Strategic
Asset Allocation

2025

moneyfarm

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Index

What is strategic asset allocation?

Strategic asset allocation (SAA) plays a fundamental role in Moneyfarm's investment process.

Every year, Moneyfarm's Asset Allocation Team (AAT) produces long-term (10-year) evaluations of all major asset classes that make up our portfolios. These evaluations are used to find the right combination of assets to create portfolios that are suitable for our clients and meet their risk and return needs. It is a complex yet critical process, a product of studying and monitoring the markets throughout the year.

What are strategic portfolios?

The ultimate goal of strategic asset allocation is the identification of the seven strategic allocations that form the basis of the portfolios we offer to investors. These combinations of assets are the final result of the SAA.

These portfolios are not the actual allocations but serve as guidelines that outline our long-term expectations.

It is important to emphasize that **these strategic portfolios provide a framework for constructing the portfolios offered to our clients.** However, the actual allocation of client portfolios is also shaped by tactical adjustments made to address short- and medium-term market dynamics.

How are strategic portfolios constructed?

These portfolios are constructed based on expected returns, expected volatility, and correlations between asset classes, all evaluated over the next 10 years.

Expected returns reflect our projections for the growth potential of various asset classes over the coming decade. These projections are shaped by our team's insights into how economic, demographic, and social trends will influence asset valuations.

Expected volatility represents the estimated level of risk and is derived from an analysis of historical data.

Correlations measure the degree to which the value of one asset moves in relation to another, providing essential insights into diversification opportunities.

With these three components—expected returns, volatility, and correlations—we can construct strategic portfolios designed to achieve specific long-term risk and return objectives.

How does the strategic asset allocation process work?

It is both a qualitative and quantitative process. Forecasts are made using a mathematical process, but there are various control steps, validations of results and interventions by the Investment Committee.

Expected returns

By looking at economic forecasts and current valuations of various asset classes, we estimate long-term returns.

Estimation of volatility

Strategy cannot be separated from risk analysis. Volatility is estimated for each asset class based on historical data.

Correlations

This measures the tendency of assets to move together, in opposite directions or completely independently. **This is the basis of diversification:** asset classes that tend to move in different directions decrease the risk in the portfolio.

Risk/return profile for each asset class

Provisional portfolios

Limits

The portfolio managers set limits for asset classes that the SAA cannot breach. This ensures the portfolios remain diversified and are not over or underexposed to any particular geography or asset class.
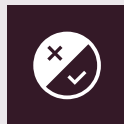
Robust optimisation

We carry out simulations to analyse the behaviour of the portfolio under different scenarios. This allows us to stress test our models and our assumptions and to create portfolios that are tested in adverse scenarios.

Strategic portfolios

Qualitative review

The Investment Comittee monitors the results obtained through the quantitative process and takes corrective action if necessary.

Richard Flax
Chief Investment Officer

Dear investor,

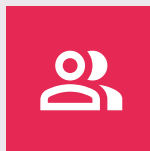Our annual Strategic Asset Allocation (SAA) process enables the Investment Committee to take a comprehensive, long-term view across **a wide spectrum of asset classes.**

The goal is really to step back from the day-to-day noise of the global economy and financial markets and think about **where we might be in ten years' time.** And with the noise even louder than usual, it's an important reminder of some of the core tenets of Moneyfarm – focus on the long term, keep your costs and turnover low, and don't get too distracted by the daily news flow.

In the SAA process, we focus on the **key macro drivers for long-term expected returns,** notably economic growth, inflation and starting valuations. It's quite a mechanical process, so there's relatively little scope for human judgement.

This year, the SAA still points to a **fairly optimistic outlook for financial returns** across the board. It's not quite as positive as a year ago, but that partly reflects the strong returns for global equities that we saw in 2024. Long-

term returns from bonds continue to look decent, giving comfort that lower risk portfolios can still generate a real return for clients over the long term.

What will it take for these forecasts to be correct and for investors to enjoy these long-term returns? There are a few points to make. First, **the SAA assumes macroeconomic stability** – inflation stays around the 2% target of most developed market central banks while the global economy expands, albeit at a fairly pedestrian pace.

All things considered, this would represent a fairly benign environment, even if there might be some bumps along the way.

Second, valuations normalise towards their ten-year average – that serves to dampen the expected returns for the US, in particular where current valuations are above their long-term average.

Third, implicitly, we assume that profits stay about the same as a proportion of the economy – **so economic growth is a decent proxy for profit growth.** That hasn't been the case over the past few years, when profit

margins have generally drifted higher, but we shouldn't assume that will necessarily be the case going forward. We don't think these are particularly heroic assumptions, but it's always worth highlighting them.

What does all this say about 2025? Not much, at least in theory. Long-term expected returns probably won't tell you much about what to expect in any single year, even if they prove to be accurate in the end. **The year 2025** is likely to have its fair share of challenges, in both economics and geopolitics. But the SAA suggests that, at least as far as long-term returns are concerned, some part of that is already reflected in asset prices.

If you have any questions, please feel free to reach out to our investment consultants through the usual channels.

We truly appreciate your time,

Richard Flax

Mapping the future:
Insights into long-term investment trends

Our annual Strategic Asset Allocation process gives the investment team the chance to take a step back and think about **long-term trends and expected returns.** We generate a set of forecasts for long-term expected returns and use those to generate some strategic portfolios. But it's also worth remembering that we run a large number of different scenarios and simulations to produce those final results.

In the following three articles, we think about **some of the key drivers** that could impact those long-term expected returns – either positively or negatively.

This year, we've chosen to focus on **Artificial Intelligence (AI), China and Emerging Markets** and the prospects for **a second Trump presidency in the United States.**

AI has received a lot of attention, and capital, over the past couple of years. High expectations are built into some share prices, particularly in the technology space, but the impact should be seen across a broad range of industries. If the reality matches the hype, or even comes close, it could represent **a step change in potential economic growth,** and that should be positive for asset returns.

The growth outlook for China remains another key area of attention, after a period of relatively weaker performance. We discuss the government's steps to support the economy and **the real estate sector** in particular, and if that will be enough to create the conditions for stronger long-term economic activity going forward.

Finally, we turn to the United States. The Republican victory could usher in a period of significant political change, and we explore how that could affect macroeconomic variables over the long term. Changes to tariffs, regulation and tax rates could all impact growth, and inflation, on a global basis, while the prospect of **a higher fiscal deficit** could extend the period of higher bond yields.

The potential implications of these dynamics are complex and nuanced, yet they provide valuable insight into how global trends may influence long-term returns.

The Artificial Intelligence Gold Rush

The launch of ChatGPT in November 2022 was one of those rare moments capable of changing the general perspective at an incredible speed. Seeing this tool in action, with its almost magical features, offered **a glimpse into the future.** You don't need to be a sharp analyst or particularly imaginative to grasp the revolutionary potential of this innovation.

A lightbulb went off for everyone: from technology novices to investors and business leaders. Artificial intelligence (AI) will change everything and could represent one of the greatest investment opportunities of all time. But is the story really that simple?

The promises of AI

Fascinated by the prospect of a new industrial revolution, billions of pounds of investments have flowed from the coffers of companies and investors eager to secure a front-row seat. This optimism has been reflected in the markets, which have seen one of the best years in recent memory. It's **one of the greatest gold rushes in the history of capitalism**. Estimating the total investment already made – and yet to come – is difficult. The final tally will be measured in trillions of dollars.

From an investment standpoint, the key question for the future of market performance lies here: to justify such substantial investment, AI must fulfill two promises. The first is that progressive integration into business systems will generate **increased productivity.** The second is that the infrastructures being built will facilitate the development of innovative products and services that find **applications across diverse industries.**

The fulfillment of these promises will be measured in corporate profits. Investors will increasingly focus on financial reports, hoping to see the start of a long wave of innovation that could last for several decades. For those who have already invested, it will be important to see **positive signs within relatively short periods** – a confirmation that AI is the revolutionary technology it's perceived to be, and not one of the greatest bubbles in the history of financial markets.

The AI boom – which has driven stock markets – has so far been led by specialized companies, like Nvidia, and tech giants developing language models. To see valuations confirmed, we need to see the benefits extend to other companies and industries capable of leveraging this technology to create innovative and market-dominating products.

Investment trends

But which sectors are driving AI investments? And what are the goals of these investments?

For now, the big numbers primarily come from **tech giants,** who are heavily betting on the future of AI, supported by the vast cash reserves they've accumulated over the years. Forty percent of R&D investments – which reflect an organization's willingness to invest in discovery and commercialization of new technologies – in the S&P 500 come from the 10 largest companies of the index.

AI functions through **large language models** (LLMs), which are at the core of various technological applications across different sectors. These models are extremely expensive and complex to develop. The major tech companies are locked in a race to release next-generation models to **establish leadership in this emerging market.** The problem is that next-gen systems require exponentially higher investments to train, potentially limiting returns.

It's estimated that the electricity used to train GPT-4 was 50 times higher than that used to train GPT-3. This particularly draws out **the challenge involving energy costs,** which could become increasingly burdensome as the technology evolves and its use becomes more widespread. Another issue is data availability. Paradoxically, while data is abundant, continued improvement in model performance depends on high-quality data, which could become increasingly difficult to acquire. The ability to access quality sources will become a critical factor and could negatively impact return on investment.

Currently, the race to develop advanced models seems limited – excluding Chinese models – to four companies: OpenAI (supported by Microsoft), Meta, Google, and Anthropic (supported by Amazon). Among the tech giants, Apple appears to be lagging, evidenced by its recent announcement of a partnership to integrate ChatGPT into the latest version of its iPhone operating system, iOS 18.1. Such a move highlights the level of concern, even for a company as large as Apple, about being left out of this wave of innovation.

The race to build large AI models is increasing the concentration of market capitalization in stock indices. The seven largest American tech companies now represent **nearly 35% of the S&P 500's market capitalization** and have contributed to over 70% of its returns

since the beginning of 2023.

This outperformance has also led to an expansion in valuations. While the rest of the S&P 500 traded at a 12-month forward price-to-earnings (P/E) ratio of 19x at the end of November, the top 10 stocks in the index were trading at 29x, according to estimates from Goldman Sachs. If skepticism about the future applications of AI were to prevail, there is a risk that we could see these valuations normalize in the medium term.

To justify these valuations, it will be crucial to begin observing profit growth. Unlike past technology races, the tech giants are in a much stronger position to win this bet. The earnings growth trend observed in recent years makes the investment **more sustainable,** as reflected in the high but not unmanageable P/E ratios.

The second investment front: infrastructure

Another key area of investment is acquiring the technology needed to power these systems. Running this technology requires **data centers and cloud connectivity.** The demand generated by AI is rapidly consuming existing capacity, pushing companies to construct new facilities, which also creates potential investment opportunities.

The development of LLMs is extremely **computationally intensive.** These processes require semiconductors, known as graphics processing units (GPUs). A decade of significant progress in GPUs has resulted in faster and more efficient performance. This advancement has rendered most computational electronics built before 2020 obsolete, necessitating widespread upgrades.

