Partners Capital

Insights 2025

Partners Capital

Our mission is to deliver sustainable long-term outperformance to our clients by bringing an evolved institutional investment approach to building and managing portfolios – called the Advanced Endowment Approach (AEA).

Find out more www.partners-cap.com

This is a financial promotion. Your capital is at risk, the value of investments may fall and rise and you may not get back the full amount you invested.

Contents

Main Authors

Kamran Moghadam
Partner, Global Macro and Tactical Asset Allocation

Alex Band
CIO

Arjun Raghavan
CEO

Contributing Authors

Nick Albertini
Emma Bewley
John Beil
Sam Diedrich
Christoph Günther
Oliver Rising
Rob Skelton
Scott Ward-Corderoy
Lewis Watson

Executive Summary

We are witnessing an era of significant political and technological disruption. We expect our central case for continued resilient growth to be frequently tested by ongoing policy uncertainty that will weigh down sentiment. Investing in this environment calls for highly diversified portfolios that can withstand a wide range of economic scenarios. Active management allows scope to benefit from the emerging dislocations. With interest rates likely to remain elevated, we favour contractual income streams, cost-effective absolute return strategies and highly specialised private market and co-investment opportunities.

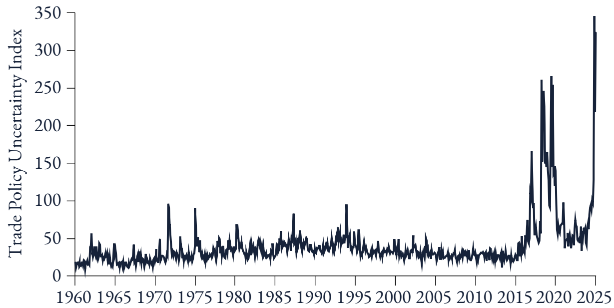
Executive Summary

Disruption: Fast and Furious

Radical disruption is emerging as a powerful macro theme in the second half of this decade. We see increasing disruption both in politics and in technology. In the former, longstanding post-war norms are being disrupted at a rapid pace in the areas of trade, immigration and global alliances. In the latter, there is a staggering pace of development, particularly in the field of artificial intelligence. These new capabilities impact both the top-down macro outlook in terms of growth, productivity and inflation, as well as the bottom-up established order in equity markets, at the sector, regional and even stock-specific levels. While any disruption can create apprehension as a new order replaces an older one, it can also have longer-term benefits. In an ideal scenario, these developments could provide better-balanced global trading relationships combined with more resilient supply chains, as well as economic productivity improvements stemming from easier-to-access AI tools. However, in the near term, there could be a severely adverse scenario. Much will depend on the implementation details, but increased trade frictions will typically generate negative impulses to growth and inflation as well as exacerbate geopolitical tensions, even with allies. Perhaps the largest negative investment implication is rising uncertainty weighing on business and consumer sentiment. Exhibit 1 shows that a proxy for trade policy uncertainty has risen to record post-war levels.

Exhibit 1

Trade Policy Uncertainty (TPU) Index at record levels



Source: Federal Reserve, Caldara

Examination of historical episodes of rising uncertainty shows clear evidence of declines in both capital investment and household consumption. Ultimately, uncertainty is a drag on growth as investment decisions (corporate and individual) are delayed or even canceled. The IMF estimates that trade uncertainty decreases US and European aggregate capital investment by about 4% relative to the baseline.[1]

It should also be noted that we see this rising disruption as wholly consistent with, and even reinforcing our broader Paradigm Shift to persistently higher inflation and interest rate volatility which we first introduced two years ago in Insights 2023 (Exhibit 2).

1 IMF World Economic Outlook, October 2024

Disruptive policies reinforce our Paradigm Shift

Exhibit 2

Trump's policies mostly turbocharge the 'Paradigm Shift'

Top-Down View	'The Great Moderation'	Impact of Trump Presidency	'The New Paradigm'
Politics & Geopolitics	New global order / free trade	→	Populist / protectionist
Energy	Cheap and abundant	←	Costly energy transition
Monetary Policy	Effectively a single mandate: Stabilise growth/employment Quantitative easing (QE)	→	The dual mandate is back: Balancing act creates policy errors Quantitative tightening (QT)
Fiscal Policy	Budget discipline / austerity -> 'dry powder'	→	Fiscal largesse –> procyclical stimulus
Government Debt / Deficits	Low	→	High
Inflation / Interest Rates	Lower / stable	→	Higher / volatile
Investment Implications	**'Financial Repression'** • Lower interest rates and volatility • Equities: 'The Fed Put' & 'buy the dip' • Passive + buy narratives • Private Equity: exploit leverage • Portfolio: 60/40 (even 100/0!)	**Positive** Lower energy costs from deregulation and Ukraine peace boosts disposable income • Greater M&A deal flow supports **Biotech**, **Merger Arbitrage** and **Private Equity** • Tariffs support **domestic small caps** over large caps **Negative** • Even higher inflation, interest rates and slower growth • Slower progress on climate	**'Return to Fundamentals'** • Higher interest rates and volatility • Higher income (yields and earnings) • Selective/active management • Private Equity: Exploit post-acquisition operational value add • Portfolio: multi-asset diversification

Source: Partners Capital Analysis

Executive Summary

Against this backdrop, our core framework for investing remains the Partners Capital Advanced Endowment Approach (AEA). An important pre-requisite for successfully implementing this approach is to 'Stay the Course' with well-structured diversification. While it is tempting to make reflexive bets (either overly defensive or overly concentrated risk-seeking) in the face of high uncertainty, we believe that approach is too unreliable given the wide range of variable outcomes. Just like a broken clock is right twice a day, simpler approaches to investing will seem appealing at certain points in time. This can lead to abandoning a diversified approach at precisely the wrong time and is perhaps the most important risk for investors to guard against.

Applying the Advanced Endowment Approach (AEA)

We set out below the five spokes of the Advanced Endowment Approach (AEA) and how we are applying it in this environment:

1. **The right portfolio building blocks:** Our Strategic Asset Allocation (SAA) is a diversified mix of asset classes that aims to balance returns and resilience in delivering strong risk-adjusted returns over the long term (e.g., 10 years). For shorter periods (e.g., one-to-three years) our Tactical Asset Allocation (TAA) deviates from the SAA to take into account current economic conditions, relative valuations across asset classes and areas of dislocation that offer the best risk-adjusted opportunities.

   In this environment, we remain underweight interest rate duration, overweight Liquid Credit and specialist Private Debt and overweight Absolute Return. We remain modestly underweight on Public Equities with a preference for specialist Private Equity strategies such as lower mid-market buyouts that offer better entry multiples and faster earnings growth relative to Public Equities and large-cap Private Equity.

2. **The right managers:** We actively seek to identify, gain access and allocate to those truly differentiated managers who are best placed to monetise outperformance opportunities within their respective areas of expertise (asset classes).

   In this environment, we partner with both emerging and well-established managers with a sharp focus on those who have demonstrable hunger, skin-in-the-game and a track record that demonstrates outperformance by executing a repeatable rigorous process. We avoid managers and strategies that rely on a narrow landing strip to outperform.

3. **The right partnership structures:** We approach all managers with a 'value for money mindset'. We use scale to our benefit in getting fee discounts, co-investments and customised strategies to access targeted strategies cost-effectively.

   In this environment, we are particularly focused on increasing our private market co-investments, benefiting from our scale as an important partner to managers. We aim to boost returns through a deep understanding of their diligence processes and/or deal selection. With the added benefit of nearly all our co-investments being fee-free, we expect this to be significantly accretive to our client portfolios.

4. **Early-mover advantage:** We aim to be ahead of the curve in finding and allocating to newer asset classes and investment themes before they have become consensus.

   Starting in 2024, we have been adding exposure to digital and power infrastructure to capitalise on strong cloud and AI-driven demand growth, as well as benefit from its stable and inflation-protected income. We have also selectively added to niche opportunities within equities (e.g., emerging tech/AI) and credit (e.g., asset-backed lending and structured risk transfer).

5. **Exceptional execution and risk management:** We monitor all aspects of risk and rigorously rebalance to a stable risk level to consistently maintain the portfolio's resilience. Our aim is to leave no stone unturned when optimising portfolio management costs as this is risk-free return.

   Our experience through previous crises suggests that active rebalancing and risk management can add meaningfully to returns in a volatile environment. We expect greater dislocations and will use market sell-offs to add exposure to areas that offer the best risk-adjusted returns.

Macroeconomic Views

Below we provide a snapshot of a subset of our views on three key macro topics that are top of mind for many investors: 1) trade tariffs, 2) fiscal deficits, and 3) artificial intelligence developments. Further analysis of these and other important questions can be found in the Macroeconomic View chapter that follows. Our most in-depth analysis of tariff policy is covered in our December *Inflections* piece, with the caveat that since publication, the balance of risks has shifted somewhat to our more tariff-heavy scenario ("*Tariff is the Most Beautiful Word*").

1. Trade: It's Fun to Play with the USMCA

Risks to the US economic outlook have escalated materially since the inauguration. President Trump's executive orders threatening to increase trade tariffs on imports from Canada (10% energy, 25% non-energy) and Mexico (25%) have been delayed to March 2025. Additional 10% tariffs on China have been imposed. Many more tariffs have been threatened affecting other countries. However, focusing on Mexico, Canada and China for now, goods imports from those three countries totaled just under $1.4T in 2024, or 4.7% of US GDP. The weighted average tariff increase for those countries is just under 19%. Absent behavioral or other changes, the increased duties would represent a $260B annual tax increase on domestic purchasers. If that tax increase were entirely passed through to prices, it is estimated to generate a 0.8% increase in domestic price levels. While behavioral or other changes might dampen these fiscal and price effects, these tariffs carry other costs. All three countries have discussed retaliatory measures, though details are still unclear at this point. Over the past twelve months, US goods exports to those countries were $826B, or 2.8% of GDP.[2]

While Europe was not part of the initial round of tariffs, there are indications that Europe's trade surplus is likely soon be in the tariff crosshairs. In any case, one of the lessons from Trade War 1.0 was that tariff and trade-related uncertainty exacted a heavy toll on Euro Area growth expectations, even when the Euro Area was not a direct target. Unlike in the case of China, there is also limited prospect of significant near-term fiscal stimulus, which means that the ECB will remain the only game in town to support the cyclical picture. European bond yields will struggle to disconnect completely from US yields, even if the US starts to discount fewer rate cuts as the ECB continues to ease policy on a more regular cadence. Analogously, to the extent that the market takes the tariff measures against Canada, Mexico and China as an indication of more to come against Europe, nascent European equity outperformance will also be difficult to sustain.

2. Fiscal: The DOGE barks, but can it bite?

In January 2025, the US Federal budget deficit exploded to $128.6B compared to expectations of $94.8B. The deficit in the first four months of the Treasury's financial year (from 1st October) was $839.6B compared with $531.9B at the same period last year, up a massive 58%. The rolling 12-month deficit was $2.14T. In GDP terms, the deficit has ballooned from 2.4% of GDP in 2015 to 6.4% of GDP in 2024 and is projected to rise further if the 2016 Tax Cuts and Jobs Act (TCJA) is extended along with other tax cuts. Much of the widening of the deficit has come from large spending increases since Covid-19. For comparison, in 2024 Federal outlays were $6.8T against tax revenues of $4.9T. However, just before the pandemic in 2019, outlays were only $4.4T, against revenues of $3.5T. Hence, the deficit has almost doubled from c. $1.0T in 2019 to c. $1.8T today. Much of the spending increase can be attributed to the $1.3T (or 48%) aggregate increase in mandatory spending categories, particularly entitlement programs. Separately, net interest payments have almost doubled to $881B, now larger than total defence spending at $850B.[3]

So far, investors seem to have given the benefit of the doubt to policymakers to bring deficits under control over the longer term. The doubling of the deficit does not appear to have detracted from either US equities or US dollar performance since 2019. Both have outperformed their counterparts in other major economies. However, so-called 'alternative currencies', such as gold and bitcoin (even with zero or negative yields), have significantly outperformed the USD over the same period. This suggests that the entire fiat currency system is seen to carry an increasing level of risk.

Looking ahead, to maintain investor confidence it will be crucial to present a viable solution to bring the US deficit back under control. As Jay Powell recently pointed out, deficit reduction does not necessarily need to happen this year, but there just needs to be a credible path over the next five to ten years. Some have suggested that the newly minted Department of Governmental Efficiency (DOGE) can serve this purpose. However, our early analysis of DOGE suggests that although some cost reduction is possible, it will likely be limited in scale. Key areas of potential savings include:

- **Executive actions:** We believe that, by far, the biggest potential saving would come from identifying and reversing some of the more costly executive orders from the Biden Administration. The Committee of Responsible Federal Budget estimates that such action could save c. $1.0T over a 10-year window. Of that, roughly one third stems from reversing Biden's student loan debt cancellation policies.

2 Bloomberg JP Morgan
3 Reuters, Bloomberg

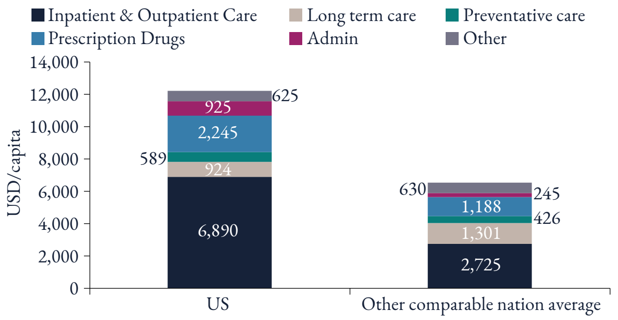
Executive Summary

- **Spending:** Congress appropriates discretionary spending through the regular annual appropriations process. Appropriations bills require 60 votes in the Senate, which means that any cuts to discretionary spending would require the support of at least seven Senate Democrats. Mandatory spending (e.g., entitlement programs) likely offer greater savings opportunities, but these cuts could be the most politically risky. President Trump has promised not to cut Social Security or Medicare, the two largest entitlement programs, constituting 57% of mandatory spending.
- **Headcount reduction:** Federal employment is roughly 2.4 million. Roughly 50% of that sits in the Department of Defence, with a further 10% in the Department of Homeland Security – agencies not typically associated with the creation of regulation. Trimming roughly 100K jobs of the remaining 960K (i.e., a c. 10% reduction) is expected to save only c. $10B annually.[4]
- **Waste:** A seemingly obvious source of efficiency, but rooting out waste incurs additional costs. For example, the government is aware of various "improper payments" such as the c. $22B incorrectly paid for Earned Income Tax Credit each year. However, solving this would require a mass audit of low-income families, requiring significant time and effort. AI may offer some help here.

Without cutting entitlement benefits, there is significant potential to reduce healthcare costs, impacting both Medicare and Medicaid. For example, a study by the Kaiser Foundation (Exhibit 3) shows that the US spends nearly twice as much per capita on healthcare relative to other comparable nations ($12,198 vs $6,515). The standout figure is inpatient/outpatient care which represents 70% of the cost differential.

Exhibit 3

The US spends nearly twice as much on healthcare



Source: Kaiser Foundation

Like-for-like medical costs are much higher in the US than in other major economies. This is driven by higher costs associated with physicians, surgeons and hospital procedures, as illustrated in Exhibit 4.

Exhibit 4

Like-for-like medical treatments are significantly more expensive in the US

USD	US	Comparable Nation Average
Hip replacement	39,313	22,408
Heart Bypass	95,282	29,470
Hospital stay/night	2,500	1,132
Physician salary	352,000	130,000

Source: Axa

On balance, however, we see little near term scope for budget savings from healthcare. While there is ample room for cost cutting here, it is questionable whether meaningful progress can take place with a relatively divided government and entrenched interests.

3. AI: Necessity is the mother of invention

In 375 BC, Plato's Republic foretold that "our need will be the real creator". In January 2025, Chinese AI startup DeepSeek released its R1 model. The model's performance was similar to the latest releases from OpenAI but had been trained at a "reported" cost of just $5.6M, versus the $100M spent on training GPT-4.[5] However, this figure does not include previous development costs.

Although the all-in costs were undoubtedly higher, some of DeepSeek's impressive gains were likely driven by the limited resources available to their engineers, who did not have access to the most powerful Nvidia hardware for training. This constraint led them to develop a series of clever optimisations in model architecture, training procedures and hardware management. This lends credence to the aspirational view that innovation is primarily driven by creativity rather than by brute force capex.

Investment Implications of DeepSeek

There are several key implications of DeepSeek. These include increased decentralisation and a weakening of network effects, combined with continued advances in speed and price. This suggests that building lasting 'moats' will be more difficult and hence ongoing disruption will be an overarching theme.

- Nvidia's monopolistic hold on the market is weakened, particularly as DeepSeek circumvented Nvidia's proprietary operating system (CUDA).

4 Deutsche Bank

5 Financial Times

- The same applies to those seeking to monopolise model development such as OpenAI (which is trying to move from a non-profit to a profit corporate structure at the worst time). Simply throwing hundreds of billions of dollars at building slightly better models will not result in a lasting monopoly ('winner takes all' moat), particularly when network effects are far more limited than in other areas such as social networking, online shopping and even search.
- There will still be a growing need for data centres (and not only for AI) but the real AI growth will be at the point of usage ('edge' or 'fringe'). According to one of our emerging technology managers, "If inference moves to the edge because it is good enough, we are living in a very different world with very different winners – i.e. the biggest PC and smartphone upgrade cycle we have ever seen."
- With cheaper and decentralised inference engines, there is more scope for vertical application (agent) development. Companies are more likely to need specialised AI agents for their specific goals rather than depending on ChatGPT for everything. This opens the door not just for application developers, but also for tech-focused consulting companies. The same manager also suggests that Advanced Super Intelligence (ASI) is close: "If a $100B reasoning model trained on 100k plus Blackwells[6] (o5, Gemini 3, Grok 4) is curing cancer and inventing warp drives, then the returns to ASI will be really high and training capex and power consumption will steadily grow."

Macroeconomic Scenarios

Our macroeconomic views help us arrive at what we consider to be the most likely 'base case' over the next two to three years, with a focus on where we expect to be at the end of 2025. We also outline a plausible set of outcomes on either side of the base case which we refer to as the 'downside' and 'upside' cases (Exhibit 5).

Building a portfolio just for the base case is rarely optimal. Rather, we believe the optimal portfolio will both weather the downside and benefit from the upside, but in doing so may give up some return in the base case. The Tactical Asset Allocation and asset class strategies all seek to reflect the optimal allocation given the weighted probability of various scenarios. To that end, we lay out our three key scenarios below.

While there has been much media discussion around the exact timing of central banks' policy easing, particularly that of the US Federal Reserve, we think this detracts from more long-term thinking about the limits of such easing. The broader context of resilient growth and tight employment markets, combined with rising risks of a second wave of inflation stemming from the impact of tariffs and large public sector deficits, will likely constrain the extent of future rate cuts.

In our base case, we expect global growth to moderate from 3.2% to 3.1% in 2025, mainly supported by a strong US economy. However, there would be a large impact if either our downside or our upside scenarios are realised. The characteristics and expected economic and investment impact of all three primary scenarios are summarised below, with the caveat that there are more sub-scenarios embedded in each than we can detail here.

6 Latest Nvidia GPUs

Executive Summary

Exhibit 5

Summary of Partners Capital 2025 Macroeconomic Scenarios

	"Tariff Wars lead to Recession"	"Resilient Global Growth with Regional Divergences"	"Broad-based Expansion"
Probability	**20%**	**60%**	**20%**
US	• US introduces wide array of global tariffs in a bid to protect American workers. • Business investment slows sharply as uncertain policy backdrop takes its toll. • Fed slow to cut rates as tariff inflation clouds picture. • Rising unemployment and slowing consumer spending creates a negative feedback loop, leading to higher corporate defaults. • Gov. budget deficits widen as tax revenues decline and spending increases, limiting scope for fiscal support. • Unemployment rate above 4.5%; Core PCE inflation below 2.0%; Growth of 1.5%.	• Growth and inflation continue to moderate towards long-term averages. • Trump introduces new tariffs on China and targeted global tariffs on the import of certain goods/sectors (e.g., autos). • Net immigration slows to 750k/year in response to tighter enforcement of border, but deportations don't have a meaningful impact on labour supply. • The Fed maintains an easing bias, but hold policy steady for an extended period. • Unemployment rate between 4-4.5%; Core PCE inflation in the range of 2.0-3.0%; Growth of 2.5%.	• Easing of monetary policy spurs renewed private sector credit cycle, accelerated by easing of regulation under Trump. • US imposes limited tariffs as part of a negotiated deal to onshore manufacturing. • Productivity benefits from AI and easing energy costs boost output. • Labour demand increases as manufacturing sector accelerates while services sector remains strong, driving wage growth. • US unemployment rate below 4.0%; US Core PCE inflation above 3.0%; Growth of 3.0%.
Europe	• EU exporters hit with US tariffs. • Fiscal impulse turns negative as countries seek to reduce deficits, including Germany. • ECB eases policy but it fails to stimulate the economy as loan demand remains weak. • Aggregate EU GDP growth falls to c. 0% in 2025, with some countries experiencing mild recessions.	• Economic growth remains weak due to trade uncertainty, fiscal consolidation and structural issues in the manufacturing sector, notably Germany. • ECB moderately eases policy as core inflation declines toward target. • EU GDP growth of c. 1% in 2025 vs. 0.8% growth in 2024.	• Negotiations with the US reach a deal that avoids large tariffs. • Germany eases the fiscal handbrake. • EU policymakers reduce regulatory burdens. • EU manufacturing growth accelerates as the war in Ukraine reaches a partial truce, and more stimulus in China drives higher export demand. • EU GDP growth of c. 1.5% in 2025.
China	• US imposes 60%+ punitive tariffs. • Local government financing issues and existing real-estate debt overhang continue to offset any policy stimulus. • The economy suffers the effects of deflation as businesses and consumers continue to deleverage and delay consumption. • GDP growth falls to 4.0%-4.5%.	• Fiscal policy is used as a counterweight to Trump's tariffs. • Effects of the 2024 stimulus measures begin to feed through to the economy, helping support growth. • GDP growth stabilises between 4.5-5%, in line with 2024.	• The Chinese government vastly increases stimulus, avoiding a "debt-deflation spiral". • Domestic consumption is supported. • Business and consumer animal spirits recover, driving spending and investments. • Clear move away from further regulatory policy tightening. • GDP growth above 5% target.
Global GDP Real Growth (PPP 2025)[7]	**2.5%**	**3.1% (2024 = 3.2%)**	**3.4%**
DM Inflation 2025	**2.0%**	**2.5%**	**3.0%**
Expected UST 10y yield (in 12m time)	**3.5%**	**4.5%**	**5.25%**
MSCI World return (next 12m)	**-20%**	**+9%**	**+16%**

Source: Partners Capital Analysis

Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance.

7 Global GDP growth estimate for 2025. Country weights are based on purchasing power parity (PPP) – the rate at which the currency of one country would have to be converted into that of another country to buy the same amount of goods and services in each country. PPP is more stable than market exchange rates, allowing for a better comparison of year-on-year growth in real GDP over time, but does tend to increase the weighting to Emerging Markets in calculations as PPP tends to be higher than the market rate in EM countries

Investment Spotlights – What matters most and why?

In this section, we share our evolving views on some of the most pressing investment questions for 2025.

1. **How should we think about interest-rate positioning in this context?**

The 'Paradigm Shift' limits the downside to interest rates absent a recession. Given persistent inflation, fiscal deficits and tariff risks, we continue to favour Absolute Return strategies, floating-rate Credit and Cash over Fixed-Income duration, but we will gradually reduce this tilt if and when conditions normalise and/or yields reach excessively high levels for any given macro context.

We believe central banks will broadly remain in easing mode but their ability to bring down interest rates will be constrained by persistent inflation, particularly in the US where recent data show a re-acceleration in both actual and expected inflation. January inflation data in the US shows core CPI accelerating to a 3.3% annual pace. More worryingly, February data from the University of Michigan survey shows consumers' one-year ahead inflation expectations jumping a full percentage point to a 14-month high of 4.3%, while five- to ten-year ahead expectations broke above their recent range to reach 3.3%. Central banks have begun easing, but at a far slower pace than the market consensus envisaged a year ago. Forward markets currently expect the US Federal Reserve to reduce interest rates by only c. 0.4% down to c. 4% in 2025.[8] Other central banks, particularly in Europe, may have more scope to ease given slower economic growth. Japan is the only major economy likely to continue tightening policy.

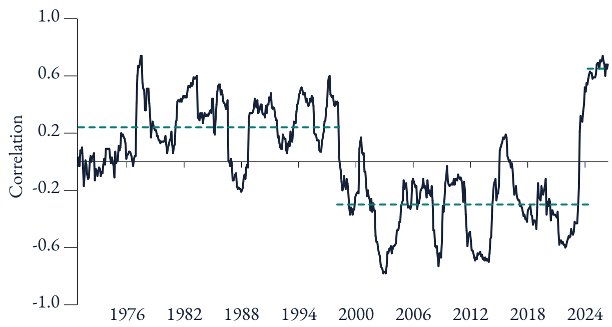
Absent a severe recession, bond yields will not likely be able to match fully any decline in short-term interest rates given ongoing supply and inflationary pressures. Fiscal positions are generally precarious, with the US budget deficit expected to average c. 6% of GDP annually over the next 10 years.[9] Moreover, given the post-pandemic policy of the US Treasury to increase short-dated T-bill issuance over bonds, c. $10T of Federal debt will need to be rolled over during the next six to nine months, creating large supply pressures. In addition, if central banks are perceived as overly accommodative despite sustained inflation, bond yields will struggle to decline in concert with short rates and may even rise, steepening the yield curve. We forecast 10-year US Treasury yields of 4.5% by year-end 2025 in our baseline scenario, 3.5% in a trade-war-induced economic slowdown and 5.25% in a broad-based economic expansion.

From a portfolio construction perspective, the correlation between equities and bond returns switched signs to become positive in mid-2021 and has remained positive since then (Exhibit 6). As a result, the diversification benefits of bonds within a multi-asset portfolio are diminished.

Exhibit 6

Bond/Equity correlation remain elevated

3-year rolling correlation of monthly returns of US 5-10yr Treasuries to Global Equities



Source: Bloomberg

We believe the future outlook for this relationship is scenario-dependent. In a classic recession, the correlation would typically revert to being negative, making bonds more attractive. However, in periods of stagflationary supply shocks, such as following the pandemic, or potentially in the event of a full-fledged trade war, the correlation will likely remain positive. Given that one of the potential catalysts for a near-term recession would be an uncontrolled rise in bond yields, we would likely look to add further duration exposure if US 10-year yields rose above 5%, subject to the macro context at the time.

8 Bloomberg
9 Congressional Budget Office

Executive Summary

2. **Will equity markets continue to be driven by just a handful of stocks?**

In our base scenario, we see a broadening out of market returns over the next one to three years, as fundamental pressures build on mega-cap stocks trading at stretched valuation multiples. Part of this results from the weakening of moats and declining comparative advantage afforded by large capex as AI moves to the edge. In addition, the relative earnings growth differential, the fundamental driver of outperformance for mega-cap tech, is expected to drop to its lowest level since 2022. Relative valuations remain close to the highs of the last 15 years leaving little room for further multiple expansion. However, in tail scenarios, particularly over the near term, mega cap tech performance will likely remain more resilient than the broader market.

Public equity markets going into 2025 were characterized by two related phenomena: high valuations in the US (22x forward P/E for the S&P 500 at year-end 2024, in the top decile most expensive in history) and unprecedented concentration of market returns in the largest companies (the "Magnificent 7" contributed over 50% of S&P 500 returns in 2024, leading the index to outperform the average stock in it by +12%).[10] These market dynamics have been a headwind to our portfolio returns, and active equities investing in general, given a structural underweight to mega-cap stocks.

The magnitude of investment in AI by the "hyperscalers" is expected to slow their earnings growth (expected at +18% in 2025 vs +33% in 2024). The USD value of capex ($175B in 2024/21% of revenues) has more than doubled since 2022 and will begin to impact earnings growth via rising depreciation costs. GPUs[11], which represent c. 40-50%[12] of this capex, have an estimated useful life of just 3-5 years. Meta's depreciation cost is forecast to grow at +40% CAGR over the next three years while Google's is expected to grow at +35%.[13] The difference in earnings growth between the Magnificent 7 and the rest of the S&P500 is expected to fall to just +6% in 2025, the lowest level since 2022.[14]

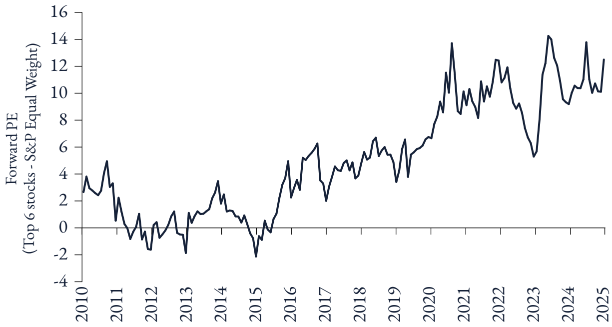
10 Goldman Sachs
11 Graphics Processing Units
12 Sequoia
13 I/B/E/S
14 Bloomberg

To offset soaring depreciation costs, the investment in AI will need to start generating returns. Analysts note that in order to match current earnings expectations, the hyperscalers will need to convert roughly 30% of their trailing three-year average capex into earnings. This is in line with what they have achieved historically, but evidence of monetisation is, thus far, limited. Total revenue for generative AI at an application level was estimated to be less than $15B in 2024. Microsoft, which has been the most successful in monetising AI to date, is expected to generate c. $10B in revenue from AI in 2025 versus capex investment in AI of c. $80B.[15]

Current valuation premiums may not reflect the change in capital intensity. The premium that large tech companies command over the average stock (S&P 500 equal weight) remains close to the highs of the last 15 years, as illustrated in Exhibit 7.

Exhibit 7

The forward PE of the largest tech stocks is close to a record premium versus the equal weight S&P 500



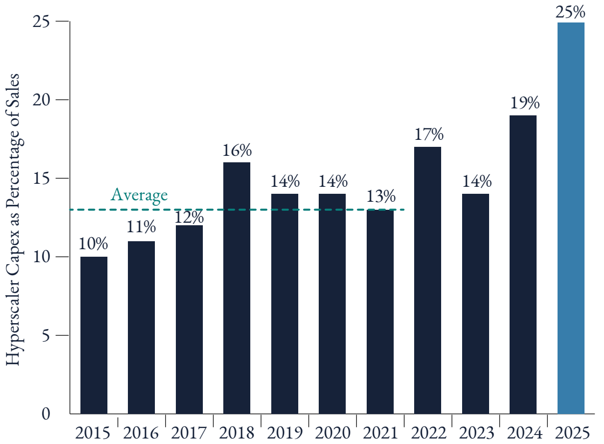
Source: Bloomberg

15 Bloomberg

This suggests that there is limited room for further multiple expansion. There may also be a risk of multiple contraction given that these companies are moving from relatively capital-light business models to more capital-intensive ones, Exhibit 8. Analysis at Goldman Sachs suggests that the long-term valuation premium for capital-light businesses over capital-heavy businesses is roughly +20%.

Exhibit 8

Rising capital intensity, capex has risen from 10% of sales in 2015 to 25% in 2025 for the hyperscalers



Source: Bloomberg, I/B/E/S

As a result, we have opted not to directly hedge our structural underweight to mega-cap stocks in our public equities portfolio, though we have reduced its magnitude in recent years through directing capital to more benchmark-relative managers and by passive funds focused on US exposure. We have also been careful not to be underweight US equities given their strong fundamentals. We view a broadening out of market performance (which would be marked by similar returns for market indices and the average stock in them, as has been the case in most of history) as a positive for our portfolio positioning and our active management outperformance potential.

We believe market concentration will likely persist in the tail scenarios. Monopoly-like pricing power in specific industries, higher free cash flow, the flexibility to dial down capex and a lower level of exposure to rising interest rates suggest that the largest tech companies will prove more resilient if the economy experiences a sharp deterioration in growth or if interest rates rise significantly in response to inflationary pressures. Analysts at BofA Securities estimate that the sensitivity of earnings to interest rates is c. -40% lower for large-cap tech companies compared to the broad S&P 500.

Overall, we expect our positions in life sciences, emerging technology and traditional stock-picking managers will benefit from a broadening of market returns in 2025. We continue, however, to add exposure to managers who we believe can deliver consistent outperformance over benchmarks regardless of market concentration, and to use our scale to drive down management fees. We have added capital to a global quantitative equity manager that has delivered consistent outperformance with limited volatility in recent years and charges only 0.30% management fee and 20% of excess return over its benchmark. This has become one of the largest investments in our public equities portfolio, allowing us to negotiate further management fee discounts.[16] We have also recently partnered with one of our strongest equity market-neutral managers to anchor a new "beta-1" fund. The fund is structured to have no structural bias towards or away from mega-cap companies and to pay performance fees only on excess return over its benchmark. Our early investment also allowed us to benefit from a management fee discount.

16 There is no assurance that the fee savings will be achieved

Executive Summary

3. **Why don't we concentrate our entire Absolute Return allocation in the largest multi-strategy funds?**

While external multi-strategy funds have a role in our portfolio, we prefer to balance this exposure and its risk profile with allocations to our internal multi-manager platform at much better terms, and to exceptional single-strategy managers. Within the world of liquid markets and hedge funds, in our view, the undisputed winners over the past five years in terms of asset growth, risk-adjusted returns and business success have been the big multi-strategy platforms, led by firms like Citadel and Millennium. We understand these firms have used the following formula for success: hire large numbers of trading teams onto their platform, pay for top talent via pass-through fees, manage risk tightly with strong technology and processes and use significant leverage to amplify returns. They have so far shown their ability to navigate market volatility and maintain returns as they scale.

While we are believers in the broad strategy and have investments in this area, we see the risks to investors building up as a result of their rapid growth and competition for talent. We are concerned that the model may be getting pushed to its limits, increasing the probability of investors being harmed by a significant miscalculation:

a. Increased Trading Impact – The large asset base, coupled with the high leverage employed by these platforms as well as the use of "center books" to add exposure on top of individual trading teams, means that the largest platforms each have around $1T of gross market value exposure. The sheer size of this exposure in the market can dilute returns in ordinary times and limit the ability to reposition portfolios in times of market turmoil.

b. Significant Industry Growth – The assets managed by multi-strategy funds have almost tripled from 2017 to 2024, according to a Goldman Sachs report. The increasing levels of capital deployed using similar investment philosophies heightens the risk of an unwinding of crowded trades. The significant growth in the number of portfolio managers that are employed by these platforms also raises questions about talent dilution across the industry.

c. High Fee Burden – Most multi-strategy platforms employ a pass-through fee structure, where almost all of the firm's expenses (including payouts to trading teams, research costs and other big items) are passed directly to investors in the fund, with the firm also taking a percentage of profits. The increased competition for investment talent and a trading edge, coupled with the lack of cost discipline enforced by fixed management fees, has led to increasing payouts to trading teams (including guaranteed sign-on bonuses) and research spending, eating into gross returns. We estimate that top platforms now have all-in look-through expenses in the high-single-digit percentage of assets per annum.

d. Deteriorating Investor Liquidity – The leading multi-strategy platforms have capitalised on the strong demand for their funds by implementing less liquid redemption terms for their investors. Multi-strategy funds now routinely command 3-5 year capital duration. While this does provide benefits to business stability, it significantly reduces the investor value proposition in what is intended to be a liquid, low-risk asset class.

Despite these risk factors, we recognise the value of these allocations as core holdings within our portfolio. We believe the high level of internal diversification, coupled with inherent structural cash efficiency and independent real-time risk management, allows for high risk-adjusted return potential. However, given the factors above, we seek to manage the risk of underwhelming future returns or a significant, correlated drawdown from these funds by taking steps to limit exposure to multi-strategy funds and to diversify into other holdings:

a. We limit our external multi-strategy platform exposure to approximately one-third of total risk in our absolute return portfolios. Within this exposure, we have a preference for platforms that are less aggressive about their asset growth, leverage, fees and liquidity in order to better protect returns in times of stress.

b. We have created an internal multi-strategy platform that we believe mitigates the risks discussed above. While maintaining diversification across trading teams and tight risk controls, our internal multi-strategy fund operates at a far smaller scale, with less leverage and substantially lower fees than the big external platforms, while offering a high degree of liquidity to investors. This platform is now in its fourth year and is an important allocation in our portfolio.

c. We also allocate meaningful risk to exceptional single-strategy absolute return funds. These provide consistent, high-quality exposure to attractive, and in some cases small/niche, markets with partners we can assess and monitor directly.

In 2024, we continued to build out our Absolute Return Managed Account Platform strategy to 26 sub-advisors diversified across strategies, managing c. $1B of capital which we believe is producing strong risk-adjusted returns. We are adding sub-advisors in strategies that complement our existing portfolio and focus on attractive market opportunities, like equity capital markets (capitalising on increased primary and secondary equity issuance), systematic macro (capitalising on increased volatility in global equity, bond, currency and commodity markets) and credit relative value (capitalising on increased dispersion within credit markets).

On single-strategy funds, we substantially grew our relationship with a specialist merger arbitrage manager, for whom we were the first and largest institutional partner. This has allowed us to drive beneficial terms, including substantial fee savings for our clients who pay a negligible management fee and discounted performance fees.[17]

4. Should we stay invested in Private Debt given the influx of capital?

We are maintaining our allocation to Private Debt but reinvesting in smaller corporate loans, specialist lending, asset-backed lending and other areas that still have attractive risk/return characteristics, while avoiding crowded ‘vanilla’ direct lending.

When we made a substantial increase in our Private Debt allocation in 2022, the opportunity in upper middle market senior direct lending had in our opinion suddenly become very attractive. Central bank tightening had increased base rates, but more importantly, spreads had widened significantly, leverage levels had declined, and loan structures and terms became more lender-friendly, as companies sought out debt financing against a limited supply of capital. We leveraged our 12+ years investment experience in the private credit asset class to establish partnerships with asset managers to rapidly deploy capital into new private loans at scale and at reasonable cost.

17 There is no assurance that the fee savings presented will be achieved

Executive Summary

Three years later, we have seen considerable excitement about this asset class and a significant amount of capital inflows, mostly to funds with total assets above $5B. While these capital flows only partially plug the hole left by decades of bank retrenchment from traditional lending activities, we have seen spreads in upper middle market senior direct lending tighten by c. 200 bps. At the same time, while private loan default rates remain below public markets, the private credit landscape appears to have shifted and terms in larger loans are now more borrower-friendly with fewer legal and structural protections for lenders.

Our existing loan portfolio remains strong. We have invested at spread levels that provide a yield of 10-12% on the majority of loans in our portfolio. Importantly, as we invested in newly originated loans after the 2022 rate change, loan servicing costs for the majority of borrowers in the portfolio have remained stable, operating performance is robust, and there is little evidence of rising stress. However, we have changed where we deploy new capital (and where we will redeploy loan proceeds at maturity), focusing on strategies which remain capital constrained and where specialist sourcing capabilities offer differentiated returns. We now invest new capital in areas where spreads have remained wide and risk-adjusted returns are still compelling: lending to smaller companies, non-sponsor lending, specialist lending in segments of the technology and healthcare industries, capital solutions and asset-backed lending.

