LOMBARD ODIER
INVESTMENT MANAGERS

2025 outlook

A year of divergence that should favour active managers

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Key points

- In the past two years of low global growth, investment returns have been dominated by select mega- and large-cap tech stocks, gold, bitcoin and the US dollar
- Now, improving global economic conditions and continued central-bank easing are disrupting these trends and supporting more balanced performance across asset classes, in our view
- These dynamics underpin our base case for potential market returns in 2025 – and our conviction that this year of divergence is one of opportunity for active strategies.

For investors, the same tune has been stuck on repeat for two years. Robust US growth contrasted with subdued output in Europe and China, fixed income was challenged as select mega and large-cap equities dominated gains as the US dollar, gold and bitcoin also enjoyed momentum. But as 2025 begins, we believe the tempo is changing. With the macroeconomic environment improving in the context of stark disparities in valuations among asset classes, a new regime for market returns could benefit active managers.

We see three potential shifts taking place:

1. **Improving macro conditions.** Global growth is increasing and inflation easing, with the majority of developed economies expanding over the past year. With the majority of countries experiencing a slowdown over the past two years, 2025 could see a reversal of that trend. The sticky inflation witnessed across developed-market (DM) economies signals that a *nominal recovery* is underway
2. **Monetary policy easing.** The ongoing trend of monetary policy easing, led by major central banks such as the European Central Bank (ECB), is set to play a pivotal role in shaping economic landscapes throughout 2025. This accommodative stance is expected to support recoveries in both DM and emerging markets (EMs), fostering an environment conducive to investment and consumer spending
3. **Balanced market returns.** Despite subdued economic activity, investors have increasingly favoured growth stocks, resulting in a pronounced concentration of market performance within US mega-cap technology stocks. This trend has created a stark disparity in the relative valuations of different asset classes – particularly between equities and bonds, as well as across EM and DM stocks.

These shifts collectively suggest that markets could revert to more regular patterns than those seen in the past three years, setting the stage for a significant reshuffling of investment strategies. In our view, a long-anticipated mean reversion – where the importance of beta diminishes and strategic alpha positioning distinguishes successful investments – may take place, which investors should prepare for. Still, challenges lie ahead:

- The need for fiscal consolidation among heavily indebted governments will clash with populist tendencies for tax cuts or increased spending
- The anticipated hike in US tariffs could disrupt world trade
- High equity valuations and tight spreads could discourage investors from adding risk to their portfolios.

These are the risks to our base case for 2025, and each would make precipitate a hard landing, yet our conviction remains in the case for a nominal recovery. In the following sections, we explain the analysis underpinning our views and provide a forecast of potential returns across equities, fixed income, convertible bonds and balanced portfolios for both scenarios.

OUR BASE CASE: A NOMINAL RECOVERY

As we enter 2025, growth and inflation dynamics appear more favourable, with central banks expected to ease monetary policy. Global interest rates are projected to decrease significantly, creating an environment conducive to economic recovery. However, our analysis indicates that this nominal recovery will not be uniform across regions, posing challenges for EMs.

Improving macro conditions

Last year largely saw a continuation of the soft-landing process initiated in 2023, which manifested differently across regions. In the US, growth remained relatively robust, contrasting with the more subdued economic expansions observed in the eurozone and China. This divergence largely stemmed from the persistently high primary deficit in the US, which has cushioned the economy against the hawkish policies of the Federal Reserve (Fed), unlike the weaker fiscal stimuli found elsewhere.

The growth data presented in Figure 1 highlights two critical points:

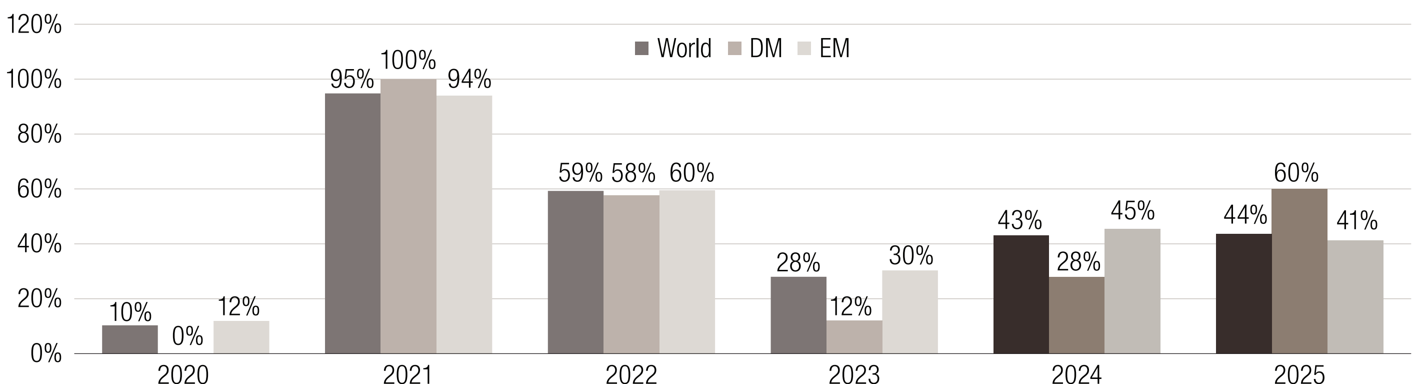
- First, the global economy has indeed experienced a slowdown over the past two years, a fact that may have been overshadowed by the world's focus on robust US output. In 2023, only 28% of countries worldwide saw an improving growth trend; in 2024, this number rose to 43%. The slowdown was more pronounced among DMs than EMs, given the impact of central-bank tightening
- Second, according to International Monetary Fund (IMF) projections, 2025 could mark a distinct shift in the macroeconomic tempo. The IMF anticipates that 60% of DM economies will experience ongoing nominal growth, signalling a potential departure from the economic conditions of the previous two years and heralding a nominal recovery.