In this context, Nvidia has been the immediate winner, and its financial results demonstrate the scale of investments in AI. Nvidia's annual revenues have grown from $4 billion in 2014 to a projected $61 billion in 2024. The extraordinary demand for Nvidia's AI processors and related products and services highlights the robust health of the AI sector and its growth potential. Nvidia estimates **the total demand for GPUs could reach $2 trillion,** including $1 trillion from data centers and $1 trillion from AI-related tasks such as training new LLMs, machine learning, and scientific simulations.
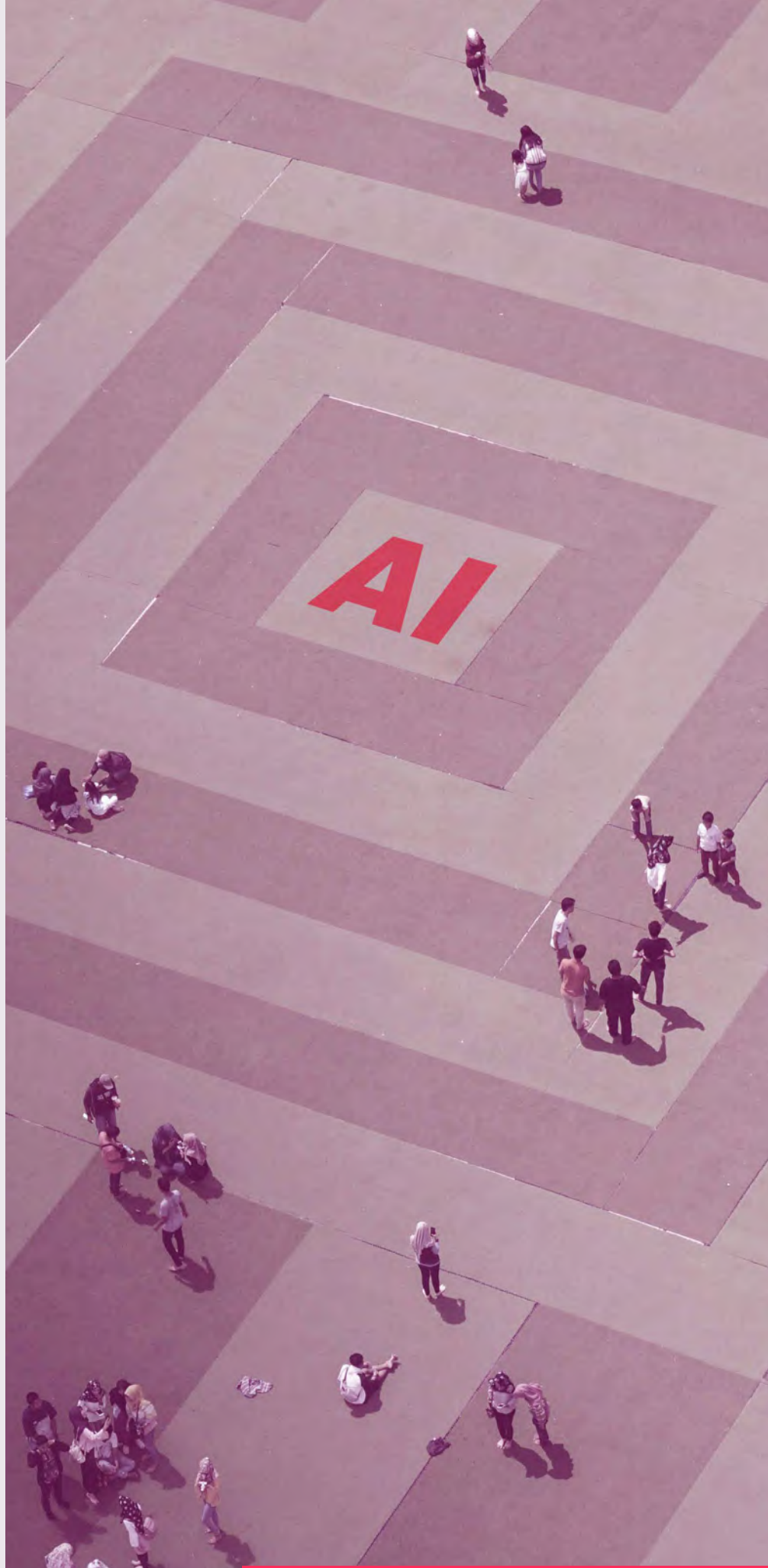
The third investment front: the "killer application"

The third critical area of investment is the development of the so-called "killer application" – a practical use of AI technology capable of driving the market. So far, there have been no significant cases of startups or companies delivering AI products or services that revolutionize their respective markets. As of now, only 5% of companies report having integrated AI into their products or services.

However, AI is driving investment in the startup sector as well. According to data from Crunchbase, 35% of startup funding this year has gone to companies operating in artificial intelligence. While it's too early to determine which of these companies will succeed, it's likely that the next cycle of AI-driven innovation will come from **industries such as pharmaceuticals, telecommunications, or robotics.**

By 2025, we may begin to see AI everywhere. If that happens, the technology will have begun to deliver on its promise.

A revolution in productivity

The success of AI will also be tied to its ability to **revolutionize production processes.** Currently, companies are still figuring out how to properly integrate artificial intelligence into their operations. Only slightly over 5% of companies claim to use AI to deliver their products or services, although this figure is rapidly increasing.

Meanwhile, many workers already incorporate AI into their daily routines. A recent study measured the productivity gains AI could bring across three tasks: **customer support, drafting simple business documents, and coding.** Assigning these tasks to workers using AI resulted in an average efficiency gain of 66%, sometimes accompanied by improvements in quality.

Interestingly, productivity gains were lower in customer support activities but significantly higher in more creative tasks: 59% for drafting business documents and an impressive 126% for coding.

Considering the potential evolution of AI models, particularly with the introduction of agent-based systems, these figures are **incredibly promising.** To provide some perspective, annual productivity growth in Europe averaged just 0.8% in the years leading up to the pandemic. While it's not entirely appropriate to compare experimental results to general averages, it's hard to imagine that a technology capable of boosting worker capacity to this degree wouldn't have a significant impact on overall productivity.

The downside, however, could be the **displacement of human labor.** Increased productivity might lead to higher corporate profits, either by reducing costs – hiring fewer workers – or enabling the production of more or better products.

Long-term market impact

The impact of productivity growth on corporate earnings will likely become a **key market trend,** potentially driving profits higher in the coming years. For now, it's still too early to detect this effect in business processes. However, this shift is underway beneath the surface, and we'll likely begin seeing its effects soon.

According to McKinsey's Global AI Survey, the percentage of companies that have adopted AI in at least one business function rose from 55% in 2023 to **72% in 2024.** This suggests that we are just beginning to see the **transformative power of AI unfold.**

Support for market performance

As managers, our role is to analyze economic phenomena through an an-alytical lens, always aiming to highlight **potential contradictions and risks.** While we recognize that the trajectory might be less linear than initially expected, the **opportunity generated by AI** appears undeniable. We believe it will be a trend that extends over the years, and we are merely at the beginning of a potentially revolutionary dynamic.

It is also important to remember that this will be a global phenomenon. In this article, we have focused primarily on the United States because it is at the forefront of developing this technology. However, China is also advancing its AI models, and the applied use of artificial intelligence, along with productivity gains, **will not be confined within national borders.** As technology advances – with the anticipated arrival of "agent" systems in 2025 capable of planning and executing more complex tasks – adoption could accelerate. We believe that artificial intelligence has the potential to become one of the greatest growth accelerators in economic history, representing a significant opportunity for investors in the coming years. It will be crucial to assess its dynamics to understand how to help investors capitalize on returns while mitigating risks.

Moneyfarm's perspective

We think that AI represents a significant opportunity to **improve global productivity,** even if there are challenges in a range of areas like energy consumption and regulation. It will probably take longer to feel the true impact of AI than the most optimistic forecasts, as has often been the way with new technologies, but it could have a meaningful impact on growth. In that case, we think that the baseline scenario that we've used for the SAA could prove conservative.

China and Emerging Markets: redrawing the map of global trade

Are we on the verge of a new international economic order? Donald Trump's trade policy could profoundly reshape the global trade map and the balance of power among emerging economies. This shift affects not only the United States but reaches **every corner of the globe**, pushing countries within the heterogeneous group of emerging economies to rethink their economic and political strategies.

Despite recent efforts by these countries to consolidate their political influence – exemplified by the expansion of the BRICS club (Brazil, Russia, India, China, South Africa) – economic disparities among them are becoming increasingly evident. The new direction set by Washington, poised to inaugurate an unprecedented era of trade diplomacy, could deepen these divisions and compel many nations to choose sides.

This is no minor issue: **with an average share of 15% of global exports by emerging countries, the United States remains their primary market.** Aligning with the "right" side – being "good" or "bad" on Trump's political scoreboard – could mean the difference between a period of economic crisis and a historic opportunity for recovery.

Meanwhile, China, the largest and most influential of these economies, is experiencing challenges that could undermine its future growth potential.

For investors who view the emerging world as an asset class, it is crucial to assess the common dynamics linking the performance of emerging countries, particularly China.

In an increasingly polarized world, the threads connecting these economies may become even thinner, as economic divergences emerge more clearly and international alignments demand difficult choices.

China between recovery and stagnation prospects

China is gearing up for 2025, a year in which policymakers will try to **reverse the slowdown in growth and prices** that threatens to stall its economy. This trend, which has been unfolding for years, was triggered by excessive debt and a real estate sector crisis. Distrust has spread to consumers, many of whom are directly exposed to the real estate market. China's problem is one of demand: companies and citizens are spending and investing less, dragging prices down and slowing growth.

To signal a turning point and attempt to reinvigorate the economy, Beijing implemented significant **countercyclical policies** in the latter part of 2024. The initiatives span a broad range, from direct support for spending through subsidies to targeted policies aimed at stabilizing real estate prices, including extreme measures such as purchasing unsold properties. **Monetary policy has also played its part**, cutting interest rates and easing credit conditions for the real estate market.

The most recent meeting of the Standing Committee of the National People's Congress announced a comprehensive plan to **restructure hidden local government debt**, estimated at 14.3 trillion renminbi (about €1.9 trillion). This debt had accumulated as local governments engaged in speculative real estate activities through satellite companies. Under pressure to reduce debt, local governments even resorted to cutting public sector salaries, worsening sentiment and exacerbating distrust.

The debt restructuring represents a sort of bailout aimed at resolving one of the economy's chronic issues once and for all. Whether it will achieve that goal remains an open question.

A "japanification" of China's economy?

The year 2024 marked a shift in Beijing's economic policies, but it is still too early to see light at the end of the tunnel. While recent months have shown encouraging signs in economic production and consumption, the real estate market crisis remains difficult to resolve, as its nature as a demand-side crisis limits the tools available to policymakers.

The coming years will be crucial for evaluating **China's economic trajectory.** According to the most optimistic analysts, the crisis is a natural consequence of years of uninterrupted growth, a necessary adjustment for an economy compelled to untangle its internal issues.

After this transition, freed from the excessive burden of the real estate sector, China could resume a growth trajectory typical of advanced economies.

Others, however, believe that China has entered a phase similar to Japan's experience in the 1990s: **a deflationary process driven by structural factors** such as a demographic decline (with a projected population drop of 50 million over the next decade) that could condemn the economy to a decade of stagnation.

In the latter scenario, the economy would fall into **a liquidity trap,** rendering economic policies ineffective. The coming years will determine whether Beijing can reverse this dynamic.

It is likely that the government will spare no effort: the economic policy guidelines for 2025 leave the door open for further fiscal expansion aimed at stabilizing the real estate market, increasing investments, and stimulating consumption. Within the constraints of the international environment, additional monetary stimuli may also be implemented.

Commercial dynamics

As if the domestic challenges weren't enough, 2025 may also see **trade tensions with the Western bloc** ratchet up even further. Analysts are divided on the extent of the impact that Trump's proposed tariffs on all Chinese goods could have on China's GDP.

It remains to be seen how much Beijing's exports to other markets could compensate for losses in trade with the US and Europe. Increased diplomatic activity and Xi Jinping's international engagement seem to be responses to this situation, although initial setbacks are evident, such as China's stalled bid to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), largely due to the Taiwan issue.