Our recent core investment activity has included providing anchor capital to a vehicle which has the capacity to lend into performing lower middle market companies and to provide capital solutions in more complex situations. This partnership on attractive terms offers the benefit of higher spreads and better covenant protections from lending to smaller companies, while allowing the investment manager the flexibility to lean into complex situations where senior capital may be priced at a premium, and which benefit from upside from equity participations. Meanwhile, the need for non-dilutive financing in specialist sectors continues to drive attractive yields and the opportunity to lend at low loan-to-value ratios. Our near-term specialist lending pipeline includes Fund II for an emerging manager sourced from our network where we acted as an anchor investor for Fund I. This fund offers exposure to life sciences lending alongside an industry specialist with differentiated proprietary sourcing and attractive fee terms grandfathered from our initial investment.

5. Will Private Equity continue to lag public markets and what might drive future outperformance?

We believe a focus on operationally skilled, lower middle market sponsors and increased co-investment activity will drive stronger earnings growth and consequently long-term outperformance of our Private Equity portfolio relative to public equities. In 2025, we expect to see more realisations than we saw in the last 24 months, which should start to unlock outperformance from selected segments in the Private Equity industry.

After more than a decade of operating in an environment of low interest rates and rising transaction multiples, Private Equity entered into a more challenging operating environment in 2022. On the back of two high-returning years in public equities in 2023 and 2024, albeit driven by a very small number of large companies, Private Equity has struggled to keep up with public market returns. Two major drivers of historical returns, low-cost leverage and multiple expansion, were effectively taken off the table. Compounding the challenge, the Private Equity industry has continued to grow into a larger, more competitive and increasingly mature industry over this period. These developments pose a significant headwind to Private Equity's ability to outperform public markets going forward.

Yet, we have seen signs of strength in Private Equity, especially in the middle market where we concentrate our investments. We view Private Equity at its core as an improved ownership and governance model for many companies, allowing a long-term lens in decision making and alignment of interest to the benefit of earnings. Median middle market private equity-backed companies grew EBITDA by +10% p.a. in the last two years, comparable to the long-term growth rate of +9% p.a. since 2000. This has been in line with the growth rate of similar-sized public companies over the past two years and +3% p.a. higher over the long term.[18] The lower returns of Private Equity in 2023 and 2024 were driven by limited multiple expansion relative to public markets, where we have always observed sponsors adjust valuations more slowly than public markets in both up and down markets. Also, we see evidence of healthy and increasing transaction multiples in the market, growing from a median 11.2x EBITDA in 2023 to 13.1x in 2024. As a result, we have seen meaningful write-ups of private assets upon sale (relative to their prior marked value) and strong return outcomes (in absolute terms and relative to public markets) for realised investments in our portfolio. We expect this dynamic to benefit Private Equity returns as transactions and exits accelerate in 2025. In addition, while Private Equity fundraising has remained robust, this has been dominated by the mega-cap ($5B+) funds. The middle market, on the other hand, has experienced a significant pullback in fundraising, with a 69% reduction in the number of funds raised from the peak in 2022.[19]

18 Pitchbook
19 Axios, Pitchbook, LCD

We are closely monitoring the operating performance of our Private Equity portfolio companies and the return outcomes from our realised investments to see if these green shoots are in fact delivering strong return outcomes for our existing portfolio. We have already seen some successful realisations in the first two months of 2025, with an omnichannel blood infusion company owned by one of our core US middle market buyout sponsors, and a cybersecurity training and compliance company owned by a European lower middle market sponsor.

For new investments, we continue to focus on sponsors with proven operational value-add capabilities, differentiated sourcing channels, clear sector-specific expertise and a focus on smaller companies to drive differentiated returns. As an example, we entered into a new partnership with a sponsor focused on small companies in defence and government services, committing to their first institutional fund at under $700M fund size. In addition, we are increasing our co-investment participation alongside these managers to reduce the overall fee burden and to enhance performance. In the midst of a continued tight Private Equity fundraising environment, we have seen growth in the attractiveness of our co-investment deal flow over the past 12 months, with $400M deployed into 12 platform companies in H2 2024. Our recent co-investments include a leading European savoury snacks manufacturer as our fourth co-investment alongside one global industrials sponsor, and a US mission-critical communication devices and network infrastructure provider alongside a US lower middle market sponsor.

Tactical Asset Allocation

Our Tactical Asset Allocation process seeks to optimise performance across our macro scenarios over the next 12-18 months. One of our founding principles is that attempting to time the entry and exit from markets is likely to lead to sub-par returns over the long run. Instead, we believe the best method for securing attractive returns over the business cycle involves setting an appropriate risk budget range and holding it relatively constant. We find aggregate equity-like risk to be a useful measure for expressing a portfolio's overall risk level. However, asset classes are not homogenous, so a careful assessment of the market risks underpinning each investment is needed to truly understand the risks in a portfolio. In this way, we ensure that portfolios are well positioned for the current macro context by capturing the most attractive risk premia, remaining diversified across return drivers and providing better resilience across multiple scenarios.

As noted above, government policy measures will be supportive of aggregate demand, but somewhat restrictive of the supply side. As such, uncertainty and volatility levels will remain elevated. These elements are consistent with the 'Paradigm Shift' macro theme we introduced two years ago. As such, we make only modest tweaks to our 2025 Tactical Asset Allocation (TAA) and continue to position portfolios for an environment of heightened macro volatility. Compared to our long-term Strategic Asset Allocation benchmark (SAA), the TAA maintains a longstanding underweight to interest-rate duration (-2.5% Government Bonds, -2.5% Index-Linked Bonds) in favour of Cash/Short-Dated Bonds (+2%) and Absolute Return (+3%). However, we may move 2% from Cash into Government Bonds if 10-year yields rise (potentially above c. 5% in the US or UK, 3% in Germany) or if the economic outlook appears likely to deteriorate meaningfully.

We continue to favour income-generating assets which offer attractive all-in yields. However, with credit spreads now tight relative to history, we reduce the size of our above SAA allocations in Liquid Credit from +3% to +2%. The allocation to Private Debt remains +3% above SAA as the asset class continues to offer attractive returns at a premium to public markets. In both cases, careful security selection is necessary to guard against deteriorating credit fundamentals as spreads have narrowed. Within Private Debt, we continue to diversify away from the more commoditised, large-cap direct lending in favour of sub-sectors where the supply of new capital has been more constrained.

The reduced Credit allocation will be gradually redeployed in Private Equity over the year. The remaining +5% overweight to income-generating assets is funded from a -2% underweight to Public Equities, -1% from Private Equity and -2% from Venture Capital. The underweight allocations to PE and VC reflect that it takes time to build out a mature, diversified allocation to these asset classes. We continue to believe that long-term institutional investors should hold roughly 40% of their portfolio in Private Markets and recommend that clients continue to steadily maximise their allocation subject to their specific liquidity needs. We express this view by adding +1% to Buyouts in 2025 relative to last year.

Executive Summary

Exhibit 9 summarises our recommended 2025 TAA for a non-taxable investor and contrasts it with both the SAA and the 2024 TAA.[20] We have modified versions of the TAA for our US, UK and other taxpaying clients with changes that move in a similar direction. A more detailed summary of our views of each asset class is provided in the asset class sections of this publication.

Exhibit 9

2025 Tactical Asset Allocation

	SAA	2025 TAA	Difference vs. SAA	Difference vs. 2024 TAA	Notes
Cash	1.0%	3.0- >1.0%*	+2.0% -> -	–	• Maintain lower interest-rate sensitivity by allocating to shorter-dated bonds and certain Absolute Return strategies rather than long-dated nominal bonds or ILBs. • Consider shifting 2% from cash to market duration bonds if US 10yr yield rises above 5.0%, but contingent on economic outlook and relative attractiveness of alternatives at the time.
Government Bonds	5.0%	2.5- >4.5%*	-2.5% -> -0.5%*	–	
Liquid Credit	2.0%	4.0%	+2.0%	-1.0%	• Favourable environment for opportunistic/event driven credit. All-in yields still attractive in higher rated Structured Credit. • Passive high yield and loans appear expensive relative to history although credit quality is improved.
Private Debt	7.0%	10.0%	+3.0%	–	• Attractive opportunities in sector specialist lending, with software, life sciences, legal and agricultural lending amongst the sectors we have in our portfolio and pipeline.
Absolute Return	12.0%	15.0%	+3.0%	–	• Higher macro volatility and asset dispersion offer strong "cash-plus" return opportunities. • Allocate to multi-strategy funds for cash efficiency and enhanced risk management, as well as strategy specialists to shape overall portfolio balance and to enhance returns.
Hedged Equities	5.0%	5.0%	–	–	• Greater economic dispersion across sectors and regions creates favourable conditions for long/short spread generation. Our emphasis remains on partnering with managers who exhibit strong research specialisation, robust portfolio construction capabilities, and disciplined risk management.
Long Equities	30.0%	28.0%	-2.0%	–	• Maintain a balanced mix of factors, as well as regional and sectoral exposures. • Underweight allocation reflects rich valuations.
Private Equity	18.0%	17.0%	-1.0%	+1.0%	• High conviction in buyout managers that possess an ability to "buy complexity" and drive post-acquisition value creation. • Below benchmark allocation reflects the fact that it takes time to build a mature, diversified allocation to Private Equity.
Venture Capital	7.0%	5.0%	-2.0%	–	• Continue to build out VC allocations with focus on early stage as we have developed strong access and relationships to several top tier established and emerging managers in the asset class.
ILBs	5.0%	2.5%	-2.5%	–	• Skew allocation towards front end of the curve which is more responsive to near-term inflationary pressures. The near-term return outlook for ILBs is modest relative to the alternatives across almost all scenarios.
Real Estate	8.0%	8.0%	–	–	• Focus on PERE managers due to favourable acquisition valuations and value-add potential – i.e., "buy-upgrade-sell". Attractive opportunities remain in digital infrastructure and power/energy infrastructure.
Total	**100%**	**100%**	–	–	
Equity-Like Risk	66%	63%	-2.6%	+0.4%	• TAA is at the lower end of equity-like risk range, reflecting attractive risk-adjusted returns in AR and income generating strategies, and gradual buildout of PE/VC.
Illiquid Assets	40%	40%	0.0%	+1.0%	• Gradually build to target illiquid allocation.

Source: Partners Capital

20 Partners Capital are not tax advisors. Tax Treatment will depend on the individual circumstances of each client and is subject to change. Clients should consult their own tax advisors to understand the tax treatment of a product or investment

Expected Returns from the 2025 TAA

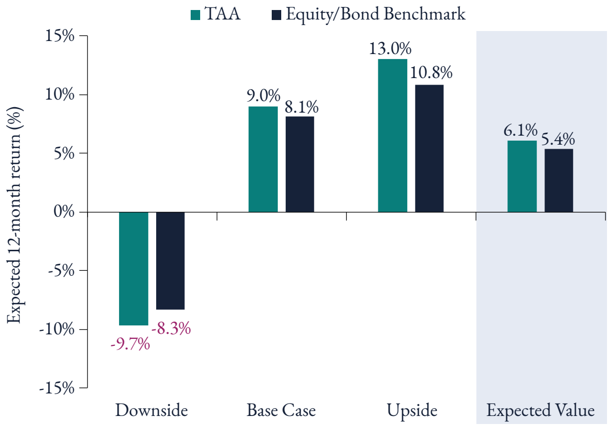
In our base case, to which we assign a 60% probability, we expect the model portfolio TAA to produce a return of roughly 9% for the 12 months starting 31 January 2025. The heightened uncertainty puts an unusually wide error band around this. Specifically, in a recession, we anticipate a decline of roughly -10%, while in the upside "broad-based expansion" scenario, the portfolio is expected to rise +13% – both scenarios are assigned a probability of 20%. Over a 10-year investment horizon, over which the benefit of diversification plays more of a role via active rebalancing, we expect the portfolio to deliver returns closer to +9% p.a.

These portfolio return assumptions compare favourably to the expected return of a 65/35 mix of Developed Market Equities and Government Bonds. The respective returns are shown in Exhibit 10 below. We expect our 2025 TAA portfolio to outperform this index by c. 1.0% in the base case and c. 2.5% in the upside case, but will likely lag a 65/35 benchmark by c. -1.5% in a recession due to the lower bond allocation.

Past performance is not indicative of future returns, your capital is at risk and you may not get back the full amount you invested.

Exhibit 10

Portfolio net returns by scenario, Partners Capital TAA vs. a 65/35 Equity/Bond benchmark



Source: Partners Capital

Hypothetical return expectations do not represent actual trading and are based on simulations with forward-looking assumptions, which have inherent limitations. No representation is being made that any investor will or is likely to achieve returns similar to those shown. Such forecasts are not a reliable indicator of future performance.

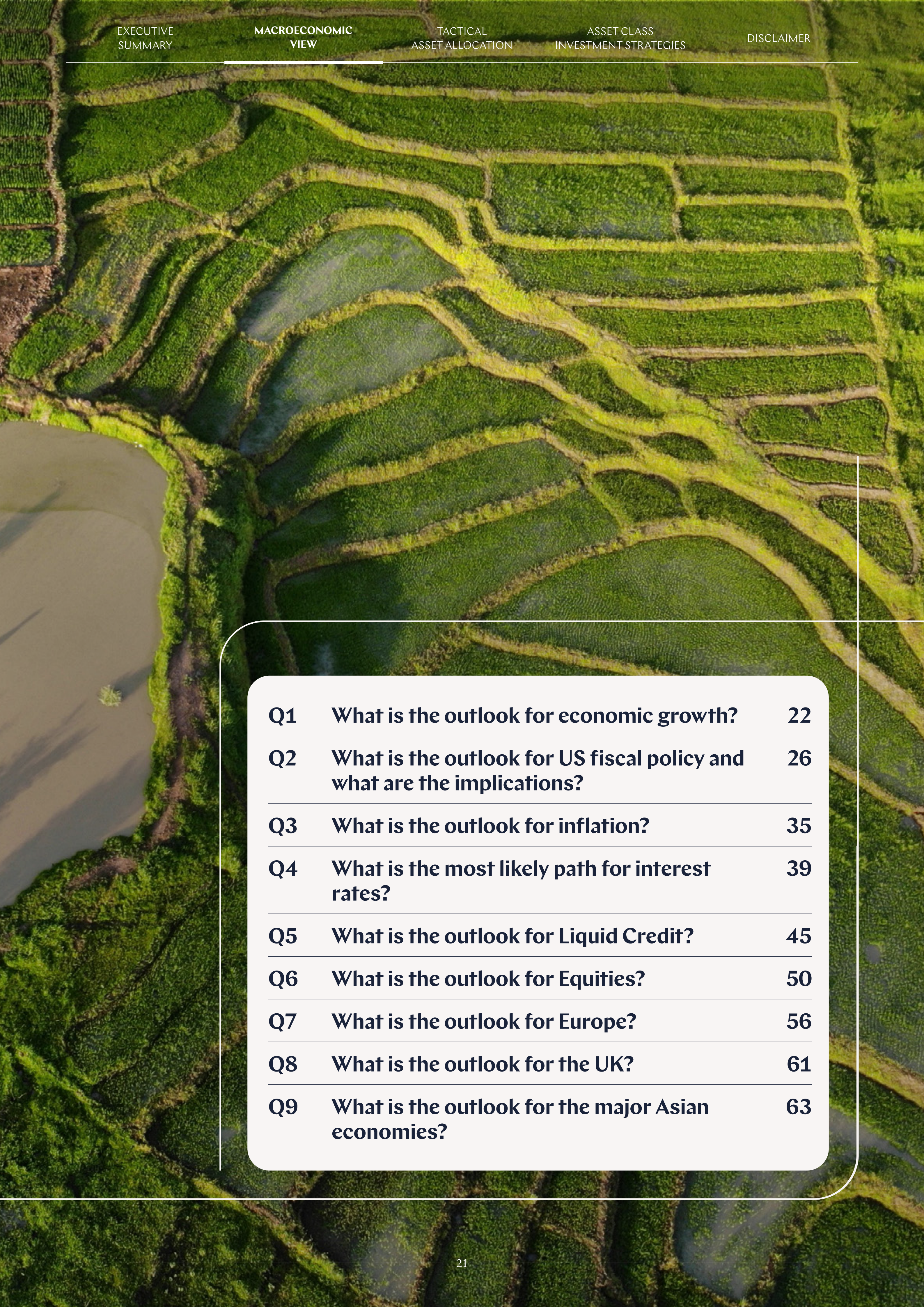
Conclusion

The remainder of this document covers more detail on our macroeconomic thinking, investment implications and the opportunities we are most excited about in each asset class.

While it is always difficult to predict what the markets have in store for investors, we hope that Partners Capital Insights 2025 provides you with some useful perspectives. We look forward to discussing our outlook and investment conclusions with you in our next meeting.

Macro-economic view

Radical disruption is emerging as a powerful macro theme in the second half of this decade. In this section, we detail our outlook for economic growth and inflation over the coming years in light of this disruption and assess the implications for the core beta returns of Interest Rates, Credit Risk and Equities.



Macroeconomic View

Q1. What is the Outlook for Economic Growth?

Slower but still resilient global economic growth with wider regional divergences is our base case scenario for 2025. Global growth exceeded expectations in 2024, increasing by 3.2%.[1] We expect a 3.1% growth rate in 2025 and 2026, aided by accommodative financial conditions, high government spending, large-scale corporate capital investment – particularly relating to AI – and robust consumer spending. In our base scenario, tariffs are increased selectively, immigration policy reduces the flow but stops short of mass deportation, regulations are pared back across the energy and financial sectors but the impact is gradual and TCJA tax cuts are extended with a few additional tax breaks but the large starting budget deficit of over -6% of GDP limits the government's fiscal options. Such policy changes will do little to derail the current macroeconomic trends and resilient growth. However, the policy landscape will likely remain uncertain and uncertainty is not without cost. Firms may refrain from large investments while they wait for greater clarity. In such a macroeconomic context, investors should maintain diversification and prepare to play offence as frequent dislocations create opportunities.

1 IMF Estimate, as per January 2025 World Economic Outlook

Another solid year of growth is the consensus view, and for good reason

Real global GDP increased by 3.2% in 2024, a growth rate that is widely expected to be sustained in 2025 and 2026. As shown in Exhibit 1, the IMF forecasts global growth of 3.3% in both 2025 and 2026, while the World Bank and the Bloomberg consensus forecast are only slightly lower at 3.0% in 2025 and 2026.

Factors underpinning the consensus for continued solid growth include:

- **Supportive monetary policy** - Most major central banks are now easing monetary policy, and financial conditions are expected to remain reasonably accommodative over the coming year. Lower interest rates and favourable credit conditions should encourage borrowing and investment, supporting growth.
- **Stimulative fiscal policies** - At least 64 countries held elections last year, and in most cases, the resulting government opted for looser fiscal policy. In France, an attempt to tighten fiscal policy led to a collapse of the government. Populism is in ascendency across the world, and it tends to accompany greater fiscal spending. In the near term, tax cuts, increased government spending and large state-sponsored infrastructure projects should stimulate economic activity, even as they add to fiscal risks over the medium term.
- **Technological advancements and capital investment** - The "AI boom" is driving enormous capital investment. According to data from S&P Global, five AI hyperscalers are projected to spend more than $1 trillion in capex collectively from 2024 to 2027. Investments range from the development of AI itself to the infrastructure supporting it, including semiconductor design and manufacturing, the building of data centres, increased energy generation needs, and further automation of supply chains. The resulting technological innovations are driving productivity improvements and economic expansion.
- **Consumer spending remains robust** - Private sector balance sheets are healthy and disposable income remains elevated thanks to wage growth of c.+4.2% in the US and +4.4% across the EU in 2024. Falling inflation helps to raise real incomes, further fuelling consumption. Strong consumer confidence and spending are expected to further bolster economic growth.

Exhibit 1

Real GDP growth forecasts for 2025 and 2026

Real GDP Growth Forecasts	2025					2026				
	World	US	Euro Area	UK	China	World	US	Euro Area	UK	China
Domestic Central Bank	N/A	2.1%	1.1%	0.8%	5.0%	N/A	2.0%	1.4%	0.8%	N/A
IMF (Jan 2025)	3.3%	2.7%	1.0%	1.6%	4.6%	3.3%	2.1%	1.4%	1.5%	4.5%
World Bank (Dec 2024)	3.0%	2.4%	1.3%	1.7%	4.7%	3.0%	2.1%	1.5%	1.3%	4.4%
Bloomberg Consensus (31 Jan 2025)	3.0%	2.2%	1.0%	1.3%	4.5%	3.0%	2.0%	1.2%	1.4%	4.2%

Source: Each respective organisation.

But the policy landscape will likely remain uncertain

Unfortunately, risks to this rosy outlook abound. This is mostly attributable to the uncertain policy landscape, particularly in the US. Four key policy areas are in focus for 2025: tariffs, immigration, deregulation and fiscal policy. Early policy shifts point to a tenuous balance between demand-side stimulus and supply-side constraints.

Exhibit 2 outlines the high-level policy framework we use to assess the balance (or lack thereof) between stimulative and restrictive measures. Stimulative demand measures, including fiscal and regulatory actions that reduce burdens on US firms, are weighted against more restrictive supply-side shifts in immigration and trade policy. Our baseline view is still that the implemented policies will maintain a balance between these objectives and avoid extremes, with a bias towards modestly weaker global growth (with greater regional divergences), higher inflation and a relative shift in global business sentiment, favouring the US.

In our base case, new tariffs are gradually introduced on China, with global tariffs applied to certain strategic goods. No universal tariffs are introduced, but their spectre hangs heavy. Net immigration is slowed to roughly 750K/year, but limited deportations occur for practical, financial, and optical reasons. Regulations are eased across the energy and financial sectors but have a limited impact in 2025 or even 2026. For example, encouraging oil drilling in coastal waters is one thing, but exploration and development will take years. Likewise, revising Basel III banking regulation would require industry consultation, and Oliver Wyman estimates that any implementation would not be able to happen until January 2027 at the earliest. There are few quick fixes to be found.

We expect the Tax Cuts and Jobs Act (TCJA) introduced by Trump in his first term to be extended, with a few additional tax breaks, but an existing budget deficit of over -6% of GDP limits the government's fiscal options. If this base case scenario plays out, it will do little to derail the current macroeconomic trends and resilient growth.

The risk is that some of the more impactful and negative policy changes are potentially contingent on each other. For example, Trump may seek to fund increased tax cuts – such as a tax break for "Made in America" companies – by raising more revenue through tariffs. Both tariffs and tax cuts would be inflationary. Goldman Sachs has suggested that large-scale tariffs could raise core consumer prices, which exclude food and energy, by as much as +0.9%.

A tariff-induced inflation rise would likely be seen as a one-off price level increase rather than a structural increase in the inflation rate, but it may still be enough to prevent the Federal Reserve from lowering interest rates to keep inflation expectations anchored. Such a policy mix would almost certainly worsen the US fiscal position, which could lead to the government borrowing at still elevated interest rates to fund deficit spending that is stimulative to an already hot economy—a classic boom-bust would likely follow.

Macroeconomic View

Exhibit 2

US Government Policy – Scenario Analysis

		Downside	Base Case	Upside
Tariffs	**Scenario**	Trump introduces wide array of global tariffs to offset cost of tax cuts in the budget reconciliation process. Dampens global growth.	Trump introduces new tariffs on China and targeted global tariffs on the import of certain goods/ sectors (e.g., autos)	Trump limits tariffs to China on selective areas as part of a negotiated deal to onshore manufacturing
	Growth Impact	Slower	Modestly slower	Minimal
	Inflation Impact	Higher, but one-off step change	Modestly higher	Minimal
Immigration	**Scenario**	Net immigration slows to 500k/year and forced deportation of immigrants with criminal records (up to 1.2m individuals)	Net immigration slows to 750k/ year in response to increased funding and tighter enforcement of border	Short-lived decline in net immigration as businesses lobby Congress for increase in labour supply to meet demand
	Growth Impact	Slower	Slower	Faster
	Inflation Impact	Loss of production capacity partly offset by loss of demand, but large variation by state	Neutral	Increase in inflation via consumption more immediate than increase in production
Regulation	**Scenario**	Some restrictions and oversight get cut back, but the process to enable major deregulation changes is slow and faces legal challenges, limiting the impact in 2025.	Increase in energy output from increased drilling on Federal Land and offshore. Lighter regulation on emissions. Increase in LNG exports. Financial regulation eased, including a more permissive environment for bank mergers, but no substantive legislative changes.	Similar energy deregulation as in the base case but with more rapid adoption by the private sector. Emphasis on unleashing the financial sector to support growth – easing lending standards and encouraging deal-making.
	Growth Impact	Neutral	Modestly faster	Faster
	Inflation Impact	Neutral	Modestly lower	Lower
Fiscal Impulse/Tax Policy	**Scenario**	2025 budget deficit of c. 5.5-6%. The government adopts a more fiscally conservative approach than expected, with greater emphasis on reduced spending.	2025 budget deficit of c. 6-6.5%. Tax Cuts and Jobs Act (TCJA) provisions extended and some other tax relief provided (e.g., overtime income exemption, increase in SALT cap), but poor fiscal outlook limits extent of cuts.	2025 budget deficit of c. 6.5-7%. Increased revenue from trade tariffs used to fund a more extensive program of tax cuts, including both individuals and small businesses.
	Growth Impact	Slower	Neutral – a continuation of current policy is not fiscally expansive	Faster
	Inflation Impact	Lower	Neutral	Higher

Source: Partners Capital

Trade policy represents the biggest risk to global growth

No one knows whether Trump sees tariffs as a negotiating tool or the degree to which he wants to shut down trade as an end goal. It might be tempting to assume that tariffs are simply a dramatic way to gain leverage. This seems to be the base case assumption in markets today. From our perspective, the most likely outcome is that neither scenario will soon emerge as the definitive result.

The imposition of incremental tariffs on China has been seen as inevitable, while selective tariffs on the rest of the world will likely be targeted at specific sectors, such as automotive. However, even if few or no tariffs our imposed, it is highly unlikely Trump will ever take the threat off the table in our view.

It is more likely that over the next four years, the tariff messaging from the Trump administration will continually alternate between pragmatism and ideology. In other words, unpredictability may be a strategy in itself. From an economic perspective, the cost of uncertainty is high. According to the IMF, over half of the damage to global growth from tariffs will stem from firms deciding to sit on their hands while ascertaining any trade war's fallout. In a c. 10% global tariff scenario[2], the IMF forecasts a cumulative hit of -0.6% to global GDP over the next 2 years, including uncertainty effects. In a scenario where Trump follows through with his 25% tariff threat on Canada and Mexico, combined with an additional 10% on China, J.P. Morgan estimates a -0.7% hit to US GDP.

In the prior trade conflict with China, US real GDP performed well in 2019, rising 3.4%, while the unemployment rate fell to 3.5% and core PCE inflation slowed to 1.5% annually from 2.0%. Part of the strength in economic activity reflected an offsetting boost from the passage of the TCJA in December 2017: based on the Brookings fiscal impact measure, the TCJA added 0.50-0.75% to growth in 2019. However, business equipment investment fell 2.2% that year despite TCJA measures to boost investment spending. Additionally, manufacturing production dropped 2.7% and manufacturing employment growth halted. The PMI and ISM manufacturing surveys both deteriorated, and export growth slowed. In short, policy uncertainty is itself a drag on growth.

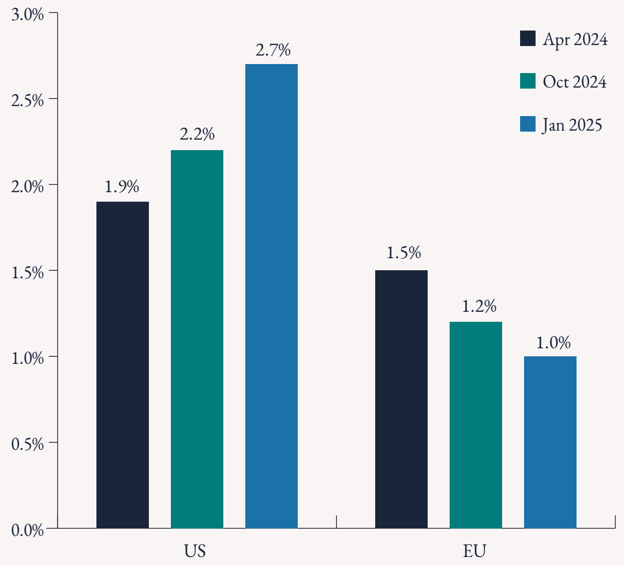
2 IMF 2024 WEO: Tariff scenario assumes trade tensions lead to a permanent increase in tariffs starting in mid-2025 and affecting a sizable swath of global trade. The United States, Euro area, and China impose a 10% tariff on trade flows among the three regions; a 10% tariff is also levied on trade flows (in both directions) between the United States and the rest of the world. The increase in tariffs directly affects about one-quarter of all goods trade, representing close to 6% of global GDP

Regional divergences are likely to widen

From a regional perspective, Europe will likely bear the brunt of the uncertainty around tariff threats, and hence suffer the largest economic drag, estimated at -0.7% cumulative over the next two years by the IMF. The divergence in growth outlook for the US and EU has been striking. In April last year, the IMF's forecast for real GDP growth in 2025 was +1.9% in the US and +1.5% in the EU. In their most recent update, the respective growth forecasts for 2025 are now 2.7% and 1.0% (Exhibit 3).

Exhibit 3

Growth forecasts have been increasing in the US, declining in Europe



Source: IMF World Economic Outlooks

The COVID-19 pandemic and subsequent wave of inflation created a period of synchronicity across major economies. However, this is now giving way to greater divergence and decoupling in regional monetary and fiscal policy. Greater political nationalism will likely serve to increase these divergences in 2025 and beyond, which will again serve as both a source of risk and opportunity for global investors.

Macroeconomic View

Q2. What is the outlook for US fiscal policy and what are the implications?

In 2025, the net amount of US Debt held by the public[1] will exceed annual GDP. Thereafer, federal debt is expected to grow by roughly 3% p.a. relative to the size of the economy. A phased fiscal adjustment of c. 2-2.5% of GDP p.a. is needed just to stabilise the debt trajectory. Sufficient headroom remains to avoid a near-term fiscal crisis as the Fed still owns 20% of the debt. Unfortunately, this will leave policymakers insufficiently motivated to implement needed reforms to Social Security, Medicare, or tax policy. Our base case outlook is that the fiscal situation will worsen before it improves. The consequences of such a scenario would be: 1) elevated interest rates as government debt issuance absorbs savings; 2) rising term premium on longer-dated bonds; 3) crowding out of private investment and limiting of potential growth; 4) rising interest payments leading to a wealth transfer to domestic and non-US debt holders; 5) constraining the government's ability to ramp up borrowing in response to a new crisis.

1 Debt held by the public, or "net debt," excludes intragovernmental debt—obligations that a government owes to its own agencies. The Federal Reserve is deemed to be independent of the government, so debt owned by the Fed is included in debt held by the public. As of 31 December 2024, US gross debt to GDP was 121%, whereas net debt was 99%

The Current Status and Outlook for US Debt

- The January 2025 Budget Projections from the Congressional Budget Office show US Government debt net of intragovernmental holdings reaching 100% of GDP in 2025 and rising to 119% of GDP in 2035, rising from c.$28 trillion to $52 trillion. This assumes Trump's 2017 Tax Cut and Jobs Act (TCJA) expire in 2026 – now highly unlikely.
- The budget deficit is projected to average 5.8% of GDP annually over the next 10 years.
- A fiscal adjustment of roughly 2.0% of GDP is needed to stabilise the debt trajectory. Debt rises as a share of GDP if (deficit / GDP) > nominal GDP growth * (debt / GDP).[2] With US debt at 100% of GDP, debt is stabilised if the deficit to GDP ratio matches the nominal GDP growth rate, which is expected to average c. 4% p.a. over the next 5 years based on IMF forecast.
- Net interest payments rose from 2.4% of GDP in 2023 to 3.1% in 2024 and are projected to rise to 4.1% by 2034. Or from 15% of total government revenue in 2023 to 22% in 2035. In fiscal year 2024, the Treasury spent $882 billion on net interest payments, exceeding the Defence Department's annual spending on military programs for the first time ever.
- The weighted average maturity of debt outstanding is currently 5.8 years, with over $9.5 trillion maturing over the coming year. The weighted average interest rate for total outstanding debt was 3.3% at the end of 2024. The CBO forecasts assume an average 10-year Treasury yield of 3.9% over the next decade. If interest rates are higher than this, the budget deficit will increase.
- Reducing the deficit will be difficult and slow for both political and economic reasons. Scott Bessent, secretary of the Treasury, aims to reduce the deficit to 3% of GDP by 2028 through a mix of deregulation and growth. Analysis shows this is unlikely without meaningful tax or spending reform.
- Since the Fed started raising rates, households, pension and insurance companies have been primary buyers of Treasuries. China has lowered its holdings of Treasuries from $1.2 trillion in 2015 to $772B as of 30 September 2024.

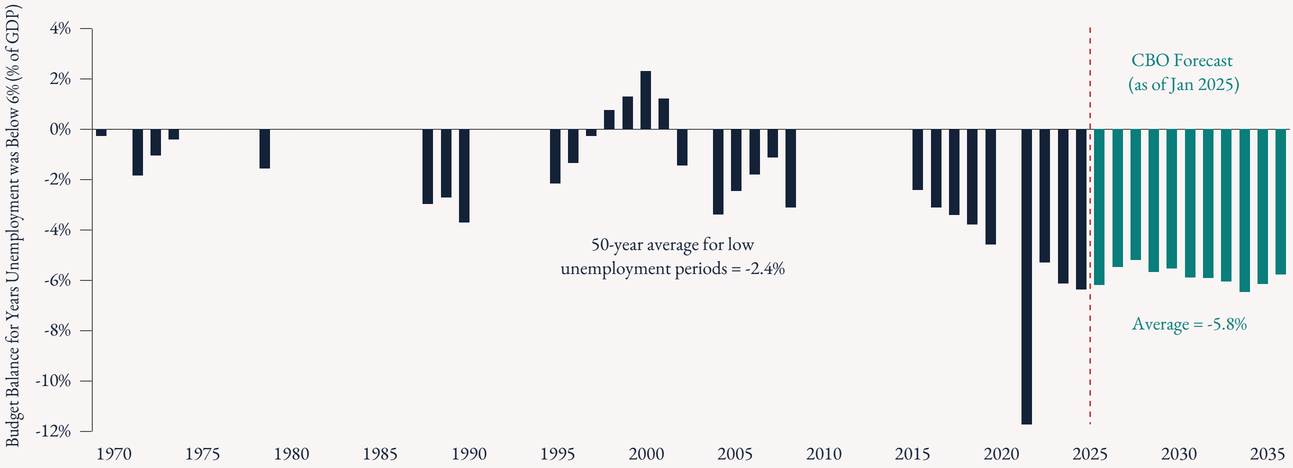
Large federal deficits are expected to persist despite low unemployment

In the fiscal year ended 30 September 2024, the US deficit recorded by the Department of the Treasury was $1.8 trillion, or 6.4% of GDP. The unemployment rate ranged between 3.7% and 4.2% that year, compared to a 50-year average of approximately 6.0%. Budget deficits of this scale are highly unusual when unemployment is below average (Exhibit 1).

2 More accurately, the debt-stabilizing primary balance = (Real interest rate - Real GDP growth rate) * Debt-to-GDP ratio. This is the budget balance before interest expense needed to keep debt-to-GDP ratios constant from one year to the next

Exhibit 1

Federal deficits are projected to be high despite low unemployment



Source: Congressional Budget Office, Peter G Peterson Foundation

Total revenues rose 11% ($479 billion) in 2024 compared to 2023, with individual and corporate income taxes accounting for most of that increase. Most of that growth is attributable to increased withholdings from paychecks, reflecting wage and salary growth. However, total spending rose by 10% ($617 billion), more than a third of which came from one category: net interest costs ($222 billion increase). Other categories that increased significantly were Social Security ($107 billion), defence spending ($53 billion), and Medicare ($27 billion).

The Congressional Budget Office estimates that mandatory spending in 2024 was 14.5% of GDP, while net interest payments were 3.1% of GDP, totalling 17.6% of GDP. That compares to total estimated revenues of 17.1%. That is, any discretionary spending, including defence, required running a budget deficit. Exhibit 2 below shows the expected evolution of different budget components over the next decade. Based on CBO forecasts (which apply current law), social security and healthcare costs will consume 71% of total revenues by 2034, up from 62% in 2023, and net interest payments will consume 23% of revenues, rising due to the combination of higher interest rates and a growing debt pile.

Exhibit 2

CBO forecast of US spending in 2035 versus 2024

Classification	Category	2024 (% of GDP)	2035F (% of GDP)	Change
Mandatory	Social Security	4.9%	5.9%	0.9%
	Major Healthcare Programs	5.6%	6.4%	0.8%
	Other Mandatory Spending	3.5%	2.4%	-1.1%
	Sub-total	14.1%	14.7%	0.6%
Discretionary	Defence	3.0%	2.4%	-0.6%
	Non-Defence	3.3%	2.9%	-0.4%
	Sub-total	6.3%	5.3%	-1.0%
Interest	Net Interest	3.1%	4.1%	1.0%
Total		23.4%	24.1%	0.6%
Forecast Revenue		17.1%	18.3%	1.2%
Budget Balance		-6.4%	-5.8%	0.6%
Total Net Debt to GDP[1]		98%	118%	21%

1 Net of intragovernmental holdings

Source: Congressional Budget Office Budget and Economic Outlook, January 2025

Deficit Likely to Be Bigger Under Trump

The CBO figures above assume that the laws governing taxes and spending remain unchanged. It is now very likely that Trump will extend the TCJA tax cuts that are due to expire in 2026 and potentially add new tax breaks. Based on analysis by the Committee for a Responsible Federal Budget, a bipartisan think tank, Trump's policy proposals are expected to increase debt by $7.75 trillion over the next decade relative to their forecasts under current law. This would take national net debt to 143% of GDP by 2035 versus their base case forecast of 125% (Exhibits 3a and 3b).

