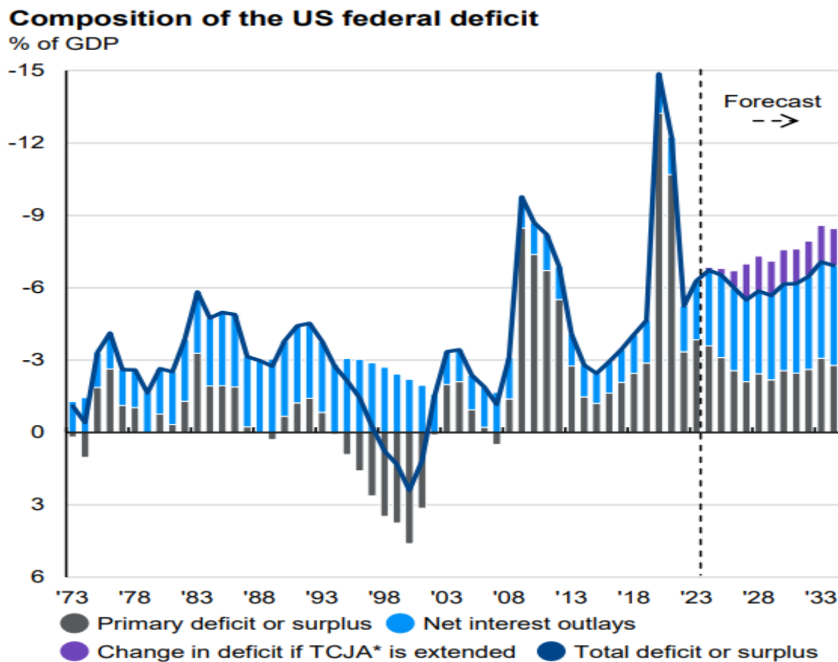
Source: Federal Reserve, LSEG Datastream and Schroders, Q2 2024

US government debt risks

Despite strong growth with low unemployment, the US fiscal deficit increased to 6.4% of GDP by September 2024 - a level typically not seen outside times of war. With Trump advocating tax cuts this looks set to worsen.

The danger with this approach is provoking the ire of bond investors, who may demand higher yields as compensation for the additional risk. The situation is made all the worse by the fact that the US government debt maturity is short, increasing the sensitivity to refinance risk.

The US government is not going to default on its debt. However, rising interest payments could consume more of government revenues, squeezing funding for public services. This is fraught with political risk, something the incoming Treasury Secretary, Scott Bessent, will have to manage extremely carefully.



Source: BEA, CBO, US Treasury, J.P. Morgan Asset Management, December 2024

Central banks remain in the spotlight

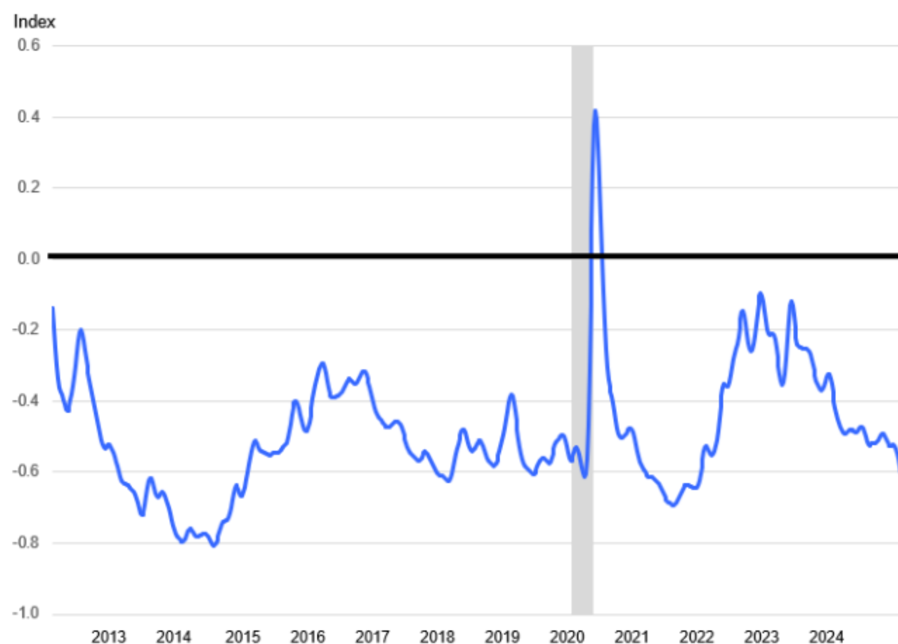
After 193 interest rate cuts globally in 2024, rates are back to more ‘normal’ levels, with market expectations now closely aligned with central bank forecasts.

However, the unpredictability of Trump’s policies could alter that, keeping central bank decisions under intense scrutiny.