Despite the uncertainties, a new trade war would undoubtedly have a significant negative impact on the Chinese economy. **Exports to the US account for about 3% of China's GDP** – a substantial share that cannot be easily replaced. If this scenario materializes, Chinese policymakers are likely to introduce further stimulus measures to mitigate the effects of the tariffs.

These measures could include fiscal, monetary, and currency policies. An initial glimpse of such measures was seen in a preliminary stimulus package aimed at supporting exports.

The logic behind this package is to create more favorable trade conditions and support export sectors by finding new markets for Chinese goods.

The impact of a strong dollar

The direct and indirect effects of the new US trade policy extend beyond China, potentially **reshaping the global trade landscape.** New tariffs, tax cuts, and stricter immigration policies could drive inflation higher, forcing the Federal Reserve to maintain elevated interest rates for a longer period – a scenario supported by rising bond yields. Higher rates tend to make a currency more attractive, potentially strengthening the dollar.

A strong dollar poses **challenges for global central banks,** as it can accelerate capital outflows, reduce foreign reserves, and amplify the effects of monetary tightening on emerging economies.

A weaker currency would also increase inflationary pressures in many countries by raising the cost of imports, delaying the return to an expansionary monetary cycle for many economies, especially in Asia.

This is not good for many Emerging Markets, including China, which needs to cut interest rates in 2025. The yuan has already begun to depreciate following rate cuts in September.

While a weaker yuan may aid exports, excessive depreciation against the dollar could significantly complicate Beijing's economic recovery.

Not everyone loses

Amid the prospects of a trade war and a strong dollar, is the fate of China and other emerging markets sealed? Not necessarily. One of the key winners in this new trade framework could be India. Unlike China, India's economy is experiencing a positive phase. With its vast production and industrial capacity, India could become a major beneficiary, replacing Chinese manufacturing if hit by tariffs. This outlook is supported by World Bank estimates, which revised India's growth forecast upward: the country is expected to grow by 7% in the fiscal year ending March 2025, following an impressive 8.2% expansion the previous year.

Relations between the US and India significantly strengthened during Trump's presidency, with India gaining a more prominent role on the international economic stage. **India is now among the top 10 US trading partners.** The political and personal affinity between Trump and Modi could further bolster ties between Washington and New Delhi.

Moneyfarm's perspective

Emerging Markets will be a key driver of the global economy for the foreseeable future, particularly driven by China and India. **We expect the Chinese economy to continue to grow,** albeit at a slower pace than we've seen in the past. It won't be easy getting the Chinese economy to grow faster, particularly given the worsening demographic profile. We shouldn't rule out the possibility that the Chinese government could engineer a better growth outcome, but it's not our base case today.

Trump 2.0 and the economic challenges of Maganomics

The 2024 US elections concluded with a decisive victory for Donald Trump and the Republican Party. The President's campaign followed the blueprint of his first term. However, this time, Trump abandoned all caution. Whereas in 2016 he had to negotiate his proposals with the moderate wing of the party, in the MAGA 2.0 campaign, his economic vision emerged without any filter. The proposals that secured his election are intended to transform the American economy decisively.

Unlike in 2017, Trump will have at least two years of freedom to act without having to negotiate his positions with a Democratic Congress. The Republicans have retained control of the House of Representatives and have captured the Senate. Both chambers share the authority to pass legislation. **The Senate controls the legislative agenda,** can ratify treaties, and confirms presidential appointments. Meanwhile, The House of Representatives holds the prerogative of initiating revenue-raising legislation.

The Maganomics agenda

Donald Trump's promised economic policies revolve around three main pillars: **significant tax cuts,** accompanied by massive deregulation to stimulate growth and the economy; **protectionist trade policies** to replenish state coffers through tariffs and revive domestic industry at the expense of imports; a **spending review,** entailing a drastic reduction in the federal budget, overseen by Elon Musk and Vivek Ramaswamy.

According to Trump and his advisers, the effects of these policies are expected to balance each other out and lead to a reduction in public debt and the federal deficit. In the short term, tax cuts are expected to be offset by new tariff revenues and the spending review. Economic growth is expected to handle the rest, bringing the federal budget back into surplus.

However, this outlook appears unrealistic. It is reasonable to expect that, even if implemented in a scaled-back form, Trump's program will generate greater pressure on the federal budget. Ten-year deficit projections range from $3 trillion, according to the conservative Tax Foundation, to $7 trillion, according to the Penn-Wharton Budget Model.

An increase in the deficit and debt could impact long-term economic growth prospects. In the short and medium term, this does not appear to be the primary concern of markets, which for now seem to trust the growth agenda.

A delicate balance

Donald Trump's victory has brought a wave of optimism to US stock markets, with investors focusing on the potential benefits for businesses. The problem is that not all of Trump's proposed policies are considered growth-friendly.

The consensus among economists and investors is that tariffs, with immigration policies, will exert upward pressure on inflation, while tax cuts will support corporate profits, potentially benefiting investors.

From a financial standpoint, it does not seem realistic to imagine that tax cuts will pay for themselves by generating sufficient growth. They are likely to contribute to increases in the deficit and inflation, leading to **medium-term pressure on interest rates,** which could partially offset the boost to stock markets driven by growth policies. Economic growth fueled by fiscal policies could also bolster the dollar and imports, undermining efforts to reduce the trade deficit.

Spending review policies and spending cuts, while theoretically capable of creating efficiencies that help fund tax cuts, have a short-term recessionary and deflationary effect. They could counterbalance inflationary pressures but may also dampen economic growth.

The Domino effect of policies

The President's first significant test is likely to involve tariffs, an area where he can act independently of Congress. In 2017, it took nearly a year from the start of investigations against China to the imposition of tariffs. This time, Trump has proposed much higher tariffs: at least 60% on China and 10-20% indiscriminately on all other countries. The key difference is that this measure would unfold in a more delicate political context, with supply chains only recently recovering from the long-term impact of Covid, inflation still not under control, and an interest rate-cutting cycle not yet concluded.

The effect on prices could be significant. According to economists at Deutsche Bank, the plan, if fully implemented, would raise US consumer
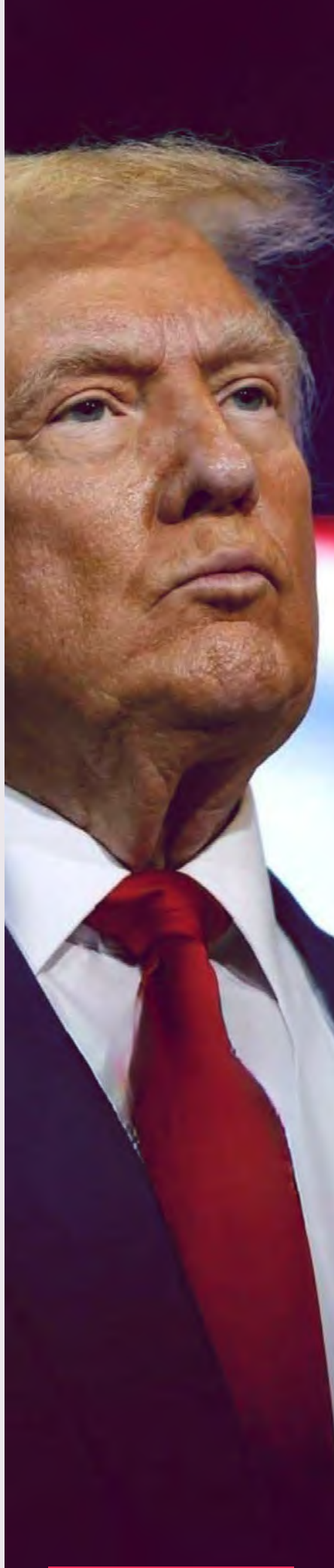
prices by 0.75% to 2.5%. Many analysts believe that **tariffs targeting China are the most likely to be enacted,** while the indiscriminate rate on other countries might instead be used as a negotiating tool. Howard Lutnick, CEO of financial firm Cantor Fitzgerald and newly appointed Secretary of Commerce, described tariffs as a negotiating tool, presumably indicating that Washington would be prepared to moderate its policy once other countries make concessions.

For Europe, a possible bargaining chip could be **increased military spending,** which would indirectly benefit US companies. In shaping market reactions, presentation will also matter: in the early months of the administration, it will be crucial to evaluate whether its approach will be dialogue-oriented or more aggressive.

Regarding fiscal policy, tax cuts remain, as in 2017, the measure most exciting to markets. Trump's plan follows two paths. The first is to extend the temporary individual income tax cuts implemented during his first term, which are set to expire in 2025. Extending these measures should be a priority. This extension was somewhat expected by the market, as it was also part of Kamala Harris' electoral program. Since these are taxes already in effect, **their impact on growth should be limited.** Other measures, notably a reduction in corporate taxes to 15%, would add a significant cost to the budget.

All estimates agree on placing the fiscal impact of this program in the trillions over the next decade. For example, a study by the Committee for a Responsible Federal Budget, an economic analysis initiative at the University of Pennsylvania, estimates that Trump's promises, if fully implemented, would cost the federal budget nearly $1 trillion annually in the median case.

The increase in fiscal spending is expected to be partly covered by tariffs and spending cuts, though market expectations are that the deficit will rise at least in the medium term. This could lead to higher interest rates, partially offsetting the positive effect of tax cuts on stock valuations. While deficit concerns are significant, it is worth noting that this measure remains **fundamentally expansionary.** Deutsche Bank estimates that a unified Repub-

lican government would boost growth by 0.5% in 2025 and 0.4% in 2026.

Spending Review

Cutting inefficient public spending is a goal of all governments. Who wouldn't want to reduce unproductive public spending to support tax cuts? Easier said than done. There are two ways to cut public spending: with a scalpel or a shovel. Cutting public spending with a scalpel means getting entangled in the complexities of the budget, risking ineffective action. Cutting with a shovel usually produces results in terms of budget savings but at the cost of creating discontent, inefficiencies, and recessionary effects. The fact that this policy is ostensibly in Elon Musk's hands brings a certain level of unpredictability. From an entrepreneur capable of anything (for better or worse), one can expect either an innovative and effective approach to the problem or actions that quickly become a source of controversy and dissatisfaction.

Musk's goals are, by definition, ambitious, having announced that he believes he can cut up to $2 trillion in public spending or "waste," as he calls it. This represents **30% of the entire federal budget.** Musk has stated he will cut bureaucracy and agencies, but looking at federal budget expenditure categories, it seems difficult to imagine achieving a $2 trillion cut without significantly affecting pensions, healthcare, education, or defense. Such cuts would require time but would likely be blocked by Congress.

The US government spends 37.5% of GDP (less than any other G7 country). Welfare measures such as food stamps and Medicare might be the first to face cuts, but these are relatively small savings that carry significant political costs. While Musk's declared goals seem unrealistic, even a much smaller reduction in spending would still have a significant impact in supporting tax cuts (though with limited growth effects).

Deregulation

Trump has proposed lighter regulations for mergers, as well as for the oil and gas industry. **These measures should favor growth, increase business confidence, and benefit specific sectors such as oil and finance.**

However, their broader economic

impact would be difficult to predict – for example, it is doubtful that these measures could significantly affect oil prices, which are primarily driven by international dynamics.

Market confidence

Looking at recent movements in US equities, bonds, and Treasury yields (with rates rising), markets currently take Trump's tax promises more seriously than his trade promises. Expectations include economic growth, inflation, and a rising deficit.

In the long term, **the sustainability of this fiscal framework** will be a crucial factor for global stock markets, both for its direct consequences and its effects on Federal Reserve policy.

Historically, no clear relationship has been proven between deficits and medium-term stock market performance.

It is also true that in economics, every period is unique. While concerns about the deficit and monetary policy persist, confidence in the US economy, its system, and its companies (leading key innovations like Artificial Intelligence) encourages optimism about the future.