While market observers often approach such forecasts with scepticism, the critical takeaway here is not the projected growth levels but rather their upward trajectory. However, this recovery will not be uniformly distributed as EMs are generally expected to face continuing economic challenges. The latest economic data needs to be analysed further to understand how these projections align with real-time economic conditions and whether adjustments in policy or market strategy might be necessary. These improving economic conditions are essential for increasing corporate profits, which in turn lead to rising market valuations.

While reservations about the IMF's assessments may be held, the latest macroeconomic data corroborates its findings. Figure 2 highlights the recent evolution of our proprietary growth and inflation nowcasting signals across all regions within the IMF's scope, revealing a consistent uptrend.

This trend is evident in both growth and inflation metrics, reinforcing the case for a nominal recovery. Specifically, growth is rising, with 57% of the data published in December indicating an improvement, while the proportion of improving inflation data stands at 53%. Notably, the regions displaying the most significant signs of progress are those that have lagged, such as China, where 65% of data points to improvement, the eurozone at 53%, as well as smaller open economies like Norway and Switzerland.

FIG 1. PERCENTAGE OF COUNTRIES IN THE WORLD DEMONSTRATING IMPROVING GROWTH



Source: LOIM, International Monetary Fund at 02 January 2025. For illustrative purposes only.

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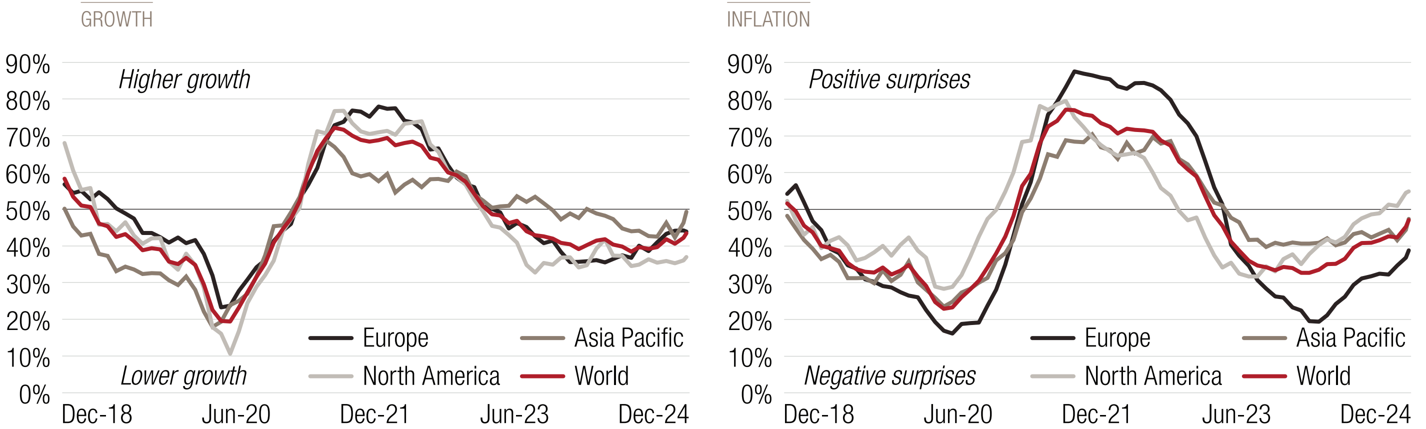
FIG 2. PROPRIETARY LOIM GROWTH AND INFLATION NOWCASTING SIGNALS ACROSS ECONOMIC ZONES



Source: LOIM, Bloomberg at 02 January 2025. For illustrative purposes only.

The broader narrative here is clear: the economic outlook looks increasingly positive. This is largely attributable to the central-bank pivot that commenced in 2024. If monetary policy was previously a drag on growth, less hawkish policies should herald enhanced growth prospects moving forward.

Reading note: LOIM's nowcasting indicator gathers economic indicators in a point-in-time manner in order to measure the likelihood of a given macro risk – growth, inflation surprises and monetary policy surprises. The nowcaster varies between 0% (low growth, low inflation surprises and dovish monetary policy) and 100% (high growth, high inflation surprises and hawkish monetary policy).

