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Notes From the Road: Investor Views at the Start of '25

We started the year having discussions with a large number of chief investment officers (CIOs) and allocators. In this short note, we reflect on the key common messages that came out of those discussions, points of consensus and important open questions for the outlook. We reflect on how those perspectives overlap with our view that a change in macro regime is the most likely description of the outlook.

There was strong agreement among investors on a positive view for risk assets and an overweight position in the US. The area of most agreement in terms of where to increase allocations was private assets, especially private debt.

We discuss the key issues that investors have raised across equities, fixed income and alternative assets, and also their views on crypto.

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We started this year by engaging in discussions with a large number of CIOs and allocators. In this short note, we reflect on key common messages that came out of those discussions, points of consensus and important open questions for the outlook.

There was broad agreement among asset owners on a near-term positive view for risk assets such as equities. The view that it was right to overweight the US was also overwhelming, with almost zero interest in other regions (in equities, at least). To be clear, this is a view that we agree with and expressed in our outlook note for 2025. In our recommendation to clients, we are overweight equities and have a positive view on the US within that allocation. However, the near-uniformity of the view does, it has to be said, give us a slight uneasiness. As one client said, “Nobody disagrees with US exceptionalism. Maybe there is even a case for complacency.”

Macro: majority view of higher inflation; policy changes influence market outlook

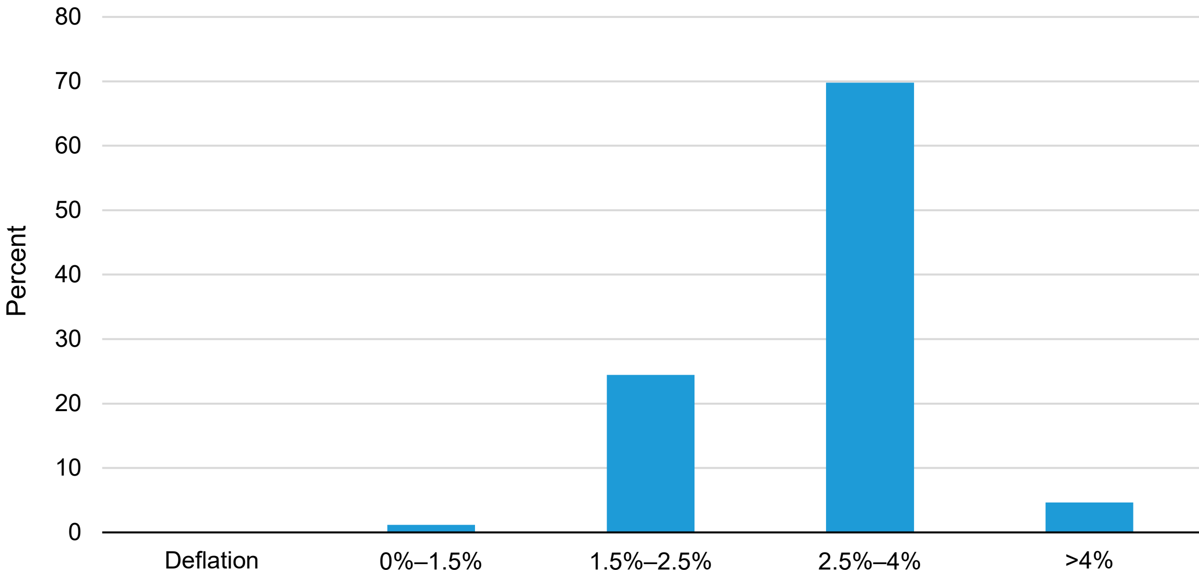
There was also a strong majority view that the medium- to long-term outlook for inflation is higher. We polled investors on this point, and there was a consensus that inflation will be meaningfully above the 2% target (*Display 1*). We agree with this, and the macro view that we have outlined is that investors face a new regime. Strategically, the combination of high public debt, deglobalization and demographic change points to higher equilibrium inflation and lower real growth rates.

In addition to those longer-term forces, in the near term the new US administration has made it clear that immigration and tariffs are areas of policy priority; both have a bearing on the market outlook. As our Economics team have pointed out, Immigration’s positive shock to the labor supply in recent years coincided with hourly wage growth moderating, and is likely a part of the reason why the US is enjoying the “soft landing.”