Moneyfarm's perspective

Assessing the long-term impact of an incoming President is no easy task, but we'd argue that there are a couple of long-term trends here. The first is on tariffs. **We'd expect tariffs to rise globally,** continuing a trend we've seen over the past few years. That could bring down global growth below the current baseline forecast. The second is on fiscal deficits. We don't expect to see meaningful action to bring down the US fiscal deficit, from either party, and that's likely to keep interest rates elevated.
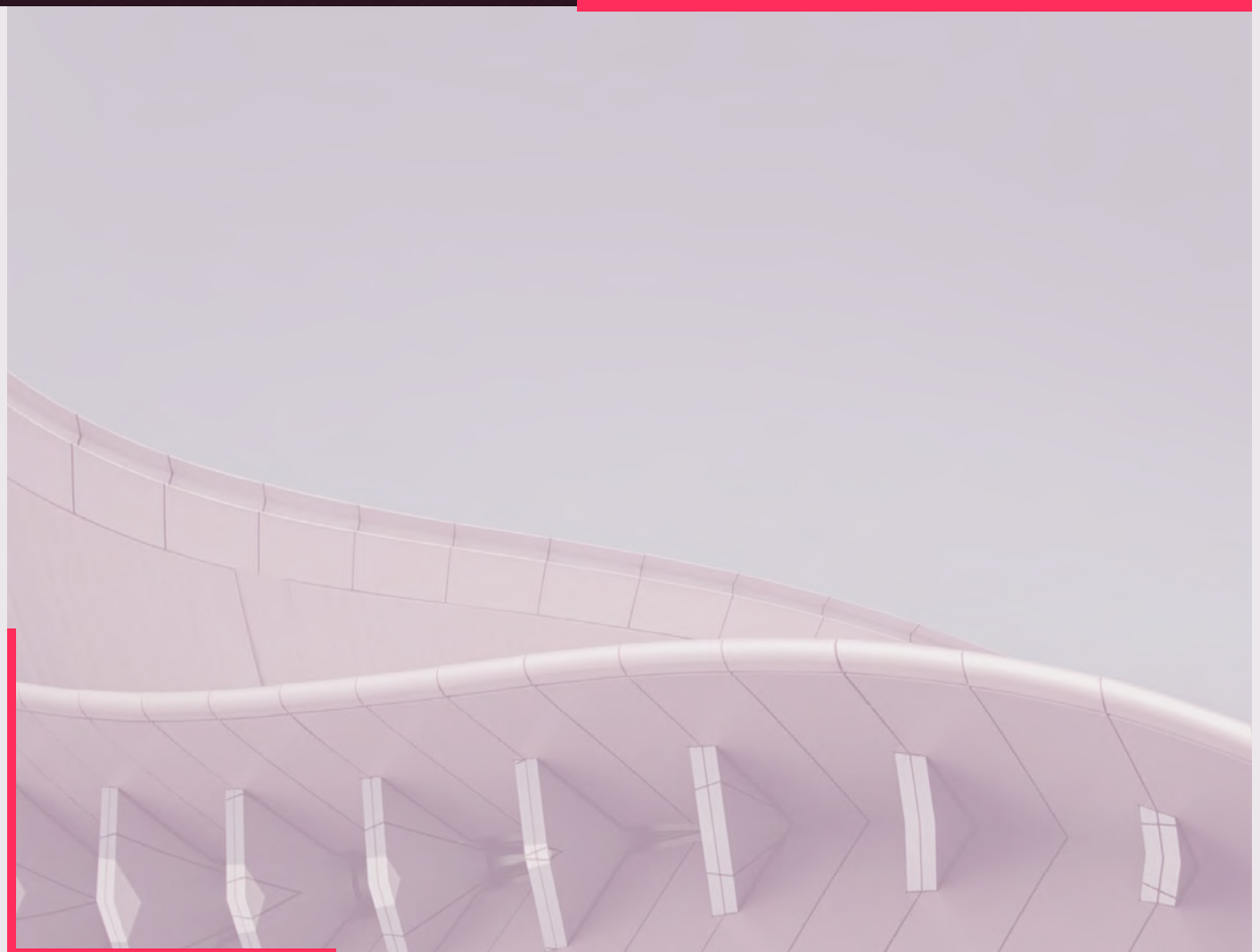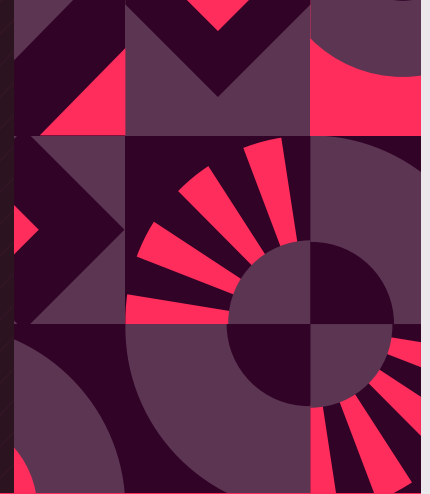
Analysis of expected returns

After discussing the logic behind our thinking along with short- and long-term outlooks, it's now time to focus on our annual **strategic asset allocation.** This process uses a range of macroeconomic variables and financial metrics, such as initial valuations, to estimate future financial performance across major asset classes. The expected returns over 10 years and the expected volatility for each asset class are used to construct the strategic portfolios. There are seven model allocations that, based on our forecasts, maximise returns for each level of risk over a 10-year horizon.

These portfolios are not the actual allocations but serve as guidelines that outline our long-term expectations.

It is important to emphasize that **these strategic portfolios provide a framework for constructing the portfolios offered to our clients.** However, the actual allocation of client portfolios is also shaped by tactical adjustments made to address short- and medium-term market dynamics.

At the core of this process, our **Asset Allocation Team** evaluates long-term economic expectations, including GDP growth and inflation, while analysing the risk and return of each asset class. The team then generates a range of portfolios aligned with six defined risk levels. This approach is based on traditional risk-return analysis, including scenario testing and stress tests to ensure robustness across various market conditions.

As part of the process, we use four key drivers to estimate long-term returns:

Historical returns – Guiding expectations for the future, though not a guarantee.

Starting valuations – A crucial factor for long-term expectations, as they tend to revert to a historical average over time.

Profitability – Evaluating corporate earnings to avoid overestimating returns based on peak or trough profitability.

Growth – Considering the relationship between GDP growth and corporate earnings to estimate potential returns, particularly for equities.

This comprehensive approach ensures that our portfolios are built to be robust, aligned with long-term goals, and adaptable to changing market conditions.

In a nutshell

▸ In absolute terms, **expected returns are fine, but generally lower** than the last couple of years;

▸ The **long-term expected return premium of equity over fixed income has decreased,** driven mostly by a reduction in equity expected returns;

▸ Equity expected returns have been **hit mostly by valuations,** while earnings growth and expected dividends (incl buybacks) payout remains positive;

▸ Returns for DM nominal and inflation-linked government bonds remain solid in absolute terms.

▸ **Duration** remains relatively unattractive, with the long term-target rate higher than current levels for all the key geographies, except the UK;

▸ **Credit has lost steam,** mostly due to increasingly **tight spreads** and - for the EU/UK - an increase in expected default.

In this next section, we will delve into the details of the expected returns forecast for the major asset classes in 2025.

The long-term expected returns for the next year are generally solid, with Emerging Market Equities (EM Equity) standing out as the asset class with the highest expected returns.

The Equity Risk Premium (ERP) is weaker than last year, at 2.3%, compared to 3.6% for 2024 and 5% for 2023.
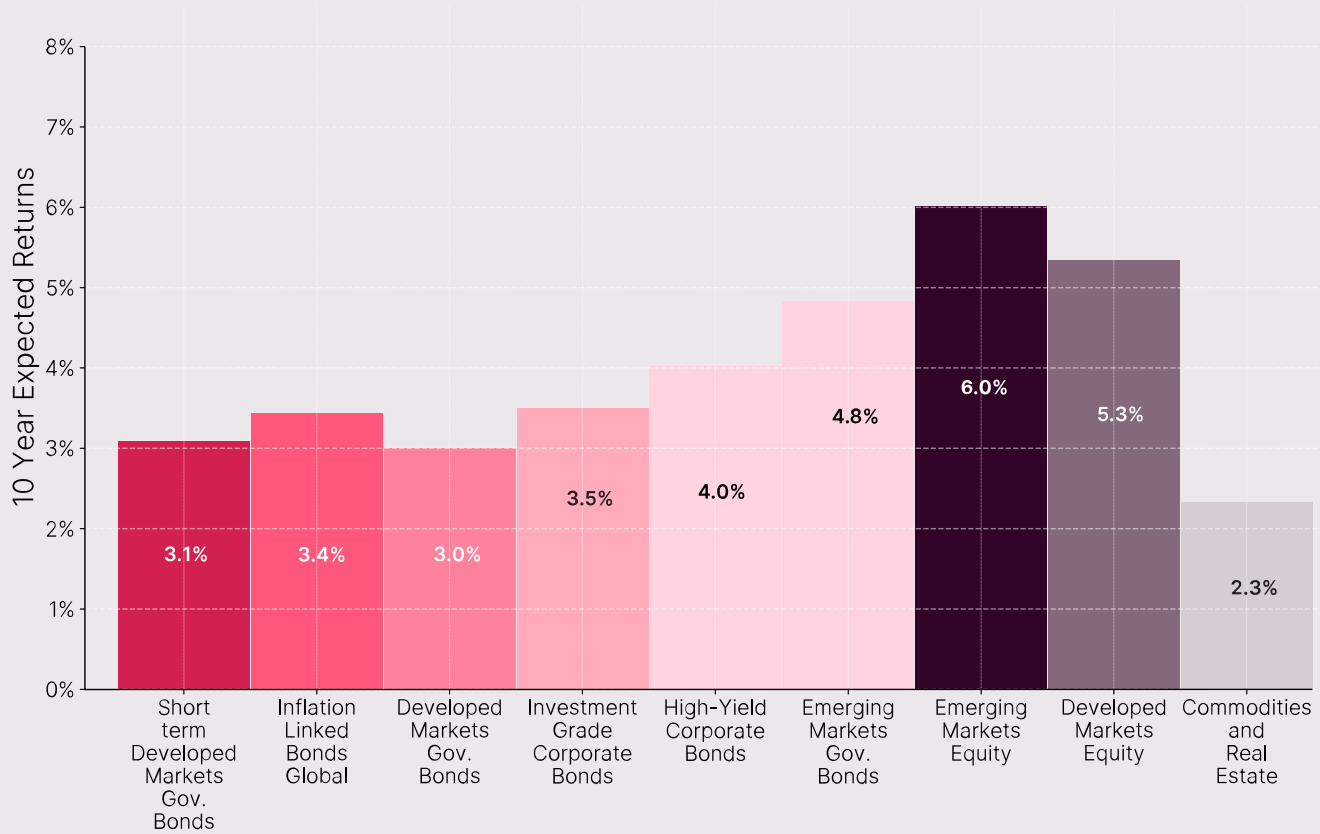
Duration risk is not providing any additional returns—in fact, it's providing the opposite.

On the other hand, inflation-linked bonds look slightly more attractive, mainly due to rising inflation expectations.

Investment-grade (IG) and high-yield (HY) bonds generally show limited appeal, while Emerging Market Debt (EMD) stands out with a material risk premium over government bonds.

Following the significant repricing in fixed income markets in 2022, long-term fixed income returns now look more appealing compared to the pre-2022 period.