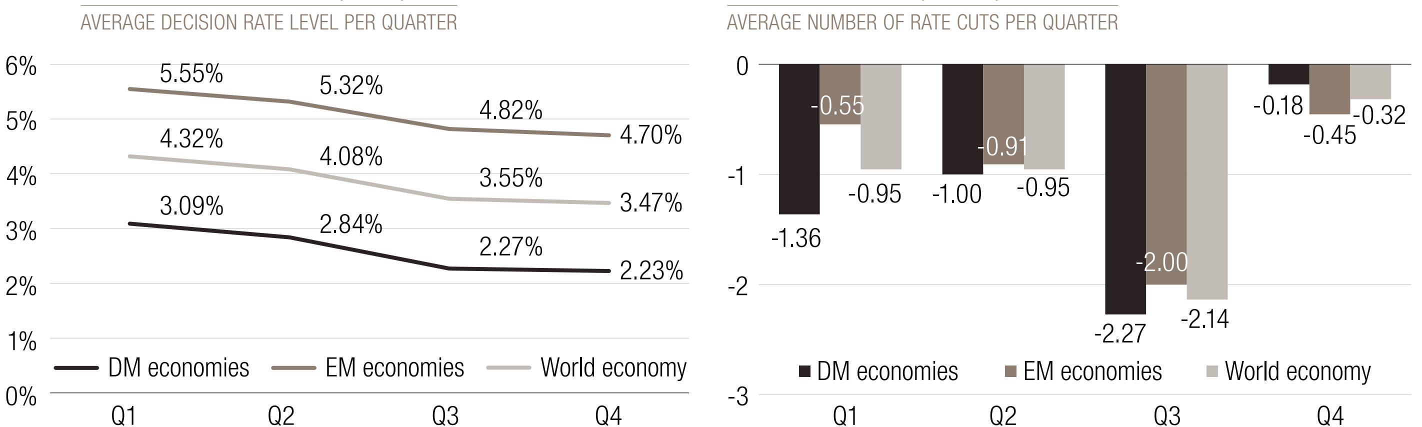
Monetary-policy easing

One aspect of the financial landscape that does not appear poised for mean reversion in 2025 is the policy direction of central banks. Figure 3 displays the average global monetary policy rate as forecasted by a consensus of professional economists, differentiated by country groups and the anticipated number of rate cuts per country for the coming year.

Key figures indicate that the global policy rate is expected to decrease from 4.3% to 3.5%, a figure substantially below the anticipated global growth rate, which is projected to exceed 5%. More specifically, rates in DMs are predicted to drop from 3.1% to 2.2%, while EMs are expected to see a reduction from 5.5% to 4.7%. This translates to approximately four rate cuts in the next year, with one cut each in Q1 and Q2, followed by an intensified pace in Q3, where two cuts per country are anticipated on average. This 1% further reduction in rates in 2025 is likely to bolster the nominal recovery.

With both growth and inflation reverting to higher levels and central banks responding by lowering policy rates, our base case is particularly supportive of corporate profits, especially small and mid-cap companies, which stand to benefit from reduced funding rates and improved domestic growth dynamics.

FIG 3. POLICY RATE TRENDS (LEFT) AND NUMBER OF RATES CUT PER QUARTER (RIGHT) OVER 2025



Source: LOIM, Bloomberg at 02 January 2025. For illustrative purposes only.

Implications for market returns

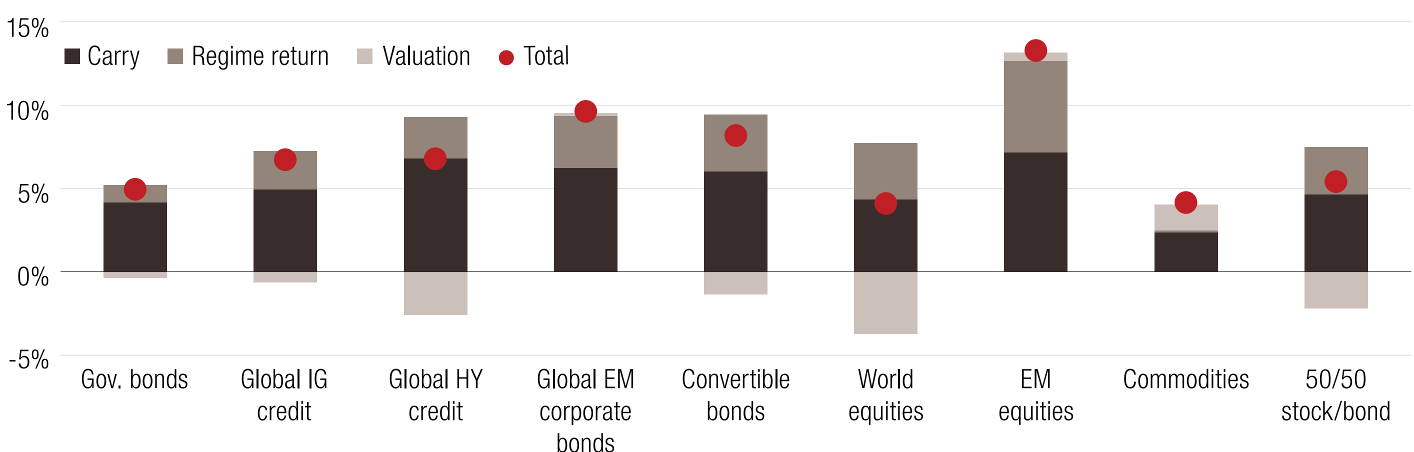
Exploring the concept of a 'nominal recovery' regime and considering the potential for a significant mean reversion of carry across asset classes, Figure 4 depicts a set of expected returns based on data from 1990 to 2024, decomposing the historical performance[1] of assets between carry, a valuation effect and a regime-return component. We define these elements below.