Some form of trade war is also coming, even if some of the severe proposals should be treated as opening bids rather than desired end points. The US has an inherent advantage here. On a comparative basis, it is a relatively closed economy. Total trade is only about 30% of gross domestic product (GDP) compared with 90% in Germany and 74% in Mexico.

This leaves a lot of questions about fiscal policy and how the market views debt sustainability (a problem across the G7 nations, not just for the US). Tariffs will do little to dent a budget deficit that is 6.5% of GDP. Increasing real growth is hard. One would really have to believe that artificial intelligence (AI) can deliver broad-based transformational gains (see below). Thus, in the long run, this likely points to higher inflation, because it offers the only plausible way to rapidly reduce the level of debt to GDP.

DISPLAY 1: WHAT DO YOU THINK AVERAGE ANNUAL INFLATION WILL BE IN THE US FOR THE NEXT FIVE YEARS?



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As of January 16, 2025

Source: AB

For capital markets, the conclusion is that this situation points to lower real returns and higher portfolio volatility (it will be harder to achieve diversification), thus raising questions about changes in strategic asset allocation (SAA), which we discuss below.

AI: how fast can it be deployed and who benefits?

In the context of powerful downward forces on growth, the only counterforce with the potential to provide a meaningful offset is AI. In that light, Daron Acemoglu, Institute Professor at MIT and winner of the 2024 Nobel Prize in Economics, spoke to a group of our clients on the impact of AI on economics and society.

He presented a view that is skeptical of AI's near-term impact but holds that over the long run it will be a transformative technology. The speed with which AI can increase productivity may be exaggerated. To see broad and rapid growth in productivity, we need parallel advances in flexible robotics, which so far have been lagging. There is also a difficulty in placing near-term hope on productivity improvements, because productivity growth has been disappointing throughout the digital age, even with the number of tech-related patents quadrupling since the 1950s.

Alongside the issue of how rapidly it is possible to deploy new technology, there is also a critical question of who benefits. There has been a breakdown of shared prosperity during the era of digital technologies. Daron's view is that this has happened because the goal of the technological changes we have seen has been automation, which has led to significant adverse consequences for distribution and wages. There is already evidence that the direction of AI development is mainly for automation.

The result is a baseline projection of an improvement in productivity growth from AI of perhaps 1.2% increase in productivity in total over a 10-year period, with the risk to that forecast being on the downside. To be clear, an uplift to productivity of this order of magnitude is meaningful. However, it is far below the hopes of some of the more bullish forecasts of the industry. Moreover, by our analysis this improvement is also materially less than the likely drag on growth as a function of fewer workers, globalization and climate change.

There are also negative implications of AI that need to be explored. If most people start using AI, then where does new information come from? There is also a high level of concern about what AI means for the amount of misinformation and disinformation, which ultimately begs the question of what AI does to democracy.

SAA: adapting to a likely decline in real-return versus risk tradeoff

The strategic problem for investors, as we see it, is that that the real-return versus risk trade-off is set to decline in a world of higher equilibrium inflation and lower growth. For investors that require a certain level of real return, this implies a need to find ways to most efficiently allocate to risk.

The exact response to this need will depend on an individual investor's preferences in aspects such as time horizon, liquidity and beliefs. But in our view, the key risk "levers" that can be pulled are likely to be some combination of greater equity risk, taking on more illiquidity risk, factor risk and allocating to idiosyncratic alpha as opposed to beta. In addition, in the defined contribution retirement context, investors can stay invested in risk assets longer and past traditional retirement ages.