Debates are likely over whether current interest rates are restrictive or not, and where the long-term neutral rate lies.

With core CPI at 3.3% and US Fed funds rate 4.25%-4.5%, there’s limited room for further cuts. Productivity is set to rise to 2.5%, which with 1% population growth suggests the neutral rate is now within a 3.4%-3.9% range. That implies less need for additional easing, especially given the prevailing strength in the economy.

Furthermore, with financial conditions already looser than they’ve been since 2021 arguably the market has already done a good deal of the Fed’s job for them. Interest rates are not expected to decline meaningfully from here - unless there’s a negative growth shock that leads to increased risk of recession. If that happens, central banks will have to be quick to respond to preserve financial and price stability.



Source: Federal Reserve Bank of Chicago and Franklin Templeton Fixed Income Research, December 2024

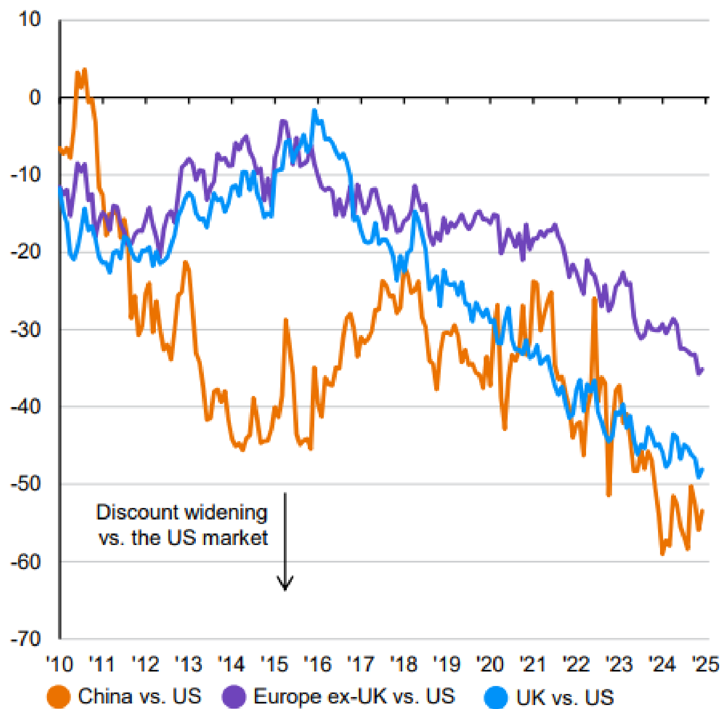
Trump targets a weaker dollar

The dollar's current strength has been the result of faster economic growth, relatively high interest rates and a source of safety as the world's reserve currency. But on most valuation metrics, it's over-valued.

This situation has helped ease inflation, but it's impeding domestic competitiveness with foreign imports. Trump needs a weaker dollar to support local businesses, especially in manufacturing, driving employment growth and boost job security.

Global growth will improve later in 2025, driven by monetary easing, political clarity and deregulation in Europe, fiscal expansion and policy reform in the UK and a variety of stimulus measures in China. At that point, the strength of the dollar is likely to abate. If this coincides with lasting settlements in Russia/Ukraine and Gaza, the flight to dollar safety can be expected to unwind.

Historically, a weaker dollar supports risk assets. Given the scale of valuation differentials between geographical regions, this is likely to lead to a notable shift in allocations towards cheaper asset classes.



Source: J.P. Morgan Asset Management, December 2024

Where are the opportunities for investors?

Broadening beyond the Magnificent 7

In 2024, the S&P 500 gained $11.4 trillion in market value, equivalent to the entire combined markets of the eurozone, Switzerland and Australia. Over 60% of this growth was driven by the Magnificent 7. As their earnings growth moderates and mid-to-small caps gain momentum, we expect market leadership to change.

The gap in value between the biggest companies in the index and the rest of the market, along with similar earnings growth rates, make it a good time to spread investments more evenly across the US market. Mid-sized companies could also gain more from deregulation and pro-growth policies under the Trump administration.