Exhibit 3a

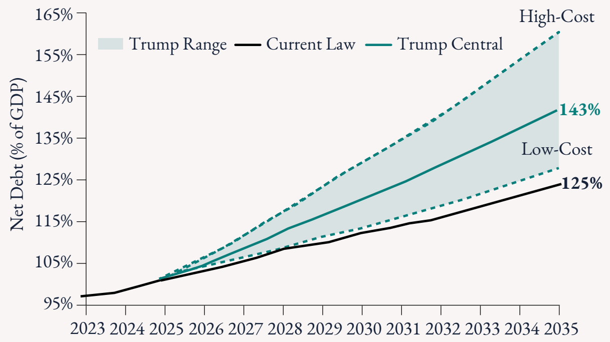
Deficit Impact of Trump's Policy Proposals (cumulative impact 2025-35, $B)

Policy Proposals	Low	Central	High
Extend and Modify the Tax Cuts & Jobs Act (TCJA)	-4,600	-5,350	-5,950
Exempt Overtime Income from Taxes	-500	-2,000	-3,000
End Taxation of Social Security Benefits	-1,200	-1,300	-1,450
Exempt Tip Income from Taxes	-100	-300	-550
Lower Corporate Tax Rate to 15% for Domestic Manufacturers	-150	-200	-600
Enact or Expand Other Individual and Small Business Tax Breaks	-150	-200	-350
Strengthen and Modernize the Military	-100	-400	-2,450
Secure the Border and Deport Unauthorized Immigrants	0	-350	-1,000
Enact Housing Reforms, Including Credits for First-Time Homebuyers	-100	-150	-350
Boost Support for Health Care, Long-Term Care, and Caregiving	-50	-150	-300
Subtotal, Tax Cuts and Spending Increases	-6,950	-10,400	-16,000
Establish a Universal Baseline Tariff and Additional Tariffs	4,300	2,700	2,000
Reverse Current Energy/Environment Policies and Expand Production	750	700	550
Reduce Waste, Fraud, and Abuse	250	100	-
End the Department of Education and Support School Choice	200	200	-
Subtotal, Revenue Increases and Spending Reductions	5,500	3,700	2,550
Net Interest	-200	-1,050	-2,100
Total, Net Deficit Impact	-1,650	-7,750	-15,550

Source: Committee for a Responsible Federal Budget
Notes: Low/Central/High scenarios refer to the net deficit impact. 'Low' assumes a 20% universal tariff and 60% Chinese tariff, 'Central' assumes a 10% universal tariff and 60% Chinese tariff, and High assumes a 10% universal tariff and 60% Chinese tariff, with a -1.2% impact on US GDP

Exhibit 3b

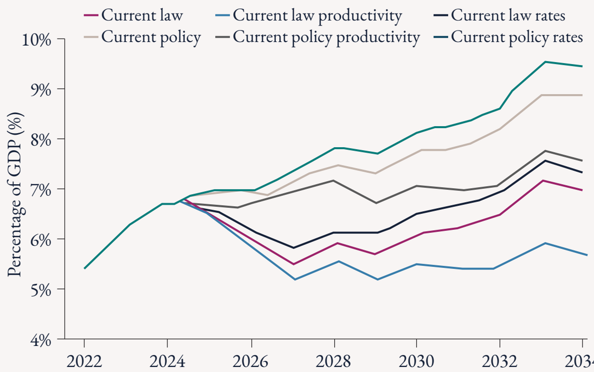
Net Debt as a Percentage of GDP under Trump Policies



Source: Committee for a Responsible Federal Budget

Exhibit 4

Scenario analysis of budget deficit, 2022-2034: higher productivity growth is not enough



Notes: "Current law" uses the CBO's June 2024 forecasts and includes the 2026 expiration of tax cuts and adherence to the spending caps. "Current policy" assumes Congress passes legislation to keep policies unchanged — specifically, passes $4.5 trillion of tax cut extensions (1.5% of GDP in 2034) and makes offsetting changes to discretionary spending levels that are roughly equivalent to ensuring that underlying discretionary spending grows with inflation plus population. "Productivity" scenarios assume growth is 0.5 percentage points faster than CBO's assumption. "Rates" scenarios assume that interest rates are 50 basis points higher than CBO's forecast starting in 2027, a proxy for a plausible market forecast for interest rates.
Source: Furman, Jason., 2024. "Eight Questions—and Some Answers—on the US Fiscal Situation"

Neither a solution nor a fiscal crisis is imminent

Productivity growth alone is not enough to stabilise the trajectory of government debt

The US fiscal outlook is a well-known problem. The Federal Reserve's November 2024 Financial Stability Report highlighted it as the number one concern. Yet, reducing the deficit will be a hard and slow process for both political and economic reasons.

For one thing, Trump did not prioritise a fiscal fix during the campaign. Secretary of the Treasury Scott Bessent has said he intends to reduce the deficit to 3% of GDP by 2028, but his plan relies largely on faster economic growth through deregulation and an expansion in domestic energy production. This is not likely to prove sufficient.

Jason Furman, a professor of economic policy at Harvard University who served as White House chief economist under Obama, ran scenarios for the deficit over the next decade. Even if productivity growth exceeds the CBO projections by 0.5 percentage points, the budget shortfall is still roughly 6% at the end of the period under current law (Exhibit 4). Similarly, the Penn Wharton Budget Model suggests that achieving a 3% budget deficit is largely unfeasible without some combination of higher taxes or reforms to Social Security and Medicare. None of which is likely to be forthcoming.

The long-term impact of Artificial Intelligence on the fiscal outlook is not necessarily positive

A working paper by the Brookings Institute (Harris, Mehrotra, and So, Oct 2024) attempted to assess the impact of AI on federal spending and revenues. They considered four primary channels through which AI could influence fiscal outcomes: 1) mortality rates and the size of the population; 2) the price of health care services; 3) demand for health care services; and 4) aggregate productivity.

Macroeconomic View

The paper notes AI's potential to improve diagnostic accuracy, optimise healthcare delivery, and reduce administrative costs, which may lower overall health expenditures. However, the resulting increase in longevity driven by improved efficacy could counteract cost reductions via both higher social security payments and increased health care utilisation. That is, the cost of medical procedures falls, but more procedures are required per person due to increased longevity.

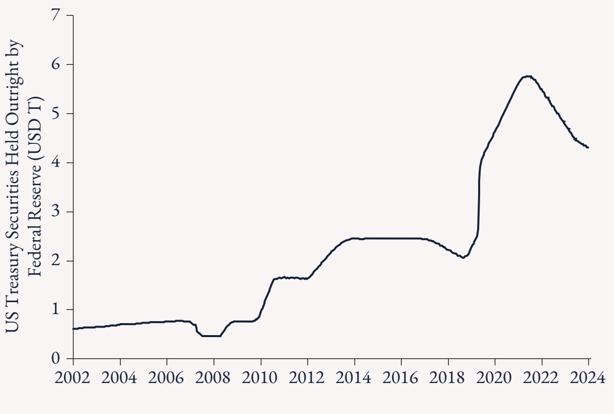
The paper underscores the uncertainty surrounding AI's long-term effects but offers scenarios based on various assumptions. It concludes that AI could reduce annual budget deficits by up to 1.5% of GDP by 2044, largely by enhancing healthcare efficiency and productivity. Conversely, if increased longevity and utilisation outpace cost savings, deficits could rise by 1% of GDP.

Enough fiscal headroom remains to limit the risk of near-term crisis, which also leaves Congress insufficiently motivated to make changes.

The US is not on the brink of a fiscal crisis. The total debt classified as "held by the public" is $28T, roughly the same as nominal GDP in 2024. Of this, $4.3T is held by the Federal Reserve (Exhibit 5 below). This is essentially cost-free debt since the Fed remits excess income to the Treasury. The Fed is reducing its holdings of Treasuries (quantitative tightening) by c. $25B per month, but this is expected to stop in the first half of 2025. I.e., something in the order of $4T in US debt is likely to remain contained on the Fed's balance sheet into perpetuity. Excluding the Fed's holding of Treasuries, US debt is closer to 83% of GDP, leaving sufficient fiscal headroom for current lenders to be confident that they will be repaid.

Exhibit 5

Fed holdings of US Treasury Securities was c. $4.3 trillion as of 31 Dec 2024



Source: Federal Reserve

However, debt cannot rise as a share of GDP indefinitely. At some point it will become impossible to roll the debt over. Debt monetisation of some sort would be needed - tantamount to default through unexpected inflation. There is no academic consensus as to what that tipping point might be. Much depends on the market's perception and confidence of lenders in the prevailing political system. For example, Argentina defaulted in 2001 when debt was just 45% of GDP, whereas Japan continues to operate with low bond yields despite net debts amounting to 150% of GDP.

Our base case assumption is that Congress will avoid unpopular reforms until the electorate is convinced that they are required. This is likely to require market pressure or a specific event. The most promising action-forcing event might be the exhaustion of the combined Social Security trust funds, projected for 2035, and of the Medicare Hospital Insurance trust fund, projected for 2036. Policymakers could address these exhaustions with a combination of revenue increases or spending reductions, although total net debt-to-GDP is expected to be over 120% of GDP by then.

A more near-term catalyst would be simple market forces driving up interest rates, directly impacting the electorate via higher borrowing costs. I.e., markets raise the cost of inaction and allow policymakers to tout deficit reduction as a solution. Examples of this include the UK in 2022 – the infamous Liz Truss budget – or Canada in 1994, when loss of investor confidence in the fiscal situation drove interest rates up nearly 3% in six months. It took a dramatic fiscal plan and two years to bring rates back down.

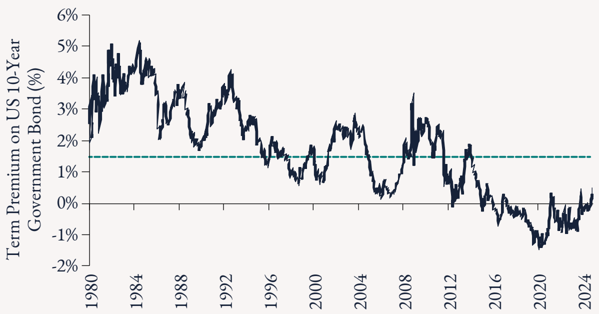
Investment Implications

Higher interest rates

Concerns over long-term debt sustainability would result in higher long-dated bond yields relative to short-dated yields. There have already been signs of this. The New York Federal Reserve's estimate of the 10yr 'term premium' - seen as the compensation investors seek for holding long-term Treasuries to maturity instead of rolling over short-term debt holdings – has risen above 0.5% for the first time since 2014 (Exhibit 6). We expect the term premium to continue to increase as the US fiscal outlook steadily deteriorates.

Exhibit 6

The US 10yr term premium has risen above 0.5% for the first time since 2014



Source: Bloomberg. Federal Reserve Bank of New York.

Crowding out private investment

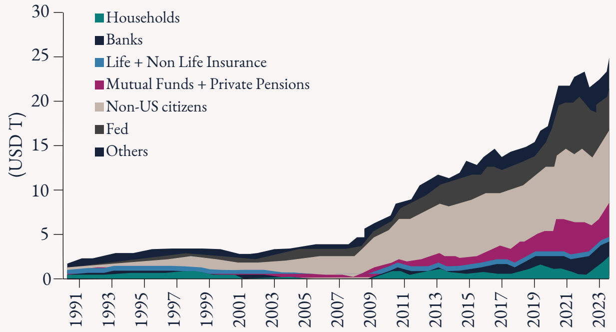
The weight of debt issuance needed to support large budget deficits will soak up savings, keeping yields elevated. This risks crowding out private investment and reducing future GDP growth. In the US, total debt across both private and public sectors is largely unchanged relative to the size of the economy since 2022, with government net debt rising from 93% to 99% while private sector debt (corporates, households, and financials) contracting from 235% to 230%. In short, total debt is unchanged, but the composition is changing.

Wealth transfer to savers and non-US citizens

The federal budget and composition of debt ownership have distributional implications. By 2034, interest payments are expected to rise to 4.1% of GDP or roughly 22% of total government revenues. Non-US citizens hold roughly 23% of total US debt. This may rise if higher deficits require more borrowing from abroad as the proportion of total debt held by the Fed shrinks. Consequently, a large fraction of future GDP will be devoted to repaying non-citizens, thereby reducing US national income. Assuming 25% non-US ownership in 2034, approximately $6 of every $100 of government revenue will be paid to non-US entities via interest.

Exhibit 7

Non-US citizens own nearly a quarter of US debt



Source: Haver, Apollo Chief Economist

Ability to respond to future crisis

Much of the current US debt load is the consequence of the crisis. Specifically, the response to the 2008 Global Financial Crisis, during which debt-to-GDP rose by 35%, and the COVID-19 Pandemic, when debt-to-GDP rose by 20%. The Treasury was able to undertake this large and rapid borrowing due to a combination of existing fiscal headroom and coordinated monetary policy that suppressed interest rates, in turn facilitated by low and falling inflation.

The now elevated debt burden and high existing deficit could leave the government less able to ramp up the borrowing needed to deal with a new crisis, particularly if the crisis was inflationary in nature. Examples might be a major war or natural disaster.

The DOGE barks, but can it bite?

DOGE, the Department of Government Efficiency, was created to advise the executive on reducing wasteful or fraudulent federal spending and eliminating excessive regulations. With guidance from the DOGE, the Trump administration has moved quickly to freeze certain spending and fire government workers, as well as effectively shutting down USAID which has an annual budget of about $40B (0.7% of total government outlays).

Our expectation is that the savings and efficiencies produced by DOGE will not materially alter the existing budget arithmetic. Already, challenges from the other two branches of the federal government - the judiciary and Congress – have sought to constrain DOGE. In February, the White House had to rescind a memo authorising a federal freeze on hundreds of billions of dollars in grants and loans, and a judge issued temporary order restricting access by DOGE to US Treasury payments data.

Ultimately Congress has the power of the purse under the Constitution, and this prerogative is likely to be fiercely defended. Democrats will not agree to a deal to fund the government in which Trump can effectively ignore Congressional spending priorities. They may demand language that makes clear Trump must follow the law and can't unilaterally close billion-dollar agencies funded by Congress. Some Republicans may agree, particularly as Elon Musk has alluded to coming cuts at the Department of Defence, an area in which some Republicans wish to see more spending, not less.

Executive actions: By far, the biggest potential saving would come from identifying and reversing some of the more costly executive orders from the Biden Administration. The Committee of Responsible Federal Budget, a bipartisan think tank, estimates that such action could save c. $1.0T over a 10-year window. Of that, roughly a third stems from reversing Biden's student loan debt cancellation policies, which was expected even without DOGE influence.

Spending: Congress appropriates discretionary spending through the regular annual appropriations process. Appropriations bills require 60 votes in the Senate, which means that any cuts to discretionary spending would require the support of at least seven Senate Democrats. It's also likely that any savings squeezed out of new contracts (e.g., defence) would be ploughed into new projects and purchases rather than used to reduce budget deficits.

Mandatory spending (e.g., entitlement programs) likely offer greater savings opportunities, but these cuts could be the most politically risky. President Trump has promised not to cut Social Security or Medicare, the two largest entitlement programs, constituting 57% of mandatory spending.

Headcount reduction: Federal employment is roughly 2.4 million. Roughly 50% of that sits in the Department of Defence, with a further 10% in the Department of Homeland Security – agencies not typically associated with the creation of regulation. Trimming roughly 100k jobs of the remaining 960k (i.e., a c. 10% reduction) is expected to save roughly $10 billion annually.

Waste: A seemingly obvious source of efficiency, but rooting out waste incurs additional cost. For example, the government is aware of various "improper payments" such as the c. $22B incorrectly paid for Earned Income Tax Credit each year. However, solving this would require a mass audit of low-income families, requiring significant time and effort. It's possible that AI will offer some help here, but that is highly uncertain.

Exhibit 8

What DOGE can and cannot do

What can DOGE do?	What can't DOGE do?
Identify examples of spending to cut, including spending that could be classified as "waste, fraud, and abuse"	Cut discretionary spending without Congressional approval (would require bipartisan support, 60 votes, to pass the Senate)
Lobby Congress to cut spending using DOGE's bully pulpit	Cut mandatory spending or entitlement programs (possible only if approved by Congress by party-line vote in budget reconciliation)
Propose that the President institute a temporary hiring freeze	Audit government agencies and departments (outside of publicly available information)
Propose reduction of government workforce through voluntary buyouts and early retirement packages	Impound or clawback spending without Congress's approval
Propose that OMB reclassify a subset of federal employees as political appointees, which could make them more easily removable (so-called Schedule F)	Restructure government agencies/departments without bipartisan Congressional approval
Propose relocation of departments/agencies or parts of agencies out of Washington to prompt voluntary resignations	Eliminate entire government agencies/departments without bipartisan Congressional approval
Propose early termination of certain government contracts to the extent permitted by law and terms of contacts	Execute a mass reduction in the Federal workforce
Propose disposition of certain government real estate	Rescind regulations or pause enforcement of current regulations outside of the normal legal process
Identify regulations for departments and agencies to review	Suspend or delay payments to government contractors
Propose efficiency improvements to government operations	Update/replace IT systems without new funding from Congress

Source: Barclays Capital

Exhibit 9

Leverage indicators by region across four core borrowing groups

	% of Global GDP	Total				Government				Corporate				Banks				Households			
		Total Debt-to-GDP(%)				Net Gov Debt-to-GDP (%)				Non Financial Corporate Debt-to-GDP (%)				Tier 1 Capital Relation to Risk Weighted Assets (%)				Household Debt-to-GDP (%)			
	2024	2007	2022	2023	2024	2007	2022	2023	2024	2007	2022	2023	2024	2007	2022	2023	2024	2007	2022	2023	2024
US	**26.1%**	**332**	**329**	**328**	**329**	**45**	**93**	**96**	**99**	**70**	**78**	**77**	**76**	**12.1**	**13.6**	**13.9**	**14.3**	**99**	**75**	**74**	**72**
Eurozone	**14.9%**	**296**	**331**	**325**	**329**	**53**	**74**	**73**	**74**	**92**	**101**	**97**	**103**	**7.5**	**16.6**	**17.2**	**17.2**	**60**	**57**	**55**	**53**
Germany	4.3%	287	248	244	262	53	46	45	46	68	73	72	92	8.2	16.6	17.7	17.7	61	55	54	51
France	2.9%	321	448	442	444	58	101	102	104	110	158	153	155	8.2	16.8	17.3	17.3	47	66	65	63
Italy	2.2%	278	304	298	294	96	127	124	127	75	68	66	61	7.0	16.7	16.9	16.9	38	41	40	37
Spain	1.5%	327	307	294	282	22	90	87	85	128	92	85	79	7.6	14.4	14.7	14.7	82	52	50	46
Greece	0.2%	216	443	418	475	103	180	169	159	55	131	121	182	9.4	14.9	16.2	16.2	52	93	90	96
Ireland	0.5%	NA	553	548	547	15	36	35	35	130	56	54	54	9.5	22.4	21.8	21.8	98	45	43	42
Portugal	0.3%	323	369	344	340	61	107	95	90	107	147	134	131	7.0	16.2	17.9	17.9	87	26	25	29
China	**16.8%**	**168**	**254**	**252**	**251**	**29**	**77**	**84**	**90**	**94**	**92**	**86**	**82**	**9.9**	**10.7**	**10.5**	**10.9**	**19**	**61**	**57**	**55**
Japan	**4.0%**	**404**	**527**	**540**	**515**	**94**	**150**	**154**	**156**	**99**	**158**	**166**	**138**	**8.0**	**9.9**	**10.6**	**11.1**	**60**	**61**	**62**	**62**
UK	**3.2%**	**431**	**455**	**453**	**451**	**36**	**90**	**91**	**92**	**81**	**119**	**116**	**117**	**8.2**	**9.0**	**9.6**	**10.7**	**95**	**68**	**68**	**65**
Canada	**2.0%**	**247**	**248**	**241**	**236**	**22**	**16**	**13**	**14**	**81**	**68**	**66**	**63**	**8.5**	**12.0**	**12.2**	**12.8**	**81**	**83**	**81**	**78**
Australia	**1.6%**	**252**	**303**	**303**	**305**	**-7**	**32**	**29**	**30**	**78**	**114**	**116**	**118**	**10.0**	**12.5**	**13.7**	**13.7**	**109**	**103**	**103**	**102**
Major developed economies (GDP-Weighted)	47.7%	331	349	348	347	49	90	92	94	78	93	92	91	10.3	13.5	13.5	13.5	85	70	69	67

Note: The colour code applied reflects a qualitative assessment of the current leverage levels relative to a country's own history. In this way it attempts to account for country specific factors such as the depth of capital markets, industry composition and debt servicing costs.
Source: Bloomberg, Haver, Bank of International Settlements

Q3. What is the Outlook for inflation?

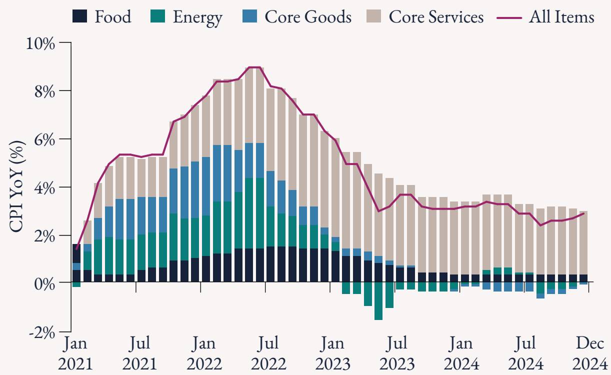
The likely policies of the Trump administration will serve to accelerate many of the inflationary forces of the post-GFC era. These forces include rising fiscal stimulus, protectionism and remilitarisation. The scale and timing of implementation is highly uncertain, but the net effect will be a mix of measures that either stimulate demand (tax cuts and deregulation) or restrict supply (immigration and tariffs). This will bias risks towards more persistent inflation. Energy deregulation may provide some offset over time, but this will accrue gradually and could underwhelm if lower oil prices disincentivise drilling. Our base case assumption for the US is that headline inflation will remain between 2-3%, as moderating wage growth reduces labour costs. However, undocumented workers account for roughly 5% of the US workforce and mass deportation could see wage costs rise sharply. The Pew Research Center estimates that deporting 1.3 million people would increase inflation by 0.5% p.a., even accounting for the resulting drop in demand.

Core US inflation remains stubbornly above 3%

The US Consumer Price Index rose 2.9% over the full calendar year 2024, a gradual moderation from the 3.3% increase in 2023. The year-on-year change in core CPI, which strips out volatile food and energy, was stubbornly close to 3.3% between May and December 2024 as the disinflationary progress largely stalled. In short, core inflation remains closer to 3% than it does to the Federal Reserve's target of 2%, and the recent trend has been sideways, not down (Exhibit 1).

Exhibit 1

Inflation pressures remain high in the services sector

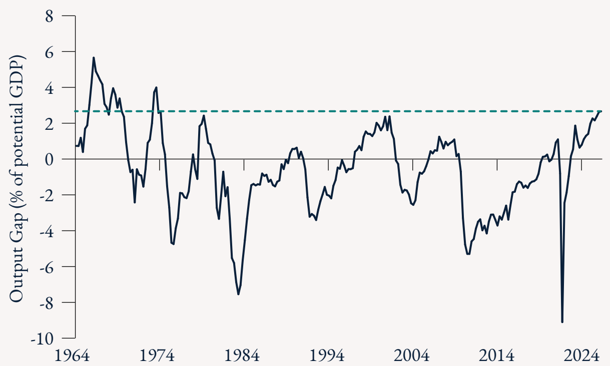


Source: Bloomberg

The reality is that the US economy continues to run hot. Through Q3 2024, growth was 2.6% faster than the CBO's estimate of potential growth - the non-inflationary level of output of an economy given its production resources. This is the highest output gap in over 50 years (Exhibit 2). An economy that is growing above its potential growth for long periods typically triggers inflation unless additional capacity can be added quickly.

Exhibit 2

US output gap is over 2.6%, indicating the economy is expanding at an inflation-inducing rate



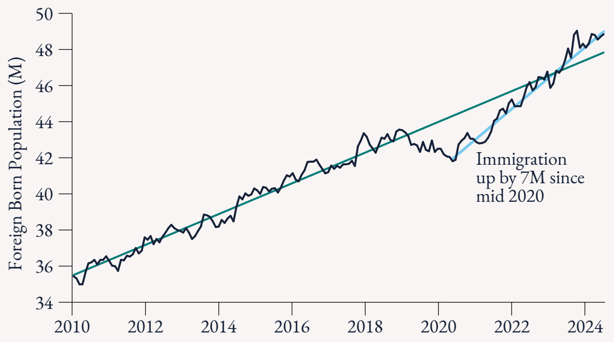
Source: U.S. Bureau of Economic Analysis; U.S. Congressional Budget Office
Notes: Output gap measured as (Real Gross Domestic Product-Real Potential Gross Domestic Product)/Real Potential Gross Domestic Product

Macroeconomic View

In this regard, high net immigration has been the necessary pressure release valve, allowing wage growth to decline even as the economy boomed. The Bureau of Labor Statistics estimates that the foreign-born working-age population has expanded by over 7M people since the pandemic, although this likely understates the true scale of immigration (see Exhibit 3). The CBO estimates that immigration into the US was about 3.3M in 2023 and 2.7M in 2024, leading to rates of population growth of 1.1% YoY and 0.9%, respectively.[1] This is roughly twice as fast as the rate of population growth prior to the pandemic.

Exhibit 3

Immigration has likely limited inflation pressures



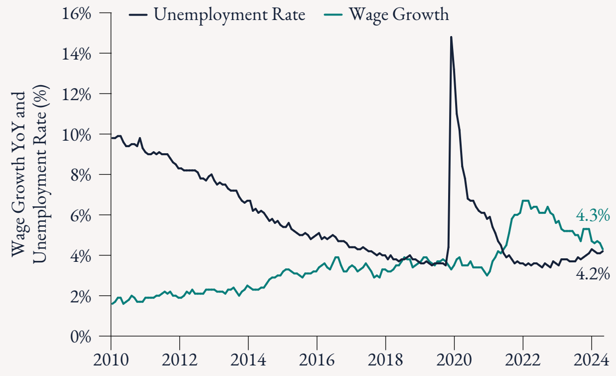
Source: U.S. Bureau of Labor Statistics

As a result, the overall US labour market has eased even as the growth remained high. The unemployment rate was 4.1% at the end of 2024, up from its most recent low of 3.4% in April 2023. Annual wage growth is slowly normalising, declining to 4.3% at the end of 2024 from a recent high of 7% (see Exhibit 4). All while underlying labour market strength remains intact, with data through December showing there were still 1.1 vacancies available per unemployed person. This is particularly important for core inflation, as core services excluding energy and housing - which make up over half of the core indices - are particularly sensitive to labour costs.

For now, wage growth remains somewhat above the pace compatible with target inflation, assuming productivity grows in line with the long-term trend. However, this partly reflects lags in the catch-up of negotiated wages to the earlier price surge. Should wage disinflation continue in 2025, core inflation should gradually decline towards the target.

Exhibit 4

Wage growth has moderated as the labour market becomes more balanced



Notes: 3-month moving average of unweighted median hourly wage growth as per FederalReserve Bank of Atlanta
Source: U.S. Bureau of Labor Statistics

US Government policy likely to be a mix of demand stimulus and supply constraints, which biases inflation higher

The expected policy changes must be viewed in a macro context of already buoyant growth and tight labour markets. Key objectives such as reduced immigration, higher tariffs and lower taxes all bias inflation higher. Deregulation may provide some offset over time, but this is likely to accrue gradually.

Reduced immigration ↑

Trump has demonstrated clear intent regarding immigration. He has declared a national emergency at the US-Mexico border and implemented an indefinite pause to America's refugee resettlement programme. Such measures will slow the flow of immigration. Our base case estimate is that net immigration slows to 750K/year, roughly in line with pre-pandemic levels in Trump's first term. This would represent a substantial slowdown in the labour force expansion that helped support the soft landing.

1 Congressional Budget Office estimates

Exhibit 5

Unauthorised immigrants account for roughly 5% of the workforce

Sector	Civilian Labour Force (in Thousands)				Share of Unauthorised Immigrants	% Change in Sector Labour	
	Total	US Born	Legal Immigrants	Unauthorised Immigrants		1.3M Scenario	8.3M Scenario
Mining	760	670	65	25	3.3%	-0.6%	-3.7%
Agriculture	2,060	1,470	300	300	14.6%	-2.5%	-16.1%
Manufacturing	16,360	13,210	2,200	926	5.7%	-1.0%	-6.3%
Services	143,520	118,930	18,425	6,240	4.3%	-0.8%	-4.8%
Total	**162,700**	**134,280**	**20,990**	**7,491**	**4.6%**	**-0.8%**	**-5.1%**

Source: Pew Research Center

There is significant uncertainty about how far these measures will go. According to the Pew Research Center, undocumented workers account for roughly 5% of the US workforce (see Exhibit 5). Mass deportations of these individuals would face significant legal, logistical and financial challenges but would not be wholly without precedent. In 1955, under President Eisenhower, roughly 1.3M Mexican nationals were rounded up and deported in a short-lived military-style operation named "Operation Wetback".

A mass deportation program today would have the biggest impact on agriculture, where unauthorised migrants are thought to account for roughly 15% of the workforce (Exhibit 5). The Pew Research Center modelled two deportation scenarios.[2] Both span the next three years, but in the first, 1.3M immigrants are deported, and in the second, 8.3M are. Their modelling suggests that even accounting for the offset for the reduction in demand, the cumulative impact on the Consumer Purchasing Index would be an increase of +1.5% and +9.1%, respectively (+0.5% and +3.0% annualised).

2 The International Economic Implications of the Trump Program, McKibbin et al, Sept. 2024

Tariffs ↑

Incremental tariffs on China are likely, while selective tariffs on the rest of the world will probably be more targeted at specific sectors. In such a scenario, inflation would rise modestly by an incremental +0.2% in the US relative to the baseline.

Inflation may prove to be an important guardrail against more extreme tariff outcomes. Republicans are fully aware that a large part of the downfall of the Democrats in 2024 was voter frustration with cost-of-living increases. Even though the rate of inflation had already declined sharply in the last year of the Biden term, overall price levels remained highly elevated compared to 2021. The distinction between inflation rates and price levels is important in the context of trade tariffs. Goldman Sachs has suggested that the tariffs could raise core consumer prices, which exclude food and energy, by as much as 0.9%. Economists argue that the impact of tariffs on prices is a 'one-off' increase – boosting inflation in the first year they are imposed but having little or no inflationary impact in subsequent years. However, voters have long memories, with a tendency to anchor on what they perceive to be 'fair' price levels for key goods and services.

Macroeconomic View

Tax cut extension

We expect the Tax Cuts and Jobs Act (TCJA) introduced by Trump in his first term to be extended. Some additional tax breaks are likely, but an existing budget deficit of over -6% of GDP will limit the government's fiscal options, particularly given the very slender majority in Congress. Maintaining existing policy does not provide a meaningful fiscal impulse or inflationary boost.

Deregulation

Hopes for a massive US energy boom are likely misplaced. Rystad Energy and Wood Mackenzie, energy-focused analytics firms, estimate that total US oil output in Trump's second term will rise by less than 1.3M barrels a day, well below the 1.9M b/d rise achieved under Joe Biden or the 3M b/d targeted by Scott Besset. Trump seeks to reduce inflation through lower oil prices, but oil companies are profit-motivated and simple economics will determine the degree to which they drill. A recent Kansas City Federal Reserve survey found that the average US oil price needed for a substantial increase in drilling was $84/barrel, versus the $65-$75/barrel range oil has largely traded in since September.

The oil price may decline significantly for other reasons. For example, Trump may manage to strike a deal with OPEC to increase production, or a truce may be struck between Russia and Ukraine that allows Russian oil to flow back onto global markets. Any material decline in inflation would help bring inflation closer to the Fed's target.

China's deflation

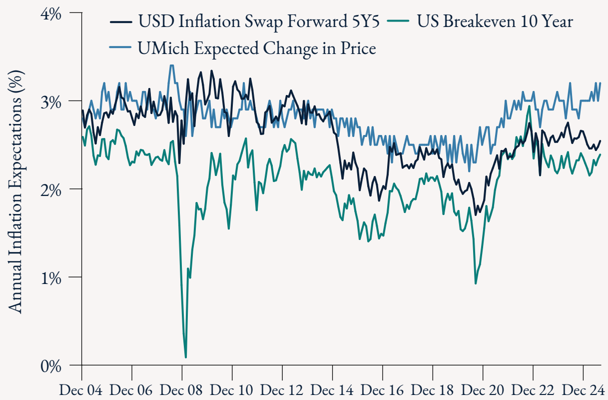
China continues to face major macroeconomic challenges, including the deleveraging of the property sector and local government financing vehicles. Annual inflation in 2024 was just 0.2%, underscoring the country's mounting deflation risks despite government stimulus measures and the central bank's supportive monetary policy stance. If China seeks to devalue the currency to stimulate the economy or offset the impact of potential US tariffs, it would transmit a degree of deflationary pressure to the rest of the world via low-cost manufactured exports.

Market pricing and scenarios

Long-term inflation expectations remain well anchored (Exhibit 6). The 10-year breakeven rate, a measure of inflation expectations priced into 10yr US TIPS, was 2.4% in early January. The five-year forward five-year inflation swap, a measure of inflation expectations used by the Fed, ended 2024 at 2.5%. The Michigan survey of consumers' five-year inflation outlook showed a small rise to 3.3% as of February 2025, up from 3.0% in December. This largely lines up with our baseline scenario, as outlined in Exhibit 7.

Exhibit 6

Long-term inflation expectations remain anchored



Source: Bloomberg

Exhibit 7

Expected inflation in 2025 by scenario

	'Tariff Wars Lead to Recession'	'Resilient Global Growth with Regional Divergences'	"Broad-based Expansion"
Scenario	20%	60%	20%
US CPI	2.0%	2.7%	3.0%

Source: Partners Capital Analysis

Q4. What is the most likely path for interest rates?

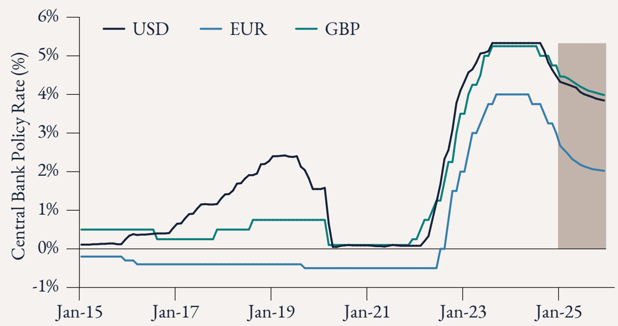
Central banks broadly remain in easing mode but their ability to bring down interest rates will be constrained by persistently above-target inflation and widening fiscal deficits, particularly in the US. Bond yields will likely not be able to fully match any decline in short-term interest rates given rising deficits. The US Federal Reserve is expected to reduce interest rates by c. 0.4% to 3.9% in 2025. Other central banks, particularly in Europe, may have more scope to ease given slower economic growth. Japan is the only major economy likely to continue tightening policy. Moreover, if central banks are perceived as overly accommodative in response to sustained inflation, longer-dated bond yields will rise, and the yield curve will further steepen. The fiscal positions are generally precarious, with the US budget deficit expected to average 5.8% of GDP annually over the next 10 years. We forecast a 10yr US Treasury yield of 4.5% by year-end 2025 in our baseline scenario, 3.5% in a trade-war-induced economic slowdown and 5.25% in a broad-based economic expansion.

Expectations of monetary policy easing in 2025 have been pared back

The upper band of the US Fed Funds Rate was reduced from 5.5% to 4.5% in 2024. Based on forward market pricing, further cuts totalling -0.4% are expected in 2025 (Exhibit 1). This represents a significant downgrade in the market's cumulative easing expectations. As recently as September, the market had expected the Fed Funds Rate to reach 3% by June 2025, or cumulative cuts of 2.5% from the recent high. In their December economic projections, the Federal Reserve scaled back the rate cuts expected in 2025 to -0.5%, down from the -1.0% projected in September. The change was attributed to persistent inflation pressures and uncertainty regarding the future policy-related inflation pressures of the Trump presidency.

Exhibit 1

Policy rates are expected to be reduced further in 2025



Source: Bloomberg, data as of 31 Jan 2025

The risks to inflation and rates continue to be skewed to the upside as Trump's policy mix is likely to either restrict supply (tariffs and immigration) or boost demand (tax cuts).

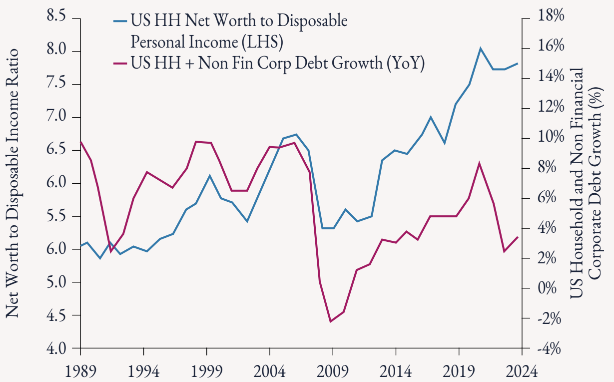
Macroeconomic View

The risk of an over-heating US cycle is under-priced

Outside of government policy, the US is seeing an asset price boom with house prices and equity values rising. This partially reflects the impact of an accommodative shift in monetary policy and high fiscal spending. As a result, US household net worth-to-income ratios are at extraordinarily high levels. However, private sector re-leveraging remains muted (Exhibit 2). There is a credible risk that if the Federal Reserve continues cutting interest rates it could spark a credit cycle, further fuelling this upward momentum as higher borrowing drives higher asset prices, increasing collateral value, which begets more borrowing.

Exhibit 2

Household net worth has surged, but private-sector debt growth has been tepid

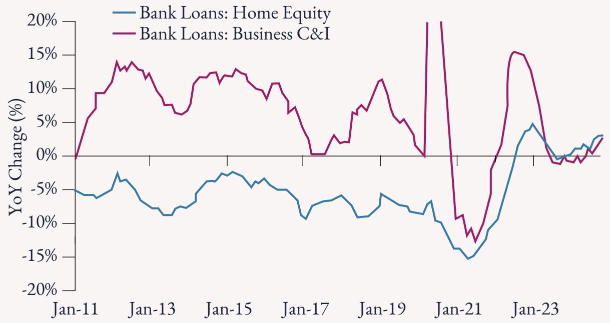


Source: Deutsche Bank

Potential catalysts for a significant private sector re-leveraging include easing government regulations and lighter antitrust laws under Trump, which could spur M&A and LBO-related financing. Amongst US households, tappable home equity (the amount available to withdraw while maintaining a 20% equity cushion) is now $11.5T. If US homeowners start tapping their substantial home equity buffers for additional spending, the risk of a more hawkish Fed will grow considerably. There are very early signs of a pickup in the credit cycle as YoY changes in US bank commercial and industrial loans and home equity loans are starting to rise (Exhibit 3).

Exhibit 3

Early signs of a pickup in business and home loans



Source: Deutsche Bank, Bloomberg

Longer-dated bond yields are likely to rise relative to short-dated bonds

The US Treasury yield curve has steepened but remains flat relative to history (Exhibit 4), with a spread of 0.35% between the 10yr and 2yr US Treasury bond. If the Federal Reserve is deemed to have an overly dovish reaction function or investors lose confidence in the US fiscal outlook, the curve will steepen further. Alternatively, if there is a growth shock or material drop in inflation, most likely from lower oil prices, then the curve may flatten. Our read of the current economic backdrop is that the former is more likely than the latter.

Exhibit 4

US Treasury Curve remains flat relative to history

Source: Deutsche Bank, Bloomberg

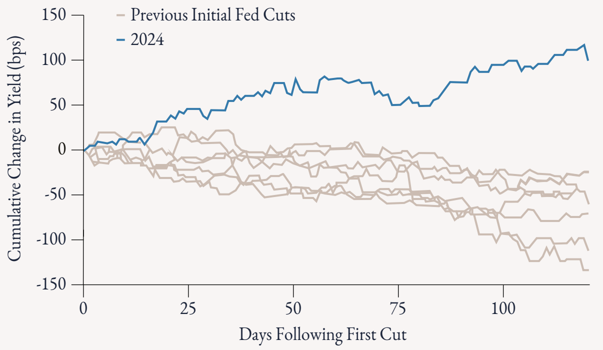
Scenario 1: The reluctant Fed – curve steepens

This easing cycle is already unusual. In all seven previous Fed cutting cycles going back to the 1980s, the 10yr US Treasury yield drifted lower over the 100 days immediately following the initial rate cut. In the current cycle, the 10yr US Treasury yield has actually increased by over +1% since September (Exhibit 5).