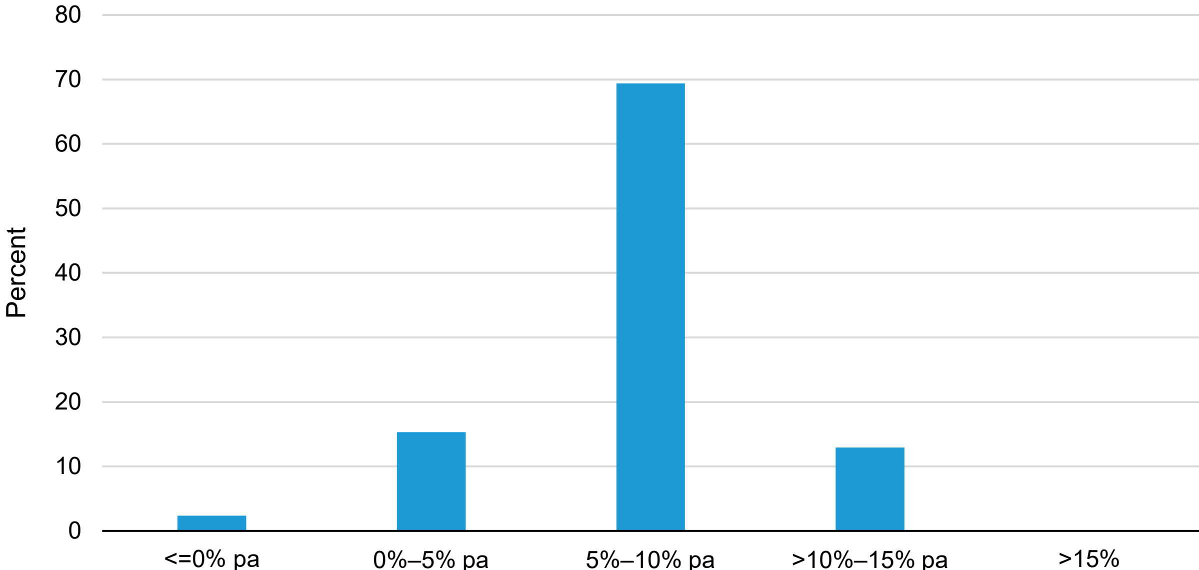
As part of the allocation to alpha, particularly in the context of a lower beta return, we suggest that portable alpha will play an increased role. We will make the case for this role in more detail in a forthcoming note. It was interesting to hear that several clients have also become more positive about the case for portable alpha again, for similar reasons.

Our view to overweight equities is a key part of the investor response to a low-return world. We expect equity returns to be below the long-run average (our-10 year-forward expected nominal return on US equities is 7.2% pa versus the 30-year average of more than 11%pa), but their ability to generate real returns is critical. When we polled clients on their capital market outlook, there seems to be general agreement that returns on equities will be firmly positive in real terms, but below the average of recent decades, *Display 2*.

Several clients have pushed back on this view, with the main point of contention being valuations. Are high levels of return on equity enough to sustain a Shiller price/earnings ratio of 38x? While there are probably social limits on how high the profit share

of GDP can rise, in the context of a new US administration and with profitability having been stickier in the US, it seems likely that high margins can be maintained for the medium term.

DISPLAY 2: WHAT DO YOU THINK THE AVERAGE ANNUAL RETURN ON THE S&P 500 WILL BE FOR THE NEXT FIVE YEARS (NOMINAL TOTAL RETURN)?



For illustrative purposes only.

Pa: per annum

As of January 16, 2025

Source: AB

Equities: concentration challenges, but belief in alpha within

Discussions about equity allocations centered on the issues of market concentration, the role of alpha and the role of equities as a source of real return in a higher inflation world.

Market concentration has created huge challenges and forced investors to rethink how they manage risk. Part of this effort involves considering the amount of the overall asset-allocation risk budget that is consumed by any under-benchmark position in the Magnificent Seven. It is very hard for many investors to take large tracking error versus their benchmark.