- **Carry** shows for the current value of each asset class's carry
- **Valuation** takes into account a 'normal' recovery of carry towards its long-term trend for each asset class
- **Regime returns** stands for the part of returns not explained by carry and valuation, and that reflects the natural sensitivity of each asset class to economic regimes, as measured over the 1990-2024 period.

Figure 4 illustrates the results for USD-denominated assets, leading to the following key conclusions for 2025:

- **Fixed Income** (investment grade, high yield, EM debt). In the current scenario, fixed-income assets exhibit considerable return potential accompanied by moderate volatility, making them increasingly appealing. These assets are anticipated to outperform DM equities and commodities, primarily due to favourable carry and valuation metrics. This positions fixed income as a potentially more secure option in an environment marked by a nominal recovery. Within this category, the BBB-BB segment is identified as particularly attractive from a risk-adjusted perspective
- **Convertible bonds.** The same is true for convertible bonds, which may perform well due to their good valuations, high carry and historically positive response to nominal recoveries
- **EM equities.** Positioned to thrive in this economic regime, EM equities begin from a compelling baseline in terms of carry and valuation, devoid of the valuation stretches often observed in DM stocks. Although accompanied by higher volatility, EM and specifically Asian equities continue to be attractive on a risk-adjusted basis, albeit demanding specific expertise and strong conviction from investors
- **Global equities.** In our analysis, world equities do not exhibit notable strength during nominal recoveries, which historically tend to favour more balanced circumstances. Currently, US equities appear overvalued and disproportionately represented in indices. However, it is critical to note – as asset-management disclaimers invariably state – that past performance is not a reliable indicator of future results. Structural shifts, such as the increasing prevalence of passive investment strategies, greater retail-investor participation and the integration of artificial intelligence might alter historical trends, potentially bolstering major global and well-recognised brands. Nonetheless, the anticipated persistence of high uncertainty and volatility provides a fertile ground for active managers to demonstrate their value-adding qualities
- **Balanced portfolios.** The current environment, where we expect returns across asset classes to be more balanced, offers an appealing setting for risk-based investment processes. Navigating through economic cycles with long-term perspectives inherently encourages diversification – a strategy that faces challenges during periods characterised by concentrated performance, like 2023 and 2024. Looking ahead, the forthcoming years appear likely to diminish the appeal of standard passive allocations, such as various adaptations of the 50/50 stock/bond portfolio. Instead, there may be a shift towards dynamic, risk-based allocations that are apt for navigating diverse market conditions.

FIG 4. EXPECTED RETURNS AS A FUNCTION OF THE ECONOMIC SCENARIO



Source: LOIM, Bloomberg at 02 January 2025. For illustrative purposes only.

Reading note: "Carry" represents the current value of each asset class carry. "Valuation" takes into account a "normal" recovery of carry towards its long-term trend for each asset class. "Excess returns" stands for the part of returns not explained by carry and valuation and that reflects the natural sensitivity of each asset class to economic regimes, as measured from the 1990-2024 period.

[1] Bond: Bloomberg Barclays Treasury Index. Global Investment Grade: Bloomberg Barclays Investment Grade. High yield: Bloomberg Barclays High Yield; Emerging: JP Morgan Emerging Corporate Index; Convertible bonds: Refinitiv Global Focus Hedged CB (USD).

If 2025 brings a change in macroeconomic and market trends, bonds and EM equities could be essential, benefiting both relative and absolute performance. On the DM equities side, benchmark deviations could be attractive given the valuation and concentration of such indices. For multi-asset investors, diversification could be rewarded given the lower concentration of expected market performance.

RISK SCENARIO: HARD LANDING

This nominal recovery scenario does not come without risks. We list here the three key risks to our baseline scenario: fiscal consolidation, trade tariffs and market valuations. Each can lead to an increase in the odds of a hard landing, with consequences for potential market returns.

Fiscal consolidation

Growth and inflation are not the only metrics undergoing a mean reversion. Their fundamental driver – fiscal policy – will likely experience some moderation. The recent increase in the debt-to-GDP ratio has positioned many economies on a trajectory that may soon face market scrutiny, necessitating some degree of fiscal consolidation. This situation sets the stage for two primary outcomes.

- First, some countries may opt to extend fiscal austerity measures beyond immediate needs, with a focus on the long-term health of public finances. Figure 5 clearly shows that US corporate profits have historically thrived during periods of larger deficits. Consequently, reducing these deficits could suppress demand and profits, which could be particularly challenging given the high single-digit earnings expectations for 2025
- Second, since the Reaganomics era, the US has required increasingly larger public deficits to achieve significant profit growth. Most recently, the Trump administration's policies led to a primary deficit exceeding 15%, coinciding with a 49% increase in profits (also highlighted in Figure 5). What does this imply? Even minor fiscal consolidation could disproportionately impact profits, potentially leading to lower-than-anticipated profit growth.

It's crucial to recognise that fiscal consolidation has become a necessity across the G10 nations, amplifying the potential magnitude of its impact on 2025 earnings. This factor, combined with historical data, suggests that investors should brace for possible shifts in profit dynamics stemming from changes to fiscal policy.