The key measure to monitor will be long-term inflation expectations. If inflation expectations start to move higher, the Fed may be compelled to act.

Exhibit 5

Change in 10-year yield following initial Fed cut



Source: JP Morgan, Bloomberg, data as of 31 Jan 2025

Scenario 2: Fiscal fears – curve steepens

The US fiscal position is precarious. As discussed in the fiscal chapter, US net debt-to-GDP is expected reach 100% this year and grow relative to the size of the economy by roughly 2-3% per annum thereafter. A phased fiscal adjustment of c. 2-2.5% of GDP p.a. is needed just to stabilise the debt trajectory.

Our base case outlook is that the fiscal situation will worsen before it improves. As a result, net issuance of government bonds in 2025 is expected to remain heavy. Exhibit 6 compares the pace of net issuance of conventional bonds (excluding T-bills, ILBs, and FRNs), central bank QT, net issuance after QT, and gross duration supply. Overall, $2.6T of net issuance is expected in 2025.

Exhibit 6

Net government bond issuance is expected to slow in 2025, but remain high from an historical perspective

	$B						$B 10yr UST	
	Net Conv. issuance		Central Bank QT		Net after QT		Gross duration	
	2025F	2024	2025F	2024	2025F	2024	2025F	2024
US	1,874	1,904	75	454	1,949	2,358	2,886	2,804
Euro Area	455	496	323	206	778	702	1,095	1,160
Japan	149	223	197	38	346	261	152	141
UK	98	175	23	31	121	206	255	271
Australia	6	-2	25	20	31	18	69	60
New Zealand	9	19	6	6	15	24	30	41
Sweden	1	6	5	5	6	11	161	116
Norway	4	3	0	0	4	3	60	62
Total	2,596	2,823	655	761	3,251	3,584	4,688	4,655

* FX rates used: EUR: 1.027; JPY: 0.0063; UK: 1.223; AUD: 0.620; NZD: 0.563; SEK: 089; NOK 0.088

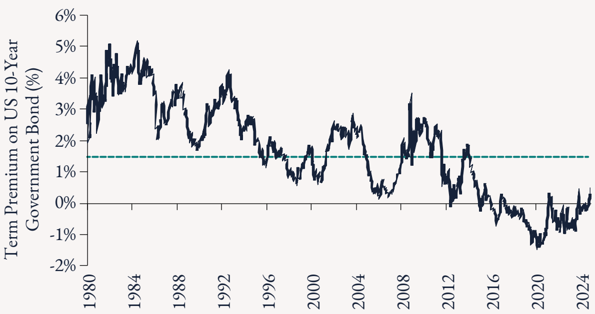
Macroeconomic View

The main consequences of this are: 1) interest rates will remain elevated as government debt issuance absorbs savings; 2) the term premium on longer-dated bonds will rise; and 3) large deficits and higher interest rates will crowd out private investment, which will reduce long-term potential growth.

Growing concerns over long-term debt sustainability would result in a higher spread between long-dated and short-dated yields. There have already been signs of this. The New York Federal Reserve's estimate of the 10yr 'term premium' - seen as the compensation investors seek for holding long-term Treasuries to maturity instead of rolling over short-term debt holdings – has risen above 0.5% for the first time since 2014 (Exhibit 7). We expect the term premium to continue to increase as the US fiscal outlook steadily deteriorates.

Exhibit 7

The US 10yr term premium has risen above 0.5% for the first time since 2014



Source: Bloomberg. Federal Reserve Bank of New York.

Scenario 3: Disinflationary surprise - curve flattens

A disinflationary surprise is possible. Likely catalysts might include a sharp drop in the oil price resulting from deregulation of the US energy sector, a deal between Trump and OPEC to increase production and lower prices, or a negotiated truce between Ukraine and Russia that allows some lifting of sanctions and allows Russian oil to flow into Europe again.

Corporate earnings may also disappoint relative to elevated expectations. If equity prices decline, a negative wealth effect may lead to a pullback in consumer spending and rising redundancies.

Implications for Treasury Yields - cross-checking models

As in previous years, we refresh our suite of models for cross-checking estimates for fair value on US 10yr yields (Exhibit 7).

Exhibit 8

Various models support a 10yr yield of c. 4-4.5%

US Yield Model	Base Case Inputs	Implied 10yr Yield
1. Term Premium Model	Risk-neutral 10yr yield (4.0%) + assumed long-term premium (0.5%)	4.5%
2. Inflation plus Real Returns Equilibrium Model	Long-term inflation expectation (2-2.5%) + normative real yield (2.0%)	4-4.5%
3. Yield Compensation for Nominal GDP Growth	Expected long-term real GDP growth (2.0%) + Inflation expectation (2-2.5%)	4-4.5%
4. Forward Curve	10yr Forward Curve	4.7%
5. Japanese Bond and US Treasuries Yields Spread Model	10yr JGB 1yr Forward 1.0% + 2.5% average spread	4.5%
Likely Base Case Scenario Range		**4-4.5%**

Source: Partners Capital Analysis

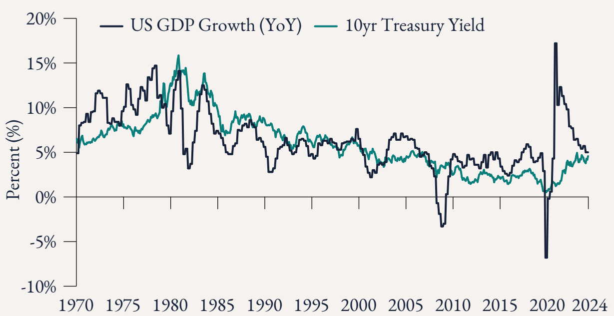
1. **Term premium model**: This takes the expected short-term rates (reflecting anticipated rises into the next 10 years) and compounds the return from investing in those rates over 10 years (risk neutral 10yr yield published by the Fed), then adds an estimate of the term premium. The estimated risk-neutral 10yr yield published by the Fed was 4.0% as of 31 December. If we assume the term premium rises to 0.75%, i.e., halfway back to the long-term average of 1.5%, then the combination of the two arrives at the 4.75% yield estimate.

2. **Inflation plus real returns equilibrium**: Bond investors typically demand a certain level of return above inflation for taking duration risk. The real yield on TIPS (i.e., 10yr yield less inflation expectations) averaged 2.7% prior to the start of QE by the Fed. This dropped to nearly zero over the last decade as the Fed expanded its balance sheet. More recently, the real yield has hovered around 2.0% since November 2022. Under the assumption that this level is sustained, adding 2.0% to our long-term inflation expectation of 2-2.5%, would put nominal yields around 4-4.5%.

3. **Nominal GDP**: At a minimum, price sensitive investors lending to the government should expect to preserve spending power relative to total economic output, meaning that the yield on a bond should roughly match the expected nominal growth over the period. Data suggests there is a loose relationship between yields and nominal growth (Exhibit 9). If real US growth reverts to c. 2% and inflation settles at c. 2-2.5%, it again suggests a fair value US Treasury yield of 4-4.5%.

Exhibit 9

Historically the 10yr yield and nominal GDP growth have been well correlated

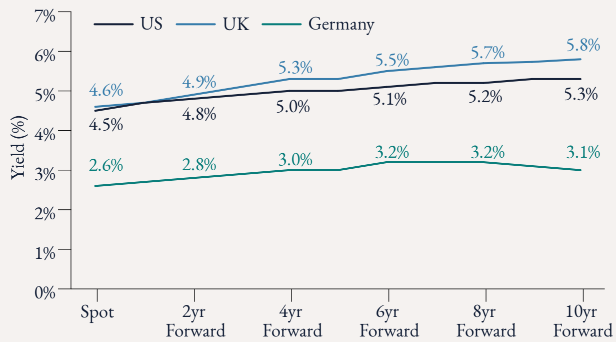


Source: Bloomberg, data as of 31 Jan 2025

4. **Forward curve pricing:** The forward curve (as at end of January) suggests 10yr US Treasury yields will gradually rise from 4.6% to 5.0% over the next 5 years, and to 5.3% in 10 years' time (Exhibit 10).

Exhibit 10

10yr Forward Yield Curve

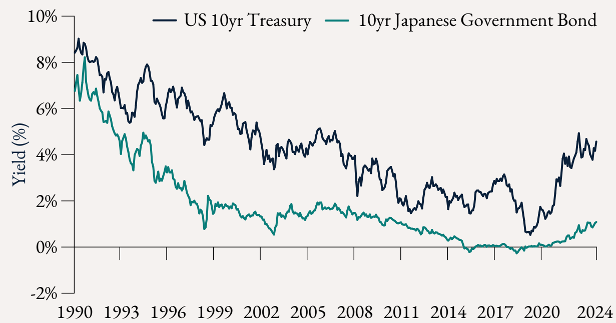


Source: Bloomberg, data as of 31 Jan 2025

5. **Japanese Bond Yields:** The Bank of Japan (BoJ) has begun to normalise policy, including ending negative interest rates and reducing asset purchases. The prospect of higher bond yields in Japan is leading to a repatriation of funds by Japanese investors, particularly as FX hedging costs are expensive. The spread between 10yr US Treasury yields is currently 3.5% compared to an average of 2.5% (Exhibit 11). If we assume the Japanese 10yr yield rises to 2.0% and the spread reverts to the average, it implies a 10yr US Treasury yield of c 4.5%.

Exhibit 11

Japanese bond yields may keep DM yields anchored



Source: Bloomberg, data as of 31 Jan 2025

Exhibit 12

Expected yields by our macro scenarios

Region	Metric (as of end of 2025)	Scenario: 'Tariff Wars lead to Recession'	Scenario: Resilient Global Growth with Regional Divergences	Scenario: 'Broad-based Expansion'
US	Inflation	2.0%	2.7%	3.0%
	Central Bank Rate	3.3%	4.0%	4.5%
	10yr Yield	3.5%	4.5%	5.3%
Euro	Inflation	1.5%	2.1%	2.5%
	Central Bank Rate	0.8%	2.0%	2.5%
	10yr Yield	1.3%	2.3%	2.8%
UK	Inflation	2.0%	2.6%	3.3%
	Central Bank Rate	2.5%	4.0%	4.5%
	10yr Yield	3.3%	4.5%	5.3%

Source: Partners Capital Analysis

Hypothetical return expectations are based on simulations with forward-looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance.

Q5. What is the Outlook for Liquid Credit?

Corporate credit fundamentals deteriorated modestly in 2024 but remain solid. The par-weighted default rate in high-yield bonds was just 1.5% in 2024, including distressed exchanges.[1] Loan defaults were higher at 4.5%, reflecting greater sensitivity to higher interest rates and the index's lower rating quality. Across high-yield and loans, default rates are expected to remain contained in 2025 given the favourable backdrop of firm global growth, cooling inflation, elevated corporate profit margins, loose US fiscal policy, and industry deregulation under the Trump administration. This optimistic outlook is reflected in the price, with credit spreads close to all-time lows.

High base rates mean that all-in yields remain elevated compared to most of the last decade, but with tight spreads, there are risks of higher yields in both the economic upside and downside scenarios. In an upside scenario, whereby deregulation and high corporate cash balances ignite investment and deal activity, yields will likely rise due to higher inflation risks, tighter than expected monetary policy and a surge in issuance from pent-up M&A and LBO activity. Floating-rate loans would likely outperform high-yield bonds in such an environment, while IG credit will perform poorly due to the duration impact.

In the downside scenario of a growth slowdown - most likely resulting from a tit-for-tat trade war, weaker labour markets and falling consumer spending - the need for a higher risk premium will push spreads wider. Falling Treasury yields will help reduce losses for those assets with duration exposure. In such an environment, IG credit should perform reasonably well, while the losses on high-yield bonds will be less bad than those on loan portfolios.

The following section assesses the interplay of public credit markets and our macroeconomic scenarios, with a focus on passive beta returns relative to equities and possible systemic risks. For a detailed explanation of recommended positioning in credit, please see the chapters on Liquid Credit and Private Debt in the Asset Class Investment Strategy section of this publication.

Review of Credit Market Fundamentals[2]

Corporate credit metrics remain healthy. Overall leverage levels are low relative to history, and strong earnings growth has led to increased cash balances relative to debts. However, median interest coverage ratios have declined (Exhibit 1), reflecting the reissuing of debt at higher coupons. This trend is likely to continue in 2025 as the index yield-to-worst remains above the median coupon rate on outstanding debt. The severity of the decline in coverage varies across industries but is not yet a concern at an overall level.

Investment grade: Modest weakening in interest coverage ratio to 10.3x compared to 11.4x a year earlier. Cash-to-debt ratio has increased by 1.2% over the past 12 months to 19.4% as issuers continue to build up cash balances. This may suggest scope for a pick-up in buybacks or capital expenditure amongst IG issuers in 2025. For the IG universe, the median profit margin rose to a record high of 11.8% as firms managed to increase selling prices while controlling wage gains and non-labour costs.

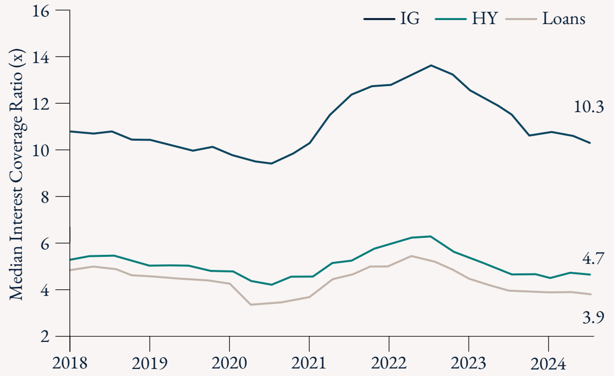
High-Yield: Robust earnings have kept leverage and coverage metrics stable over the last 12 months. High-yield interest coverage was 4.7x with leverage net of cash of 2.9x. Balance sheet cash rose over the year, with the cash-to-debt ratio increasing to 11.2%. Across ratings, the improvements in financial metrics were more notable among lower-quality credits.

Loans: The median interest coverage ratio dipped to 3.9x, but loan companies saw strengthening liquidity profiles with cash-to-debt up to 14.3%, the highest in over two years. Strong earnings have pushed the median free cash flow-to-debt ratio to a record high and an easing of monetary policy saw the growth in interest expenses slow significantly.

1 JP Morgan Default Monitor, Jan 2025
2 All data shown here is for US corporate credit and calculated using earnings reports through to the end of Q3 2024. Sourced from Bloomberg, ICE, S&P and Morgan Stanley

Exhibit 1

Median Interest Coverage Ratios through Q3 2024



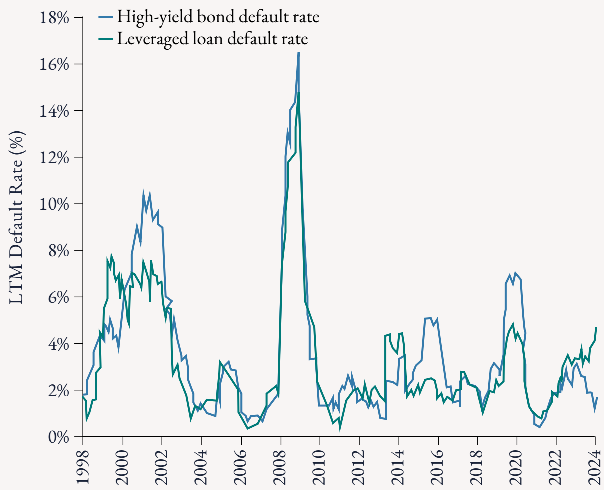
Source: Morgan Stanley Research

Why are default rates expected to remain low?

In corporate high-yield, the trailing 12-month bond default rate steadily declined to 1.5% during 2024 (par weighted, including distressed exchanges), while the default rate on loans increased over the year to 4.5% (Exhibit 2). Excluding distressed exchanges, these figures drop to 0.4% for bonds and 1.5% for loans.

Exhibit 2

High-yield bond default rates have fallen while loan default rates have increased

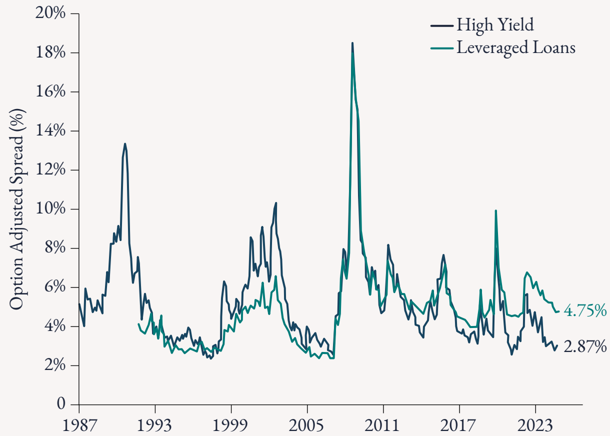


Source: JP Morgan, data through 31 December 2024

The higher default rate on loans is largely explained by the weaker credit profile. Only 17% of the leveraged loan universe is rated at or above BB compared to 51% for the high-yield index. There is also a lack of covenant protection in loans. According to S&P Global, since the mid-2000s, the percentage of covenant-lite loans has increased from approximately 25% to over 90% today. To compensate for this risk, the Leveraged Loan Index has an incremental spread of nearly 2.0% over bonds (Exhibit 3), and as a result, despite higher default rates in 2024, the Leveraged Loan Index outperformed the US High-Yield Index over the calendar year, rising +9.1% vs. +8.2%.

Exhibit 3

Loans offer a higher yield spread than bonds to compensate for higher risk



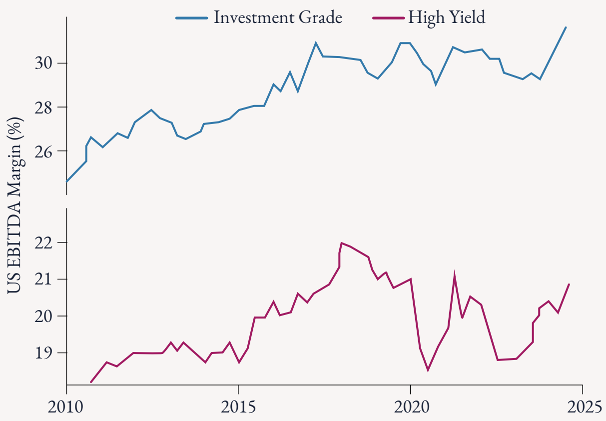
Source: Bloomberg, data through 31 Dec 2024

1. Nominal growth is firm, inflation is cooling, profit margins are high

Global economic growth is underpinned by resilient labour markets and moderating inflation. In the US, deregulation and reduced taxation are on the political agenda. Even without this, the EBITDA margins for both investment-grade and sub-investment-grade issuers continue to rise. Companies have managed to increase prices while controlling costs, as shown in Exhibit 4. This is expected to continue, with the Bloomberg consensus estimates calling for further improvement in sales, earnings, and EBITDA margins in 2025 compared with 2024 in most regions.

Exhibit 4

Profit margins are high and rising

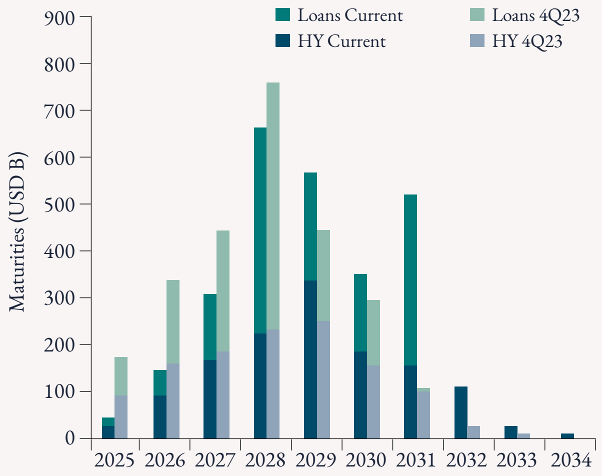


Source: Bloomberg, Alpine Macro, data through Q3 2024

2. The maturity walls have been addressed
Favorable credit conditions in 2024 enabled companies to extend maturities, easing short-term liquidity pressures for many lower-rated issuers. Less than 10% of the High-Yield Bond Index and 4% of the Leveraged Loan Index matures in 2025, and over half of that is rated BB, where refinancing should not cause any issues (see Exhibit 5).

Exhibit 5

The maturity profiles of both HY and Loans have improved relative to Q4 2023

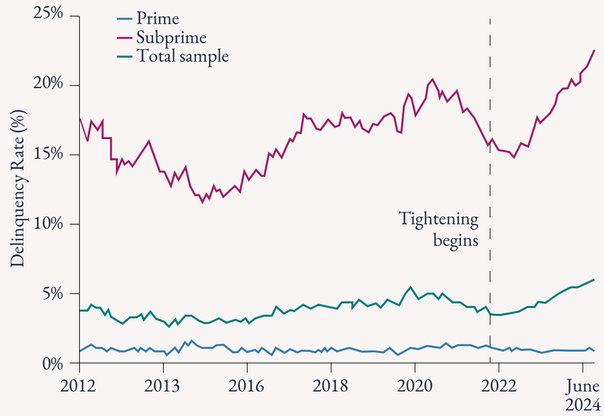


Source: Bloomberg, Alpine Macro, data through Q3 2024

3. Credit card delinquencies are low and stable outside of subprime
Credit card delinquency rates have risen, but so far, this is heavily concentrated among subprime borrowers. Exhibit 6 shows that subprime delinquency rates have risen to 22.5% as of September 2024, up 5.6% since the Federal Reserve began tightening. Meanwhile, delinquency rates are largely unchanged for prime borrowers over this period. Subprime makes up 23% percent of the total consumer credit market.

Exhibit 6

Credit card delinquency rates show signs of stress in subprime credits, but not prime



Note: Rates are weighted by outstanding credit card balance.
Source: Board of Governors of the Federal Reserve System

Watching trends in consumer delinquencies will be imperative to maintaining a good handle on credit markets. Reasons for optimism currently are that:

a. Revolving balances (the percentage of credit card balances rolled into the following pay period and thus carry interest) for prime and subprime borrowers remain below their pre-pandemic levels. Stable revolving balances suggest households are not rolling over additional credit card debt, and so remain able to pay off balances.

b. Internal bank forecasts of subprime defaults typically lead delinquencies by 12-18 months. These bank forecasts have remained stable since the first quarter of 2023, suggesting banks see few signs of further credit deterioration and charge-offs amongst their customers.

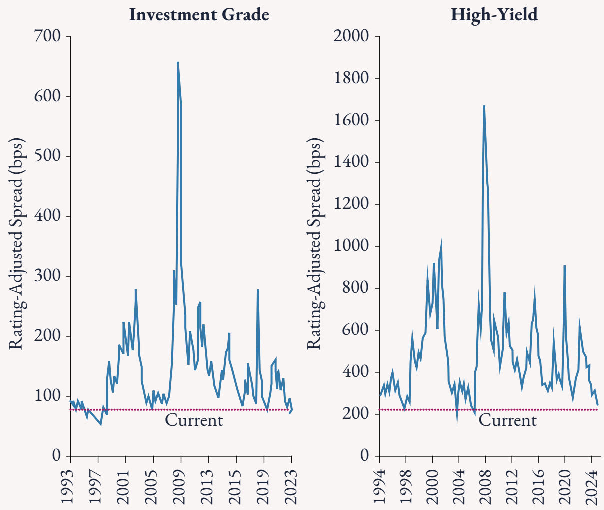
Macroeconomic View

Valuations are rich, increasing downside risk

The solid fundamentals and expectation of low defaults have resulted in exceptionally tight spreads. Adjusting the historical index spread of IG and HY for their current ratings mix shows that the IG spread of 0.78% (as of 31 December 2024) is the tightest since 1998 and the HY spread of 2.6% is the tightest since 2007 (Exhibit 7).

Exhibit 7

Adjusting for today's ratings, spreads are the tightest since May 1998 & May 2007



Source: Deutsche Bank, Bloomberg, data as of 31 December 2024

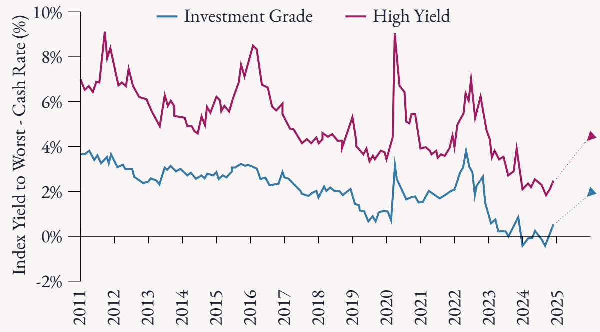
Expensive valuations limit the potential for excess returns over the risk-free rate and increase the risk of loss in a downturn. That is to say, the risks in credit are negatively asymmetric. Despite the tight spreads, the overall yield of 5.5% on IG and 7.5% on the HY Index as of 31 December 2024 is still high relative to history, even if most of this return is derived from the risk-free rate, with the 5yr US Treasury offering a yield of 4.4%.

Whether current valuations are justified will depend on the evolution of Fed policy

The gap between credit yields and cash yields has demonstrated a tendency to revert to the mean over time. If the Fed cuts rates to 3-3.25%, then this spread can revert with little change to current credit yields. However, if the Fed stops cutting at 4%, then yields may need to rise by 100-150bps from here to normalise the spread over cash rates (Exhibit 8). Our base case macro scenario is that the Federal Reserve will ease policy by less than is generally expected, which will likely translate into higher credit yield.

Exhibit 8

Spread over cash yield could potentially normalise by cash rates falling, or credit yields rising



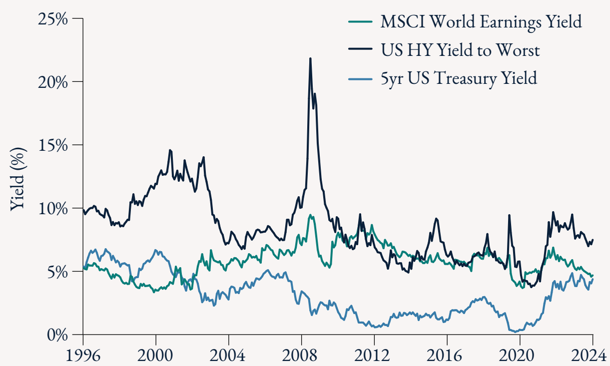
Source: Deutsche Bank

Credit alternatives are also expensive

Credit valuations must be viewed relative to the alternatives, and equity market valuations are also richly priced. The MSCI World earnings yield (the inverse of the forward P/E ratio) was just 4.7% as of 31 December 2024, close to the 5yr US Treasury yield of 4.4% (see Exhibit 9). Clearly, sector composition affects the historical comparison of equity valuations given the increasing index weight of tech companies with high margins and low fixed costs, but at these valuations, equity investors are relying on the delivery of strong earnings growth to drive returns. The last time equities earnings yield and 5yr US Treasury yield converged was in the late 90s dot-com boom, when earnings growth forecasts became excessive.

Exhibit 9

Equity earnings yield is now similar to the 5yr US Treasury yield



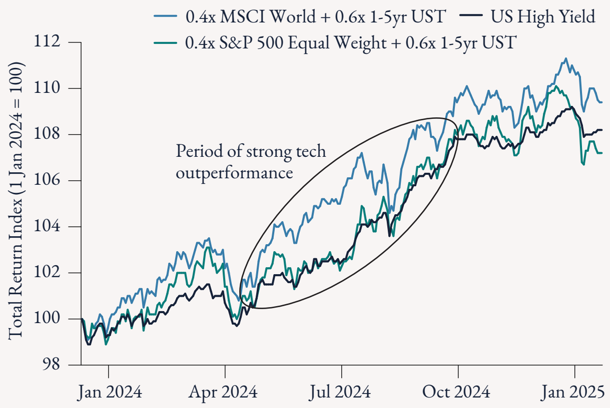
Source: Bloomberg

There is an intuitive argument that credit and equity risk premia should be smaller when the risk-free rate is higher; the higher risk-free rate leaves more room for counter-cyclical monetary policy, which in turn helps stabilise the financial system.

In this regard, the beta rally in high-yield credit and equities in 2024 was consistent with a proportionate contraction in risk premia across both asset classes. Specifically, the US High Yield Credit Index rose +8.2% and moved in step with a 40/60 equity/bond benchmark comprised of the S&P500 Equal Weight Index and the 1-5yr US Treasury Index. This lagged a 40/60 equity/bond benchmark comprised of the market cap weighted MSCI World Index, which benefitted from a sizable allocation to high-growth large-cap tech stocks and so rose +9.4% in 2024 (Exhibit 10).

Exhibit 10

High-Yield Credit largely tracked a 40/60 equity/bond benchmark in 2024



Source: Bloomberg

Herein lies an additional risk to high-yield credit. The US High-Yield Index has no direct exposure to the so-called "Magnificent 7" mega-cap tech companies. Indeed, the High Yield Index has only a 7.5% weighting to the IT sector, compared to 26.2% for the MSCI World Index. Should tech stocks continue to outperform the broad equity market by virtue of higher-than-expected earnings growth, high-yield credit will not participate in the rally and so will lag its equity beta benchmark.

Key Risks & Scenario Analysis

Our base-case macro and policy outlook is generally positive for credit spreads. Profit growth is expected to be robust, fiscal policy will remain loose and deregulation is expected under the Trump administration. However, sub-investment grade yields are likely biased higher in both an economic upside and downside scenario.

In an upside scenario, whereby deregulation and high corporate cash balances ignite investment and deal activity, yields will likely rise due to higher inflation risks, tighter-than-expected monetary policy and a surge in issuance from pent-up M&A and LBO activity. There is little scope for further tightening of spreads to offset this rise in yields. For investors, floating-rate loans will likely outperform high-yield bonds in such an environment, but this will be checked by the potential for more defaults within loans as a higher-for-longer rate environment tests the resilience of some companies. IG credit will perform poorly in this environment due to the duration impact.

In the downside scenario of a growth slowdown - most likely resulting from a tit-for-tat trade war, weakening labour markets and falling consumer spending - the need for a higher risk premium will push spreads wider. Falling US Treasury yields will help reduce losses for those assets with duration exposure. In such an environment, IG credit should perform reasonably well, while the losses on high-yield bonds will be less bad than those on loan portfolios.

Exhibit 11

Liquid Credit Scenario Analysis

		Economic Scenarios		
	31 Jan 2025	Downside	Base Case	Upside
Scenario		Tariffs and trade wars trigger slow down as private consumption falls.	Macro picture remains solid. Growth remains firm, inflation continues to moderate slowly.	Deregulation ignites animal sprits. No Fed cuts. Much more issuance due to M&A and LBOs.
Credit Beta Performance		IG > HY > Loans	HY = Loans > IG	Loans > HY > IG
IG Spread	0.78%	1.5%	0.8%	0.6%
HY Spread	2.61%	6.5%	2.8%	2.3%
Loan Spread	4.52%	8.5%	4.7%	4.0%

Macroeconomic View

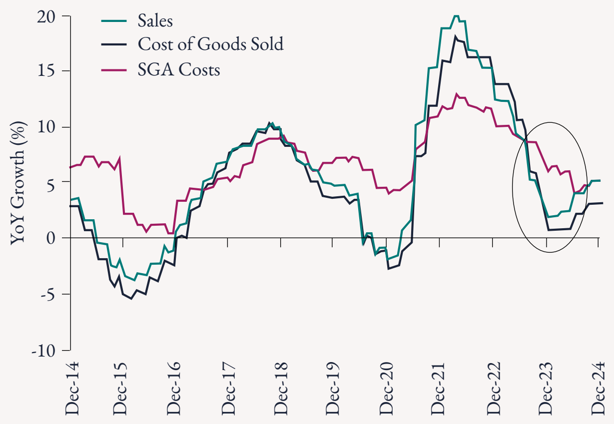
Q6. What is the outlook for Equities?

Earnings delivery will be the key determinant of equity market performance in 2025. Strong earnings growth is anticipated to drive high single-digit returns. Above trend nominal economic growth (real + inflation) will likely support revenue growth. Hence, profit margin maintenance will be critical. However, the path to those returns is unlikely to be smooth. While elevated valuations have little to no predictive power for 12-month returns, they raise the probability of market drawdowns. The new administration will present no shortage of potential catalysts for volatility.

Earnings. S&P 500 earnings growth is expected to accelerate to +11% in 2025, relative to a historical average of c. +8%.[1] This is a function of +5% revenue growth, in line with forecasts for US nominal GDP growth, and +0.75% of margin expansion. While a significant proportion of the margin expansion is expected to come from the Magnificent 7 (c. 30% of the S&P 500) due to their high operating leverage, every sector, with the exception of real estate, is forecast to see margins expand in 2025.[2] This expansion will likely be driven by a decline in the growth of input costs relative to sales revenue for the S&P 500, as shown in Exhibit 1.

Exhibit 1

The S&P 500 (ex-financials) is expected to see margin expansion as sales grow faster than input costs, reversing the trend from 2023/2024

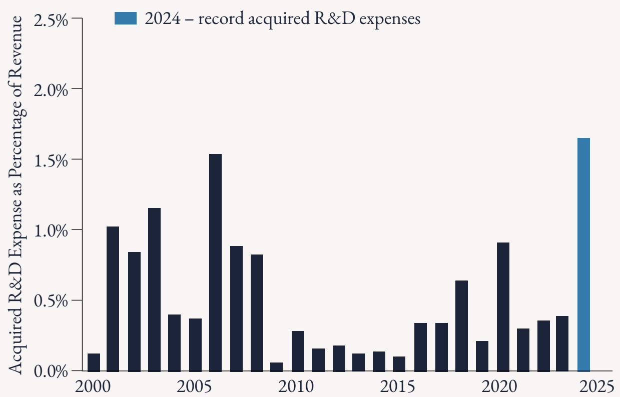


Source: SocGen

Healthcare and semiconductors, which represent just 20% of the S&P 500's market cap, are expected to contribute just shy of 50% of earnings growth in 2025. In the healthcare sector, earnings growth is expected to rise +17%. This is a result of a sharp fall in costs associated with M&A which reached a record level in 2024 (Exhibit 2).[3] The acceleration in semiconductor earnings growth is expected to be powered by PC and mobile sales. The c. 650M PCs (+40% higher than average) that were purchased during 2020/2021 to facilitate working from home will have reached the end of their replacement cycle (average depreciation time 3-5 years).[4]

Exhibit 2

A decline in costs associated with M&A is expected to lead to strong growth in healthcare earnings



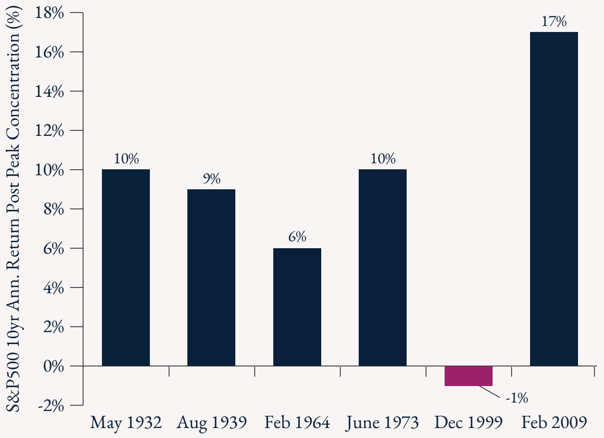
Source: Goldman Sachs

1 Bloomberg, Goldman Sachs, Morgan Stanley, Deutsche Bank
2 FactSet
3 Goldman Sachs
4 IDC Global

Valuations and concentration. The S&P 500 trades at a forward PE multiple of 22x[5](93rd percentile historically). While analysts note that valuations above the 90th percentile raise the probability of a >10% drawdown in a calendar year to 80% (vs a 20% unconditional probability) their predictive power for 12-month returns is negligible.[6] The consensus is that multiples will compress in 2025 but not by enough to prevent high single-digit gains across global equities. While much has been made of the risk associated with highly concentrated equity markets, historical data shows that 10-year subsequent returns following periods of high market concentration, outside of 1999, have been in line with or above average returns (Exhibit 3).

Exhibit 3

Outside of 1999, periods of extreme concentration haven't led to lower long-term returns[7]



Source: Goldman Sachs PWM

Q6.1 What impact will the new Republican administration have on equities?

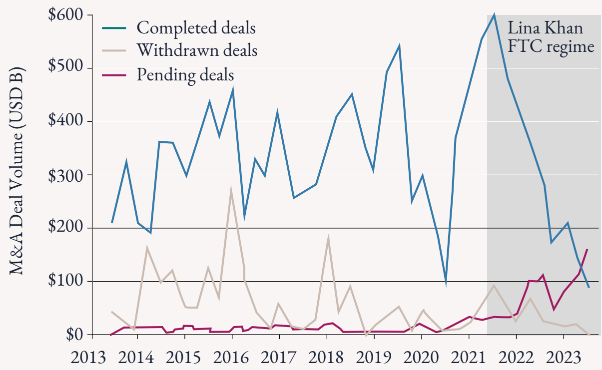
President Trump's top priorities are clear: lower taxes, less regulation, reduced immigration and higher tariffs. The sequencing and the degree to which these priorities will be diluted are the key variables that will increase dispersion at both a sector and regional level. Experts agree that deregulation should face the least resistance and could catalyse a new wave of M&A activity, with smaller cap stocks seen as a beneficiary.