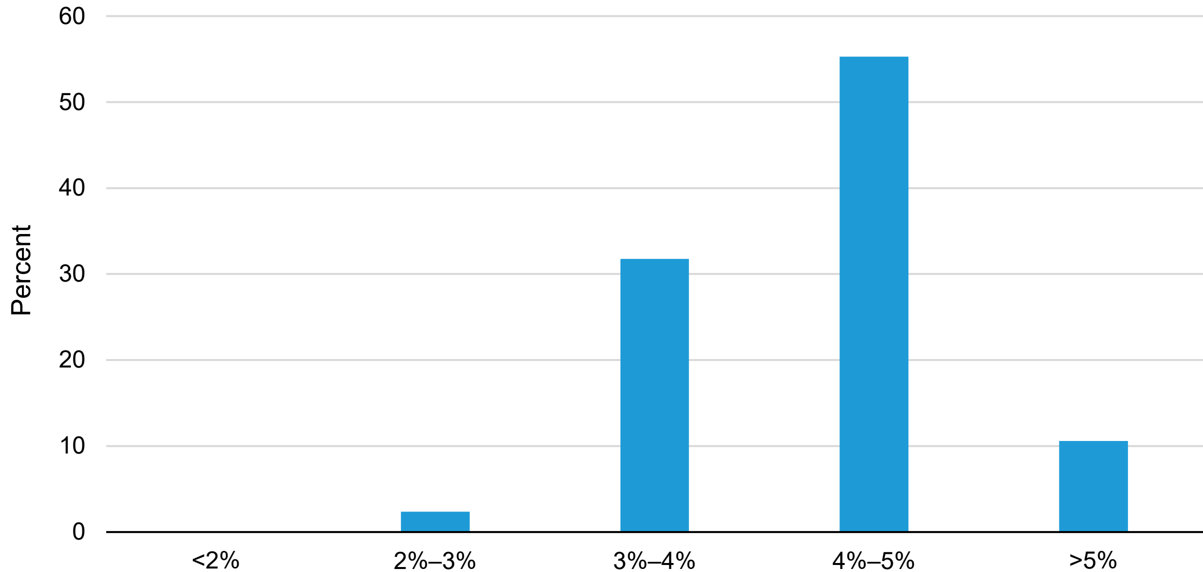
Despite these difficulties, we have found strong investor belief in the role of alpha, and in alpha within equities being a critical part of that role. To some extent, this belief reflects the observation that asset classes are expensive, but that there are large valuation spreads within them, implying an opportunity for active approaches.

The bigger picture is the need for alpha in a future of lower potential returns from passive allocations to asset classes. Elevated valuations and high concentrations also prompt a discussion about relative versus absolute risk. While acknowledging the difficulty in taking tracking error risk (relative risk), several investors also pointed to the concentration of the cap-weighted index as raising the risk of passive index allocations. The view from several investors was that this state points to a bigger role of extension strategies, portable alpha and allocations other than the cap-weighted index.

Fixed income: higher yields, active potential and an inflation question mark

Discussions on fixed income focused on the set-up for future returns, given current yields and the role of active approaches. With yields having reset higher than the last decade, it potentially makes a positive case for the future returns of fixed income (*Display 3*).

DISPLAY 3: WHAT DO YOU THINK THE AVERAGE YIELD WILL BE ON THE US 10-YEAR TREASURY BOND OVER THE NEXT FIVE YEARS?



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Source: AB

Inflation is the big question mark. If the risk is that inflation remains elevated, then there is also a need for assets generating inflation protection. The view from investors was that this need points to a cocktail that includes real estate, private credit and asset-backed securities. In general, these are assets with rates that adjust when inflation hits.

