

What's the outlook for the economy and markets in 2025?



2024 was a positive year for investors. The US was particularly resilient, with strong economic growth and falling inflation, while shares delivered strong returns.

What does next year have in store? Below, we share our outlook for the economy and markets in 2025.



US economic growth will slow

The US has experienced a favourable combination of strong economic growth, falling inflation and a relatively healthy jobs market. We believe this has been largely driven by increased productivity (meaning the economy can produce and consume more goods and services for the same amount of work) as well as a surge in the availability of workers.

While these positive drivers may continue in 2025, there are some risks that could offset the gains. These include higher tariffs on imported goods and stricter immigration policies.

As a result, we expect US economic growth to slow from around 3% to closer to 2% in 2025. The Federal Reserve (the US central bank) is likely to reduce interest rates to 4%, but further cuts may be difficult because of the risk of reigniting inflation.



Growth outside the US will be mixed

Other countries have not benefitted from the same economic advantages as the US has.

In Europe, inflation is close to the European Central Bank's (ECB's) 2% target, but this has come at the cost of little-to-no economic growth in 2023 and 2024. Growth is expected to remain below the long-term average next year because of the risk of a slowdown in global trade. The ECB is likely to cut interest rates to 1.75% by the end of 2025.

In the UK, growth is forecast to rise above the long-term average, thanks to measures in the Autumn Budget that aim to boost spending and investment. The Bank of England is expected to cut interest rates more aggressively in 2025, with rates ending the year at 3.75%.

In China, growth should pick up as measures that aim to stimulate the economy kick in. However, further measures are needed to overcome external and domestic challenges, such as weak confidence among households and businesses.



The long-term outlook for shares is more cautious

US shares have generally delivered strong returns in recent years. 2024 was no exception, with US companies' earnings growth exceeding expectations and share price valuations (a measure of how much investors are willing to pay for shares based on company earnings) increasing further. The key question for investors is, 'What happens next?'

In our view, US share price valuations are elevated. However, we believe there are recent developments that justify higher valuations, leaving US shares not as stretched as traditional metrics would suggest. For example, many large companies borrowed money when interest rates were low, insulating them from subsequent interest-rate rises. And, importantly, the US stock market has been increasingly concentrated in growth-oriented sectors like technology. These sectors have favourable growth prospects, which tend to support higher valuations than shares in other sectors.

Nevertheless, the likelihood that we are in the midst of a productivity boom—whereby strong economic growth driven by technological advances supports high valuations—must be balanced with the possibility that the current environment may be more like 1999. That's when the 'dot-com bubble' started to burst, with technology stocks falling after a rapid rise in valuations.

History shows that, without a shock to the economy or company earnings, US shares can continue to defy concerns about high valuations in the short term. Ultimately, however, high valuations will drag down long-term returns for investors. We expect annualised returns¹ of 2.9%-4.9% for US shares² over the next decade.

Shares outside the US offer more attractive valuations. Over the next decade, we expect annualised returns of 5.7%-7.7% for UK shares, 7.4%-9.4% for developed markets excluding the US and 5.3%-7.3% for emerging market shares³. However, economic growth and profits matter more over shorter horizons. How these factors develop in the coming years will determine whether and when the more attractive valuations translate into higher returns for investors.



Interest rates will support bonds

With the rise in interest rates in recent years, bond⁴ yields (which show income from bonds as a proportion of the current price) have increased too.

Although central banks are cutting interest rates, we expect rates to settle at higher levels than in the 2010s. This sets the stage for solid returns from bonds over the next decade.