Given this risk of fiscal consolidation, however, timing is crucial. While populist trends favour continued debt accumulation, significant budgetary adjustment appears inevitable in the long run. Although 2025 may not see new austerity measures, the risk of substantial fiscal tightening in the longer term cannot be ignored. The central question remains: how will markets price-in this risk? Whether this transpires as a gradual adjustment or sudden correction has implications for returns in 2025.

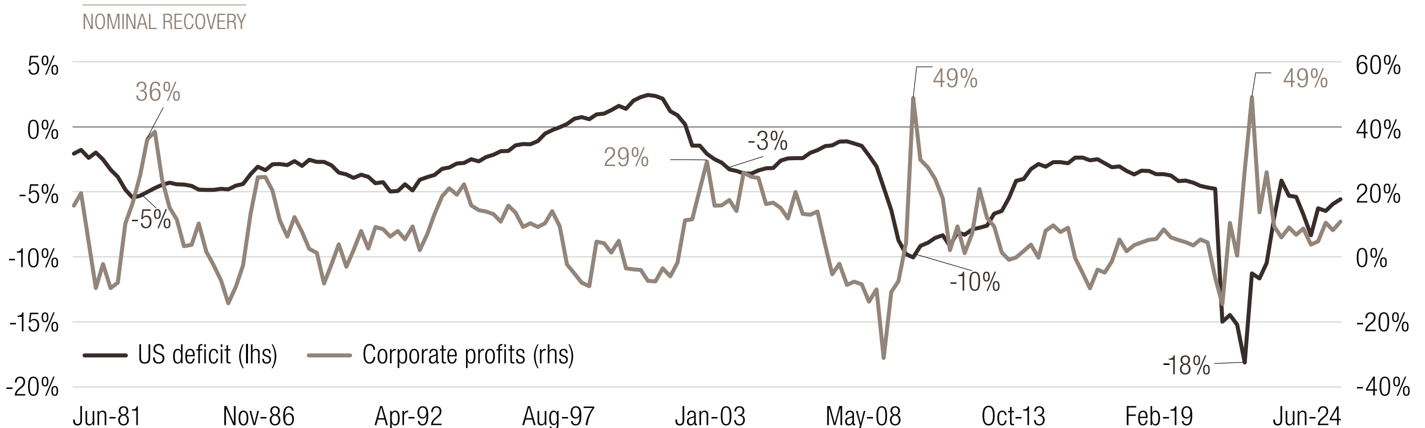
US trade tariffs

Setting aside Donald Trump's policies on immigration and corporate taxes, which will predominantly affect the US economy, his stance on trade tariffs is a potential game changer for the global economy and markets in 2025. These tariffs, primarily viewed as an inflationary force within the US, present a broader economic challenge that may be underestimated.

Trade tariffs tend to suppress economic growth. Our estimates suggest that a 10% increase in tariffs could reduce trade growth by 1.2%, which translates to a 0.8% decrease in global GDP. This effect is substantial and would disproportionately impact regions that are currently in a fragile-yet-improving state, such as Europe and China. Figure 6 compares the results of a 10% trade tariff, based on an economic model,[2] to the actual events of 2018, when Trump first implemented tariffs.[3]

FIG 5. BUDGET DEFICIT VERSUS CORPORATE PROFIT GROWTH IN THE US

NOMINAL RECOVERY

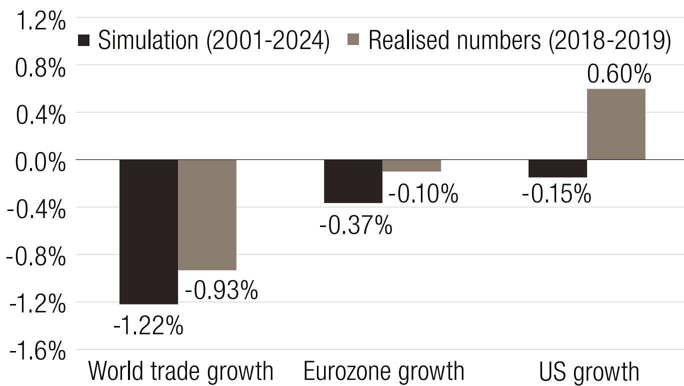


Source: LOIM, Bloomberg at 02 January 2025. For illustrative purposes only.

[2] The model used is a Vector Autoregressive model with 3 lags based on quarterly data is used here, from which Impulse Response Functions are cumulated to assess the dynamic impact of tariffs on growth.

[3] This simulation exercise bodes well with US and European data, but poorly with Chinese data which present too much smoothness to be incorporated in such an exercise.

FIG 6. EXPECTED IMPACT OF A 10% TARIFF HIKE IN THE US VERSUS THE 2018 PRECEDENT



Source: LOIM, Bloomberg at November 2024. For illustrative purposes only. "Simulation" reflects the outcome of the impulse response function from a Vector Autoregressive model, treating a 10% tariff hike as a 10% increase in imported inflation.

New or elevated tariffs could lead to a net destruction in global demand, which is not inherently inflationary over the medium term. Instead, reduced demand is likely to exert deflationary pressure. This mirrors the experience of 2018, indicating that Trump's return to the White House will likely see a reversion in global trade dynamics, posing a risk to global growth.

This analysis assumed a blanket 10% tariff increase and provides a benchmark impact on real GDP growth. Should tariffs be applied in a more moderate way, or less severely for close trading partners under a 'friendshoring' umbrella, the impact on world growth could be much more modest.