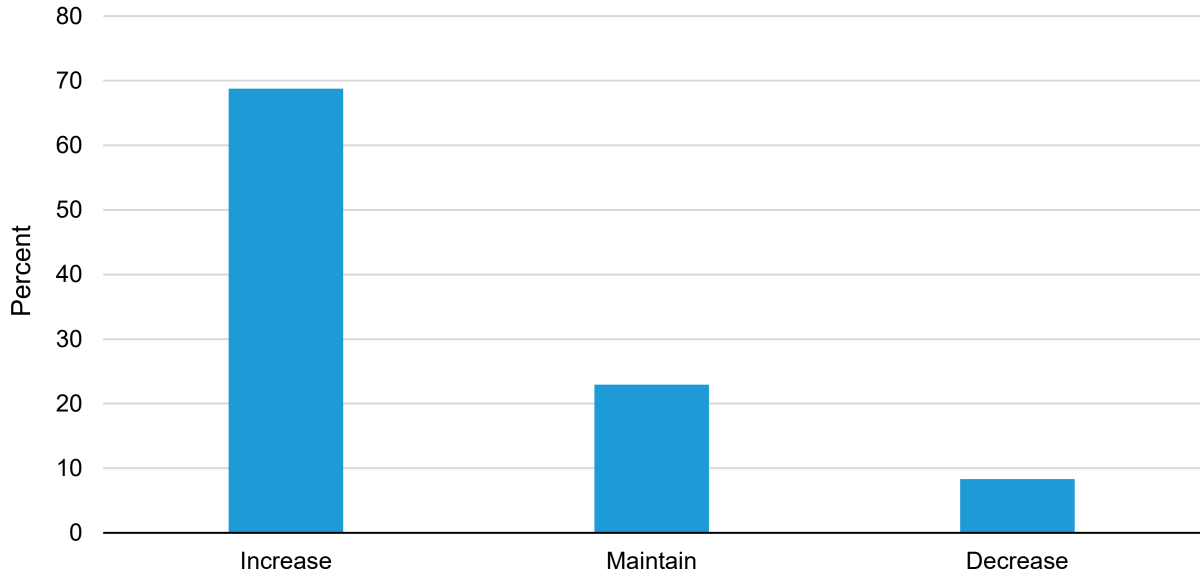
Alongside the issue of asset allocation, there were numerous client conversations about the way structural inefficiencies in fixed income provide a good basis for the role of active management. Debt weighting is just inefficient, so in the context of a greater need for alpha, fixed income has an important role to play.

There was also a discussion around the high yield asset class. The view expressed was that people under-allocate to high yield because of its risk relative to bonds, and because current spreads are tight. However, the positive case presented was that the correlation of high yield to Treasuries is near zero.

Private assets: allocations set to continue rising

When we ask clients about new allocations they anticipate making in 2025, private asset exposure is, without doubt, at the top of the list. Two thirds of clients that we polled said that they intended to increase their allocation to private assets over the course of 2025 (*Display 4*).

DISPLAY 4: DO YOU PLAN TO INCREASE, MAINTAIN, OR DECREASE YOUR PRIVATE ASSET ALLOCATION IN 2025?



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Source: AB

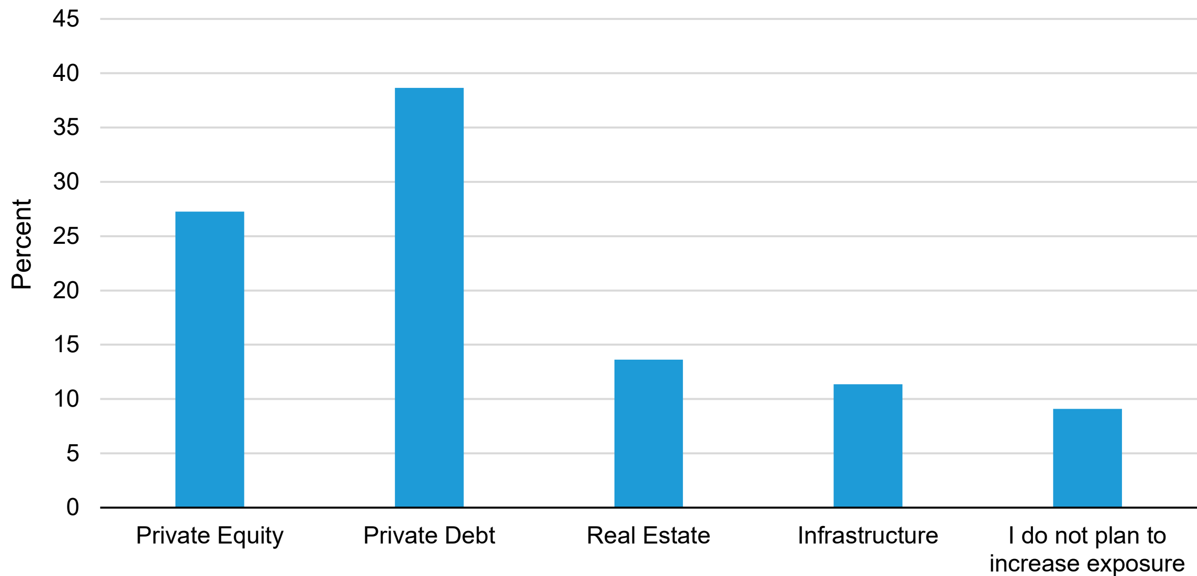
Historically, the key reason driving this allocation was the desire to earn an illiquidity premium. After the very large rotation into private assets in recent years, investors have become more discerning about where an illiquidity premium can be found, but that quest is still driving allocations. Investors have also cited better flexibility, especially with the private debt side, and better access to a wide variety of different sectors. This point on sector exposure is important, the asset class is a key source of economic diversification in a world where diversification may be harder to come by.