Annual expected returns by asset class

Asset Class	10 Year Expected Returns
Short term Developed Markets Gov. Bonds	3.1%
Inflation Linked Bonds Global	3.4%
Developed Markets Gov. Bonds	3.0%
Investment Grade Corporate Bonds	3.5%
High-Yield Corporate Bonds	4.0%
Emerging Markets Gov. Bonds	4.8%
Emerging Markets Equity	6.0%
Developed Markets Equity	5.3%
Commodities and Real Estate	2.3%

Source: Moneyfarm Research. Projections are never a perfect predictor of future performance, and are intended as an aid to decision-making, not as a guarantee.

10-year expected returns by asset class
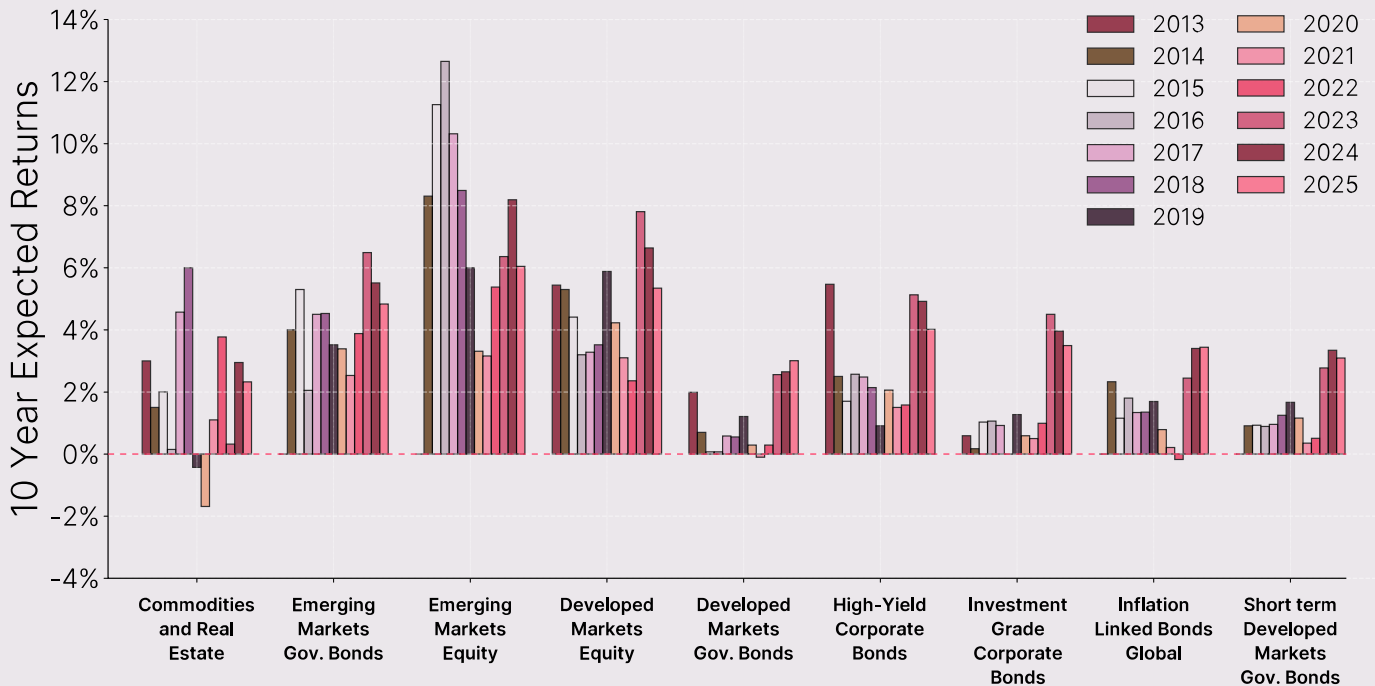
Source: Moneyfarm Research. Past performance is not a reliable indicator of future performance. Projections are never a perfect predictor of future performance, and are intended as an aid to decision-making, not as a guarantee. Data provided shows gross returns. Actual returns may be lower due to the costs and charges associated with investing in these instruments.

The macro-economic environment

Macroeconomic analysis is a crucial element of the strategic asset allocation process as it helps us estimate **long-term earnings growth** that influences equity outlooks and interest rate scenarios for bonds.
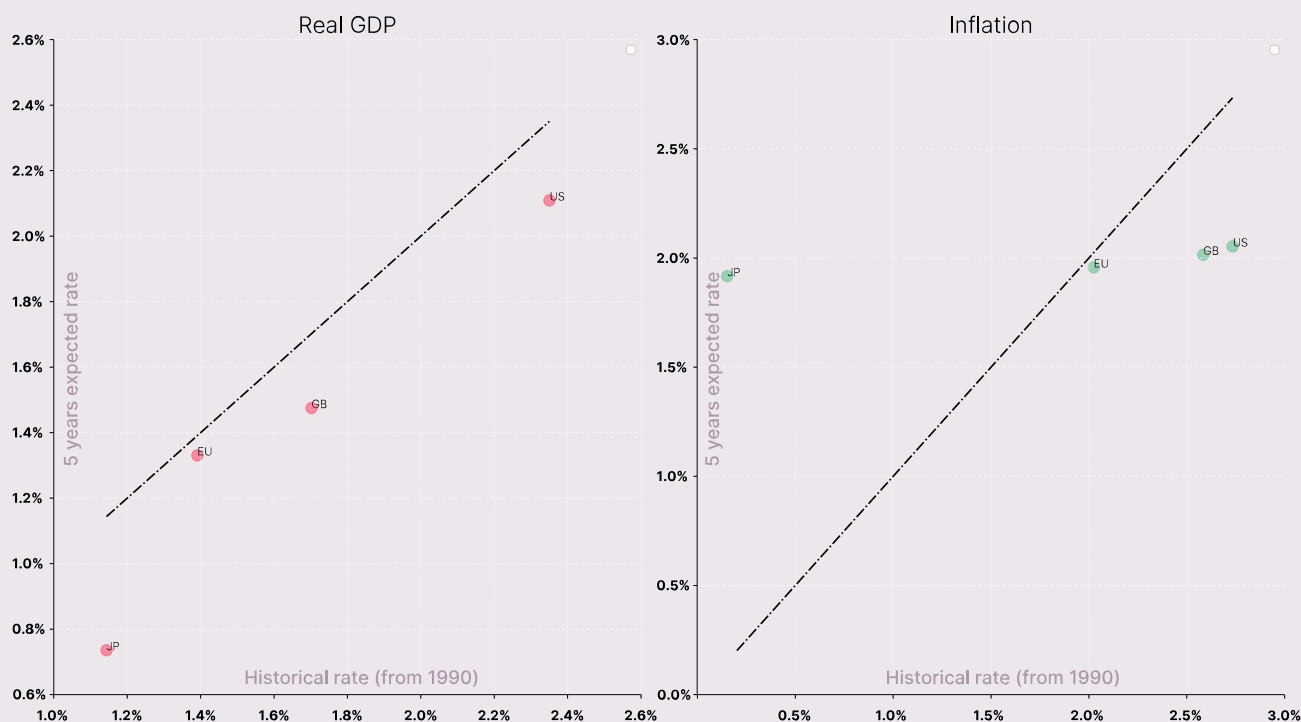
We utilise estimates from the International Monetary Fund to forecast the terminal rate for bonds and earnings growth for equities. For emerging markets, we do not consider nominal GDP and estimate earnings growth through export volume estimates, always using the International Monetary Fund's forecasts as a source. The IMF's long-term expectations for real GDP are **slightly more cautious,** with the US 5-year growth forecast standing at 2.1%, compared to a historical median of 2.4%. However, expectations have risen compared to last year, particularly for Europe. CPI expectations remain generally below historical levels, except for Japan, but are higher than last year. For the EU, the UK, and the US, inflation expectations are now closer to 2.5% rather than 2%.

CPI expectations are generally in line with last year, hovering around the 2% level. The US stands out with a somewhat unusual pattern: lower inflation is expected for the coming year, followed by a pickup and a plateau slightly above the Federal Reserve's 2% target, at around 2.15%.

5-year growth and inflation forecasts and historical median

Real GDP

(scatter plot: x-axis "Historical rate (from 1990)" ranging 1.0% to 2.6%; y-axis "5 years expected rate" ranging 0.6% to 2.6%. Points labelled: US at approx 2.35%, 2.1%; GB at approx 1.7%, 1.47%; EU at approx 1.4%, 1.33%; JP at approx 1.15%, 0.73%. Dashed diagonal line.)

Inflation

(scatter plot: x-axis "Historical rate (from 1990)" ranging 0.0% to 3.0%; y-axis "5 years expected rate" ranging 0.0% to 3.0%. Points labelled: JP at approx 0.2%, 1.93%; EU at approx 2.05%, 1.95%; GB at approx 2.55%, 2.0%; US at approx 2.75%, 2.0%. Dashed diagonal line.)

Source: Moneyfarm Research, the IMF

In a nutshell

▶ There is **no recession priced in for the next few years.**

▶ **The US is expected to continue growth**, and without a material worsening of the inflation conditions. Overall, the average nominal growth rate over the long term remains largely unchanged compared to last year.

▶ For the rest of the world, nominal growth expectations have weakened for **Europe and the UK**, while staying stable for Emerging Markets (EM).
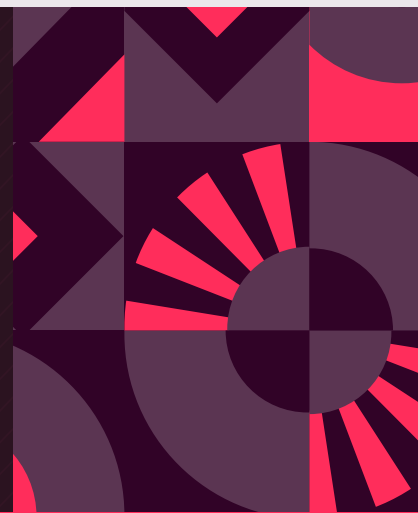
Analysis of expected returns by asset class

Equities

The figure below shows the different components that contribute to the expected return (coloured bins) and the total expected return (dots).

The impact of valuations is quite negative this year, particularly for the US for which it erodes a great part of the expected return coming from earnings growth. Amongst our key reference geographies, **the UK has once again the highest expected return**, thanks to solid expected earnings growth, a solid dividend payout and not-too-bad starting valuations.