High valuations

The concluding aspect of our mean-reversion narrative for 2025 concerns valuations, which have evolved from two years of slower growth across a majority of global economies. This environment has naturally favoured growth-style assets, particularly the largest names within equity indices, leading to a highly concentrated market rally. This trend has created challenges for active asset managers like us, who have faced difficulties due to the narrow focus of market gains.

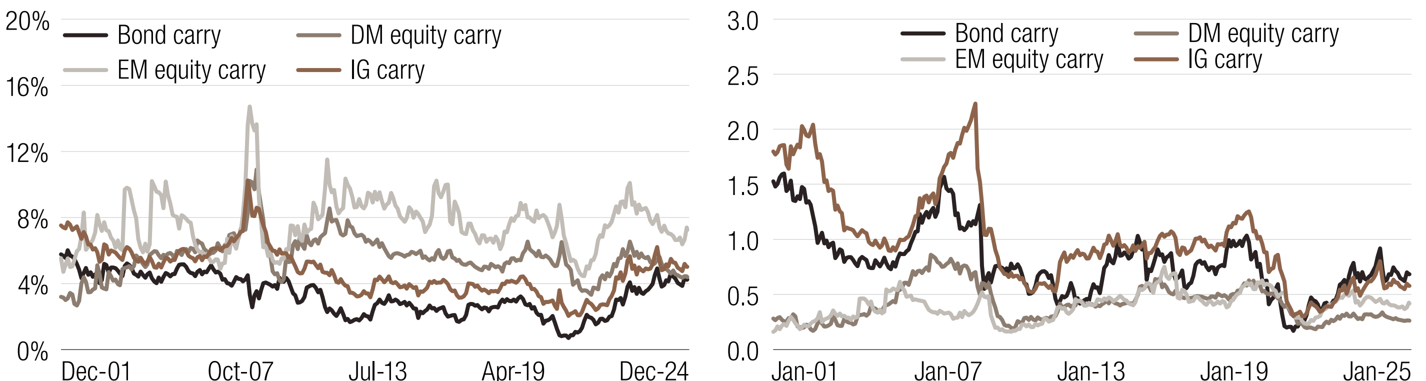
In assessing this scenario, we distinguish between the expected and extraordinary elements. Normally, slower economic activity encourages a tilt towards growth stocks, as investors seek companies with the potential for earnings expansion. Concurrently, inflation and rising interest rates, typical of late economic cycles, tend to negatively impact bonds. However, the current cycle has been marked by new dynamics, driven by significant retail investor participation and a surge in passive investing. This combination has created strong demand for US and tech names, keeping active management in check.

Recent reports on investor positioning reveal that professional investors, having maintained a defensive posture during the period of slower growth, are strategically repositioning in anticipation of a nominal recovery. This shift presents a risk, as depicted in Figure 7, where we see valuations and their inverse, carry, in a rare alignment with fixed income. The chart shows bonds' carry surpassing that of DM equities – a direct reflection of recent trends – while EM equities now offer attractive valuations.

Professional investors are cognisant of this anomaly, and the latest shifts in hedge fund betas now favour equities in Japan, Europe and EMs. A mean reversion under these circumstances could herald a more positive year for bonds, yet also bring about volatility for DM equities, particularly as they enter 2025 with high valuations and are effectively 'priced for perfection'.

Valuations thus remain a critical investment criterion in periods of mean reversion. We must keep this in mind, ensuring that our investment strategies are well-aligned with these evolving market dynamics and balanced with fundamentals.

FIG 7. COMPARED CARRY (LEFT) AND CARRY TO VOLATILITY RATIOS (RIGHT) PER ASSET CLASS



Source: LOIM, Bloomberg at 02 January 2025. Past performance is not a guarantee of future returns. For illustrative purposes only. Bond carry is yield; for equities, it is roll-down and earnings yield.

IMPLICATIONS FOR MARKET RETURNS

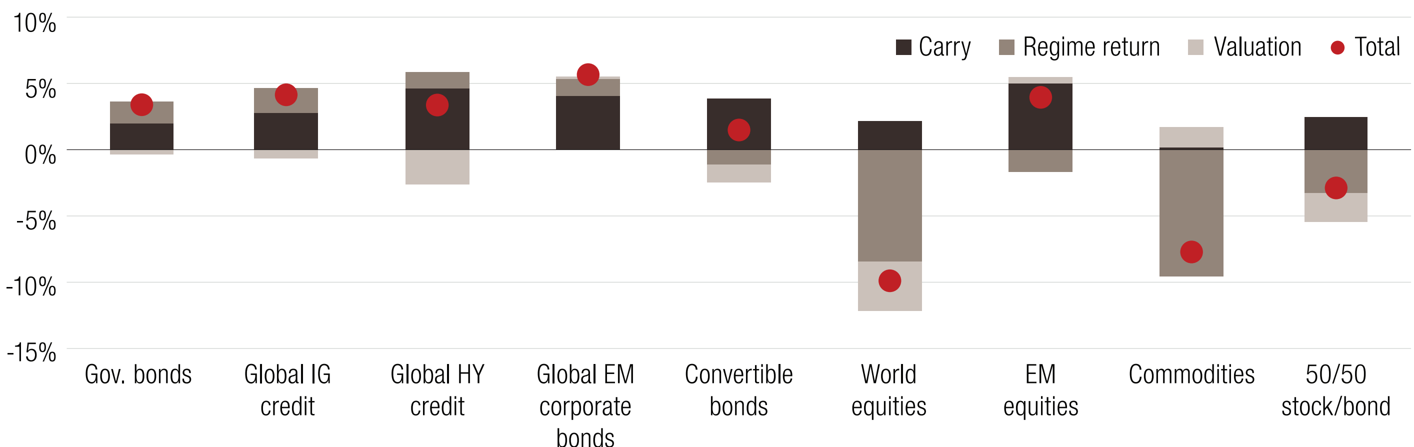
These three risks would lead to an unexpected decline in world GDP growth. For that reason, the alternative outcome to the nominal recovery is a hard landing. These come with dramatically lower earnings growth that force investors to revisit the 'regime' underpinning of returns: lower in the case of cyclical assets such as high yield or equities, and higher in the case of government bonds as 'flight-to-safety' sentiment grips markets. This time around, investors would also need to consider the fact that the current valuation imbalance could expose some asset classes more than others to that growth risk.