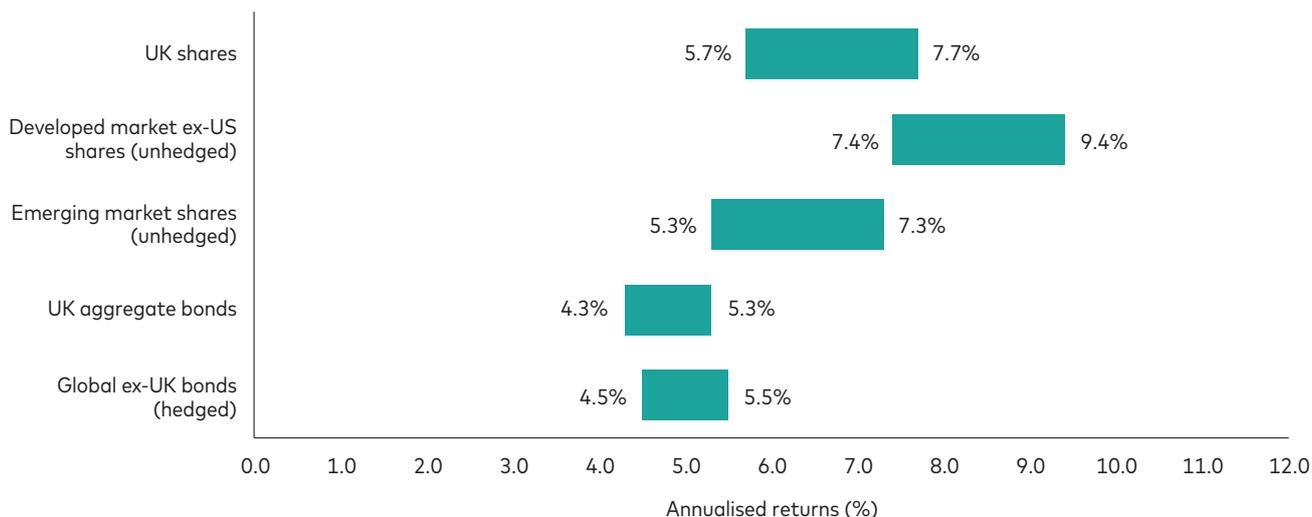
We now expect annualised returns of 4.3%-5.3% for UK bonds and 4.5-5.5% for global ex-UK bonds over the next decade⁵.

If interest rates fall, holders of existing bonds are likely to benefit from rising prices. Bond prices tend to rise when interest rates fall because existing bonds paying higher interest become more attractive. As prices rise, bond yields fall and vice versa. This rise in prices should lead to capital gains for investors, on top of the interest income that bonds pay.

Even if interest rates were to rise by a modest amount, leading to a decline in bond prices, the higher income stream from bonds should be sufficiently large to keep total returns positive. This strengthens the case for bonds as a ballast in long-term portfolios, to offset any fluctuations in other investments such as shares.

- 1 Annualised returns show what an investor would earn over a period of time if the annual return was compounded (i.e. the investor earns a return on their return as well as the original capital).
- 2 US shares are represented by the MSCI USA Total Return Index Sterling.
- 3 UK shares are represented by the MSCI UK Total Return Index, developed market ex-US shares are represented by the MSCI AC World ex USA Total Return Index Sterling and emerging market shares are represented by the MSCI Emerging Markets Total Return Index Sterling.
- 4 Bonds are a type of loan issued by governments or companies, which typically pay a fixed amount of interest and return the capital at the end of the term. Once issued, bonds are traded, like shares, and their prices can fluctuate.
- 5 UK bonds are represented by the Bloomberg Sterling Aggregate Bond Index and global ex-UK bonds (hedged) are represented by the Bloomberg Global Aggregate ex Sterling Bond Index Sterling Hedged. With hedging, managers typically use derivatives (a type of financial contract) to offset exchange rate movements. The contracts typically lock in a pre-determined exchange rate at which the manager can buy or sell the foreign currency at a future date.

Expected 10-year annualised asset class returns for UK investors



IMPORTANT: The projections and other information generated by the Vanguard Capital Markets Model® (VCMM) regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Distribution of return outcomes in GBP from VCMM are derived from 10,000 simulations for each modelled asset class. Simulations as at 8 November 2024. Results from the model may vary with each use and over time.