Expected returns for equity by geography and by key contributors
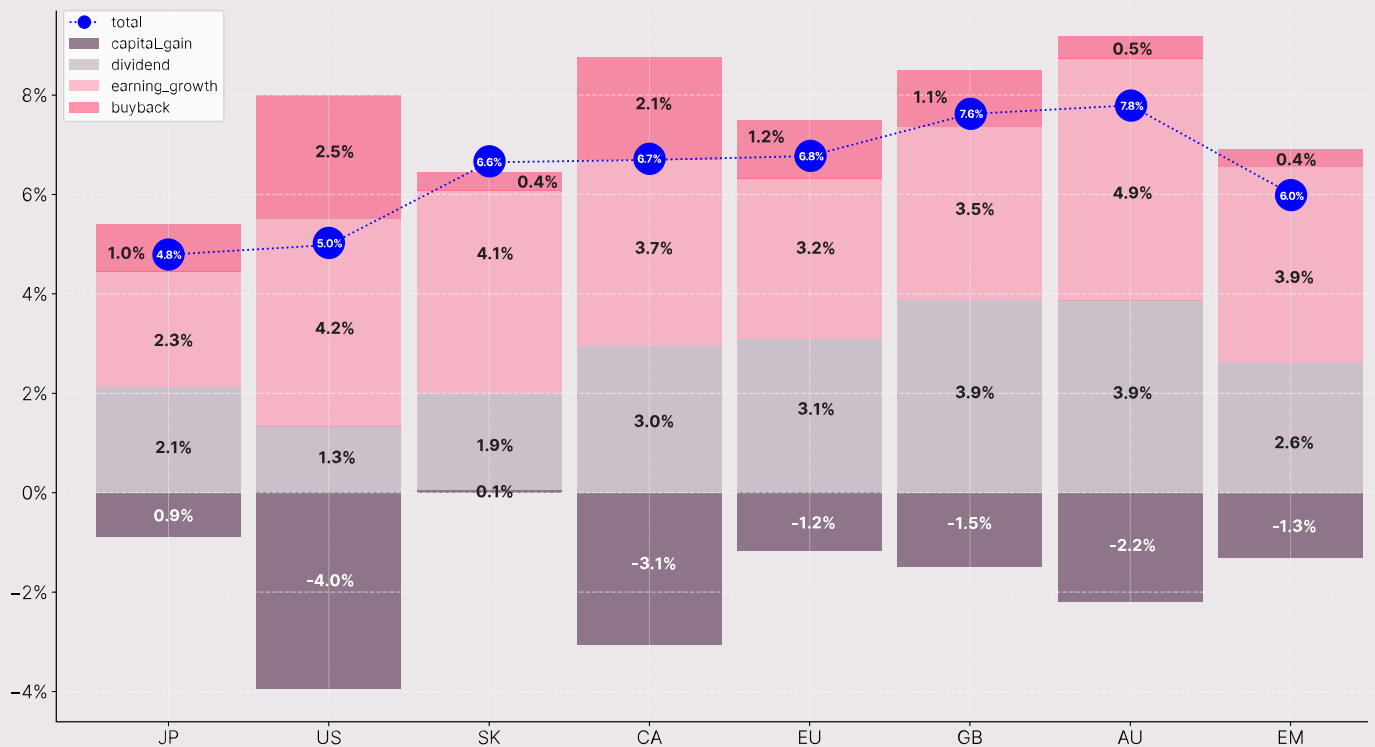
Source: Moneyfarm Research. Projections are never a perfect predictor of future performance, and are intended as an aid to decision-making, not as a guarantee.

Here's what drives expected returns of equity

Valuations

Valuations are important because they relate stock prices to earnings. Higher valuations should, all else being equal, lead to lower long-term expected returns.

The current valuation for all regions are low compared to historical levels. However in the US, valuations are much higher, with multiples approaching the peaks seen in 2021. This is partly explained by the concentration of certain sectors, but mainly due to higher profit margins for the leading companies in the S&P 500. If you believe large US tech companies will continue to dominate the market and maintain strong profitability, this could justify a higher valuation, even though the current level remains quite high. However, our models point to higher US valuations having a negative price impact over the next 10 years (although expected returns are still positive due to other factors).

Earnings growth

Earnings growth is a key factor for equity returns as it represents the forecasted growth of companies driving cash flows for shareholders. Our earnings growth expectations seem reasonable, but they are more conservative compared to historical trends. Over the last 10 years, the median earnings per share (EPS) growth for the US has been 8.5%, while we are assuming just 4.2% - because our data is taken from the IMF expectations for GDP growth. Are our assumptions realistic? Analyst expectations for EPS growth, as seen in Bloomberg's composite, are generally more optimistic across most regions compared to our forecasts based on nominal GDP.

Dividends

Dividends and share buybacks are generally the least volatile component of equity returns. These returns are periodically received by equity investors through:

Buybacks: Companies repurchase their own shares from the market, reducing the number of shares in circulation. This can potentially increase the value of the remaining shares and reflects confidence in the company's future prospects.

Dividends: Payments made directly to shareholders, distributing a portion of the company's profits in cash. Drawing on historical data, we project what we believe to be the most realistic level of "coupon-like" yield from this asset class over the reference time horizon.
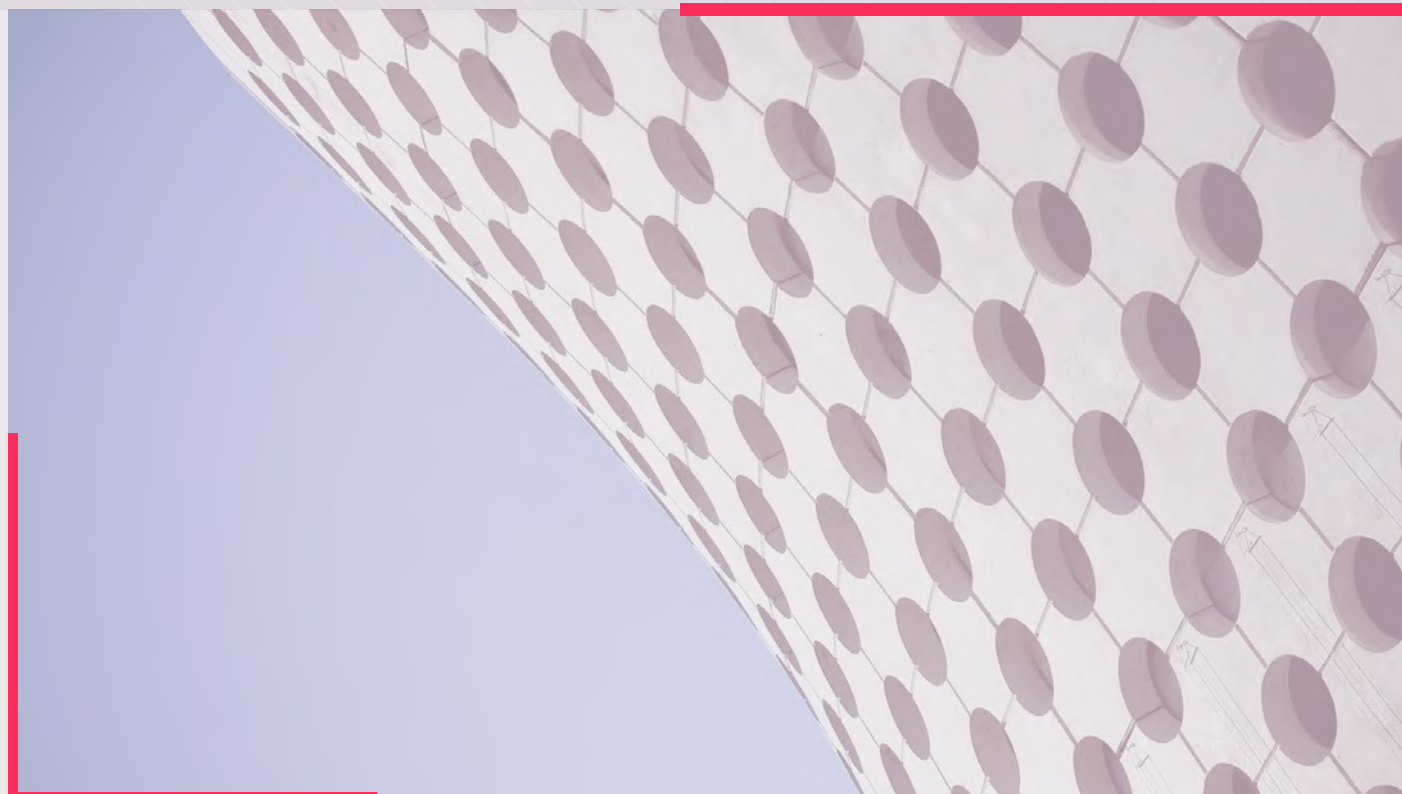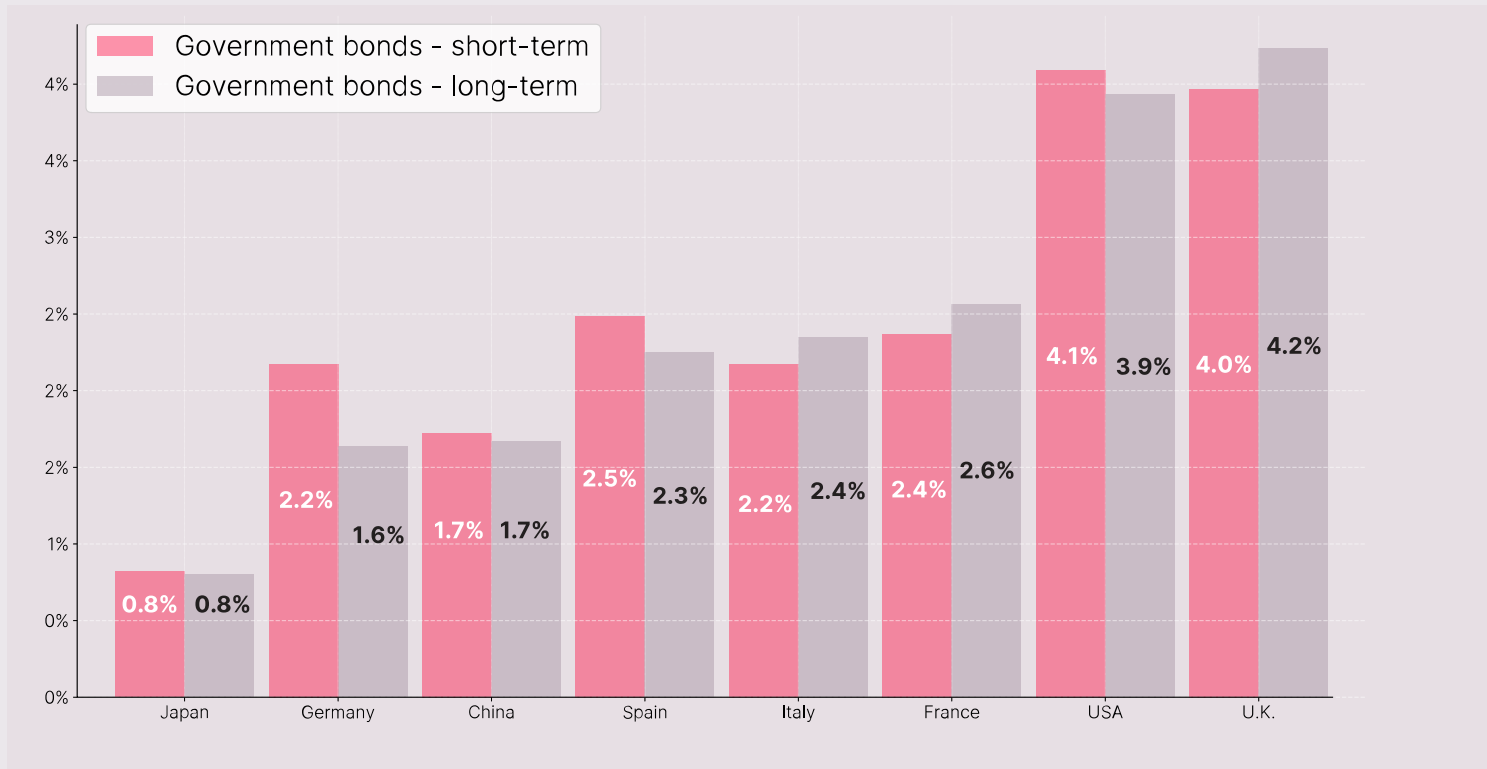
Government bonds

This year, **short and long-term expected returns** for government bonds are quite similar. Short-term returns generally look better than long-term returns across all geographies, as target rates are higher than current long-term rates.

The main exception is the UK, where this might underestimate the additional risk premium investors require for GILTs (bonds issued by the UK government) since the Truss government crisis. In other words, the slope of the UK's target rate could be higher than the historical average of 0.5%. Meanwhile, **Italy and Spain** are still feeling the effects of the euro crisis, with their expected return components looking quite high compared to France. When comparing Italy and France, the argument may favour increasing the French term premium rather than decreasing Italy's.