5 Based on 2025 earnings
6 R-squared 6%
7 Market cap of largest stock: market cap of 75th percentile stock

The Biden administration adopted a restrictive approach towards M&A. The threshold for antitrust investigations was lowered sharply in 2023 following guidance issued by the DoJ and FTC. This approach, alongside a move higher in interest rates, lowered the appetite for corporate deal activity. **Completed M&A volume fell by roughly -80% during Lina Khan's tenure at the FTC (Exhibit 4).**[8]

Exhibit 4

Under the Biden administration M&A volume had declined to levels last observed in the aftermath of the GFC



Source: JP Morgan

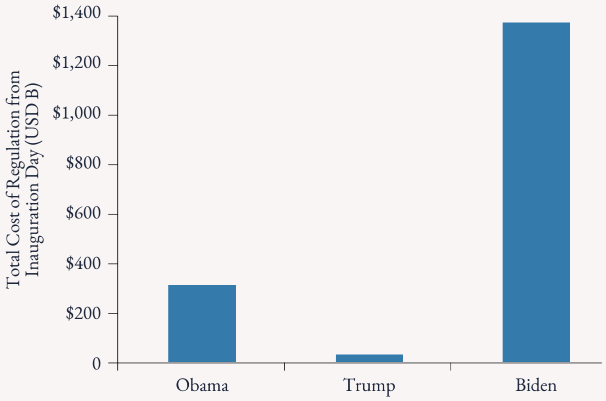
President Trump nominated Gail Slater as the head of antitrust at the DoJ and Andrew Ferguson as the Chair of the FTC – both are seen as more supportive of deal activity. Trump had pledged to roll back the guidance introduced by the FTC/DoJ in 2023. However, in a surprise announcement on 18 February, the agencies stated that, for now, they would retain the rules adopted under the Biden administration. While this leaves in place a headwind for the prospects for M&A activity, experts note that keeping the guidelines unchanged and the actual approach to enforcement of these guidelines are two very different matters. There is a significant amount of discretion built into the rules that allows for selective application and enforcement, characteristics that the administration could leverage to facilitate their broader policy objectives. **For now, the change in the administration and key personnel have prompted analysts to expect a +25-50% increase in deal flow in 2025.** Experts have highlighted several sectors that are ripe for consolidation: Banks, Biotech, Media, Consumer Goods and small-cap stocks. Analysis from Bloomberg Intelligence shows that since 2000, the volume of small-cap M&A activity has had a strong correlation with the total return of the Russell 2000.[9] Large-cap tech, by contrast, will continue to be heavily scrutinized. The new FTC Chair, Andrew Ferguson, has vowed to undo large parts of Khan's agenda, but he has also said he will "end big tech's vendetta against competition". Gail Slater, head of antitrust at the DoJ, is a close aide of VP Vance and has praised Khan's work against big tech.[10]

8 Bloomberg
9 Correlation of 0.52
10 The Economist, Financial Times

Macroeconomic View

Exhibit 5

The Biden administration significantly increased the regulatory burden for corporations

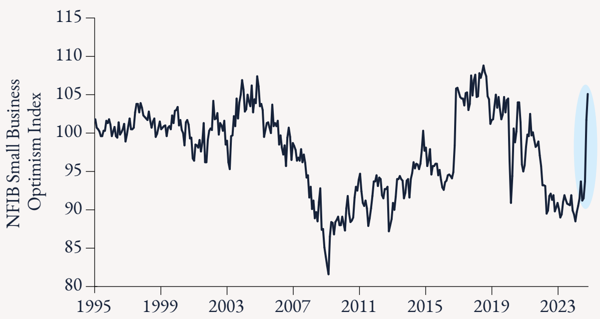


Source: JPM

The American Action Forum estimates that the total cost of regulation introduced during the Biden administration reached a cumulative $1.4T (Exhibit 5), compared with $100B during Trump's first term and $300B during Obama's second term. Small cap stocks, which are particularly sensitive to these costs, are expected to be relative beneficiaries of the push to reduce regulation. The NFIB Small Business Optimism Survey rose by the largest amount on record in the two months following Trump's re-election as illustrated in Exhibit 6. US banks are also expected to benefit. Analysts estimate that a step away from plans to adopt Basel III would free up an estimated $200B in capital to facilitate more lending activity.[11]

Exhibit 6

Small business optimism has surged following Trump's election



Source: Bloomberg

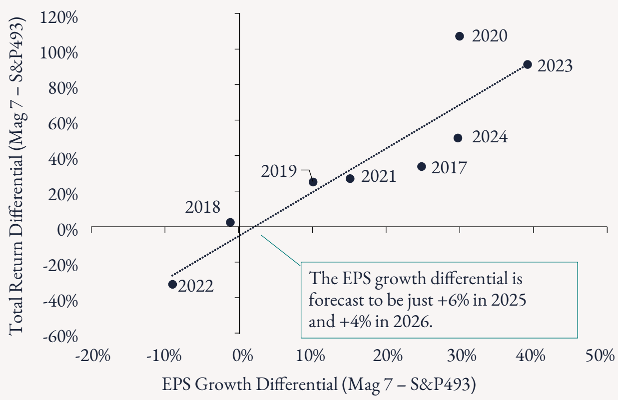
Q6.2 Will equity markets continue to be driven by just a handful of stocks?

> The balance of probability favors a broadening out of market performance, but in the tail scenarios, large-cap tech will prove more robust than the broader market. The relative earnings growth differential, the fundamental driver of outperformance for large-cap tech, is set to drop to its lowest level since 2022. Relative valuations remain close to the highs of the last 15 years leaving little room for further multiple expansion.

Relative EPS growth is expected to slow. The magnitude of investment in AI by the "hyperscalers"[12] is expected to decelerate earnings growth (+18% in 2025 vs +33% in 2024). The USD value of capex ($175B in 2024, 21% of revenues) has more than doubled since 2022 and will begin to impact earnings growth via rising depreciation costs. GPUs[13] which represent c. 40-50%[14] of this capex, have an estimated useful life of just 3-5 years. Meta's depreciation cost is forecast to grow at a +40% CAGR over the next three years while Google's is expected to grow at +35%.[15] The difference in earnings growth between the Magnificent 7 and the rest of the S&P 500 is expected to fall to just +6% in 2025, the lowest level since 2022 (Exhibit 7).

Exhibit 7

Relative earnings growth has been the key driver of outperformance for the Mag 7



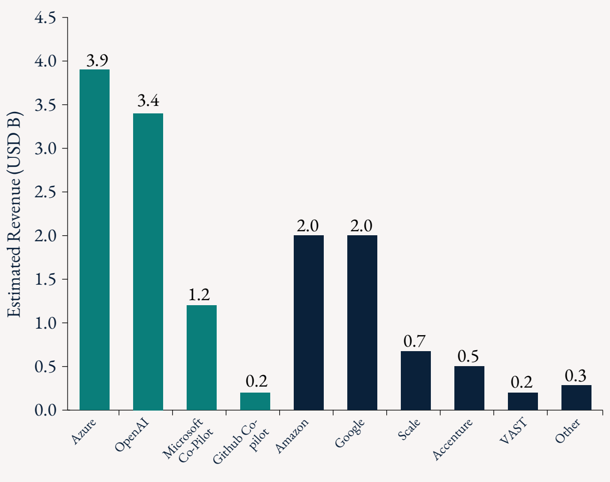
Source: Bloomberg

11 JP Morgan
12 Google, Amazon, Meta, Microsoft
13 Graphics Processing Units
14 Sequoia
15 Goldman Sachs

To offset soaring depreciation costs, the investment in AI will need to start generating returns. Analysts note that in order to match current earnings expectations, the hyperscalers will need to convert roughly 30% of their trailing three-year average capex into earnings. This is in line with what they have achieved historically, but evidence of monetisation is, thus far, limited. **Total revenue for generative AI at an application level was estimated to be less than $15B in 2024** (Exhibit 8).[16] Microsoft, who have been the most successful in monetizing AI to date, is expected to generate c. $10B in revenue from AI in 2025 versus capex investment in AI of c. $80B.[17]

Exhibit 8

AI revenue generation was just $15B in 2024, Microsoft (Green Bars) has been the most successful in monetising thus far

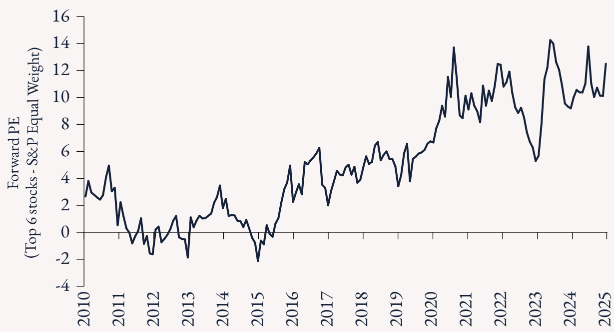


Source: Generative Value

Current valuation premiums may not reflect the change in capital intensity. The premium that large tech companies command over the average stock (S&P 500 equal weight) remains close to the highs of the last 15 years, as illustrated in Exhibit 9.

Exhibit 9

The forward PE of the largest tech stocks is close to a record premium versus the equal weight S&P 500

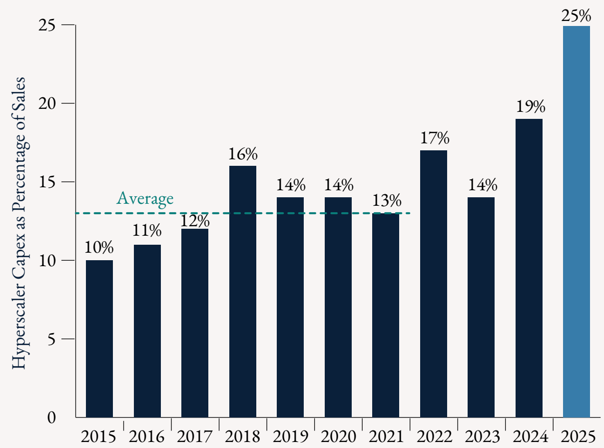


Source: Bloomberg

This suggests that there is limited room for further multiple expansion. There may also be a risk of multiple contraction given that these companies are moving from relatively capital-light business models to more capital-intensive ones (Exhibit 10). Analysis at Goldman Sachs suggests that the long-term valuation premium for capital-light businesses over capital-heavy businesses is roughly +20%.

Exhibit 10

Rising capital intensity, capex has risen from 10% of sales in 2015 to 25% in 2025 for the hyperscalers



Source: Bloomberg

Market concentration will likely persist in the tail scenarios. Monopoly-like pricing power in specific industries, higher free cash flow, the flexibility to dial-down capex and a lower level of exposure to rising interest rates suggest that the largest tech companies will prove more resilient if the economy experiences a sharp deterioration in growth or if interest rates rise significantly in response to inflationary pressures. Analysts at BAML estimate that the sensitivity of earnings to interest rates is c. -40% lower for large-cap tech companies compared to the broad S&P 500.

16 Generative Value
17 Goldman Sachs

Macroeconomic View

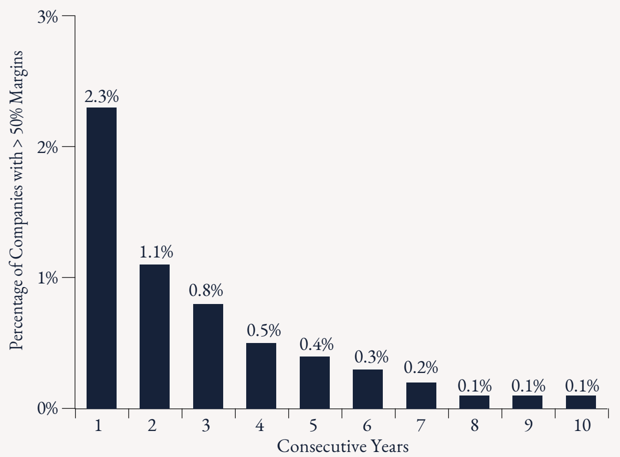
Q6.3 What market moving developments will there be in AI in 2025?

The scaling law in AI, bigger compute = better performance, may be under threat. The maturation of model development has the potential to lead to a shift in the AI supply chain with the Nvidia monopoly starting to feel some competitive pressures.

Nvidia has been the biggest beneficiary of the AI arms race. Scaling laws suggest that putting more data into large language models (LLMs) with more parameters leads to superior results. Models with more parameters require more compute power which in turn requires larger "clusters" of computer chips. These computer chips have almost exclusively been designed by Nvidia who enjoy greater than 90% market share. The race to build larger models has seen Nvidia's share price rise +800% since the launch of Chat-GPT in November 2022. Investors have priced Nvidia as an effective monopoly. It trades at 40x 2025 earnings, its earnings are forecast to double over the next 3 years and its gross margin is expected to remain above 50% for more than 5 years[18], a feat only achieved by less than 0.5% of companies historically, as illustrated in Exhibit 11.

Exhibit 11

Less than 0.5% of companies have managed to achieve >50% margins for more than 5 consecutive years



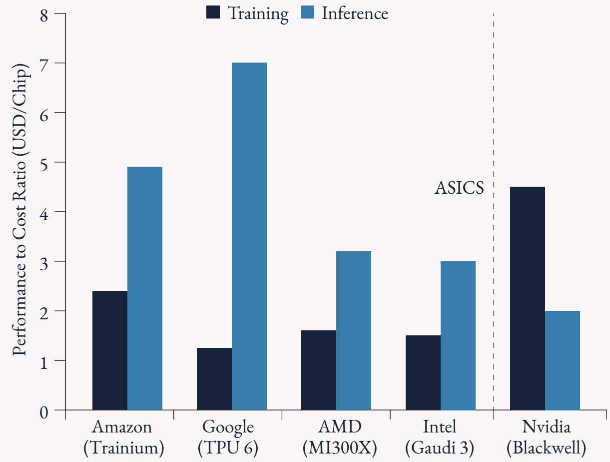
Source: Goldman Sachs

The shift from model "training" to "inference" creates vulnerabilities. A chorus of industry experts have suggested that the LLM performance enhancement from the addition of computing power may be showing signs of exhaustion. Mark Andressen noted in November 2024 that "AI model capabilities are topping out on pre-training alone". Employees at OpenAI told The Information that the increase in quality for Chat GPT-Orion[19] relative to GPT-4 was far smaller than anticipated and significantly less than the jump observed between GPT-3 and 4.[20] Microsoft CEO, Satya Nadella, noted that "it didn't actually matter if pre-training yields were shrinking" because models were now making more gains from "reasoning" at the inference level.

Inference refers to models computing answers in response to prompts from end users. **This shift towards optimising models for inference, away from training, leaves Nvidia vulnerable.** Analysts at Morgan Stanley have highlighted that application-specific integrated circuits (ASICs) offer superior cost-adjusted performance when it comes to model inference relative to Nvidia's latest chips (Blackwell GPUs). This is in stark contrast to model training where Nvidia's GPUs remain the most cost-effective solution (Exhibit 12).[21]

Exhibit 12

In contrast to training where Nvidia's GPUs are a clear winner, ASICs may offer superior cost-adjusted performance for inference



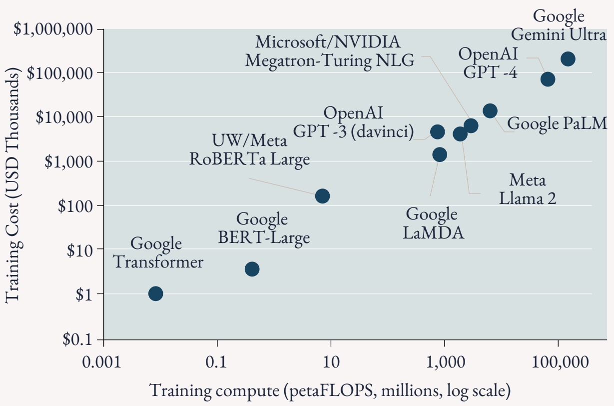
Source: Morgan Stanley

18 Bloomberg
19 Latest GPT model
20 The Information
21 Total Processing Performance/Total Ownership Cost

Innovations from new entrants raise questions about Nvidia's moat. In late January 2025, Chinese AI startup DeepSeek released their R1 model. The model's performance was in line with the latest releases from OpenAI but had been trained at a "reported" cost of just $5.6M, versus the $100M spent on training GPT-4 (Exhibit 13). DeepSeek claim the model was trained on just over 2,000 Nvidia H800 GPUs (older gaming GPUs not subject to export restrictions). This compares to 25,000+ Nvidia H100 GPUs (leading edge, export restricted) used to train GPT-4. To achieve this, DeepSeek used a series of innovative approaches that significantly reduced their memory requirements (-75%) for just a small reduction in model accuracy (-10-15%).[22]

Exhibit 13

Chat GPT-4 was trained for $100M



Source: JPM

Atreides CIO, Gavin Baker, notes that the $5.6M figure is "deeply misleading" as 1) it excludes costs associated with prior research, 2) DeepSeek had the potential to access 50,000 H100 GPUs to train R1's parent model, and 3) it is highly likely they used distillation training[23] based on access to either GPT-4 or Llama-3. Analysts at Bernstein have reached a similar conclusion. Despite this, many experts believe that this is a game changer. Most of the innovations used are expected to significantly lower the costs associated with training models and inference.

As a result:

- Nvidia's moat doesn't appear as strong as it did prior to this release.
- Other capex beneficiaries' such as data centre providers and energy/utilities are vulnerable to some valuation derating in the near term.
- It is possible that the hyperscalers will reassess the magnitude of their investment.
- In the medium-long term, Jevons' paradox will prevail, that is lowering the cost of a technology will lead to increased usage of that technology.

Exhibit 14

In the base case we expect high single-digit returns

MSCI World Scenario Analysis	Downside Case	Base Case	Upside Case	Expected Return
Probability	20%	60%	20%	
Trailing PE Ratio	16.5	21.5	22.0	20.6
2025 EPS Growth	6%	11%	16%	11%
Implied change in index price	-22%	7%	14%	3%
Dividend Yield	2%	2%	2%	2%
Total Return	**-20%**	**9%**	**16%**	5%
Market Concentration	**Increases**	**Decreases**	**Increases**	

22 Alliance Bernstein
23 A training technique based on other LLM

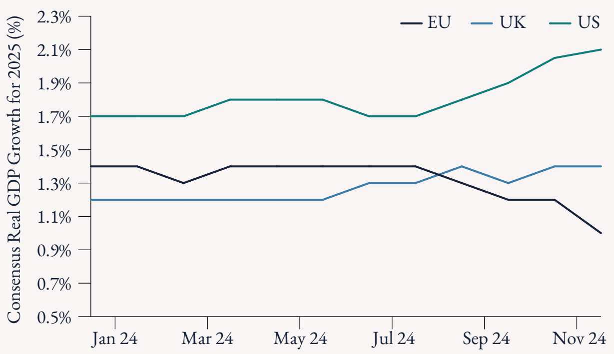
Macroeconomic View

Q7. What is the Outlook for Europe?

Eurozone growth is likely to remain below 1% in 2025 (Exhibit 1). The main headwinds to growth will be uncertainty over trade, fiscal consolidation and the structural issues facing the manufacturing sector. A rise in consumption will, however, serve as an offset, and receding inflationary pressures will allow the European Central Bank (ECB) to ease policy by more than other developed market central banks.

Exhibit 1

In contrast to the US, Eurozone growth expectations for 2025 have been lowered since the start of 2024

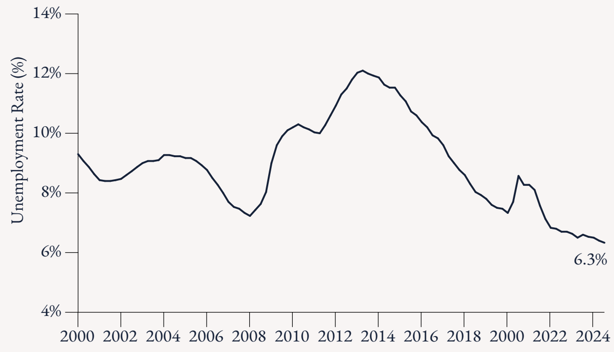


Source: Bloomberg

Consumption is a potential bright spot. Consumption is expected to be a significant contributor to European growth in 2025, rising +1.6% YoY. This will be driven by 1) a record low level of unemployment, 6.3%, as shown in Exhibit 2, 2) real disposable income growing by +1% in 2025 as inflation recedes faster than wage growth (as a result of lags from wage negotiations) and 3) European consumers drawing down excess savings - the excess savings rate stands roughly +3% above its pre-pandemic level. Analysts believe that the savings rate will decline by c. -1% as the ECB continues its rate-cutting cycle in 2025.[1]

Exhibit 2

Unemployment in Europe is at an all-time low, supporting consumption

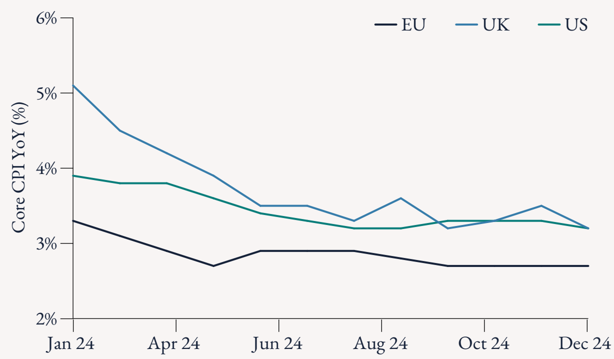


Source: Bloomberg

The ECB has room to ease policy. While the labour market is in relatively rude health, experts note that forward-looking indicators suggest unemployment will start to rise in 2025 by +0.4%.[2] This implies that wage growth will decelerate from 4.4% at present to 3.2% by the end of the year. With inflation pressures subsiding (Exhibit 3), the relatively anaemic growth backdrop, coupled with the threat of tariffs, should allow the ECB to ease policy more substantially than other central banks in 2025. Investors expect the ECB to lower rates by roughly -1% in 2025, with the Federal Reserve and Bank of England expected to cut rates by only -0.4% and the Bank of Japan expected to increase rates by +0.5%.[3] This is expected to offer some support to consumption and investment in the Eurozone.

Exhibit 3

Lower core inflation will allow the ECB more room to ease policy



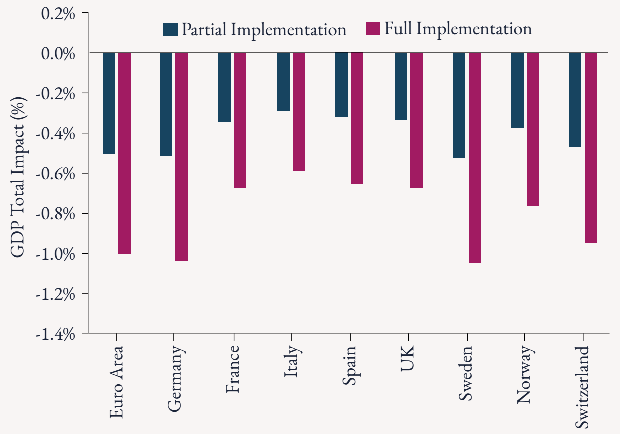
Source: Bloomberg

1 Morgan Stanley
2 Goldman Sachs
3 Bloomberg

Trade tariffs and uncertainty are expected to weigh on growth. While there is a significant amount of uncertainty, much of it is deliberate on the part of the new US administration. The consensus among analysts is that the US will impose a set of targeted tariffs on specific European industries, primarily automobiles. If tariffs on European autos were to increase by c. +20%, analysts estimate it would lead to a drag of roughly -0.5% of GDP. An across-the-board 10% tariff on all European imports would result in a drag on GDP of -1%, as illustrated in Exhibit 4. Experts also note that trade policy uncertainty, as opposed to just the tariffs themselves, is responsible for much of the impact on growth. The uncertainty lowers investment with companies seeking clarity on future policies before committing to investments. European leaders have, however, stated a willingness to work with the US on defence spending and imports of natural gas. It is possible this could lead to an agreement that would represent an upside risk to growth in Europe.

Exhibit 4

Analysts estimate a -0.5 to -1% drag on Euro Area GDP from trade tariffs

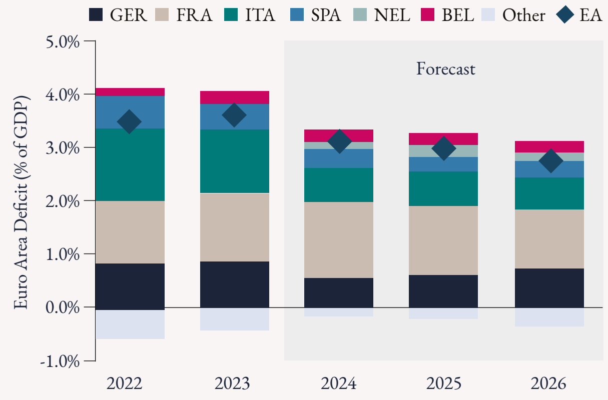


Source: Goldman Sachs

In the base case, we assume there will be a fiscal drag in 2025. Analysts expect further fiscal consolidation in Europe with the deficit projected to shrink to 3% of GDP in 2025 from 3.2% in 2024 (Exhibit 5). The majority of fiscal tightening will occur in Italy and France which are now subject to the EU's Excessive Debt Procedure (EDP). The EDP requires both countries to narrow their fiscal deficits to less than 3% of GDP by 2027 in the case of Italy and 2029 in the case of France. Our modeling of Italian debt sustainability, shown in Exhibit 13, suggests that Italy is broadly on track to reach this deficit target. The government is forecast to run a primary surplus from 2025 onwards and the weighted average debt maturity of over seven years means that the cost of debt will not change materially. On France, most analysts are sceptical that the deficit reduction plan outlined by the new government will be met. The marginal fiscal tightening in the euro area will translate into a c. -0.3% reduction in GDP growth.[4]

Exhibit 5

The Euro Area fiscal deficit is expected to shrink marginally in 2025

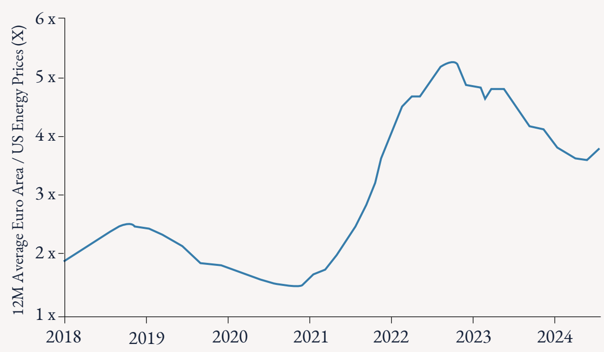


Source: Morgan Stanley

The wild card for fiscal policy is Germany. As discussed in Insights 2024, the German business model appears broken. The economy had been powered by cheap energy, tailwinds from globalisation and the most effective automotive supply chain in the world. Energy prices in Europe are now 4x the level they are in the US (Exhibit 6), the world is stepping back from free trade and the rise of electric vehicles has structurally changed the automotive value chain, turning China from a consumer into a competitor.

Exhibit 6

Energy prices remain elevated in Europe



Source: JP Morgan

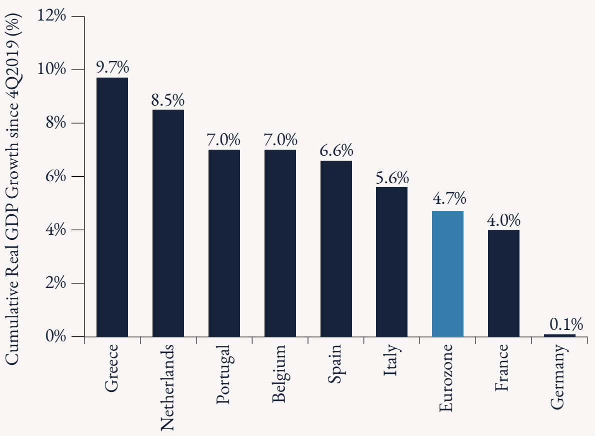
The German economy has contracted in real terms for two successive years and is forecast to grow by just +0.4% in 2025. Exhibit 7 shows that since Q4 2019 the German economy has seen cumulative real GDP growth of just +0.1%, significantly lagging its European peers. Total manufacturing in Europe has declined by a cumulative -3% since 2019 and German energy-intensive manufacturing has fallen c. -20%.[5]

4 Financial Times
5 ECB

Macroeconomic View

Exhibit 7

Germany is the "sick man" of Europe again



Source: Goldman Sachs

The initial results of the German election in February suggest that a grand coalition between the CDU (Conservatives) and SDP (Social Democrats) with Friedrich Merz, the CDU leader, as the new chancellor is the most likely outcome. Their combined 45% share of the vote is the lowest on record but will be enough to form a government thanks to a fracturing of the vote on the left which resulted in two of the far-left parties falling below the minimum 5% threshold. The AfD (Alternative for Deutschland) received just over 20% of the vote, a record, and will serve as the main opposition party given that all other parties have refused to partner with them. A new government is expected to be formed by the end of April and given the challenges facing the economy experts anticipate a loosening of fiscal rules. The "national debt break" currently limits additional borrowing to 0.35% of cyclically-adjusted GDP. Analysts assume that an adjustment to fiscal policy could increase growth by up to +1.5%, as illustrated in Exhibit 8, but this will only begin to be felt in 2026 given the protracted negotiations that will be required to secure a two-thirds majority for constitutional reform.

Exhibit 8

Fiscal easing could boost growth by +1.5%

Likely fiscal policy options	Mechanics	Potential impact on GDP
Reform the Debt Break	Increase debt limit to 0.7% GDP	+0.5%
Special Funds (Off Balance Sheet)	Launch of 1-2 specific financing vehicles for defence spending and other strategic objectives	+1.0%

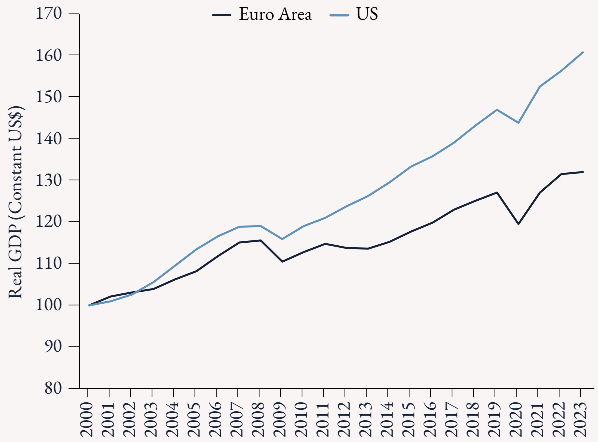
Source: Goldman Sachs

Can Europe become more competitive? Increased public and private investment is the key to making Europe more competitive. Increasing investment will require a structural shift in fiscal policy in the Eurozone and a significant change in the regulatory landscape. Both are likely to happen, but only at the margin and reactively as opposed to proactively.

Exhibit 9 shows that growth in the Eurozone was roughly in line with the US until 2008. Since then, there has been a sharp divergence with US GDP rising 43% while EU GDP has risen by roughly half that amount.

Exhibit 9

GDP growth in Euro Area has lagged the US in the aftermath of the GFC

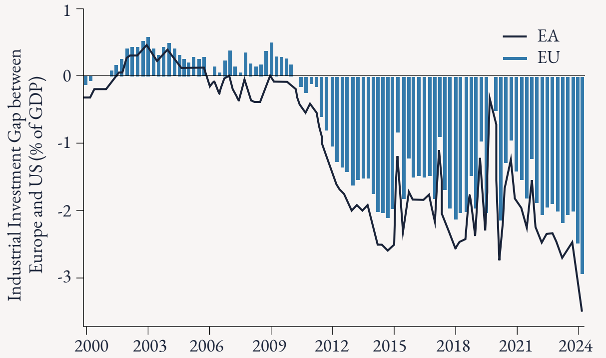


Source: Bloomberg

In September 2024, the former head of the ECB and former Italian Prime Minister, Mario Draghi released his much-anticipated report on European competitiveness. Draghi's headline takeaway was that if productivity did not increase, Europe's economy would be no larger in 2050 than it is today. While the report highlighted several areas, the key issue identified was a lack of investment (Exhibit 10). Draghi noted that in order to lift productivity and prevent Europe from falling further behind the US it would require boosting public and private investment from 22% of GDP to 27%.

Exhibit 10

Investment in the Euro Area relative to the US declined sharply post the financial crisis

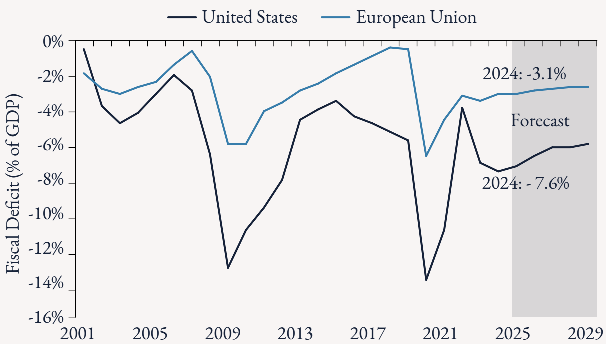


Source: Goldman Sachs

Draghi noted that to stimulate private investment, public investment will likely have to take the lead, but this will require a sea change from policy-makers. The European response to the GFC was austerity whereas the US stimulated the economy via expansionary fiscal policy. Since 2010, the Euro Area fiscal deficit has averaged -3% versus -7% in the US (Exhibit 11).

Exhibit 11

More conservative fiscal policy has been a significant drag on the EU's economy



Source: Bloomberg

Private investment has also been hindered by regulation. The EU has taken a far more stringent approach to regulation than the US. Since 2020 alone, US productivity has grown by +1% more than in the Euro Area. That has coincided with 13,000 new pieces of corporate legislation in Europe versus roughly 3,000 in the US, under the supposedly more muscular Biden regulatory regime.[6] A survey conducted by the European Commission found that legislation under the European Green Deal umbrella has led to a €2.3B increase in administration costs for small and medium enterprises. This regulatory burden has led to a flight of private capital, with 30% of Europe's unicorns having left the bloc since 2008 to source capital in the US.[7]

There are tentative signs of positive change. The NextGenEU fiscal response to the pandemic represented the first effort to raise funds at a significant scale at a supranational level to drive strategic investment. If Germany were to loosen fiscal policy, it would represent a significant shift from one of the major fiscal hawks in Europe. On the regulatory front, France became the latest country to call for reform in late January noting that the laws are "ill-adapted to the new context of exacerbated international competition". European Commission President Ursula Von der Leyen has titled a proposal "Making Europe simpler and faster", where she calls for a 25-35% reduction in reporting obligations for businesses.[8]

Exhibit 12

Europe Macro Scenarios

	Downside Case	Base Case	Upside Case
Real GDP	0.0%	1.0%	1.5%
Inflation (CPI)	1.5%	2.1%	2.5%
Central Bank Rate (End 2025)	0.8%	2.0%	2.5%
10yr Bund Yield	1.25%	2.25%	2.75%
Fiscal Deficit	-4.0%	-3.0%	-3.5%
Equities	-18%	11%	25%

Source: Bloomberg

6 Financial Times
7 Financial Times
8 Politico

Macroeconomic View

Exhibit 13

Italian Debt Sustainability Model [1, 2, 3]

Italy (IMF Forecasts)	2023 Actual	2024 Est.	2025 Est.	2026 Est.	2027 Est.	2028 Est.	2029 Est.	2030 Est.	2031 Est.	2032 Est.	2033 Est.	2034 Est.	2035 Est.
Net Debt-to-GDP (end of year)	124%	127%	127%	127%	127%	126%	126%	125%	124%	124%	123%	123%	122%
Real GDP growth	0.7%	0.6%	0.7%	0.9%	0.6%	0.7%	0.7%	0.7%	0.7%	0.7%	0.7%	0.7%	0.7%
Inflation (GDP deflator)	5.8%	1.8%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Nominal GDP growth	6.5%	2.4%	2.7%	2.9%	2.6%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%
Weighted average interest rate on total outstanding debt	2.8%	3.1%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%
Debt servicing cost as percent of GDP (int rate x debt level)	3.5%	3.9%	4.0%	4.1%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	3.9%	3.9%
IMF baseline forecast of government primary balance, % GDP	-3.6%	-0.1%	0.2%	0.6%	0.9%	1.1%	1.2%	1.2%	1.2%	1.2%	1.2%	1.2%	1.2%

Source: IMF, Partners Capital

1. Forecasts from 2024-2029 are from IMF October 2024 World Economic Outlook and the January 2025 update
2. Growth, inflation and cost of debt held constant at expected trend rate after 2029
3. Net debt is debt held by public, which excludes intragovernmental debt but includes debt held by the ECB

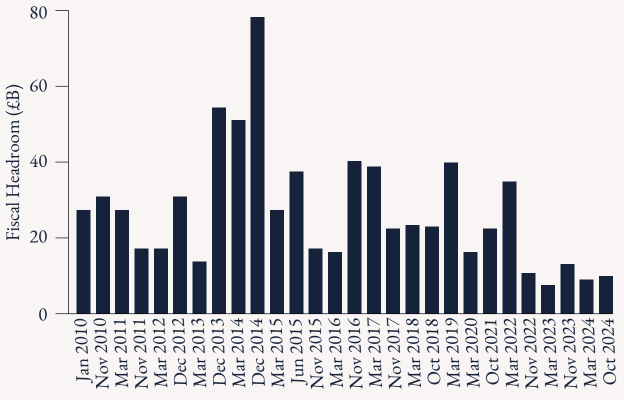
Q8. What is the Outlook for the UK?

Economic stagnation, persistent inflation pressures, declining corporate confidence and limited fiscal headroom leave UK policymakers facing a series of unpalatable choices. UK assets largely reflect this reality.

In her Autumn Budget, UK Chancellor Rachel Reeves increased government spending by £71B. This was funded through the largest tax hike in history totalling £41B and additional borrowing of £30B. **Reeves has committed to adhere to Britain's main fiscal rule which requires that government debt falls as a percentage of GDP by the fifth year of a five-year forecast by the OBR.**[1] Post budget, the OBR forecast debt to GDP would fall from a peak of 98.4% in fiscal year 2024/2025 to 97.1% in 2029/2030. This would leave the government with only an estimated £9B of "fiscal headroom", the amount of leeway the government has to increase spending or cut taxes without breaching the aforementioned rule. Exhibit 1 shows just how small this headroom is relative to history.

Exhibit 1

The UK has razor thin fiscal headroom

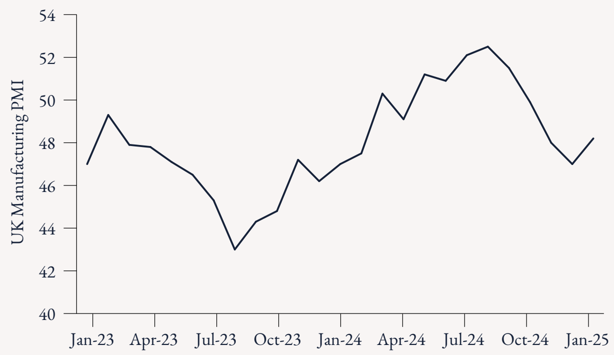


Source: Financial Times

This limited fiscal headroom has left the UK vulnerable to a move higher in interest rates and/or a deterioration in real growth expectations. Since the OBR made its post-budget assessment, analysts estimate that average UK borrowing costs have risen by over +50bps.[2] They suggest this will remove c. £6B of the £9B fiscal headroom. Perhaps more troublingly, the OBR made the rather optimistic assumption that the UK economy would grow by +2.0% in 2025. Consensus estimates now suggest that growth will be closer to +1.2% with analysts at Morgan Stanley suggesting this could be revised lower by a further -0.2% if rates remain elevated (due to the impact on mortgages). The Bank of England (BoE), at its February policy meeting, halved its previous estimate of 2025 growth to just 0.75% citing concerns from businesses, Exhibit 2, around the increase in the minimum wage coupled with rising national insurance contributions. Economists at the BoE suggest that there is now a 40% chance the UK will enter a technical recession in 2025.

Exhibit 2

UK PMI has fallen sharply in the aftermath of the election



Source: Bloomberg

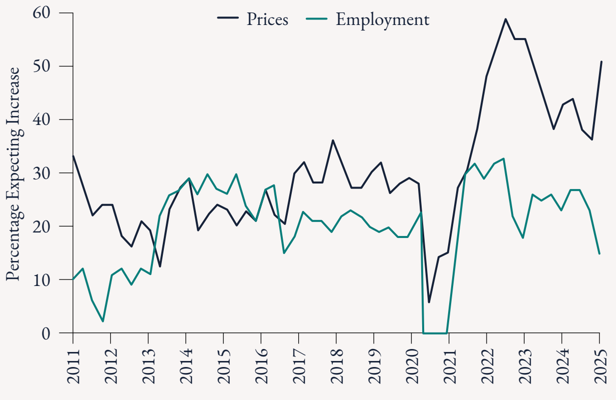
Policy makers have limited room for manoeuvre. Typically, a sharp decline in growth expectations, as outlined by the BoE in February, would prompt an abrupt easing of monetary policy. However, the room to significantly ease policy is limited by inflation. While growth estimates for 2025 were halved, inflation estimates were simultaneously increased from 2.7% to 3.5%. The BoE has pointed to short-term, supposedly transitory, factors such as energy prices and regulated transport fares as near-term drivers of inflation but there are more structural issues. Core CPI is running at 3.2% YoY and the Indeed Wage Tracker Index remains above 6.0% YoY, compared to 3.3% for the same measure in the US. A key issue for the UK labour force is limited supply. The number of long-term "economically inactive" individuals is 700K higher than it was before COVID.[3] Data from the British Chamber of Commerce (BCC), as shown in Exhibit 3, echo the stagflation concerns from the BoE. Investors believe the BoE will reduce rates by just a further -0.5% in 2025 to 4.0%.