Yet another factor driving private-asset allocations is alpha, with several investors citing this as a reason for increasing allocations. We view this as part of the broader point about the need to allocate more of the overall risk budget to alpha as opposed to asset-class beta.

A very different reason for allocations to rise relates to how capital is raised in the contemporary economy, with a greater share of growth capital being sourced in private markets than public equity, high yield or traditional bank credit. One investor noted that the US high yield public market is the same size it was 10 years ago. Meanwhile, private credit has risen from $460bn to $1.6tn. This shift in where risk sits within the system has been cited as a potential source of systemic risk. However, when this point was brought up in discussion, the view we heard back from investors was that the shift of credit sourcing from banks to private credit is a good thing— it better matches risk, a point we agree with. Indeed, one investor went beyond this and pointed to the flow of credit from private sources being a key driver of US growth and exceptionalism.

Within private assets, the standout area where investors most expect to add allocations is private debt (*Display 5*).

DISPLAY 5: WHAT ASSET CLASS ARE YOU MOST LIKELY TO INCREASE YOUR ALLOCATION TO IN 2025?



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As of January 16, 2025

Source: AB

There are a number of reasons why the preference has switched to private credit. Our own work points to a potentially better illiquidity premium versus public market equivalents in private credit than in private equity. Also, an increased focus on liquidity on the part of investors favors the shorter horizon over which one receives positive cash flows in that asset class versus private equity.

In addition to those considerations, investors also cited that for private credit, the return premium also tends to come with risk mitigation potential from the ability to control and proactively work out any issues that arise. As banks reduce lending, private-credit investors have new opportunities beyond private corporate loans. These include privately originated asset-backed finance, a massive market that provides access to consumer-residential and commercial lending. These segments are all important within the context of the new macro regime that we think is likely: lower real returns and less-plentiful diversification.

Indeed, private credit, asset-backed finance and infrastructure were all cited by clients as part of their response to a potentially higher-inflation world. Alongside this, another common specific area of interest is on investment in data centers as part of the infrastructure allocation.

Amongst all this positive sentiment, the other side of the coin needs to be considered. There has not been a meaningful default cycle since private debt became a significant asset class. What does a default cycle look like? This is indeed an outcome that must be included in potential scenarios and the determination of the appropriate allocation to private debt, in particular. Having said that, one investor expressed the view that default in private debt is a multiple-year event, making it more muted and potentially less of a system-wide shock than suddenly banks needing help.

It should be noted that there was also a series of specific conversations about the role of private assets for insurance companies. Private credit has become a much more accepted asset class for diversification with insurance investors. One client went as far as to suggest that public bond allocations will be only around 25% for traditional insurance funds within five years.