However, Spain's economic outlook could potentially justify a lower slope going forward.
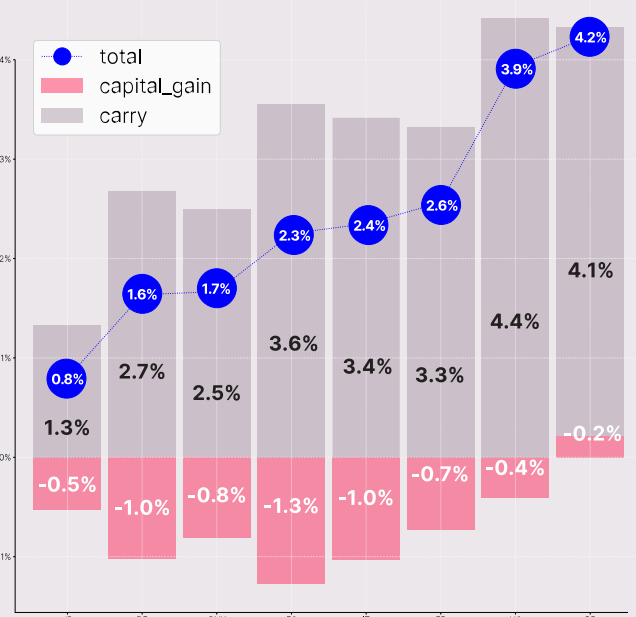
Expected returns: short vs long government bonds

Short maturity government bonds
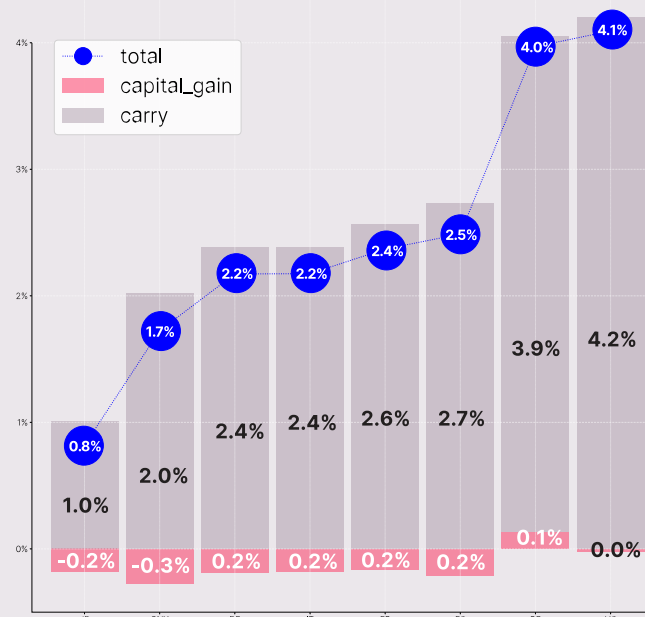
Long maturity government bonds

*Source: Moneyfarm Research. Data as of 29/11/2024*

Here's what drives expected government bonds returns

Yield to maturity (carry): It can be approximated as the coupon yield paid by the bond for its entire duration. Higher interest rates have a positive effect on expected returns but may be correlated with higher risk. **Capital gains and losses:** If a bond is not held until maturity, the difference between the purchase price and the selling price of the bond can generate a return or a loss. This price is influenced by interest rate movements. Higher interest rates negatively affect the bond price.

Remarkably, Fixed income E[R] are the highest since 2015 for all ex-EU key geographies. The UK looks the most attractive, with a 4.2% long-term expected return for long duration government bonds.

Long-term government bonds - Expected return by year
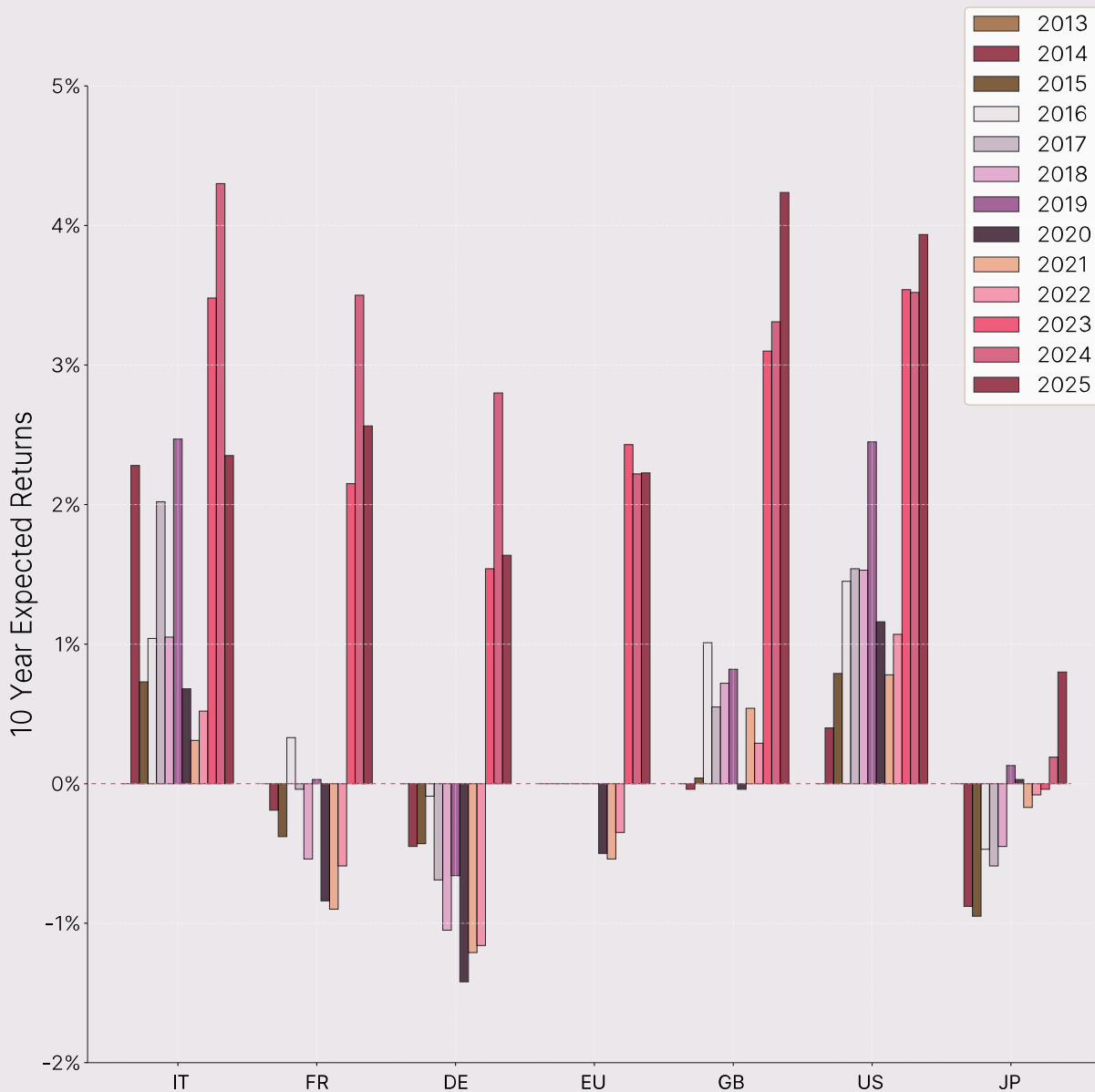
Corporate bonds and emerging market debt (EMD)

The credit market remains stable overall, but tighter spreads and higher expected default rates have generally worsened the outlook compared to last year.

US high-yield bonds (HY) are the most promising, while the outlook for their European counterparts is weaker, mainly due to a high expected default rate, which has lowered their expected returns to below those of investment-grade bonds. These returns reflect the tight spreads in the market.
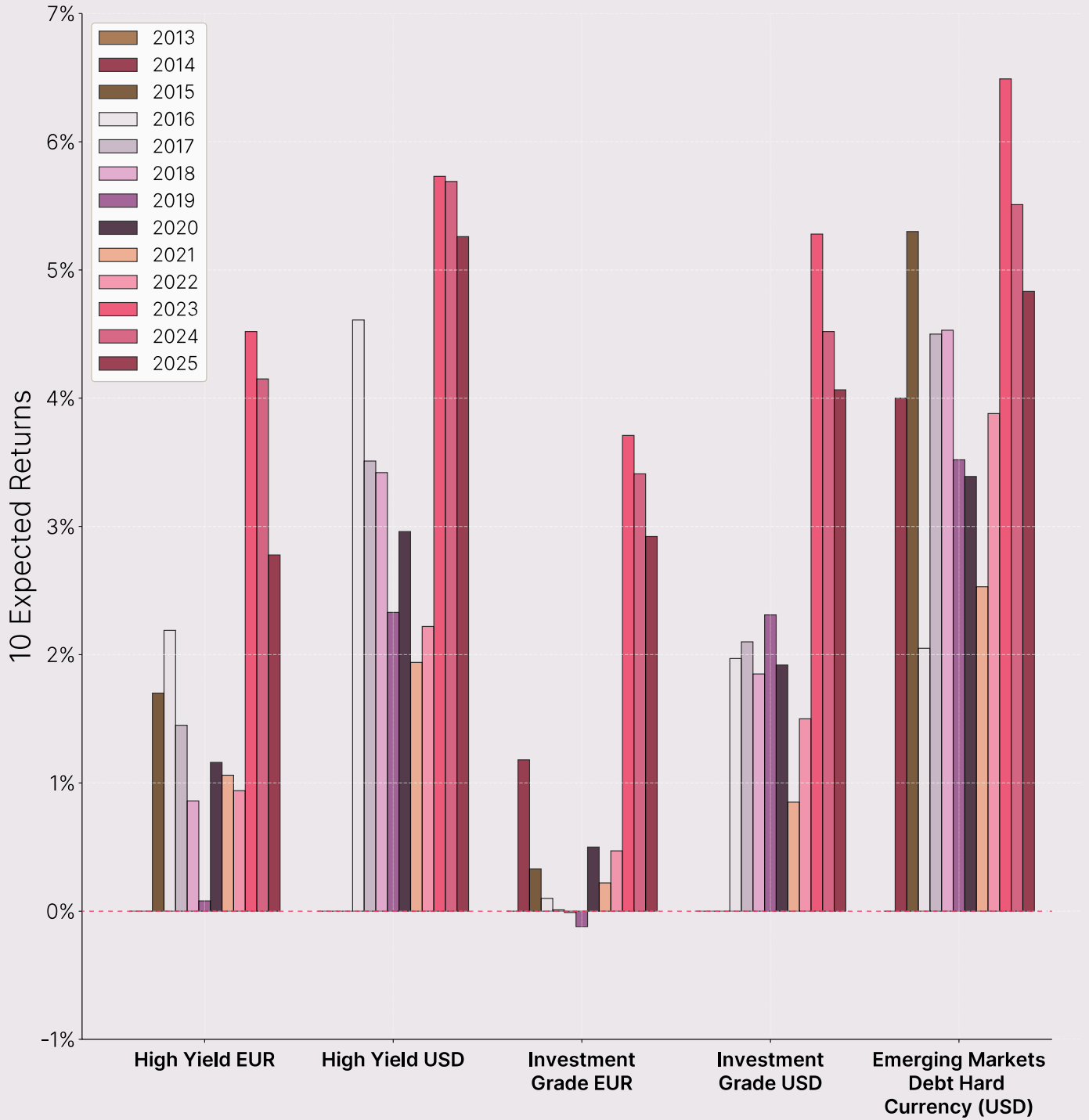
On the positive side, expected returns for all asset classes remain amongst the highest ever forecasted by us for most sub-asset classes.