Note: Figures are based on a 2-point range around the 50th percentile of the distribution of return outcomes for shares and a 1-point range around the 50th percentile for bonds. All projections are in GBP. Benchmarks used for asset classes: UK shares: MSCI UK Total Return Index; developed market ex-US shares (unhedged): MSCI AC World ex-USA Total Return Index Sterling; emerging market shares (unhedged): MSCI Emerging Markets Total Return Index Sterling; UK aggregate bonds: Bloomberg Sterling Aggregate Bond Index; global ex-UK bonds (hedged): Bloomberg Global Aggregate ex Sterling Bond Index Sterling Hedged.

Source: Vanguard.



Holding a balanced portfolio is key

The strong outlook for bonds, together with a more cautious long-term outlook for US shares, means that holding a balanced portfolio is key. As an example, we expect a balanced portfolio of 60% shares and 40% bonds to provide annualised returns of 5.0%-7.0% over the next decade⁶.

Although return expectations for different assets, regions and sectors can vary, it's very difficult to time when to buy or sell correctly. Even if a region or sector is undervalued—and therefore might be expected to deliver above-average returns—it can continue to be undervalued for some time, often years. Similarly, a region or sector may remain overvalued for some time.

This is one of the key benefits of having a global portfolio that spreads your money across different asset types, regions and sectors. It saves you from trying to time the markets, which is a strategy that rarely pays off. It also means you can reap the benefits of having exposure to regions or sectors that may perform well to offset those that perform less well.

⁶ The 60% shares/40% bonds portfolio is represented by UK and global ex-UK shares (MSCI UK Total Return Index and MSCI AC World ex UK Total Return Index), and UK and hedged, global ex-UK bonds (Bloomberg Sterling Aggregate Bond Index and Bloomberg Global Aggregate ex Sterling Bond Index Sterling Hedged).

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The VCMM is a proprietary financial simulation tool developed and maintained by Vanguard's primary investment research and advice teams. The model forecasts distributions of future returns for a wide array of broad asset classes. Those asset classes include US and international equity markets, several maturities of the US Treasury and corporate fixed income markets, international fixed income markets, US money markets, commodities, and certain alternative investment strategies. The theoretical and empirical foundation for the Vanguard Capital Markets Model is that the returns of various asset classes reflect the compensation investors require for bearing different types of systematic risk (beta). At the core of the model are estimates of the dynamic statistical relationship between risk factors and asset returns, obtained from statistical analysis based on available monthly financial and economic data from as early as 1960. Using a system of estimated equations, the model then applies a Monte Carlo simulation method to project the estimated interrelationships among risk factors and asset classes as well as uncertainty and randomness over time. The model generates a large set of simulated outcomes for each asset class over several time horizons. Forecasts are obtained by computing measures of central tendency in these simulations. Results produced by the tool will vary with each use and over time.

The primary value of the VCMM is in its application to analysing potential client portfolios. VCMM asset-class forecasts—comprising distributions of expected returns, volatilities, and correlations—are key to the evaluation of potential downside risks, various risk–return trade-offs, and the diversification benefits of various asset classes. Although central tendencies are generated in any return distribution, Vanguard stresses that focusing on the full range of potential outcomes for the assets considered, such as the data presented in this paper, is the most effective way to use VCMM output.

The VCMM seeks to represent the uncertainty in the forecast by generating a wide range of potential outcomes. It is important to recognise that the VCMM does not impose "normality" on the return distributions, but rather is influenced by the so-called fat tails and skewness in the empirical distribution of modelled asset-class returns. Within the range of outcomes, individual experiences can be quite different, underscoring the varied nature of potential future paths. Indeed, this is a key reason why we approach asset-return outlooks in a distributional framework.

Investment risk information

The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.

Important information

Vanguard only gives information on products and services and does not give investment advice based on individual circumstances. If you have any questions related to your investment decision or the suitability or appropriateness for you of the product[s] described, please contact your financial adviser.

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