1 Office for Budget Responsibility
2 As at Jan 9
3 Institute for Fiscal Studies

Macroeconomic View

Exhibit 3

The BCC are expecting stagflation-like conditions, limiting the room for policy easing by the BoE



Source: British Chamber of Commerce

This leaves the government at the behest of the bond market and facing a test of their credibility. The OBR is set to review its estimates for fiscal headroom on March 26, and the Chancellor is set to announce her longer-term spending review in June. The bond market may press the government to act sooner. Assuming no further tax increases and barring an acceleration in real growth or a fall in funding costs, the only two options available are:

1. A cut to public expenditure
2. A change/suspension of the fiscal rules

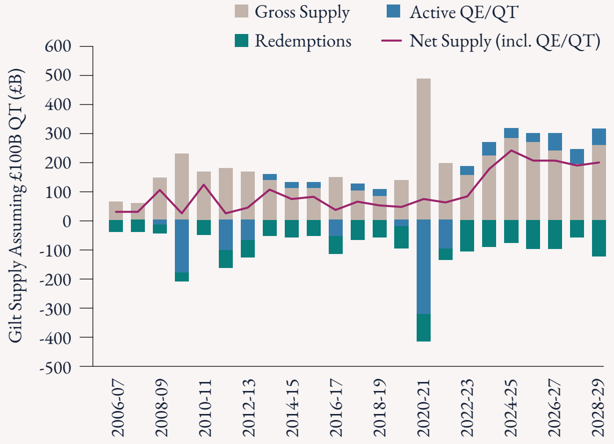
Experts believe that the latter could call the government's credibility into question and lead to significant problems in rates and currency markets. A cut to public spending is therefore seen as the most likely course of action. Analysts at Morgan Stanley believe that spending cuts could reduce growth by -0.3% in 2025.

Investment implications: Gilts carry a number of risks, but if yields continue to rise, they may offer value relative to other global bonds. In January 2025, UK 10yr Gilt yields reached 4.9%, their highest level since 2008. The 2.25% yield spread above equivalent-maturity German Bunds is the widest since the early 1990s.[4] Gilts do carry several risks: 1) net issuance in fiscal year 2024/2025 will be the highest on record at £250B[5] (Exhibit 4), 2) demand for Gilts is now more price sensitive with the BoE, pension funds and insurers accounting for 15% less of total demand than they did in 2020, with most of that demand being taken up by foreign investors and private funds[6], and 3) the UK has the second largest twin deficit in the G7 after the US making it particularly vulnerable to capital flight.[7]

4 Bloomberg
5 Morgan Stanley
6 DMO
7 Financial Times

Exhibit 4

The market will have to digest the largest net supply of Gilts on record in fiscal year 2024/2025



Source: Morgan Stanley

However, a large selloff in the Gilt market similar to what occurred following the "mini-budget" in September 2022 appears unlikely, given the risk structures that have subsequently been put in place by pension and insurance companies to reduce leverage and increase cash levels. Experts also believe that the government is well aware of the risks associated with fiscal largesse and will likely respond to rising rates/breach of fiscal rules by reducing spending. This would ultimately hurt growth and could prompt a decline in yields.

Exhibit 5

UK Macro Scenarios

	Downside Case	Base Case	Upside Case
Real GDP	0.5%	1.3%	1.8%
Inflation (CPI)	2.0%	2.6%	3.3%
Central Bank Rate (End 2025)	2.5%	4.0%	4.5%
10yr Gilt Yield	3.25%	4.5%	5.25%
Fiscal Deficit	-4.9%	-3.8%	-3.3%
Equities	-18.0%	11.0%	25.0%

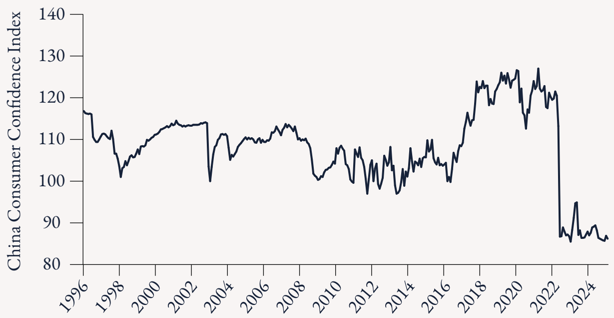
Q9. What is the outlook for the major Asian economies?

China: A stabilisation in growth, between 4.5-5%, is more likely than an acceleration in 2025. Fiscal policy will be key to a recovery in consumer confidence. China is exposed to tariffs, but a grand bargain with Trump remains an upside risk, albeit a remote one. Demographics will continue to be a drag.

Fiscal policy is the most important policy lever. The deleveraging in the property sector has been a c. -2% per annum drag on GDP growth with new home sales having fallen -70% from their peak in 2022. Housing accounts for more than 60% of total household assets and the decline in property prices has left consumer confidence at an all-time low, as illustrated in Exhibit 1.

Exhibit 1

Consumer confidence in China is close to all-time lows

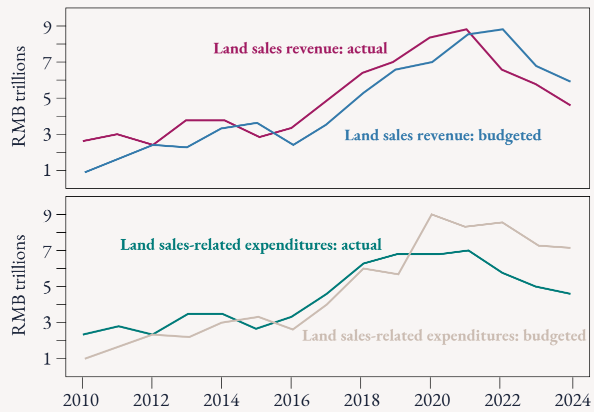


Source: Goldman Sachs

To address this, the government launched a multifaceted stimulus package in September 2024, focused on easing monetary conditions, loosening restrictions on the property market and a series of measures intended to boost equity markets. Analysts noted that the nature of the problems facing the Chinese economy, namely a balance sheet recession[1], have rendered monetary policy largely ineffective. **Fiscal stimulus is seen as the most important policy lever.** Local government spending, the traditional avenue for fiscal spending, has been severely constrained by 1) declining revenues: c. 40% of local government revenue came from land sales which have declined by -45%[2] since 2021 (Exhibit 2) and 2) soaring off-balance sheet debt levels: Chinese local government financing vehicles (LGFVs) have increased from 30% of total debt in 2018 to an estimated 50% in 2024.

Exhibit 2

Revenue from land sales, one of the primary sources of local government financing, has collapsed



Source: Gavekal

1 The Economist
2 Gavekal

Macroeconomic View

In November 2024, the National Party Congress announced **the much-awaited fiscal package which left analysts underwhelmed.** It amounted to a headline RMB12T debt swap for local governments, replacing more expensive off-balance sheet debt with government-backed issuance. It is estimated that the package will save local governments RMB120B per year, just 0.1% of GDP. Policymakers have, however, guided towards further initiatives coming at the legislative session in March 2025. **The consensus among analysts is that the fiscal deficit will increase by c. 1.5% in 2025**[3], from 7.5% to 9% (Exhibit 3). Analysts at Deutsche Bank estimate that the multiplier effect will mean this should translate into a +2% boost to GDP, offsetting some of the headwinds from the property sector and tariffs.

Exhibit 3

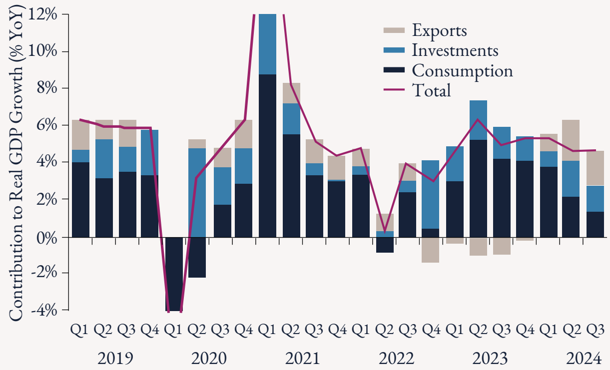
Analysts expect further stimulus to be announced in March 2025, lifting the fiscal deficit to 9%

Source: Deutsche Bank

China is exposed to the risk of tariffs. Analysts estimate that the new US administration will impose significantly higher tariffs on China, resulting in a drag of -0.5 to -1% of GDP. Exports have moved from less than 10% of GDP to c. 22% as growth in consumption has slowed markedly (Exhibit 4). This leaves the economy more vulnerable to the threat of US tariffs, which represent 15% of all Chinese exports.[4] A Bloomberg survey of economists shows a median expectation of 38% tariffs on Chinese goods from the Trump administration, a far higher figure than the 7.5%-25% levied on Chinese goods during his first term.

Exhibit 4

As consumption has slowed, exports have grown to account for c. 22% of GDP growth



Source: Goldman Sachs

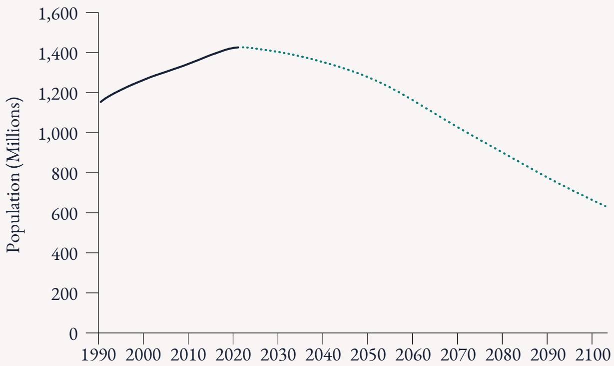
Chinese policymakers are expected to use a combination of stimulus, currency depreciation and domestic investment in manufacturing to offset the impact of tariffs. The government has increased lending to the industrial sector from RMB0.5T in 2019 to more than RMB3T in 2024, signalling to manufacturers that the domestic economy will provide an alternative source of demand. Experts believe that China will ultimately determine the magnitude of fiscal stimulus it chooses to deploy in 2025 based on the severity of tariffs imposed. A weakening of the Renminbi to 7.50/$ (-3.5%[5]) is also viewed as a potential policy lever. A grand bargain with President Trump remains an upside risk to this view, but analysts at Gavekal view this as highly unlikely. They note that Beijing believes the overarching goal of the US is to contain China and constrain its technological progress.

3 Average: Deutsche Bank and Goldman Sachs
4 Goldman Sachs
5 As at 21 January 2025

China is contending with a sharp demographic decline (Exhibit 5). China's population fell by -1.4M in 2024, its third consecutive year of decline. Before the one-child policy's introduction in 1979, China had a total fertility rate of 5.8.[6] By 2010, this number had fallen to 1.2, and despite the policy's abolition in 2015, the total fertility rate has risen to just 1.3 today, significantly below the population replacement level of 2.1. By 2050, over 60s will represent c. 40% of China's population. In contrast to Japan, China is getting old before it gets rich. When Japan's population started to decline in 2008, its GDP/capita was $47,500. China's is just $21,000.[7] The National University of Singapore estimates that the current projected decline in the labour force will result in just under a -1% decline in growth rate each year over the next decade.

Exhibit 5

China's population is forecast to halve over the next 50 years



Source: Goldman Sachs

Japan: There is tangible evidence that a virtuous cycle between rising wages and prices is in place, ending three decades of economic stagnation. Fiscal policy is anticipated to become more expansionary as a result of the recent election, and a weak Yen should help to insulate Japan from tariffs. The recovery remains fragile but is facilitating a normalisation of monetary policy.

Virtuous wage, price cycle. Japan has been fighting deflation for decades. Between 1992 and 2022 headline inflation was at or above 2% in just 7% of all months. Headline inflation currently sits at 2.9% and has remained above 2% since March 2022. This has been facilitated by 1) the sharp rise in global inflation post-pandemic, 2) aggressive monetary policy easing by the Bank of Japan (BoJ): trade weighted JPY has depreciated -20% since the beginning of 2022, 3) a concerted effort by policymakers to ensure corporates raise wages in line with inflation and 4) a rise in medium-term inflation expectations which are now close to record highs.[8] In 2024, Japan's economy experienced its largest yearly wage increase in more than three decades, at 3.6% (Exhibit 6). Early indications for the Shunto negotiations in 2025 suggest wage growth will remain strong, moderating only slightly to c.3% in 2025. Analysis from Morgan Stanley suggests that there has been a statistical change in the relationship between wages and prices which confirms that a virtuous cycle is now in place. They estimate the beta of wage growth to a 1% price shock has risen from 0.1 in 2022 to 0.7 in 2024.

The rise in inflation and real GDP growth has allowed the Bank of Japan to begin the process of normalising monetary policy. In 2023, the BoJ abandoned their yield curve control policy, and in 2024 they began increasing interest rates for the first time since 2007, lifting rates from -0.1% to 0.5% as at January 2025. The consensus is that the BoJ will raise interest rates by a further +0.25% this year.

6 Fertility Rate: The total fertility rate in a specific year is defined as the total number of children that would be born to each woman if she were to live to the end of her childbearing years and give birth to children in alignment with the prevailing age-specific fertility rates.

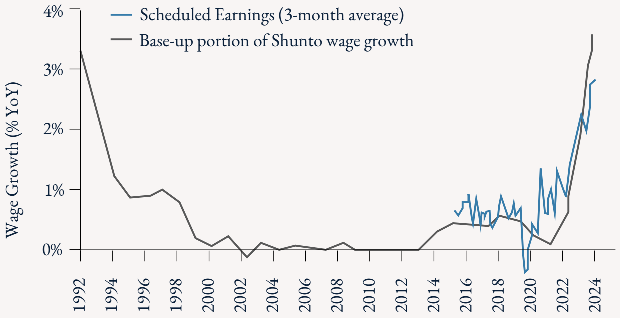
7 The Economist

8 The Economist

Macroeconomic View

Exhibit 6

Japanese wages rose at the fastest pace in three decades in 2024

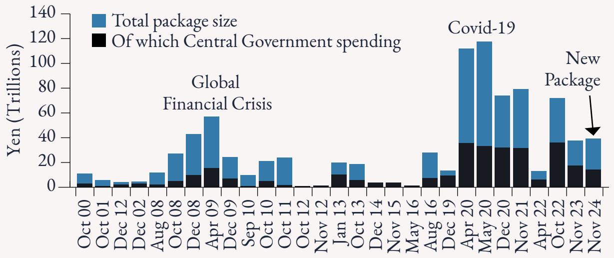


Source: Morgan Stanley

The recent election will lead to fiscal expansion. The Liberal Democratic Party (LDP) lost their Lower House majority for the first time in over a decade. Analysts believe that the lack of a majority will necessitate the use of populist policies to garner the support of other parties. This will lead to an expansion in fiscal policy, offering a further tailwind to consumption. The new government, under the leadership of Shigeru Ishiba, has since approved a \$250B (¥39T) economic stimulus package. The package was originally proposed by the Democratic People's Party (DPP), upon whom the LDP is now reliant for support. The package significantly increases the minimum salary threshold at which income tax is applied (\$6,640 to \$11,500) and provides energy subsidies to low-income households. Critics argue that the package, shown in Exhibit 7, takes unnecessary fiscal risks and exposes the fragility of the government to populism, noting Ishiba's rapid transition from fiscal hawk to dove. The DPP has also proposed a cut to income tax rates, which they estimate could boost GDP by +0.1-0.3%. However, a decision on this has been delayed until later in 2025.

Exhibit 7

The ¥39T stimulus package will be one of the largest since the GFC, outside of the response to the pandemic and energy crisis



Source: Japanese Ministry of Finance

Japan is unlikely to be vulnerable to tariffs. Exports constitute 23% of Japan's GDP, with the US being Japan's largest trading partner (20% of its exports[9]). Japan is estimated to have a \$65B trade surplus with the US,[10] behind only China, Mexico, Vietnam and the EU. Despite this, most equilibrium models suggest that the impact of a universal 10% tariff on all imports to the US would have a negligible, marginally positive impact on GDP growth (+0.1%[11]). This is a function of:

1. Japanese exports being high value add with limited domestic alternatives for substitution.
2. The depreciation in the trade weighted JPY (-20% since start 2022) offering a significant competitive advantage versus other alternative imports (Exhibit 8).
3. Japanese firms have relocated relatively more factories to the US post the first Trump administration than other countries (Japanese FDI to the US has increased +180% since 2016, vs +124% for German firms).[12]

Exhibit 8

The trade weighted JPY has declined by -23% since the beginning of 2022

Source: Bloomberg

However, in the case of targeted industry specific tariffs on automobiles and heavy industrial goods, Japan would be much more vulnerable. If Trump were to raise tariffs to 25% on Japanese automobiles as was proposed on the campaign trail in 2024 and in his first term in 2018, experts believe this would decrease GDP growth by -0.4%.[13]

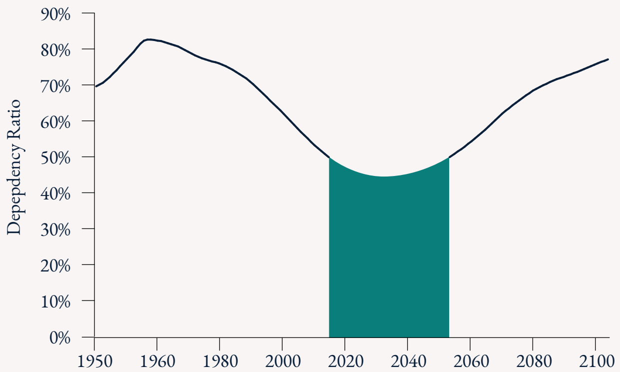
9 Morgan Stanley
10 The Economist
11 Morgan Stanley
12 United States Bureau of Economics
13 Morgan Stanley

India: Real GDP in India is expected to grow by +6.5% CAGR[14] to 2029, more than any other emerging market country. This is driven by a demographic dividend, a growing middle class and a stable government committing to focused investment. India is unlikely to be impacted by tariffs but could lose its energy advantage.

Demographic dividend. India is reaping the benefits of a demographic dividend[15] (Exhibit 9) and will continue to do so for the next three decades, with an estimated population peak of 1.7B in 2060, up from 1.4B today. This growing labour force is also becoming an increasingly highly skilled one, with more than one-third of Indian students choosing STEM degrees[16], significantly higher than in the US and UK with 20% and 23%, respectively. There is evidence of an emerging middle class. Spending on education, durable goods and consumer services has increased by +53% since 2010 versus just a 10% increase in consumption on essentials such as clothing and electricity. Additionally, the spending gap between rural and urban populations is diminishing. In wealthier states such as Delhi the urban-rural spending ratio is 1.2x versus a country average of 1.7x, further growing the consumer base within the country. Indian household expenditure has increased by an average of +12%/year since 2010.

Exhibit 9

India will benefit from a demographic dividend for the next thirty years

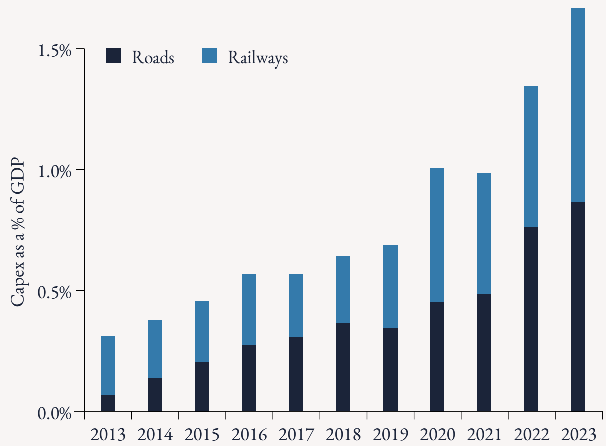


Source: United Nations

Government stability & investment. Following Modi's re-election in June, the Bharatiya Janata Party (BJP) is now serving its third successive term in government. This is the first time this has happened since 1962. Modi's power has been curtailed somewhat following the election as the BJP will now govern as part of a coalition. However, analysts note that the agenda will continue to focus on growth and fiscal discipline, allowing the country to take advantage of its demographic tailwinds. Modi's government has increased expenditure on roads and railways from 0.4% of GDP in 2014 to 1.7% of GDP in 2023, Exhibit 10. The budget for 2025 will focus on addressing India's skill gap, particularly in the manufacturing sector as well as a planned reduction in the corporate tax rate from 40% to 35%, which aims to increase manufacturing and infrastructure investment.

Exhibit 10

Under Modi's leadership, investment in infrastructure has quadrupled as a % of GDP



Source: Financial Times

14 CAGR: Compound Annual Growth Rate

15 Demographic Dividend: The economic growth potential that can result from shifts in a population's age structure, mainly when the share of the working-age population (15 to 64) is larger than the non-working-age share of the population (14 and younger, and 65 and older) (Source: United Nations Population Fund (UNFPA))

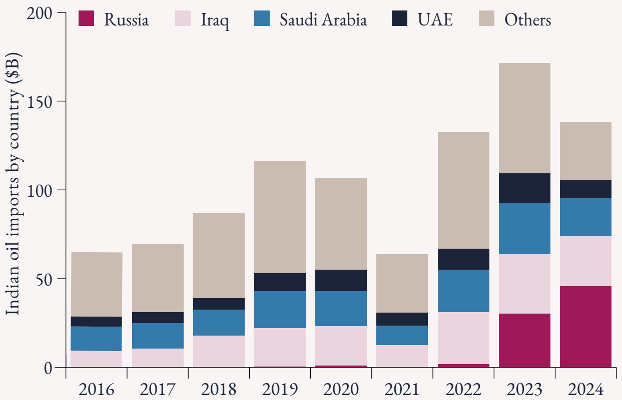
16 STEM: Science, Technology, Education, Maths

Macroeconomic View

The impact of Trump. The Indian economy is primarily domestically driven, with c. 90% of Indian corporate profits coming from domestic industries. Exports as a percentage of GDP are just 14% compared to over 20% for China and Japan. This reduces the country's exposure to Trump's potential protectionist policies even with the US as India's largest export partner (17.7% of exports). Analysts at Deutsche Bank estimate that in their "maximalist tariff" scenario, **Indian GDP would be reduced by less than -0.2% in each of the next three years, less than any other Asian economy.** Trump's pledge to end the war in Ukraine also has the potential to impact India. Prior to the war, Russian oil imports represented just 2% of India's oil supply. In 2024 that figure was closer to 40%,[17] as shown in Exhibit 11. Analysts estimate that the purchase of discounted Russian oil versus prevailing market prices has saved India c. 0.4% of GDP since the war began. Were Russian sanctions to be removed, this energy dividend could evaporate.

Exhibit 11

Roughly 40% of India's oil imports in 2024 were Russian



Source: The Economist

What are the investment implications? We recommend remaining at benchmark weight in emerging market and Japanese equities. We maintain an allocation to these regions given their growth profile, portfolio diversification benefits and the high level of dispersion within indices that creates a fruitful environment for active managers. Within emerging markets, we are neutral at a country level as we believe valuations accurately reflect the respective fundamental outlooks (Exhibit 12).

Exhibit 12

Country valuations largely reflect fundamentals

	2025 EPS Growth	2025 PE Ratio	10-year Z-Score	Tariff Sensitivity
China	7.2%	9.7x	-0.9	-0.5%-1% GDP Drag
Japan	9.2%	14.1x	+0.2	< 0.4% GDP Drag
India	15.9%	23.8x	+0.5	< 0.2% GDP Drag

Source: Bloomberg, Deutsche Bank

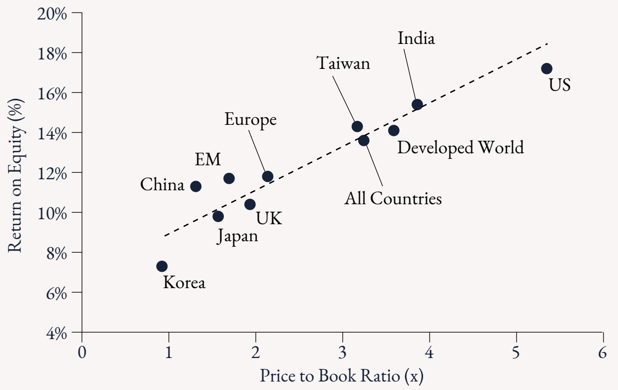
China: Despite the rally following the stimulus announcement in September (+16% MSCI China in USD), valuations remain well below their long-term average (9.7x 2025 EPS). While tariffs present a significant risk for Chinese equities, much of that risk is already reflected in valuations. A grand bargain with Trump is a risk to the upside. Fiscal stimulus has, so far, fallen flat. The national congress in March is a key catalyst for further details on next steps. From a longer-term perspective, demographics will remain a significant drag, but China has invested heavily to become a market leader in emerging technologies such as AI and nuclear energy.

17 The Economist

Japan: Corporate reform is driving real change. Share buybacks as a percentage of net income have doubled in the last two years to 30%, the number of companies employing anti-takeover measures has fallen to 8% from close to 20% just 5 years ago and M&A activity in 2024 has risen to the highest level since 1985.[18] While the return on equity for Japanese stocks has risen from 8% to 10%, it remains -4% below that of global equities.[19] This limits the degree of multiple expansion that is possible from here, as illustrated in Exhibit 13. Tariffs are not viewed as a significant threat unless they are targeted. The key risk for Japanese equities is that the belated tightening in monetary policy by the BoJ triggers an appreciation in the JPY after its sharp decline in recent years.

Exhibit 13

Japan needs to raise its ROE to justify higher multiples

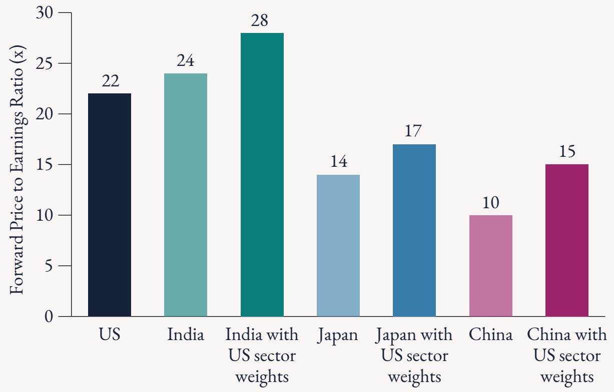


Source: Bloomberg

India: India is expected to be the fastest-growing emerging market nation over the next three years at 6.5% CAGR, reaping the benefits of its demographic dividend and government-driven investment in infrastructure. The domestic nature of its economy also leaves it less vulnerable to the threat of tariffs. The problem is that this is reflected in valuations (forward PE 24x 2025 EPS) with India now one of the most expensive equity markets in the world, even after making sectoral adjustments (Exhibit 14). India also faces a number of threats: 1) corporate governance remains weak as evidenced by the ongoing Adani scandal, 2) an end to the war in Ukraine could reduce the competitive advantage India has enjoyed in oil markets and 3) the rise in AI and in particular "agentic AI" poses a threat to parts of India's service sector "the global back office".

Exhibit 14

Indian equities are more expensive than US equities, even after adjusting for sector mix



Source: Goldman Sachs

18 Deutsche Bank
19 Bloomberg

Tactical Asset Allocation

We believe the global economy has entered an era of heightened macro volatility. Recent political and economic trends are consistent with the 'Paradigm Shift' macro theme we introduced two years ago. As such, the current portfolio positioning remains largely appropriate for long-term investors and we make only modest tweaks to our 2025 Tactical Asset Allocation (TAA), continuing to position for an environment of higher long-term interest rates and more persistent but volatile inflation. Key recommendations:

- Remain underweight government bonds given the upward pressure on interest rates and large budget deficits across developed markets, but aim to be nimble, adding interest rate exposure if longer-dated yields spike higher (e.g., above 5% on the 10-year US Treasury Note).

- Overweight income-producing assets in Liquid Credit and Private Debt relative, targeting areas where the supply of capital has been more constrained.

- Overweight Absolute Return as an important source of low equity risk/uncorrelated returns in a volatile environment.

- Within Public Equities, remain balanced across various strategies and sectors.

- Continue to build highly targeted exposure to Private Equity. In a higher interest rate environment, Private Equity firms must rely on increased earnings growth to sustain their strong returns. We favour teams with a lower middle market focus, sector specialists, and dedicated operating resources.

Compared to our long-term Strategic Asset Allocation benchmark (SAA), the 2025 Tactical Asset Allocation (TAA) maintains a longstanding underweight to interest rate duration (-2.5% government bonds, -2.5% Index-Linked Bonds) in favour of Cash/short-dated bonds (+2%) and Absolute Return (+3%). However, we may move 2% from Cash into government bonds if 10-year yields rise (potentially above c. 5% in the US or UK, 3% in Germany) or if the economic outlook appears likely to deteriorate meaningfully.

The TAA continues to favour income-generating assets which offer attractive all-in yields. However, with credit spreads now tight relative to history, we reduce the size of our above-benchmark allocations in Liquid Credit from +3% to +2%. The allocation to Private Debt remains +3% above benchmark as the asset class continues to offer attractive returns at a premium to public markets. In both cases, careful security selection is necessary to guard against deteriorating credit fundamentals. Within Private Debt, we continue to diversify away from the more commoditized, large cap direct lending in favour of sub-sectors where the supply of new capital has been more constrained.

The reduced Liquid Credit allocation will be gradually redeployed in Private Equity over the year. The remaining +5% overweight to income-generating assets is funded from a -2% underweight to Public Equities, -1% from Private Equity and -2% from Venture Capital. The underweight allocations to PE and VC reflect that it takes time to build out a mature, diversified allocation to these asset classes. We continue to believe that long-term institutional investors should hold roughly 40% of their portfolio in private markets and recommend that clients continue to steadily maximise their allocation subject to their specific liquidity needs. We express this view by adding +1% to buyouts in 2025 relative to last year.

We remain at weight in Real Estate, which continues to offer compelling risk-adjusted returns, most notably in digital infrastructure and power/energy infrastructure.

Partners Capital advises a wide range of clients, each with a bespoke portfolio catering to different objectives and constraints. To allow us to talk about asset allocation in more general terms, we reference a model portfolio that reflects our median client. All Tactical Asset Allocation (TAA) changes discussed here reference this central policy portfolio for a large non-taxable institutional investor. The direction of these changes will be relevant to our taxable clients and those with different strategic benchmarks, but with different total allocations depending on each client's specific requirements.

One of our founding principles is that attempting to time the entry and exit from markets will generally lead to sub-par returns over the long run. Instead, we believe the best method for securing attractive returns over the business cycle involves setting an appropriate risk budget range and holding it relatively constant. We find aggregate equity-equivalent risk to be a useful measure for expressing a portfolio's overall risk level. Our model portfolio benchmark targets a similar level of equity risk as a 65/35 equity/bond benchmark. However, asset classes are not homogenous, so a careful assessment of the market risks underpinning each investment is needed to truly understand the risks in a portfolio.

The model portfolio Strategic Asset Allocation (SAA) is optimised to maximise the return per unit of risk using our long-term market assumptions, constraining for the risk tolerance and liquidity needs of a typical client. Our TAA process considers the cyclical nature of financial markets and uses scenario analysis to best position the portfolio over the next 12-18 months.

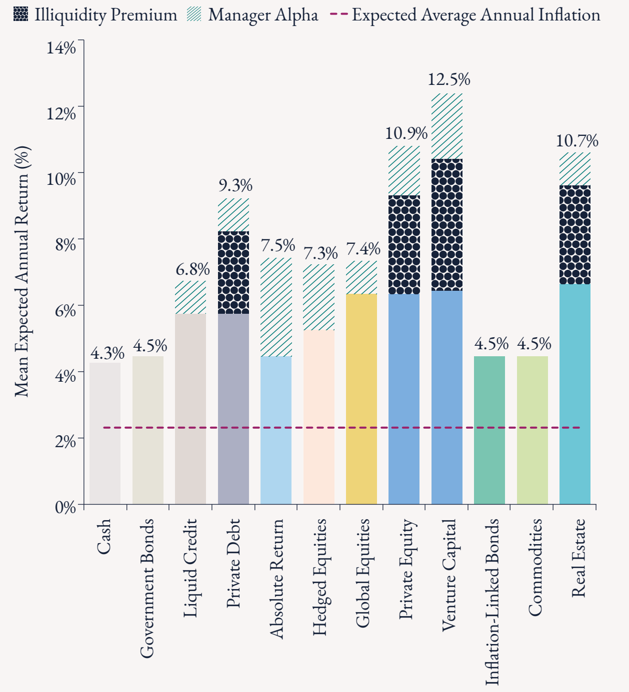
Long-term return assumptions

Determining the SAA requires both quantitative and qualitative analysis, including forecasts of returns, volatility, and correlations over the full cycle. Exhibit 1 below provides the Partners Capital 10-year mean annualised return forecast for each asset class in nominal USD. The returns are decomposed into the market return (risk-free rate plus risk premium), estimated illiquidity premium where relevant, and the level of manager outperformance that Partners Capital believe is achievable in each asset class. These forecasts are incorporated into our portfolio modelling, with probable distributions (defined by the forecast asset class volatility) and correlation assumptions.

Hypothetical return expectations do not represent actual trading and are based on simulations with forward looking assumptions, which have inherent limitations. No representation is being made that any investor will or is likely to achieve returns similar to those shown. Such forecasts are not a reliable indicator of future performance.

Exhibit 1

Mean 10-year return forecast by asset class



Source: Partners Capital

Note: The 10-year annualised forecast returns for market return, illiquidity and potential manager outperformance should be viewed as indicative. Manager outperformance estimates by asset class are net of manager fees.

Summary of deviations from SAA in 2025

The 2025 TAA continues to position the portfolio for an environment of heightened macroeconomic volatility, particularly around the rate of change of key variables such as interest rates and inflation. Our baseline scenario calls for resilient global economic growth. However, as inflationary impulses recede, the recovery dynamics will generate divergences in growth, monetary policy and political pressures across regions. The global election cycle of 2024 resulted in a shift toward greater fiscal stimulus in a wide range of countries—including the US, France, Germany, Japan, the UK, Brazil and China. On a standalone basis, this should have a positive growth impact but may also increase the cost of capital via higher yields. Any such growth impulse might be more than offset by supply shocks as restrictive tariff and immigration policies are implemented in the US. The result will be a policy mix that is neutral to slightly restrictive on growth, and supportive of inflation.

Against this backdrop, we aim to bias the portfolio in favour of income-producing assets to take advantage of attractive yields with higher certainty of return, while maintaining selective allocations to those assets poised to benefit the most should growth continue to exceed expectations. Below, we outline our rationale for positioning by asset class.

Tactical Asset Allocation

Cash: Overweight moving to neutral. Cash typically has a limited investment role in an optimized long-term portfolio as it offers no risk premium for which we expect to be compensated, resulting in a low real return over time. However, with yield curves still flat relative to history, cash yields remain competitive. Based on the yield of one-year government Bills, a proxy for expected average cash yield over the next 12 months, we believe investors can expect to earn something close to 4.1% in USD, 4.6% in GBP and 2.2% in EUR cash deposits in 2025, although this is a variable rate and subject to change. As of early 2025, we continue to recommend a +2% overweight position to cash and short-dated bonds, but we expect to reduce this allocation back to benchmark weight during the year in favour of longer-duration bonds.

Government bonds: Underweight moving towards neutral. The risks are two-sided for bond yields. Should growth stall, yields will fall and bonds will provide some offset to the associated equity market declines. However, in the event of excess fiscal largess or tariff-induced stagflation, rising inflation expectations would likely cause bond yields to rise, and the positive stock/bonds correlation of the last four years will persist. As such, we see a strong argument to hold a more diversified mix of low-risk assets, including Cash and Absolute Return managers, in lieu of bonds. That said, we will look to add duration if the yield curve steepens via rising long-end rates. For example, if the 10-year US Treasury or UK Gilt yield rose above c. 5.0%, or the German Bund above 3.0%. Such a move would be contingent on our economic outlook at the time and an assessment of the relative attractiveness of alternative uses for the capital.

Liquid Credit: Reduce overweight. After significant credit spread narrowing across the spectrum of credit assets over the previous year, 2025 is likely to be a year of income-driven returns in credit, with interest rates the key driver of any volatility. Security selection, relative value opportunities, and the ability to act as a provider of liquidity during periods of higher volatility or dislocation will be key to navigating a tighter spread environment and mitigating downside risk. More complex strategies where specialists benefit from better access to data and the capacity to source off-the-run assets offers the potential for excess returns. Higher-rated exposures in structured credit may also offer an attractive income with more limited downside risk in an environment where spreads in lower-rated assets may no longer adequately compensate for underlying risk.

Private Debt: Overweight. Private Debt continues to offer attractive returns at a premium to public markets, driven by lower liquidity, the smaller average size of private borrowers, and the greater flexibility afforded to borrowers by a single or smaller group of lenders. However, we believe investors should seek to diversify portfolios away from more commoditised, large cap direct lending in favour of sub-sectors with more attractive supply of and demand for capital such as non-sponsored lending, asset-backed lending, and capital solutions. We maintain a long-term positive view on the opportunity in Private Debt, viewing alternative lenders as an increasingly important component of the financing ecosystem, with a clear secular trend towards further disintermediation of the banks in the financing of corporate borrowers, financial and physical assets. We believe that a multi-strategy portfolio of complementary exposures in Private Debt should offer a resilient source of long-term income. In the near term, higher-for-longer interest rates and robust operating performance for corporate borrowers is expected to support attractive risk-adjusted returns from the asset class. However, as the asset class matures, we are carefully monitoring areas of the market where an oversupply of capital and resulting competitive pressures may lead to a change in risk profile and the quality of returns generated.

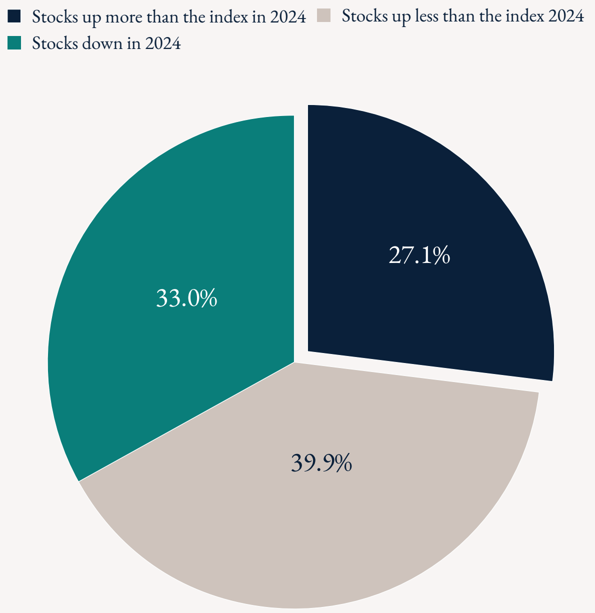
Hypothetical return expectations based on simulated market conditions which has inherent limitations. Such returns are not a reliable indicator of future performance.