Figures 8 and 9 present several crucial insights relevant to this scenario. Interestingly, a hard landing has historically been caused by a variety of factors, ranging from fiscal and trade policies to higher central bank rates or business-cycle fluctuations. The data we analyse is based on historical medians that naturally exclude more extreme events, thus providing a more moderate perspective on such tail risks.

In this scenario, the chart depicts bonds outperforming equities, with high-yield bonds likely to underperform relative to government bonds, and EM equities demonstrating resilience compared to DMs. This resilience in EM equities might seem counterintuitive but can be attributed to two factors. First, the carry for EM equities is supportive, indicating that EM valuations already factor in more negative scenarios than their DM counterparts. Second, during downturn periods from 1990-2024, the median return for EM equities has generally been less negative than that of DM equities. This suggests that, while the average returns are skewed by anomalies such as the 2008 financial crisis, the typical outcomes have been more favourable for EM stocks.

The same applies to the global investment-grade (IG) credit segment: its median return during hard-landing periods is higher than its average return, a point worth remembering (unless a scenario similar to the 2008 crash is expected). A 'median' hard-landing scenario would call for defensive positioning, but also for diversified equity and bond exposure as EM could weather the downturn well and the IG premium could also prevail. A typical situation could make active management a source of performance, both from 'within' and 'between' cross-asset exposures.

FIG 8. EXPECTED RETURNS AS A FUNCTION OF THE ECONOMIC SCENARIO



Source: LOIM analysis, Bloomberg as at 02 January 2025. Past performance is not a guarantee of future returns. For illustrative purposes only.

FIG 9. CASH, EXCESS RETURN AND SHARPE RATIOS PER SCENARIO

	NOMINAL RECOVERY			*HARD LANDING*			1990-2024		
	CASH	EXCESS RETURN	SHARPE RATIO	*CASH*	*EXCESS RETURN*	*SHARPE RATIO*	CASH	EXCESS RETURN	SHARPE RATIO
Gov. Bonds	4.0%	0.8%	0.18	*2.0%*	*1.3%*	*0.27*	4.6%	1.89%	0.41
Global IG Credit	4.0%	2.6%	0.46	*2.0%*	*2.0%*	*0.35*	5.7%	3.08%	0.54
Global HY Credit	4.0%	2.7%	0.33	*2.0%*	*1.2%*	*0.15*	8.0%	4.61%	0.57
Global EM Corp Bonds	4.0%	3.6%	0.48	*2.0%*	*1.6%*	*0.22*	7.5%	4.62%	0.62
Convertible bonds	4.0%	4.1%	0.46	*2.0%*	*-0.6%*	*-0.07*	9.0%	2.79%	0.31
World Equities	4.0%	0.0%	0.00	*2.0%*	*-12.0%*	*-0.79*	15.1%	3.59%	0.24
EM equities	4.0%	9.2%	0.41	*2.0%*	*1.8%*	*0.08*	22.1%	5.35%	0.24
Commodities	4.0%	0.1%	0.00	*2.0%*	*-9.8%*	*-0.67*	14.6%	1.62%	0.11
50/50	4.0%	1.3%	0.20	*2.0%*	*-5.0%*	*-0.77*	6.5%	3.33%	0.51
Swiss Bonds	0.5%	1.2%	0.34	*0.0%*	*2.8%*	*0.78*	3.6%	0.71%	0.20
Swiss Equities	0.5%	2.2%	0.18	*0.0%*	*-6.1%*	*-0.50*	12.2%	2.92%	0.24
LPP25	0.5%	2.1%	0.51	*0.0%*	*-0.2%*	*-0.05*	4.2%	0.87%	0.21

Source: LOIM analysis, Bloomberg as at 02 January 2025. Past performance is not a guarantee of future returns. For illustrative purposes only.