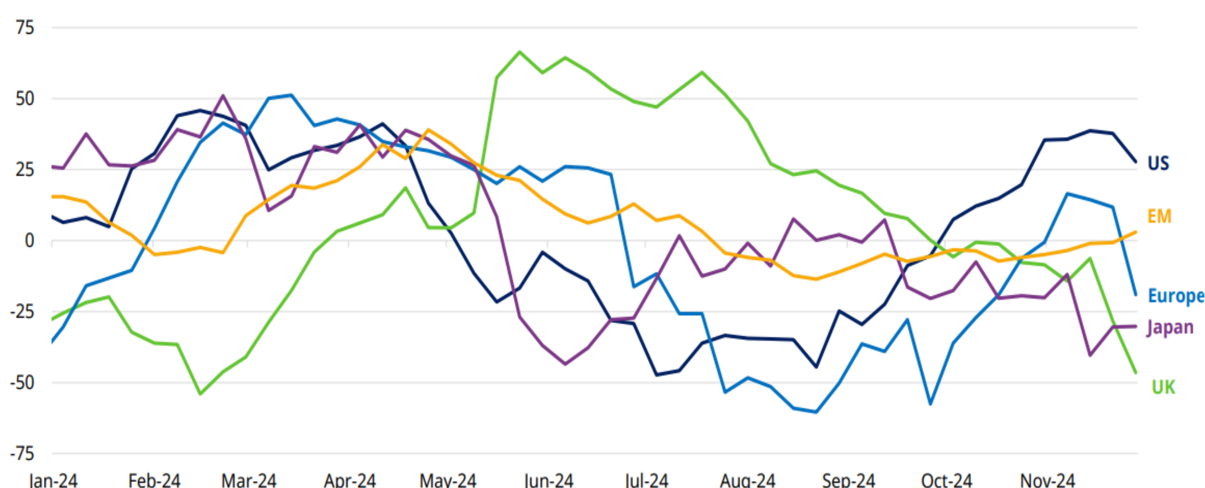
Source: FactSet, S&P Global and J.P. Morgan Asset Management, December 2024

Expanding horizons outside the US

Valuations outside the US are looking increasingly appealing, with the challenges in these economies well discounted in asset markets. Japan stands out, as improvements in corporate governance feed through, boosting profitability and shareholder returns. In the UK, strong cashflow and steady revenue growth add to its appeal as a cheap, high-yielding market.

Meanwhile, Emerging Markets (EM) have had a torrid time in recent years, but we saw signs of improvement in the second half of 2024, as economic data came through better than expected.

Combined with controlled inflation and high real interest rates, EM central banks are well positioned to cut rates, which is expected to support domestic consumption and therefore reduce EM sensitivity to shifts in global economic activity.



Source: LSEG Datastream and Schroders, November 2024

Policy stimulus in China is also beginning to show signs of traction, raising the prospects of an improvement in business and consumer confidence. The Politburo is waiting to see the details of Trump's tariff policies before announcing their responses, but they have indicated their intention to support domestic consumption. This would be a long term structural positive for the country as well as the global economy. For patient investors, low valuations here offer a promising long-term opportunity.

The case for income

Global dividends are forecast to rise over 8% in 2025, and income-generating assets like high yielding equities and fixed income are heading back into the spotlight. Corporate balance sheets and cashflow are looking strong, payout ratios remain low, and as interest rates moderate, a rotation out of cash and deposits could drive further demand.

However, versus pre-Covid levels this further enhances the appeal of the opportunity. Furthermore, it also offers investors a source of ballast within a diversified portfolio should growth and momentum factors wane.

In the same way, nominal yields in fixed interest are also looking attractive, with one caveat which is to stay up in quality. Historically tight credit spreads mean investors need to avoid being drawn into chasing lower quality income.

Lastly, if interest rates do nudge down, a portion of the more than $9 trillion globally sitting in fixed-term deposits and money market funds is likely to rotate into the more attractively yielding fixed-interest and dividend income equities, representing a source of additional demand.

Quality and value will narrow the gap with growth and momentum

Growth and momentum investing has driven returns for investors through 2024, powered by AI and lower interest rates.

As the rate cutting cycle slows, factor leadership should become more balanced, with quality and value likely to catch up. Equally, if economic activity falters, a flight to quality would help strengthen portfolio resilience.

Seek protection from spikes in inflation

With deteriorating global demographics, mounting debts, decarbonisation and geopolitical risks, inflationary spikes can be expected.

To help protect portfolios, it's important to maintain exposure to real assets such as infrastructure, commodities and real estate. These assets don't remove the risk but will help to mitigate the impact, bringing diversification and lower correlated returns.

Alpha opportunities for active managers

US technology's leadership of equity returns has been justified by exceptional earnings growth in 2024 and a re-rating of their valuations. However, looking into 2025 consensus forecasts show that the leadership baton is expected to shift away from the Magnificent 7.

Not all members of the Magnificent 7 will be affected in the same way or at the same time, but we do think change is likely. This should open the way for good active managers to add alpha.

Final thoughts

2025 promises a dynamic landscape. Adaptability and a disciplined strategy will be key. Avoid overcommitting to extreme bullish or bearish positions. Stay diversified and be ready to pivot as risks and opportunities emerge.

By keeping portfolios flexible and focused, investors can navigate market shifts and protect long-term capital growth.

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If you'd like to chat to us about markets or our current positioning, please get in touch.

Phone:
03300 945 900

Email:
mail@parmenion.co.uk

Parmenion
Investment Management

Registered office: Aurora, Counterslip, Bristol BS1 6BX.

Website: www.parmenion.co.uk

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