Expected returns for credit and EMD
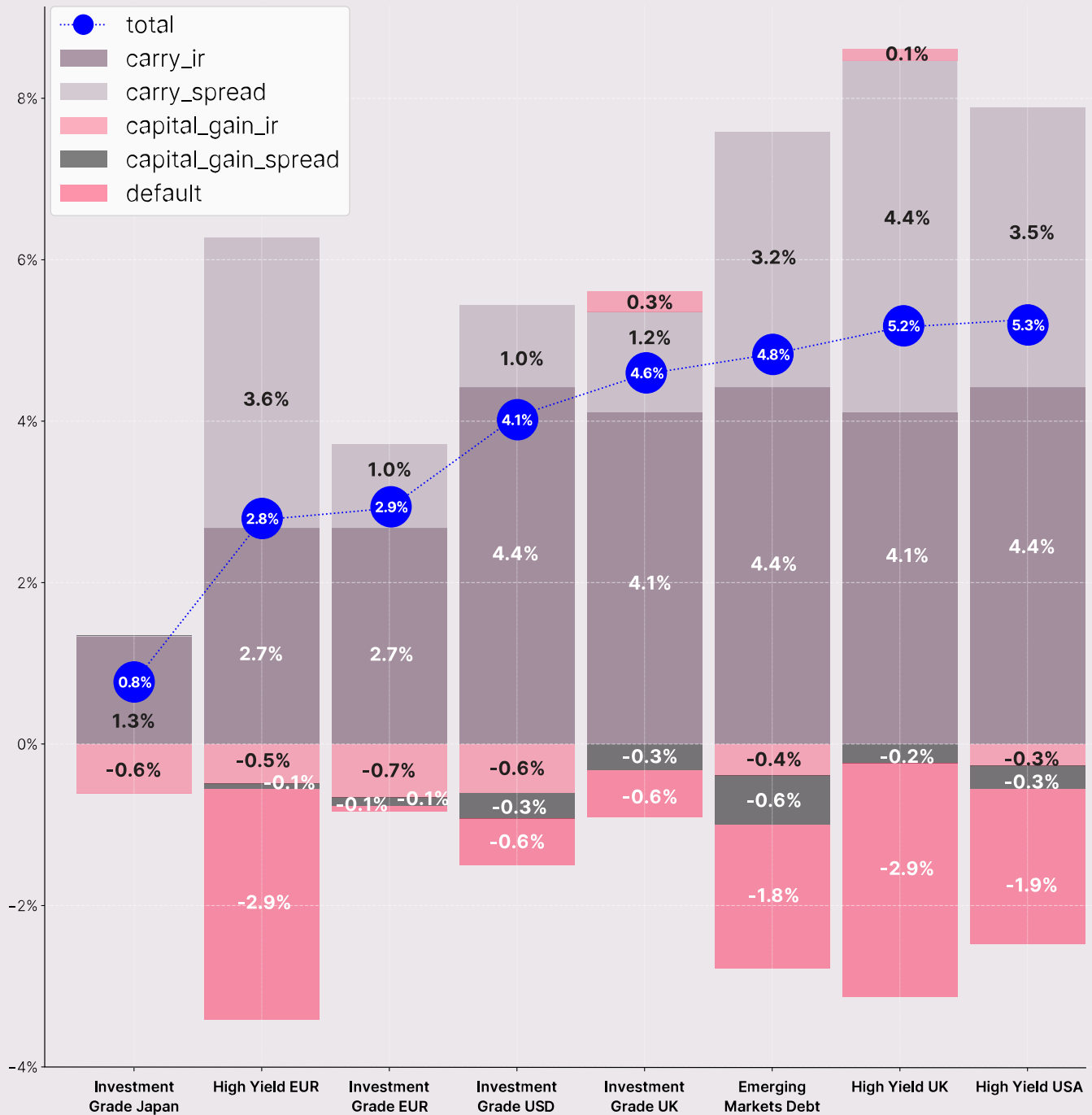
Source: Moneyfarm Research. Projections are never a perfect predictor of future performance, and are intended as an aid to decision-making, not as a guarantee. Data as of 29/11/2024.

Expected returns of credit compared to history

Legend: 2013, 2014, 2015, 2016, 2017, 2018, 2019, 2020, 2021, 2022, 2023, 2024, 2025

Y-axis: 10 Expected Returns (−1% to 7%)

X-axis categories: High Yield EUR, High Yield USD, Investment Grade EUR, Investment Grade USD, Emerging Markets Debt Hard Currency (USD)

Source: Moneyfarm Research. Past performance is not a reliable indicator of future performance. Projections are never a perfect predictor of future performance, and are intended as an aid to decision-making, not as a guarantee.

Here's what drives expected yield for corporate bonds

Yield to maturity: This can be approximated as the coupon yield paid by the bond for its entire duration. Higher interest rates are positive for expected yield but could be caused by higher risk. The yield to maturity of corporate bonds is measured in terms of spread compared to risk-free government bonds. The spread is the risk premium paid by corporate bonds. **Gains/losses in capital:** If a bond is not held until maturity, the difference between the purchase price and the selling price of the bond can generate a return or a loss. This price is influenced by movements in interest rates and spreads.

Higher interest rates or spreads negatively affect the bond price level.

Expected default: The bond's default rate. This component tends to be correlated with credit risk.

Strategic portfolios

The final stage of the strategic asset allocation process is **the creation of our strategic portfolios.**

Once the spectrum of risk levels is identified, w**e select different combinations of assets** that maximise the expected return for each portfolio.

Finding the optimal composition means **considering expected returns, expected volatility, and the correlation between different asset classes.** To simultaneously consider these three elements, we use mathematical formulas and processes, incorporating precautions against risk underestimation.

Subsequently, **quality checks are carried out** on both input and output phases.

Every assumption - from the risk level of asset classes to the estimation of expected returns and expected diversification benefits - is subject to verification by members of the Asset Allocation team, as well as the Investment Committee.

The result is a series of portfolios that optimise the expected return for the investor at each risk level. Here are our strategic portfolios, which reflect **our long-term outlook for the next 10 years. These portfolios are not the actual allocations** but serve as guidelines that outline our long-term expectations.

It is important to emphasize that **these strategic portfolios provide a framework for constructing the portfolios offered to our clients.** However, the actual allocation of client portfolios is also shaped by tactical adjustments made to address short- and medium-term market dynamics.

In a nutshell

▸ **Expected returns are lower than last year**, partly reflecting the strong performance witnessed in 2024, which saw both profits and valuations rise.

▸ The Strategic Asset Allocation (SAA) process adopts **a conservative approach to forecasting equity returns,** aligning earnings growth projections with GDP growth. This estimate, however, is lower than the projections currently put forth by analysts.

▸ The SAA also assumes that **valuations** (the price paid for a share relative to its earnings) **will revert to their long-term average**, which further moderates expected returns. While this methodology provides accurate estimates over longer horizons (~10 years), it is not designed to predict short-term performance—highlighting a key distinction between these portfolios and our short- to medium-term tactical positioning.

▸ If earnings growth exceeds GDP growth—a plausible scenario given that the largest companies often outperform the broader economy—**equity returns, and by extension, portfolio returns, could surpass these conservative estimates.**

▸ For **perspective**, achieving annual returns of 5% would allow you to double your investment in approximately 14 years.

UK Strategic Asset Allocation
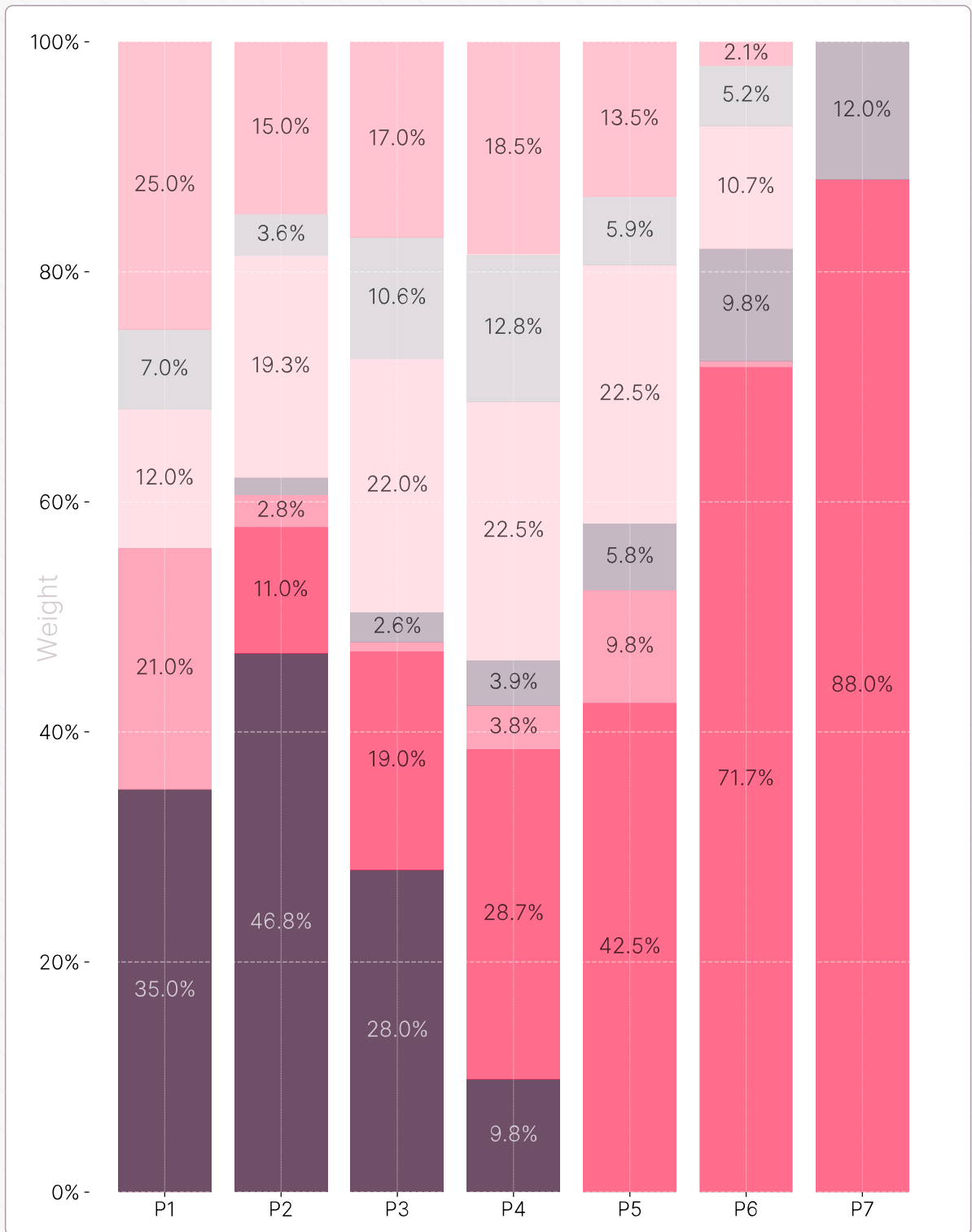
Legend:
- Cash & short-term Gov. Bonds
- Commodities and Real Estate
- Developed Markets Equity
- Developed Markets Gov. Bonds
- Emerging Markets Equity
- High-Yield & Emerging Markets Bonds
- Inflation Linked Bonds
- Investment Grade Corporate Bonds

Source: Moneyfarm Research. As part of our ongoing portfolio refinement, we have made several adjustments to our asset allocation and volatility targets. Volatility targets go from 4% for P2 to 14% and 16% for P6 and P7. We believe these are reasonable, particularly now that P6 has around 80% of equity. Finally, we simplified the optimization effort by using the more generic MSCI World All Country index for P2-P6, while maintaining a more detailed split between US Equity, DM ex-US Equity, and EM Equity for P7.

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2025