Absolute Return: Overweight. We maintain an above-benchmark allocation to Absolute Return as the policies introduced by the Trump administration are expected to broaden the opportunity set for alternative investments. Pro-business regulatory changes, particularly a more accommodative stance on mergers and acquisitions, will likely enhance deal flow. Additionally, rising US debt levels and increased Treasury issuance to finance expanding fiscal deficits may heighten bond market volatility, presenting opportunities for relative-value strategies. Regional economic divergences are also expected to create macroeconomic investment opportunities. Emerging markets (EM) will likely experience elevated volatility, with new tariff regimes potentially producing distinct winners and losers. These developments could drive significant movements in EM currencies, credit, and equity markets, fostering a dynamic landscape for active investors. We focus allocations on multi-strategy funds for cash efficiency and enhanced risk management, as well as strategy specialists to shape overall portfolio balance and to enhance returns.

Public Equities: Underweight. Our investment philosophy remains grounded in maintaining steady equity exposure over time, with only modest adjustments to the total allocation. In 2025, we recommend a -2% below benchmark allocation to Long Equities. This underweight does not reflect an outright negative view on equities, but rather a relative preference for Liquid Credit and Private Debt where the contractual nature of the return is more certain, and Absolute Return where some strategies are likely to benefit from the current environment. Within equities, we maintain an overall preference for hedged strategies compared to more directional strategies, given the ripe dispersion opportunity set within Emerging Technology, especially from Generative AI. While the US economic outlook remains favourable, the stretched valuations caused by the rally in 2024 introduce greater downside risks. Historically, elevated valuations have not been strong predictors of short-term returns, but they can amplify losses if earnings growth expectations are not met. Consequently, the equity market's trajectory in 2025 will depend heavily on the ability of companies to deliver on forecasted earnings growth, and our long-term equity return expectations continue to compress.

Exhibit 2

Fewer than 30% of companies in the S&P 500 outperformed the index in 2024



Source: Bloomberg

Private Equity: Continue building to max allocation. Clients should steadily build out their allocations to Private Equity, which we expect to outperform public market equivalents by 3-4% p.a. over the long-term through operational improvement, specialization and better management alignment. We implement this view with a +1% increase to Buyouts in the 2025 TAA. This leaves the model portfolio with a 22% allocation to PE (17% Buyouts, 5% VC) compared to the long-term strategic allocation of 25% that we believe most institutional portfolios should strive for (18% Buyouts, 7% VC). The TAA's below benchmark allocation reflects the fact that it takes time to build out a mature, diversified allocation to Private Equity, and our average client remains underweight.

In 2025, we anticipate robust earnings growth, higher transaction volume and increased exit activity as buyer and seller expectations continue to converge. However, the current environment of elevated interest rates and limited multiple expansion will reduce the scope for a repeat of the broad-based industry beta that drove more than half of buyout industry returns over the past decade. We believe that the best performing firms of the future are those that generate the most earnings growth in their portfolio companies via organic and inorganic revenue growth and margin expansion rather than leverage or multiple arbitrage. Our approach is characterized by a broad sourcing strategy, rigorous manager evaluation framework emphasizing both qualitative and quantitative attributes, and proprietary tools and data enabling us to understand how managers create value. We also aim to leverage our relationships with managers to source co-investments that can reduce management fees and carried interest expenses while concentrating capital in the sub-sectors in which they excel. Within Venture Capital allocations, we continue to expand exposure to early-stage investments which exhibit lower correlation with macroeconomic risks, as outcomes are dependent upon innovative technologies and product-market fit, rather than interest rates or the corporate earnings cycle.

Inflation-Linked Bonds/TIPS: Underweight. We actively monitor the optimal source of portfolio duration and the relative attractiveness of nominal and real yields. Current long-term inflation expectations priced into ILBs appear modest relative to the risks of structurally higher inflation from protectionism, populism, and remilitarization or the scale of investment associated with AI development and the energy transition. This should make ILBs relatively attractive over the long term, although returns in this scenario will be reduced by higher nominal yields. In an economic slowdown, inflation expectations will fall, dampening the decline in real yields, resulting in underperformance of ILBs relative to nominal bonds. On balance, our scenario modelling suggests the returns from ILBs are modest in almost all scenarios except significant stagflation. As such, we maintain a -2.5% underweight relative to benchmark, with a preference for Cash and Absolute Return managers.

Real Estate: At Weight. We maintain an 8% allocation to Real Estate, in line with the SAA benchmark. We favour a targeted investment strategy, focusing on Private Equity Real Estate (PERE) over core and core-plus strategies, due to more favourable acquisition valuations and value-add potential, especially given the current uncertainty in financing and valuation environment. In terms of sector exposure, we skew towards industrials and digital infrastructure. We favour accessing industrials through owner-operators executing a portfolio roll-up strategy in small (100-250K square feet) last-mile assets, as small assets continue to trade at a discount to large portfolio sales. In digital infrastructure, the rapid growth in data consumption driven by internet usage and cloud adoption is set to further accelerate as AI adoption becomes more widespread. Hyperscalers, the largest users of data centre assets, have made several large-scale capex announcements over recent months, with Meta and Microsoft announcing plans to spend $60B+ and $80B respectively. While demand drivers are well understood, supply remains constrained due to challenges accessing appropriate sites with ability to secure the right zoning and access to sufficient power. We believe there is an opportunity to partner with experienced managers in this space, with the network and execution capabilities to take advantage of long-term secular growth.

Tactical Asset Allocation

Exhibit 3 summarises our recommended 2025 TAA for a non-taxable investor and contrasts it with both the SAA and the 2024 TAA. We have modified versions of the TAA for our US, UK and other taxpaying clients with changes that move in a similar direction. A more detailed summary of our views of each asset class is provided in the asset class sections of this publication.

Exhibit 3

Changes in Tactical Asset Allocation

	SAA	2025 TAA	Difference vs. SAA	Difference vs. 2024 TAA	Notes
Cash	1.0%	3.0->1.0%*	"+2.0% -> -"	–	• Maintain lower interest-rate sensitivity by allocating to shorter-dated bonds and certain Absolute Return strategies rather than long-dated nominal bonds or ILBs. • Consider shifting 2% from cash to market duration bonds if US 10yr yield rises above 5.0%, but contingent on economic outlook and relative attractiveness of alternatives at the time.
Government Bonds	5.0%	2.5->4.5%*	"-2.5% -> -0.5%*"	–	
Liquid Credit	2.0%	4.0%	+2.0%	-1.0%	• Favourable environment for Opportunistic/Event Driven credit. All-in yields still attractive in higher rated Structured Credit. • Passive High Yield and Loans appear expensive relative to history although credit quality is improved.
Private Debt	7.0%	10.0%	+3.0%	–	• Attractive opportunities in sector specialist lending, with software, life sciences, legal, and agricultural lending amongst the sectors we have in our portfolio and pipeline.
Absolute Return	12.0%	15.0%	+3.0%	–	• Higher macro volatility and asset dispersion offer strong "cash-plus" return opportunities. • Allocate to multi-strategy funds for cash efficiency and enhanced risk management, as well as strategy specialists to shape overall portfolio balance and to enhance returns.
Hedged Equities	5.0%	5.0%	–	–	• Greater economic dispersion across sectors and regions creates favourable conditions for long/short spread generation. Our emphasis remains on partnering with managers who exhibit strong research specialization, robust portfolio construction capabilities, and disciplined risk management.
Long Equities	30.0%	28.0%	-2.0%	–	• Within Equities, maintain a balanced mix of factors, as well as regional and sectoral exposures. • Underweight allocation reflects rich valuations
Private Equity	18.0%	17.0%	-1.0%	+1.0%	• High conviction in buyout managers that possess an ability to "buy complexity" and drive post-acquisition value creation. • Below benchmark allocation reflects the fact that it takes time to build a mature, diversified allocation to Private Equity.
Venture Capital	7.0%	5.0%	-2.0%	–	• Continue to build out VC allocations with focus on early stage as we have developed strong access and relationships to several top tier established and emerging managers in the asset class.
ILBs	5.0%	2.5%	-2.5%	–	• Skew allocation towards front end of the curve which is more responsive to near-term inflationary pressures. The near-term return outlook for ILBs is modest relative to the alternatives across almost all scenarios.
Real Estate	8.0%	8.0%	–	–	• Focus on PERE managers due to favourable acquisition valuations and value-add potential – i.e., "buy-upgrade-sell". Attractive opportunities remain in digital infrastructure and power/energy infrastructure.
Total	**100%**	**100%**	–	–	
Equity Like Risk	66%	63%	-2.6%	+0.4%	• TAA is at the lower end of Equity-Like risk range, reflecting attractive risk-adjusted returns in AR and income generating strategies, and gradual buildout of PE/VC.
Illiquid Assets	40%	40%	0.0%	+1.0%	• Gradually build to target illiquid allocation.

Source: Partners Capital

Portfolio Duration

Exhibit 4 below shows the portfolio-weighted duration resulting from allocations to Government Bonds, Liquid Credit, Private Debt and Inflation-Linked Bonds. It does not include other asset classes such as Property and Growth Equities because the statistical relationship between these asset classes and interest rates is less consistent. If we reach the trigger to add 2% to government bonds from Cash as discussed above, the weighted duration of the TAA will roughly match that of the SAA for USD and GBP portfolios, but still 0.2 years less in EUR due to the higher European ILB duration.

Exhibit 4

Estimated look-through portfolio duration exposure by client currency

	SAA	TAA	US		UK		Europe	
			Default Benchmark	Duration	Default Benchmark	Duration	Default Benchmark	Duration
Government Bonds	5.0%	4.5%	Bloomberg Treasury 5-10 Years TR	6.2	FTSE A British Govt All Stocks TR	8.1	Citigroup EMU GBI TR	7.3
Liquid Credit - IG	0.0%	0.0%	Bloomberg US Corporate BBB	6.7	Bloomberg Global Corporate BBB TR LC	5.6	Bloomberg Global Corporate BBB TR LC	5.6
Liquid Credit - HY	2.0%	4.0%	Bloomberg U.S. Corporate High Yield TR	3.0	50/50 Bloomberg Global HY / CS Leveraged Loan	2.9	50/50 Bloomberg Global HY / CS Leveraged Loan	2.9
Private Debt	7.0%	9.0%	Partners Capital Private Debt Vehicle	1.3	Partners Capital Private Debt Vehicle	1.3	Partners Capital Private Debt Vehicle	1.3
Inflation-Linked Bonds	5.0%	2.5%	Bloomberg U.S. TIPS TR	5.5	FTSE Actuaries UK Index-Linked Gilts up to 10 Years	5.2	Bloomberg Euro Govt Inflation Linked TR EUR	8.1
SAA Weighted Duration				**0.7**		**0.8**		**0.9**
TAA Weighted Duration				**0.7**		**0.7**		**0.8**
Duration Gap				**-0.1**		**-0.1**		**-0.2**

Source: Barclays, Bloomberg, Partners Capital

Tactical Asset Allocation

Expected Returns from 2025 TAA

In Exhibit 5 below, we summarise our 2025 return forecasts by asset class for our downside, base case and upside scenarios, as well as the long-term return that we expect to earn over the next 10 years. The short-term returns are for the 12-months starting 31 January 2025. In the base case, to which we assign a 60% probability, we expect the model portfolio TAA to produce a return of roughly 9%. The heightened uncertainty puts an unusually wide error band around this. Specifically, in a policy-error-induced recession, we anticipate a decline of roughly -10%, while in the upside scenario of a broad-based expansion, the portfolio is expected to rise +13% - both scenarios are assigned a probability of 20%. Over a 10-year investment horizon, over which the benefit of diversification plays more of a role via active rebalancing, we expect the portfolio to deliver returns closer to +9% p.a.

Exhibit 5

Expected 12-month returns by scenario (starting 31 Jan 2025, includes alpha and beta assumptions)

Asset Class	Allocation			Short-Term, Scenario Specific Forecast (Inc. Alpha)				10-year Return Forecast (inc. alpha)
	SAA	2025 TAA	Deviation	Downside (20%)	Base Case (60%)	Upside (20%)	Expected Value	
Cash	1.0%	1.0%	-	3.7%	4.2%	4.4%	**4.1%**	**4.3%**
Fixed Income	5.0%	4.5%	**-0.5%**	13.1%	5.2%	-0.8%	**5.6%**	**4.5%**
Liquid Credit	2.0%	4.0%	**2.0%**	-6.1%	5.9%	6.3%	**3.5%**	**6.8%**
Private Debt	7.0%	10.0%	**3.0%**	-4.6%	7.4%	8.7%	**5.2%**	**9.3%**
Absolute Return	12.0%	15.0%	**3.0%**	2.3%	7.6%	8.6%	**6.8%**	**7.5%**
Hedged Equities	5.0%	5.0%	-	-8.1%	8.4%	12.3%	**5.9%**	**7.3%**
Long Equities	30.0%	28.0%	**-2.0%**	-19.8%	9.7%	17.1%	**5.3%**	**7.4%**
Private Equity	18.0%	17.0%	**-1.0%**	-16.8%	11.7%	19.1%	**7.5%**	**10.9%**
Venture Capital	7.0%	5.0%	**-2.0%**	-19.6%	13.4%	22.0%	**8.5%**	**12.5%**
Inflation-Linked	5.0%	2.5%	**-2.5%**	2.7%	4.0%	3.0%	**3.5%**	**4.5%**
Real Estate	8.0%	8.0%	-	-2.8%	8.9%	10.3%	**6.8%**	**10.7%**
SAA	**100%**			**-10.3%**	**9.1%**	**13.4%**	**6.1%**	**9.0%**
TAA		**100%**		**-9.7%**	**9.0%**	**13.0%**	**6.1%**	**9.0%**

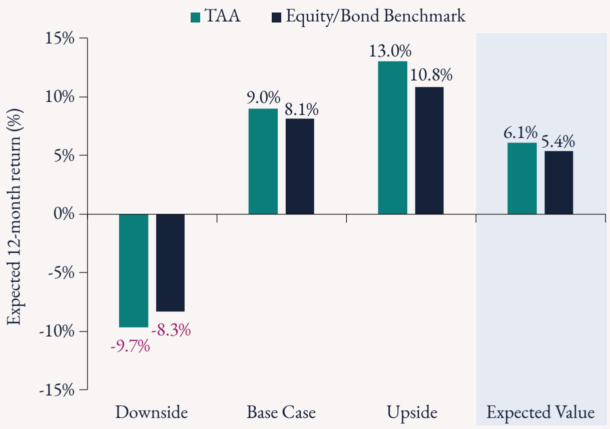
Note: Short-term assumptions are for the 12-months starting 31 January 2025
Source: Partners Capital analysis

Hypothetical return expectations do not represent actual trading and are based on simulations with forward looking assumptions, which have inherent limitations. No representation is being made that any investor will or is likely to achieve returns similar to those shown. Such forecasts are not a reliable indicator of future performance.

These portfolio return assumptions compare favourably to the expected return of a 65/35 mix of Developed Market Equities and Government Bonds. The respective returns are shown in Exhibit 5 below. We expect our 2025 TAA portfolio to outperform a 65/35 equity/bond index by c. 1.0% in the base case and c. 2.5% in the upside case, but will likely lag a 65/35 benchmark by c. -1.5% in recession due to the lower bond allocation.

Exhibit 6

Portfolio net returns by scenario, Partners Capital TAA vs. a 65/35 Equity/Bond benchmark



Source: Partners Capital

Sub-asset class positioning

Within each asset class, we favour particular strategies or sub-asset classes. The asset class summaries at the end of this publication provide more detail on sub-strategy attractiveness and our strategic priorities for each asset class. Exhibit 7 below summarises our sub-asset class skews across each asset class.

Taxable Client Asset Allocation

All changes discussed above reference our central benchmark policy portfolio for a large non-taxable institutional investor denominated in USD. While some of these changes are relevant to our taxable clients as well, special consideration must be given to each client's tax situation and the nature of the underlying investment strategies in the portfolio.

For our tax paying clients, our goal is to maximize expected after-tax returns from a multi-asset class portfolio with a relatively high level of certainty. To do this, we have developed the following four "*Golden Rules of Tax-Efficient Investing*":

Hypothetical return expectations do not represent actual trading and are based on simulations with forward looking assumptions, which have inherent limitations. No representation is being made that any investor will or is likely to achieve returns similar to those shown. Such forecasts are not a reliable indicator of future performance.

1. Increase portfolio risk to reflect the dampening effects of taxation
2. Allocate across asset classes based on after-tax returns, volatility and correlations
3. Select asset managers based on a range of after-tax expected returns
4. Utilize tax efficient structures

The practical implications of the above golden rules will vary depending on the underlying investors status, location and objectives.

US Taxpayers: Taxable investors may be able to take on more risk relative to non-taxable portfolios because taxes dampen the realized impact of volatility on an after-tax basis. This allows for greater exposure to equity-like risk and higher allocations to illiquid asset classes, such as Private Equity and Private Equity Real Estate. These asset classes tend to be more tax-efficient than public market alternatives while also offering illiquidity premiums and potential for manager-driven outperformance.

The post-tax performance of an active strategy is contingent on the tax efficiency of a manager's beta exposures relative to a passive benchmark, and the level of outperformance a manager is expected to generate. Active strategies often come with a higher tax burden due to portfolio turnover, making them less efficient than passive alternatives. To assess this trade-off, we calculate a "breakeven outperformance hurdle" – the minimum amount of pre-tax outperformance an active manager must generate to offset their higher tax burden. We prioritise active management in asset classes and strategies where we believe expected pre-tax outperformance will exceed this threshold.

Partners Capital are not tax advisors. Tax treatment will depend on the individual circumstances of each client and is subject to change. You should consult your own tax advisor to understand the tax treatment of a product or investment.

Tactical Asset Allocation

Exhibit 7:

Partners Capital sub-asset class positioning

Asset Class	Most Negative	Negative	Neutral	Positive	Most Positive
Cash, Fixed Income, ILBs, Gold, Commodities		• Inflation-Linked Bonds • Broad Commodities	• US Treasuries • UK Gilts • German Bunds • Gold	• Cash (incl. low-duration government bonds)	
Liquid Credit		• High Yield Bonds • Leveraged Loans • IG Munis	• Consumer Lending • Short Duration Lending • EM LC/USD Bonds	• Opportunistic/Event Driven • Residential Mortgage Bonds • Commercial Real Estate Credit	• Asset-Backed Lending • IG CLOs
Private Debt and Uncorrelated Strategies	• EM Direct Lending	• Distressed for Control • Mezzanine Lending • Venture Lending • Music Royalties	• UMM Direct Lending • Portfolio Finance • Insurance (life run-off) • Pharmaceutical Royalties	• Real Estate Lending • LMM Direct Lending • Non-sponsor Lending • Litigation Funding • Drug Trial Financing	• Asset-Backed • Capital Solutions • Specialty Lending (tech, healthcare)
Absolute Return		• Risk Premia • Reinsurance	• Convertible Arbitrage • Statistical Arbitrage • Macro/Trading • Managed Futures/CTA	• Fixed Income RV • Fundamental EMN	• Event-Driven/Merger Arbitrage
Public Equities		• US Small Cap	• Traditional Long Equities • Generalist ELS • Global EM	• Life Sciences • Equity Market Neutral • Emerging Tech	• Alpha Extension (benchmark-relative)
Buyouts	• Emerging Markets (ex-Asia)	• Large Cap Buyouts • Distressed/ Turnaround • Asia Buyouts	• Growth Equity • GP-Led Secondaries	• Sector Specialist Buyouts • US Buyouts • European Buyouts • LP-Led Secondaries	• Lower Mid-Market Buyouts • Complex Situations Buyouts • Co-Investment
Venture Capital	• China	• Life Science	• Europe • Late-Stage • Consumer Tech • Deep Tech	• US • Enterprise Tech • Generative AI	• Early-Stage
Real Estate	• Office • Emerging Markets	• Hospitality	• Core-Plus Property • REITs • Retail	• Industrial/Logistics • Multifamily	• Infrastructure (Digital, Power/Energy) • Opportunistic (incl. Cap Solutions/Loans)

Source: Partners Capital

In practice, this means focusing on high-returning (e.g., opportunistic or distressed) Private Debt strategies. Within Public Equities, we emphasise tax-managed strategies that engage in systematic tax-loss harvesting, reducing tax drag at the portfolio level. We also allocate to passive strategies that defer gains into the future. We are selective when investing in active Long Equities managers, favouring those with benchmark awareness and cost efficiency. For Hedged Equities, we prioritise managers with high information ratios and those incorporating tax-loss harvesting. Finally, by optimising tax efficiency across various asset classes, we create room in the portfolio for less tax-efficient Absolute Return strategies, where despite being taxed at ordinary income rates, the breakeven outperformance hurdle is relatively low—allowing investors to retain a significant portion of pre-tax return.

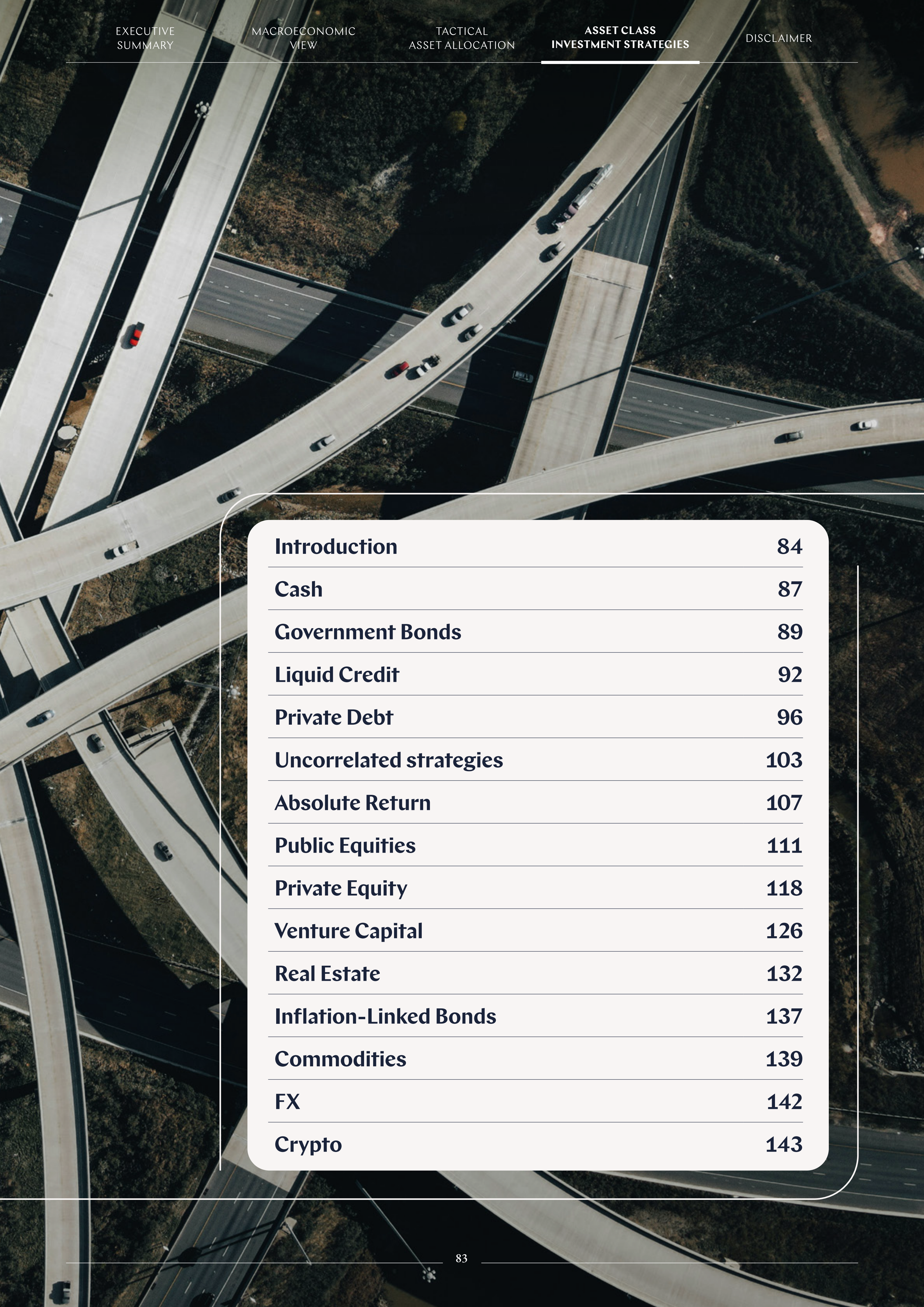
UK Taxpayers: Unlike some other European tax regimes, the UK taxes capital gains, dividends and income differently. Strategies appropriate for non-taxpaying entities such as charitable endowments may not be appropriate for a tax-paying investor and vice versa. For UK taxpayers, as with the US taxpayer portfolios, the allocation should be skewed toward equities given capital gains tax treatment combined with a selection of leading reporting status funds. Absolute Return funds with reporting status should also receive a meaningful allocation as they provide better after-tax returns than fixed income. We will exceptionally allocate to certain non-reporting funds if they are expected to provide truly exceptional performance.

If you would like further information on optimising your portfolio for after-tax returns, we provide whitepapers on this subject on our website.

Asset Class Investment Strategies

We develop our investment strategies for each asset class based on our outlook for the macroeconomic environment, our assessment of the underlying investment opportunities and our partnerships with asset managers. While we adjust our portfolios to reflect these inputs throughout the year, we formally set out asset class investment strategies at the start of the year in Insights.

In the following pages, we cover for each asset class in our asset allocation: the major trends impacting the opportunity set, our "golden rules" for investing, the attractiveness of key sub-strategies and our strategic priorities for 2025.



Asset Class Investment Strategies

Introduction

We develop our investment strategies for each asset class based on our outlook for the macroeconomic environment, our assessment of the underlying investment opportunities and our partnerships with asset managers.

As we enter the third year of the Paradigm Shift in the macro environment, we continue to position portfolios for higher long-term interest rates and persistent inflation. We are also navigating a landscape of evolving investment opportunities and risks driven by heightened market volatility due to political and technological disruption, as well as increased dispersion within markets driven by fundamentals, sentiment and capital flows. We have written extensively about the macro outlook earlier in this report and are broadly “staying the course” on asset allocation as new developments reinforce our baseline views on growth, inflation and interest rates. However, we have seen greater shifts in the asset-level dynamics within markets, which has led to a more significant rotation of investments within our asset classes.

The radically divergent fortunes of different assets and segments within markets have been notable: US equities vs. the rest of the world, the Magnificent 7 vs. practically everything else in US equity markets, AI-related startups vs. the rest of the venture market, US upper middle market direct lending vs. the rest of private credit, to name a few examples. Much of this dispersion has been rooted in substantive differences in fundamentals, but these may be upended by ongoing policy and technological disruption. Furthermore, the magnitude of the dispersion has been exacerbated by sentiment and capital flows, which introduce distortions into markets. We are therefore seeking exposure to market segments and strategies that seem well-positioned to deliver strong returns, alongside asset managers that seem well set up to capitalise on asset-level dispersion.

We remain dedicated to our overall objective of delivering what we believe to be superior risk-adjusted returns over the long term. We set out our latest asset class investment strategies in the subsequent pages, with the following key messages:

1. **Credit** – In the face of significant spread tightening in “vanilla” upper middle market direct lending driven by strong capital inflows, we have rotated new capital into strategies which remain capital constrained and where specialist sourcing capabilities offer differentiated returns. These strategies include lending to smaller companies, non-sponsor lending, specialist lending in segments of the technology and healthcare industries, capital solutions and asset-backed lending, all areas where we see stable pricing and more compelling risk-return opportunities. Our existing loan portfolio remains strong, investing at spreads that provide a yield of 10-12% on the majority of loans and little evidence of rising stress given stable operating performance and loan servicing costs. While we are modestly decreasing our liquid credit allocation and view corporate loans and bonds as fully priced, we are still finding strong risk-return opportunities in structured credit.
2. **Absolute Return** – We were pleased to see strong results in 2024 as our strategies capitalised on market volatility and dispersion to generate attractive excess returns over cash. We continue to allocate risk across a set of strategies and managers providing diversified alpha sources, high idiosyncratic return potential and low correlation to markets and each other. We are mindful of the growing risks in the asset class from the large multi-strategy funds despite the undisputed success of their model. We navigate this by (a) investing in multi-strategy funds but focused on those less aggressive about their asset growth, leverage, fees and liquidity and limiting aggregate exposure to one-third of total risk; (b) building our own internal multi-strategy platform which leverages the benefits of the model while operating at a far smaller scale, with less leverage, substantially lower fees and better investor liquidity; and (c) allocating significant risk to exceptional single-strategy Absolute Return funds that provide consistent, high-quality exposure to smaller/niche markets with partners we can assess and monitor directly.
3. **Public Equities** – After the headwind to active equities in recent years due to an unprecedented concentration of market returns in mega-cap stocks, we see a broadening out of market returns over the next one to three years as our baseline view. We expect our positions in life sciences, emerging technology and traditional stock-picking managers to benefit from this. We continue, however, to add exposure to managers who we believe can deliver consistent outperformance over benchmarks regardless of market concentration (“risk-managed beta-1” strategies), and to use our scale to drive down management fees. We emphasise generating meaningful alpha with stability over the medium term through a core allocation to risk-managed beta-1 strategies, manager sizing based on risk contribution and balanced thematic/factor exposures at the portfolio level.

4. **Private Equity** – Private equity has struggled to keep up with public markets in recent years due to limited private investment realisations and high-returning public equity markets in 2023 and 2024. We have been heartened, however, by the strong operating performance of portfolio companies and accretive investment results from recent exits; we expect these characteristics to support private equity performance as transaction volumes accelerate in 2025. For new investments, we continue to focus on sponsors with proven operational value-add capabilities, differentiated sourcing channels, clear sector-specific expertise and a focus on smaller companies to drive differentiated returns. We also see compelling pockets of opportunity in value-added infrastructure, early-stage venture capital and structurally advantaged real estate.

Investment Examples

We set out below several examples of investments in our portfolio that we believe capitalise on the evolving opportunity set within their respective markets.

1. **Systematic Long Equities** – Added meaningful capital to a leading quantitative equity manager that has delivered consistent outperformance relative to global equity markets with limited volatility in recent years and charges only 0.30% management fee and 20% of excess return over its benchmark. This has become one of the largest investments in our public equities portfolio, allowing us to negotiate further management fee discounts.
2. **Managed Account Platform** – Continued buildout of our internal multi-strategy fund to 26 sub-advisors diversified across strategies, managing c. $1B of capital and producing strong risk-adjusted returns. We are adding sub-advisors in strategies that complement our existing portfolio and leverage attractive market opportunities, like equity capital markets (capitalising on increased primary and secondary equity issuance), systematic macro (capitalising on increased volatility in global equity, bond, currency and commodity markets) and credit relative value (capitalising on increased dispersion within credit markets).
3. **Direct Lending and Capital Solutions for Lower Middle Market Companies** – Provided anchor capital to a vehicle which has the capacity to lend into performing lower middle market companies and to provide capital solutions in more complex situations. This partnership on attractive terms offers the benefit of higher spreads and better covenant protections from lending to smaller companies, while allowing the investment manager the flexibility to lean into complex situations where senior capital may be priced at a premium, as well as benefiting from potential upside through equity participations.
4. **Specialty Lending in Life Sciences** – Committing to Fund II for an emerging specialist lending manager sourced from our network where we acted as an anchor investor for Fund I. This fund offers exposure to life sciences lending alongside an industry specialist with differentiated proprietary sourcing and attractive fee terms grandfathered from our initial investment.
5. **Value-Added Infrastructure in Digital and Power** – Added allocations to digital and power infrastructure, starting a year ago, to capitalise on strong secular trends (cloud and AI-driven demand growth and data centre undersupply) and positive characteristics for this macro environment (asset class with relatively stable and inflation-protected income). Digital infrastructure investments have been alongside two sponsors with attractive development sites contributed to the fund at cost, strong credibility and relationships with hyperscalers, and in-house industry-specific operational expertise to manage development.
6. **Lower Middle Market Buyouts in Defence and Government Services** – Entered into a new partnership with a sponsor focused on small companies in defence and government services, committing to their first institutional fund at under $700M fund size. This partnership continues our focus on sponsors with proven operational value-add capabilities, differentiated sourcing channels, clear sector-specific expertise and a focus on smaller companies to drive differentiated returns.

Asset Class Investment Strategies

Introduction
continued

7. **Tail-End Secondaries** – Committed to a new fund with an established manager relationship that focuses on small and mid-sized tail-end secondaries deals with meaningful portfolio complexity. This manager leverages their experience from almost 20 years transacting in this market, accumulated data on sponsors and portfolio companies over its history, and active sourcing networks as its competitive advantage. They purchase assets at an average discount to NAV of 30%, with no compression of the discount in their deals in recent years, targeting strong near-term and lifetime returns.
8. **Private Equity Co-Investments** – Increased co-investment participation alongside our managers, taking advantage of a continued tight private equity fundraising environment. We deployed $400M into 12 platform companies in H2 2024, including a leading European savory snacks manufacturer as our fourth co-investment alongside one global industrials sponsor, and a US mission-critical communication devices and network infrastructure provider alongside a US lower-middle market sponsor.

As a reminder to readers, our overall investment approach is summarised below. We concentrate our capital in what we see as structurally attractive investment strategies and themes, and we focus on building durable manager partnerships to execute on these. We focus our investment research on identifying, evaluating and mapping investment areas that we believe can contribute meaningfully to portfolio returns over a 3+ year time horizon. We work tirelessly to identify new asset managers and investments for our portfolios both to pressure test existing allocations and to upgrade our holdings.

Within our target strategy areas, we harness our global sourcing network to identify what we believe to be the best talent and investment opportunities. We have a long history of successful partnerships with emerging asset managers, and we have built durable strategic relationships with some of the leading investors in the world.

We structure our investment relationships creatively and appropriately for the individual opportunity. We have increasingly anchored fund investments, established managed accounts and co-invested with our managers to improve the net investment results for our clients. We often find that our conviction in the specific asset manager, quality of the partnership and structure of the investment are just as important to our investment outcomes as our outlook on the broader strategy area.

We focus on leveraging our scale, platform and capabilities to enhance client returns by accessing attractive investment areas with more control over asset selection and at a fraction of the fees of “standard” external funds. As examples, we have built dedicated internal teams to execute private market co-investments alongside our sponsors and to allocate risk directly to external trading teams as sub-advisors on our managed account platform. We also use our asset scale and manager partnerships to create customised exposure vehicles and to drive down asset management fees.

We construct our overall investment portfolio to benefit from meaningful allocations to our high conviction investments and to possess true diversification across underlying alpha sources, while staying aligned with market risk and asset allocation targets. We size individual investments based on their risk contribution to the portfolio, while carefully managing aggregate thematic and factor exposures at the portfolio level.

We design our portfolio with the goal of producing, under various potential market conditions, robust outperformance relative to market risks in the medium term and superior total risk-adjusted returns in the long term.

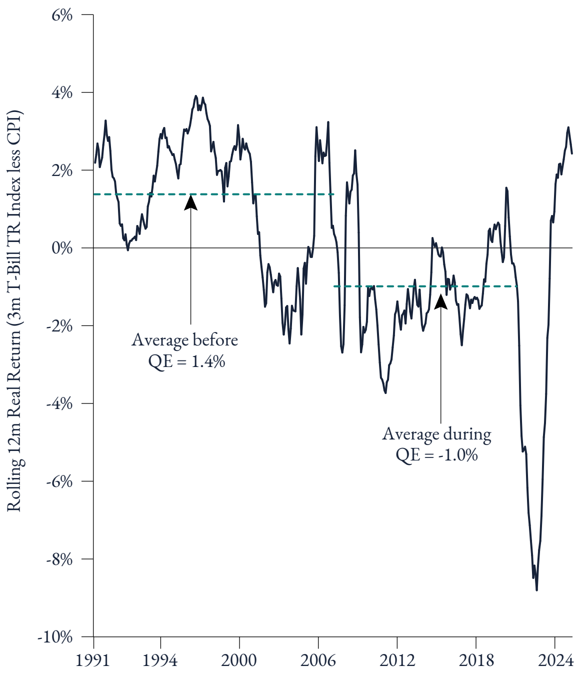
Cash

Major Trends

Positive real yields: Based on the yield of one-year government bills, a proxy for expected average cash yield over the next 12 months, investors can expect to earn something close to 4.1% in USD, 4.6% in GBP and 2.2% in EUR cash deposits in 2025, although this is a variable rate and subject to change. Based on 1-year inflation swaps, this represents an expected positive real yield of roughly 1.6% in USD and GBP and 0.2% in EUR. This is a change from the years between the 2008 financial crisis and the 2020 pandemic when real cash yields were negative (Exhibit 1).

Exhibit 1

Real cash yields are positive



Source: Bloomberg, data as of 28 Jan 2025

Easing monetary policy: Policy rates are expected to be reduced over 2025. Overnight interest rates are expected to decline by roughly -0.6% in USD, -0.8% in GBP and -1.0% in EUR. In USD, this would take the effective Fed Funds rate down from 4.3% at the start of January to c. 3.8% by the end of December (Exhibit 2).

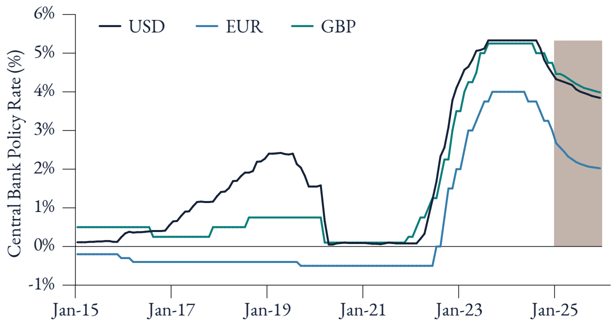
Hypothetical return expectations based on simulated market conditions which has inherent limitations. Such returns are not a reliable indicator of future performance.

Golden Rules

1. The role of cash is primarily operational, in that a small allocation is necessary to facilitate portfolio management (e.g., meeting capital calls or portfolio withdrawals).
2. Cash has a limited investment role in an optimised long-term portfolio as it offers no risk premium for which we expect to be compensated, resulting in a low real return.