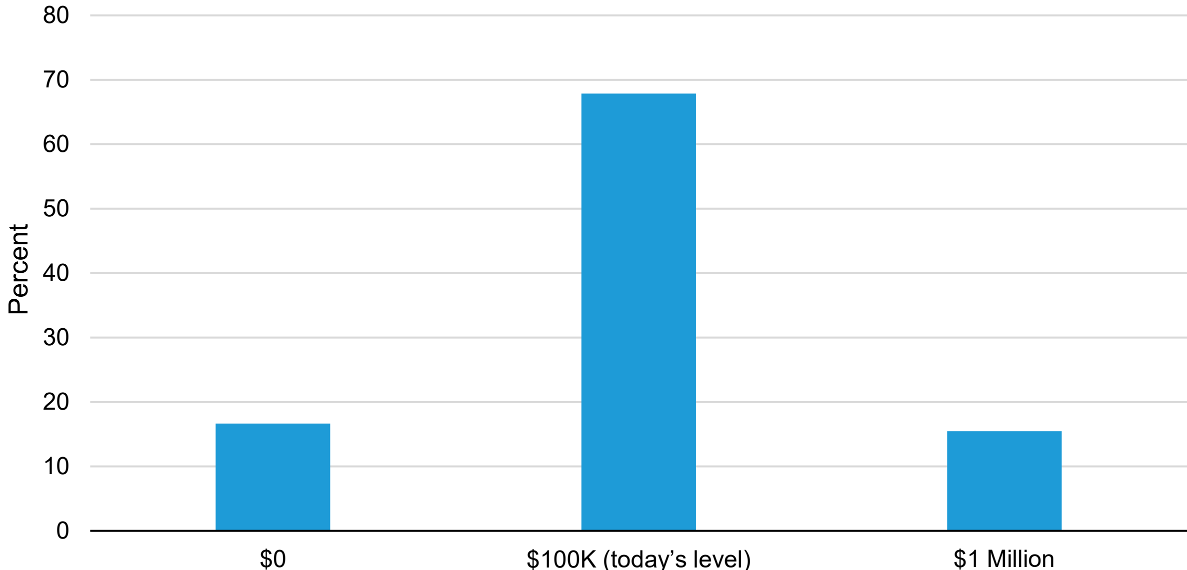
Crypto: divergent views on the allocation case

In our recent research, we have made the case that crypto deserves a role in asset allocation as part of exposure to non-fiat, zero-duration assets. This case derives from the view that high debt levels and continued central bank gold buying supports gold and potentially crypto.

When we polled clients on this point, it is perhaps no surprise that there was a very wide spread in responses. There is most definitely not a consensus view among institutional investors. We deliberately phrased the question in a provocative way, asking investors if the price of Bitcoin in five years would be closest to the current price or $0 or closer to $1 million. An equal number of clients voted for the $0 and $1 million answers, an elegant expression of the breadth of views we have encountered in one-on-one meetings over the last year! (*Display 6*).

It goes without saying that the majority of asset owners we spoke to have no crypto exposure, but the number was not zero. A small number of pension funds and endowments have started to take exposure. This prompted much debate on the pros and cons of such a position, how to go about implementing it and what role it really plays in a portfolio.

DISPLAY 6: WHAT DO YOU THINK THE PRICE OF BITCOIN WILL BE CLOSEST TO IN FIVE YEARS?



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Retirement: implications of a new economic regime

The prospect of a new economic regime is of particular importance to the way that people think about saving for retirement.

The shift from defined benefit (DB) to DC plans continues, though it's still in its early stages outside the US. In the top 22 markets for pension assets, the majority of the ~$55 trillion in assets are still in DB plans. The shift to DC is most advanced in the United States and Australia, followed by Canada, Japan and China. In the Netherlands, some employers offer hybrid models in which participants make contributions but plans pay a pension based on salary and years of service. This enables participants to plan on some level of income in retirement rather than just having to manage a pot of money.

Yet some plan sponsors and regulators wonder whether the shift to DC has gone too far, too fast. A key concern is whether today's pensions can adequately provide for participants as lifespans lengthen. Several investors in this area noted that people are often working longer because they fear they will run out of money, and that many should consider buying annuities. There was discussion about adding lifetime income guarantees such as immediate annuities, deferred annuities, guaranteed lifetime withdrawal benefits (GLWBs), etc. in DC plans, either as an option for participants to select or as part of the default. The general consensus was that DC plans need to incorporate a guarantee of lifetime income to replace diminished defined benefits and discussion focused on the potential structure, costs and benefits of various solutions.

Private assets are increasingly being folded into DB and DC plans. Private real estate seems to be utilized most broadly in DC plans, though allocations to private equity and private credit are starting to increase. Sponsors are hoping a private allocation can help glide-path plans to meet their long-term return targets as well as reduce short-term tail risks.

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