THE CASE OF SWITZERLAND SCENARIO

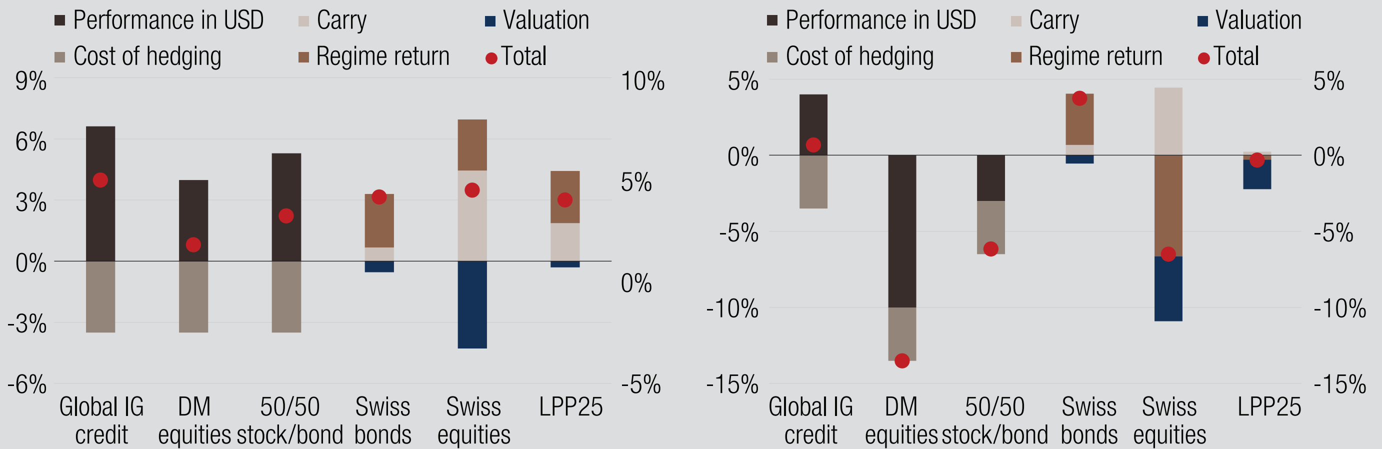
As a Swiss investment house, it is only natural for us to focus on our outlook for domestic assets. In terms of macro conditions, Switzerland stands out on several metrics. Over the last 20 years, average real growth has consistently exceeded that of the largest European countries and is expected to do so in 2025 as well. Meanwhile, inflation is likely to remain well within the Swiss National Bank's mandate for price stability and significantly below European inflation rates. As a result, interest rates in Switzerland, which are already below the estimated neutral level, are more accommodative than those of peer countries, while expectations of negative rates in the near future seem premature, in our opinion. Nonetheless, the combination of accommodative rates, decent growth, and manageable inflation creates a solid backdrop for the Swiss economy moving forward.

Turning to investments, in Figure 10, we provide a breakdown of our forecast for key Swiss assets compared to CHF-hedged foreign investments, using the same methodology applied in Figure 4. We compare them to the expected performance for each scenario from Figure 4, including the cost of hedging currency risk. When assessed properly, Swiss assets appear attractive in both scenarios:

- **Nominal recovery.** This could see Swiss bond benchmarks perform closely to a comparable world IG benchmark, while Swiss equities are expected to outperform DM equities hedged in Swiss francs
- **Hard landing.** In this scenario, Swiss bonds would potentially become a safe haven, outperforming their foreign counterparts once hedged. Quality Swiss equities might deliver returns that are less negative compared to DM equities, with or without currency hedging. However, given the currently low yields for Swiss francs, bonds denominated in other currencies could prove to be an unexpectedly appealing opportunity in the event of a hard landing, considering their potential for retaining yield compression.

For Swiss investors, accurately factoring in the cost of hedging will be essential over the next year, especially to avoid the misleading perception of higher rates outside Switzerland. Our set of expected returns, incorporating the cost of hedging, demonstrates how domestic assets can robustly withstand global comparisons – which is an important consideration for 2025. However, with yields returning to notably low levels, investors will undoubtedly value alpha in their portfolios. This means that skilled managers with proven expertise and experience are needed to handle the specificities of the Swiss markets, which are often seen as challenging due to their less-liquid nature.

FIG 10. EXPECTED RETURNS FOR SWISS ASSETS COMPARED TO HEDGED PERFORMANCE OF FOREIGN ASSETS



Source: LOIM analysis, Bloomberg as at 02 January 2025. Past performance is not a guarantee of future returns. For illustrative purposes only.

CONCLUSION

As 2025 progresses, the economic landscape can potentially improve significantly, in a welcome departure from the previous two years. This anticipated shift toward a nominal recovery could support a broad-based rebalancing across various markets, addressing some of the anomalies that emerged in the post-COVID era.

However, this scenario is not devoid of risks, notably geopolitical tensions and trade tariffs. Particular concerns include the potential recessionary impacts of fiscal consolidation and trade tariffs, which may be underestimated. Additionally, high valuations could impede further advances by markets, creating a headwind.

In this context, bond exposures and strategic diversification across asset classes emerge as especially appealing options. Such approaches would likely benefit from the conditions of a nominal recovery. Moreover, in this context, the performance of global equities could become more balanced, in stark contrast to the trends of the past two years.

Ultimately, it will be critical for investors to reassess their portfolios, considering the potential shifts in economic conditions and their implications for asset classes. Such a strategic recalibration will be essential in harnessing the opportunities created by changing economic conditions while mitigating associated risks. Mean reversions in 2025 could prove more profitable for active managers, in our view.

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