Exhibit 2

Cash rates expected to decline in 2025



Note: Shaded area shows implied path of forward rates over the next 12 months.
Source: Bloomberg, data as of 28 Jan 2025

Asset Class Investment Strategies

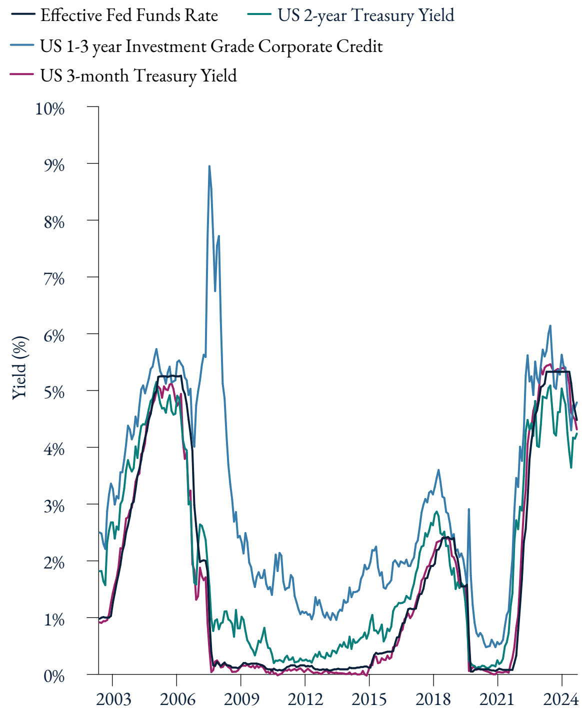
Cash
continued

2025 Strategic Priorities

- **Prepare to add duration:** We anticipate bond yields remaining volatile in 2025 and will seek to exploit this by reducing the cash allocation in favour of benchmark duration bonds if longer-dated yields rise and the yield curve steepens, or if the economic outlook deteriorates such that central banks may be forced to cut more quickly.
- **Make use of cash-like alternatives with higher yields:** For larger cash allocations, we recommend holding short-duration investment-grade bonds (both government and corporate) that represent an acceptable level of risk for roughly 0.5% of additional yield and good liquidity (Exhibit 3).

Exhibit 3

Short-duration credit offers a higher yield, but with higher risk



Source: Bloomberg, data as of 31 Dec 2024

Government Bonds

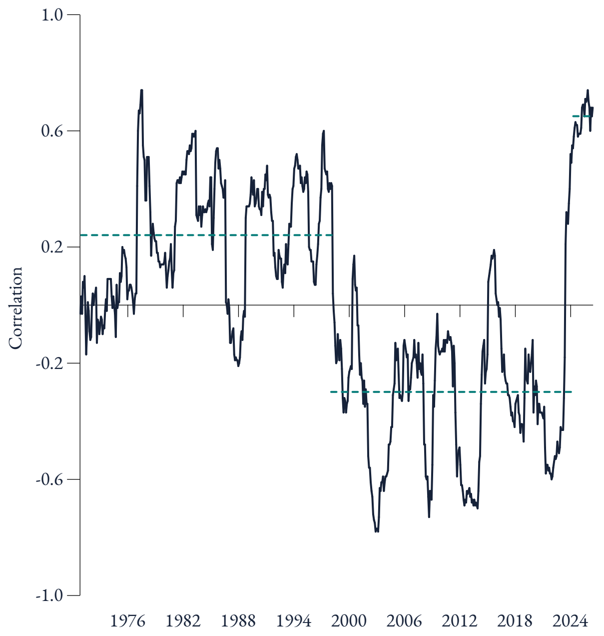
(Note: Our interest rate and bond yield outlook is covered extensively in the Macroeconomic View section. This section focuses on the role of Government Bonds as part of a multi-asset portfolio)

Major Trends

Higher correlation of bonds and equities. The correlation between global equities and bond returns switched sign to become positive in mid-2021, and has remained positive since then (Exhibit 1). As a result, the diversification benefits of bonds within a multi-asset portfolio are diminished.

Exhibit 1

Bond/Equity correlation remain elevated

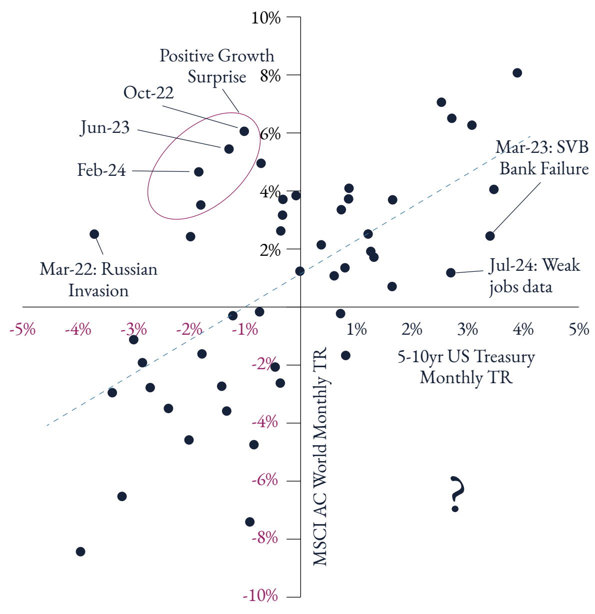


Source: Bloomberg, data as of 28 Jan 2025

Over the last four years in particular, bonds have generally been a less attractive investment, with very few instances of bonds rallying in months when equities declined in value. As shown in Exhibit 2, bonds have either: 1) been positively correlated to equities, rising and falling at the same time as equity values, largely driven by changes in inflation data; or 2) fallen in value in those months when equity prices have increased, driven by stronger-than-expected growth (e.g., June 2023, Feb 2024) or inflationary shocks (e.g., March 2022 Russian invasion).

Exhibit 2

Not once in the last four years has the return on Treasuries exceeded +1% in a month when equities have declined in value



Source: Bloomberg, data as of 28 Jan 2025

We believe the future outlook for this relationship is scenario dependent. In a classic recession, the correlation would typically revert to negative. However, during periods of stagflationary supply shocks, as is likley in the event of a full-scale trade war, the correlation would be expected to remain positive.

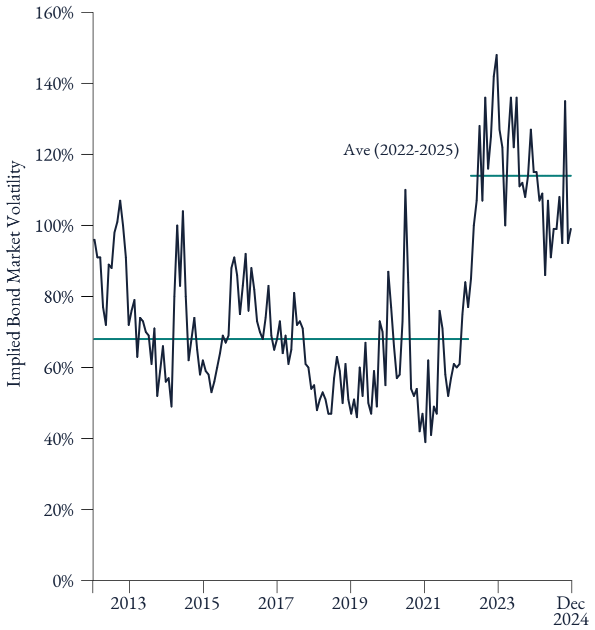
Asset Class Investment Strategies

Government Bonds
continued

Heightened yield volatility is set to continue. Bond market implied volatility is nearly double what it was before the global rate-hiking cycle began at the end of 2021 (Exhibit 3). We expect elevated volatility to persist as Trump adopts strategic unpredictability in international relations.

Exhibit 3

Bond volatility has been structurally higher



Source: Bloomberg, data as of 28 Jan 2025

Notes: The MOVE index is a yield-curve weighted index of the normalised implied volatility on 1-month Treasury options

Longer duration magnifies volatility. As shown in Exhibit 4, the 1-3 year Treasury Index has increased without any major drawdowns over the last two years. This contrasts with the 7-10 year Index, which suffered a -10% peak-to-trough decline in 2023 and a -7% decline in 2024.

Exhibit 4

The 7-10 year Treasury Index has suffered frequent drawdowns over the last two years

Source: Bloomberg, data as of 28 Jan 2025

Economists at the Bank of International Settlements argue that this uncertainty, combined with a higher correlation, should increase the term premium on bonds since investors should require additional compensation for the now less diversified risk in Government Bonds.[1]

Large issuance expected in 2025. The large deficits being run by several developed market countries will result in high net issuance of government bonds. Morgan Stanley estimates that G7 governments will issue c. $6.8T gross, which is +$2.6T net of maturities. The US makes up the bulk of supply, with c. $4.0T gross and US$1.8T net (the estimated size of the budget deficit in 2025).

As such, we see a strong argument for owning less-correlated assets that can provide diversification to both equities and fixed income. Composite hedge funds have outperformed core fixed income by a remarkable +20% cumulatively since the end of 2020.

Golden Rules

1. Investors should gain interest-rate exposure in the most cost-effective and tax-efficient manner possible. This is typically via passive ETFs or futures.
2. Investors should typically own bonds denominated in their home currency, i.e., that currency in which their future liabilities are likely to be incurred.

2025 Strategic Priorities

- Yield curves remain flat relative to history, providing little additional compensation for taking on the extra interest rate risk that comes with longer maturity assets.
- Risks to bond yields are two-sided and are likely to remain volatile. Against such a backdrop, a more diversified mix of low-risk assets including Cash and Absolute Return is preferable.
- However, in a scenario where central banks may eventually overtighten monetary policy to the extent that a recession becomes more likely, it would be advantageous to add to Government Bonds.
- We will look to add duration if the yield curve steepens via rising long-end rates. For example, if the 10-year US Treasury or UK Gilt yield were to rise to c. 5.0%, or the German Bund to 3.0%, we would consider adding duration to portfolios. Such a move would be contingent on our economic outlook at the time, and an assessment of the relative attractiveness of alternative uses for the capital (e.g., liquid Absolute Return managers).

1 BIS Quarterly Review, Dec 2023

Asset Class Investment Strategies

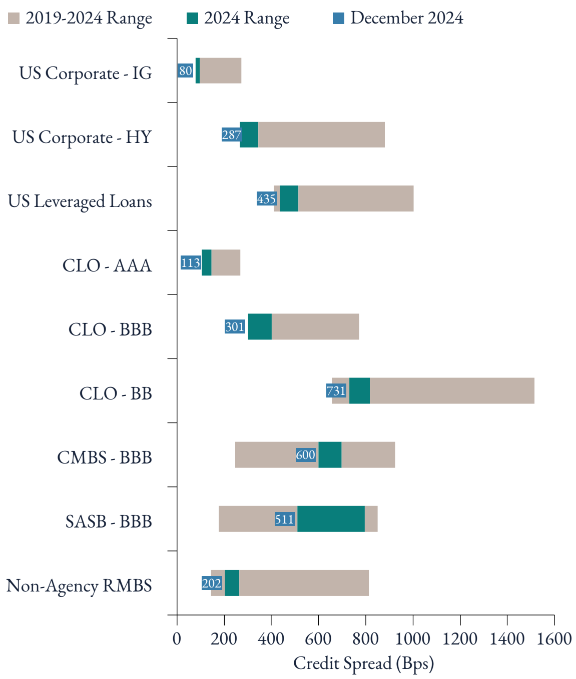
Liquid Credit

Major Trends

After significant spread tightening across the full spectrum of credit assets in 2024, 2025 is likely to be a year of income-driven returns in Liquid Credit, with interest rates the key driver of any volatility. The majority of credit assets closed 2024 at, or close to, the tightest spread levels for the last five years, with only select mortgage- and real estate-backed assets lagging on lower visibility of underlying credit quality (see Exhibit 1). Despite tight credit spreads, the highest base rates for c. 20 years mean that all-in yields remain attractive to institutional investors (Exhibit 2) which should be supportive to credit assets overall, albeit with limited scope for further price appreciation. This leaves credit risk asymmetrically positioned and less able to absorb the impact of increased market or economic risk. We view interest rates as presenting the most material risk to performance in 2025 – higher/higher-for longer rates (on inflationary pressures) or materially lower rates (on recessionary concerns) – could both result in spread widening given current tight levels.

Exhibit 1

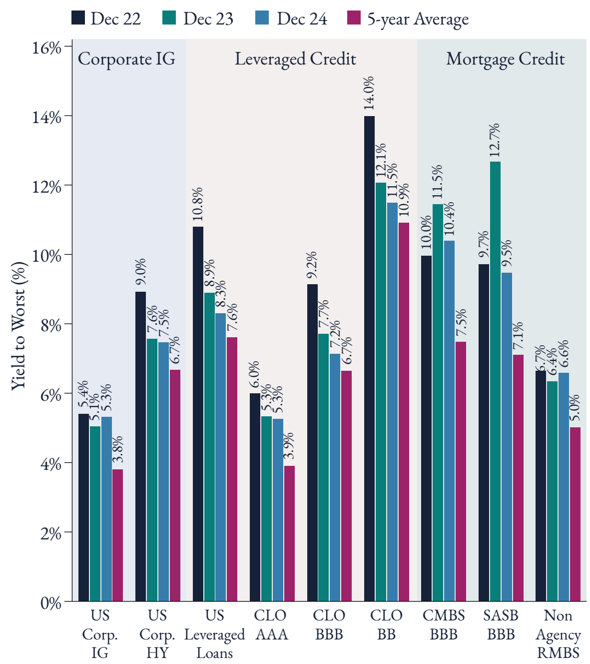
Spread levels at the end of 2024 were the tightest in 5 years for most credit products



Source: JP Morgan, Barclays

Exhibit 2

All-in yields remain attractive to credit buyers who had become accustomed to lower yields during the period of zero interest rates

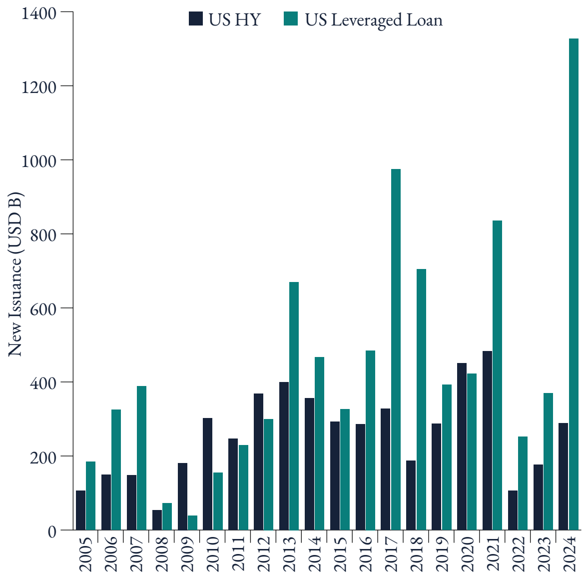


Source: JP Morgan, Barclays

2024 was characterized by solid operating performance for corporates and a return to functioning capital markets, although issuance activity was driven by refinancing and repricing, rather than new deal activity. Credit metrics for high yield and loan issuers stabilized in 2024, although high interest rates continue to erode interest coverage, particularly for loan issuers. New issuance for high yield bonds and loans grew by 64% and 260% respectively in 2024 (see Exhibit 3), albeit from a low base and heavily driven in the loan markets by repricings (~57% of 2024 gross issuance) as the broadly syndicated market continues to compete for market share with a growing private credit market in financing of sponsor-led transactions and M&A. This activity has reduced near term refinancing pressure with maturities for both high yield and leveraged loan issuers now peaking in 2028.

Exhibit 3

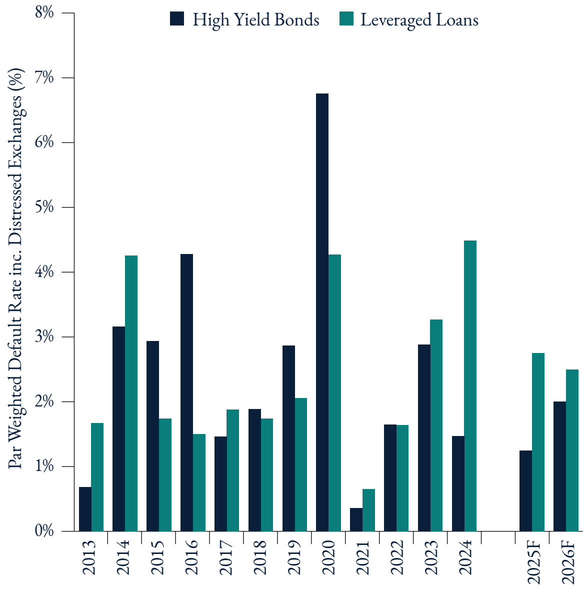
Record new issuance in the loan market was driven by repricing and refinancings, rather than new deal activity



Source: JP Morgan

Exhibit 4

The high yield bond default rate is well below historical average levels, while leveraged loan default rates ended 2024 higher than 2020 levels



Source: JP Morgan

With pricing continuing to reflect a benign outlook, there remain drivers of dispersion in performance at the region-, asset- and issuer-level, which creates opportunities for security selection in 2025. Economic divergence between the US and Europe is likely to create relative value opportunities between European and US credit assets, but also between issuers in the same sectors with differing regional exposures. The material difference in credit quality and composition between the high yield and leveraged loan markets has already resulted in a divergence in default rates, which we expect to be persistent (see Exhibit 4). We believe this creates opportunities to participate from both the short side as valuations decline, and from the long side following the ultimate restructuring of those assets. Finally, higher-for-longer interest rates are expected to exert further pressure on those issuers who had been 'muddling-through' the higher rate environment since 2022, delaying capital investment and managing for debt service, anticipating a return to lower financing costs in the medium term.

Mortgage-backed securities continued to lag both corporate credit and other asset-backed markets in 2024, given greater interest rate sensitivity and persistent concerns about real estate fundamentals. Legacy areas of the commercial mortgage-backed market are expected to remain under pressure, given persistent illiquidity, lower participation from the banks and a lack of clarity over how and whether interest rates will 'normalise', allowing for a flow-through to cap rates. However, these dynamics create attractive security selection opportunities for managers who conduct detailed security-level analysis. The picture for residential mortgage-backed securities is more stable – higher mortgage rates and supportive borrower fundamentals, as well as a structural under-supply of housing, should support an attractive carry profile and lower prepayment risk given higher mortgage rates, but the path of interest rates from here could introduce material volatility in both commercial and residential mortgage assets.

Liquid Credit
continued

Asymmetric spread risk, potential for increased dispersion and interest rate volatility create an attractive environment for opportunistic credit strategies. Security selection, relative value opportunities, and the ability to act as a provider of liquidity during periods of higher volatility or dislocation will be key to navigating a tighter spread environment and mitigating downside risk. More complex strategies where specialists benefit from better access to data and the capacity to source less liquid assets will also offer potential for outperformance. Higher-rated exposures in structured credit may also offer attractive income with more limited downside risk in an environment where spreads may no longer adequately compensate credit risk in lower rated assets.

Golden Rules

1. Use a bottom-up approach to identify and position for relative value across sub-sectors over the economic cycle.
2. Employ a dynamic approach to asset allocation, as sub-sector selection is a significant driver of returns and market pricing can change quickly.
3. Partner with specialists with deep knowledge of a sub-sector's credit fundamentals, market technicals and legal documentation.
4. Focus on niche, capacity constrained sub-sectors marked by complexity to uncover additional value.
5. Use custom vehicles where appropriate to maximise flexibility and allow for control of sub-sector exposures.

Sub-Strategy Attractiveness

Opportunistic / Event Driven Credit: Favourable view. We believe tight spread levels and persistently high financing costs will create attractive opportunities to short corporates with declining credit profiles and to participate in the restructurings of those with inappropriate capital structures.

Residential Mortgage Bonds: Selectively positive view. We believe residential mortgages offer attractive value given the expectation that mortgage rates are likely to stay higher for longer, generating attractive carry and lower negative convexity risk. While spreads have tightened meaningfully over the last year, they have lagged other credit products, so with underlying fundamentals for the asset class remaining positive, there is scope for further tightening from current levels and alpha generation from security selection.

Commercial Real Estate Credit: Selectively positive view. Commercial real estate remains under fundamental pressure given challenging fundamentals and persistently high cost of financing, but many assets have already seen these challenges priced in. We see an attractive security selection opportunity for experienced investors with the capacity to analyse and source differentiated assets.

CLO Debt: Selectively positive view. Investment grade tranches are generating attractive cash-plus income relative to similarly rated corporates given high interest rates, high levels of diversification and structural credit enhancement. High yield tranches continue to offer a premium to high yield corporate debt but may offer greater downside mark-to-market risk in a widening spread environment.

Asset-Backed Securities: Neutral view. Aviation-backed securities benefitted from a significant recovery in 2024, but pockets of opportunities remain in selected assets. We are cautious on direct consumer credit exposure in a higher interest rate environment but believe that the economic picture in the US with respect to employment and economic growth remains supportive of prime consumer lending exposures, at least in the near term.

Short Duration High Yield: Neutral view. While spread tightening over 2024 leaves us cautious regarding the potentially asymmetric risk in high yield at the start of 2024, shorter duration yield-to-call paper is typically less sensitive to spread widening and offers an attractive cash-plus return.

Emerging Market Debt: Neutral view. Opportunities exist to generate attractive returns from opportunistic trading of sovereign and quasi-sovereign debt.

Leveraged Loans: Negative view. We shifted more negative in our view on leveraged loans in 2024 and maintain that stance. While yields remain attractive on an absolute basis and relative to historical levels, we view these as being fully valued given the weaker fundamentals of the loan market and relative tightness in spreads. Higher-for-longer interest rates, weak covenants, and the largely asset-light nature of the loan market are leading to lower recovery rates in the event of default, which may not be fully reflected in current pricing.

High Yield: Negative view. US Corporate High Yield ended the year trading at spreads close to the post-GFC lows. Yields remain above the 5-year average at 7.5%, but we view risk here as being asymmetrical, with a higher chance of spread widening than tightening from these levels.

2025 Strategic Priorities

- **Take profits on fully valued exposures:** We will rotate out of long exposures where spread levels are at all time tights and where income generation does not compensate for the downside risk of spread-widening. We plan to reduce exposure to liquid credit as a result of these moves.
- **Exploit structural opportunity set in more complex assets:** We see what we believe are attractive yields relative to the fundamental risk in certain areas of structured credit and MBS. Our preference is for securities with structural credit enhancement, avoiding subordinate or first-loss exposures. Where no structural credit enhancement is available, we focus on higher-quality fundamental profiles that we believe are resilient to broader market stress.
- **Prepare for dispersion and a potential stressed and distressed opportunity:** The opportunity set for distressed investing has been limited over the past five years, except for a brief spike in defaults related to Covid. Structurally higher costs of capital over the longer term will ultimately put pressure on more marginal borrowers. This higher dispersion will create opportunities for long-short managers and those with restructuring experience who can be opportunistic in allocating to stressed and distressed opportunities.

Asset Class Investment Strategies

Private Debt

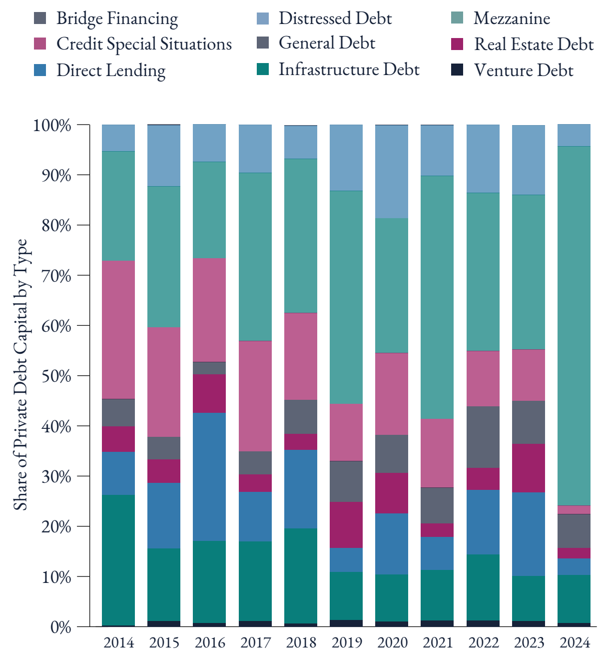
Major Trends

Private Debt continues to offer attractive returns at a premium to public markets, driven by lower liquidity, the smaller average size of private borrowers, and the greater flexibility afforded to borrowers by a single or smaller group of lenders. However, we believe investors should seek to diversify portfolios away from more commoditized, upper middle-market direct lending in favour of sub-sectors with a more attractive supply of, and demand for, capital such as non-sponsored lending, asset-backed lending, and capital solutions. We maintain a long-term positive view on the opportunity set in Private Debt, viewing alternative lenders as an increasingly important component of the financing ecosystem, with a clear secular trend towards further disintermediation of the banks in the financing of corporate borrowers, financial, and physical assets. We believe that a multi-strategy portfolio of complementary exposures in Private Debt should offer a resilient source of long-term income. In the near term, higher-for-longer interest rates and robust operating performance for corporate borrowers are expected to support attractive risk-adjusted returns from the asset class. However, as the asset class matures, we are carefully monitoring areas of the market where an oversupply of capital and resulting competitive pressures may lead to a change in risk profile and the quality of returns generated.

Fundraising remains below the peak of 2021, with assets raised accruing disproportionately to senior direct lending strategies and to funds with total assets above $5B. Despite increased interest in Private Debt strategies from a range of new investors, total assets raised in 2024 will be broadly in line with the $226B raised in 2023 and roughly ~20% below the 2021 peak.[1] As of Q3 2024 direct lending strategies accounted for 71% of total funds raised (Exhibit 1), and large-cap funds (over $5B in total assets) were 50% of assets raised (Exhibit 2). Funds over $1B in AUM accounted for 87% of assets. This trend reflects the further institutionalisation and broader adoption of the asset class as well as the attractive risk-adjusted returns that have been available in this period of higher rates. However, it also illustrates the requirement for managers to be able to compete for sourcing in the largest parts of the market.

Exhibit 1

Direct lending strategies accounted for 71% of assets raised in Private Debt by Q3 2024

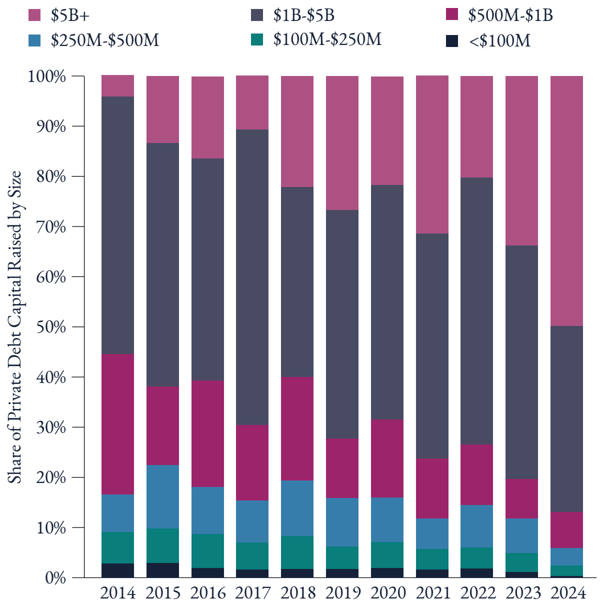


Source: Pitchbook; Geography: Global; As of 30 Sep 2024

1 Pitchbook Q3 2023 Global Private Market Fundraising Report

Exhibit 2

Funds greater than $1B in AUM received 87% of the capital raised by Q3 2024



Source: Pitchbook; Geography: Global; As of September 30, 2024

The broad investor focus on senior lending and large-scale managers has left specialists, complex strategies, and smaller managers capital constrained. First-time funds only accounted for $2.2B of capital raised by Q3 2024, as compared with $14.8B for the full year in 2021. The dearth of funding presents an opportunity to partner with managers in specialist and emerging strategies where investors can still be well compensated for risk assumed. This aligns with our strategy of focussing on areas of the market where we believe a specialist focus confers a material advantage. Partnering with earlier stage managers also makes it possible to obtain attractive fee terms, to have input into vehicle structuring and risk profile, as well as offering enhanced access to co-investment capacity. We value specialist managers who are not forced to compete on terms, and who are not compelled to deploy significant capital into areas of the market where terms and credit protection may be at risk of erosion by competitive dynamics.

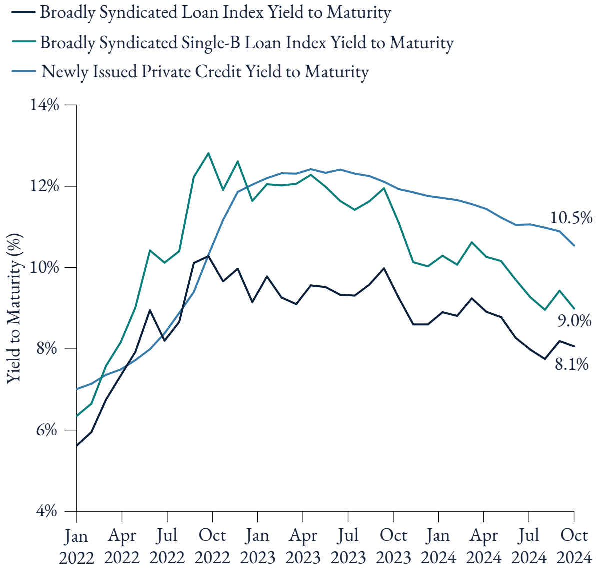
In large-cap and upper-middle-market corporate direct lending we believe the conditions for an *'age of dispersion'* in asset- and fund-level performance are in place. Higher returns from senior direct lending driven by higher interest rates and a scarcity of capital in 2022 led some market participants to declare a '*golden age*' of private credit, leading to a slew of capital raising and new entrants into the market which we highlighted in Insights 2024. While new issue private credit continues to offer a >200bps premium to public loans, and ~150bps in premium to lower-rated (single-B) public loans (see Exhibit 3), we have seen material spread compression in large cap and upper-middle market lending, as well as a deterioration in the strength and number of covenants, and in the quality of loan documentation. While this partly reflects the fact that these are larger cap issuers who may benefit from more stable operating profiles and higher equity valuations, we believe competitive pressures driven by excess capital flows into direct lending strategies is one factor in the weakening of the risk/return profile. Deals where issuers have the option of choosing between financing in the public loan markets and a private financing are those where we see the tightest spreads and the weakest terms, as the revival in public loan issuance in 2024 offers a cheaper alternative generally subject to fewer covenants, putting further downward pressure on pricing and terms in private credit.

We expect this dynamic, combined with the legacy of aggressive lending which took place in 2021 at similar spreads but at higher levels of leverage, to lead to a higher dispersion in outcomes than we have previously seen. We continue to believe that direct lending should remain a core component of a Private Debt allocation, but where previously there was little differentiation between fund returns, we believe that manager selection will be key to maintaining high quality risk-adjusted returns in future.

Private Debt
continued

Exhibit 3

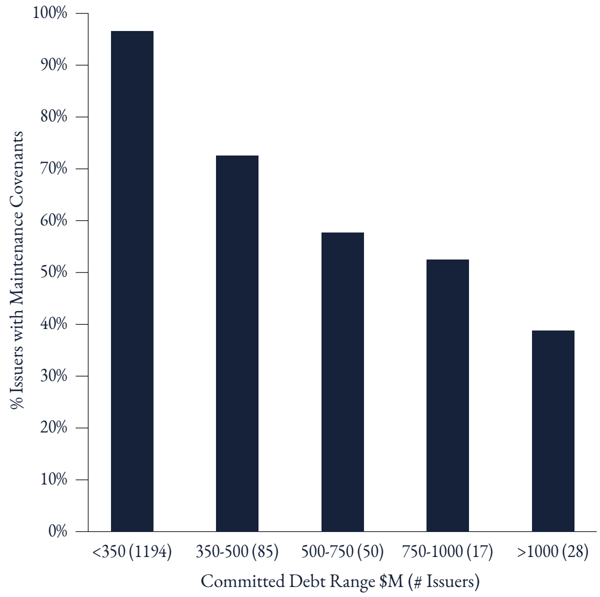
New issue private credit continues to offer a premium to public loans



Note: J.P. Morgan Leveraged Loan Indices are designed to mirror the investable universe of USD institutional leveraged loans, including US and international borrowers. Yield to Maturity includes Original Issue Discount.
Source: JP Morgan Market (public loan Indices), KBRA Private Credit Index

Exhibit 4

Maintenance covenants become less prevalent as deal sizes grow



Source: Morgan Stanley, S&P

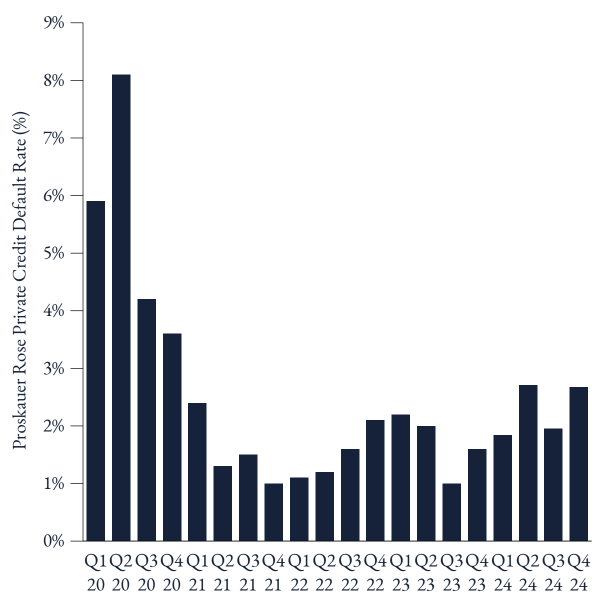
In corporate lending our preference is to focus on less well-trafficked areas of the market, on opportunistic credit, and on sector specialists providing an alternative to dilutive equity financing. We view lower middle-market lending and non-sponsored lending (i.e. where the equity owner is not a private equity firm) as offering the potential to lend at higher spreads with lower leverage. While smaller companies may be more susceptible to challenges during periods of economic weakness, they typically have lower leverage, tighter covenant packages and the lender is more likely to control the deal, enabling them to work directly with the borrower to mitigate any issues early. Smaller loans tend to attract better covenant packages (see Exhibit 4), with nearly 100% of issuers borrowing <$350M having maintenance covenants in comparison to roughly 50% or less for those borrowing $750M+ in a single issue. Accordingly, we believe that despite the underlying companies being higher risk, lower leverage and tighter structuring more than compensates, resulting in enhanced risk-adjusted returns.

We continue to see opportunities in sector specialist lending, with software, life sciences, legal, and agricultural lending among the sectors we have in our portfolio and pipeline. We favour sectors with clear long-term secular growth and where specialist underwriting confers a competitive advantage. With M&A and IPO volumes still at relatively muted levels, the appetite for non-dilutive financing (i.e. non-equity) at low LTVs (loan-to-value) remains high amongst founders creating the opportunity to obtain attractive contractual debt returns with attached equity upside.

Reported default rates and credit losses remain lower than in the public markets (see Exhibit 5). However, there is anecdotal evidence of a wave of 'silent defaults'. The reported use of loan amendments, injections of capital from sponsors, and extensions of existing debt to mitigate pressure on more marginal borrowers and reduce the risk of default is rising. This is one of the key attractions of the asset class. Historically, private lenders have been able to control credit losses due to the bilateral nature of the loans which confers a high level of control over outcomes during periods of stress, as well as tighter covenants than in public markets. While this remains the case for a large proportion of loans, we believe that default rates are likely to increase at the margin. An extended period of higher interest rates is likely to increase the need for restructurings and creative financing solutions for over-levered borrowers, particularly those whose current debt financing was arranged prior to the increase in base interest rates in 2022. This presents an opportunity for capital solutions managers who can provide flexible financing to idiosyncratic situations and benefit from contractual returns on newly issued senior debt. We are increasingly seeing the opportunity for lenders to structure private solutions to both private and public companies, substantially increasing the addressable market for these types of managers.

Exhibit 5

The Proskauer Rose Private Credit Default Index remains muted through Q3 2024

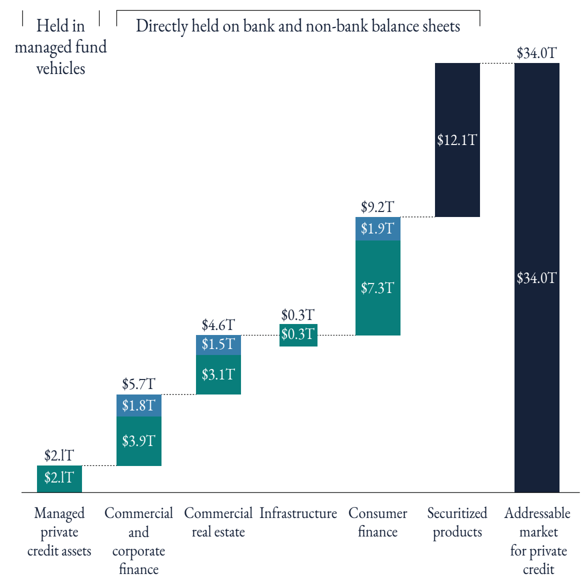


Source: Proskauer Rose

Outside corporate lending, there is secular opportunity developing in asset-backed finance which could see a material transfer of assets from banks to non-bank institutions over the next 10 years. Asset-backed finance is lending secured by cash-flowing contracts with predictable cash flows, such as leases, mortgages, receivables and licenses. These assets have historically been financed by banks who are now retreating from the market due to regulatory requirements, risk aversion and a reduction in balance sheet capacity. McKinsey estimates the overall size of the addressable market for private credit at over $30T (see Exhibit 6) of which $5-6T could shift to non-bank lenders in the next 10 years. The assets most likely to move are those in asset-backed finance, mortgages, consumer lending, infrastructure, and direct real estate lending. We believe the size of the opportunity could mirror the direct lending opportunity which arose following the GFC, and that scale players in asset-backed finance will be the first beneficiaries. although we also see opportunities for smaller players to finance the middle market. The breadth of the collateral pools available offers the opportunity to invest in highly diversified, income-generating assets which complement exposures in corporate lending. Our pipeline includes a range of potential investments in both physical- and financial-asset backed strategies, including equipment finance, portfolio finance and, selectively, consumer lending.

Exhibit 6

The potential addressable market for private lenders includes a broad range of asset-backed strategies



Source: McKinsey

Asset Class Investment Strategies

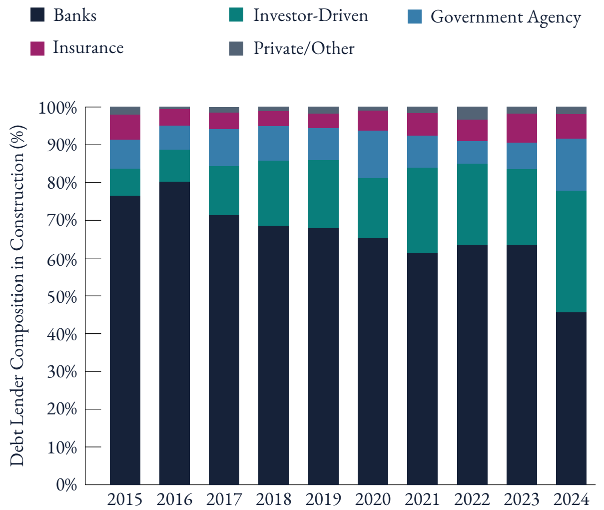
Private Debt

continued

The need for debt financing in commercial real estate remains persistent amid a material reduction in riskier real estate lending activity by bank lenders. While there continues to be stress in real estate credit with delinquencies continuing to rise, albeit slowly, there is evidence that the US real estate cycle has troughed with some non-bank lenders beginning to return to the market and increased CMBS issuance. However, the regional banks which traditionally provided debt financing for real estate, and particularly construction, have tightened their lending standards, reduced the leverage they are prepared to extend and increased their pricing. This has resulted in much lower participation, particularly in construction lending (see Exhibit 7).

Exhibit 7

The participation of banks in construction lending declined meaningfully in 2024

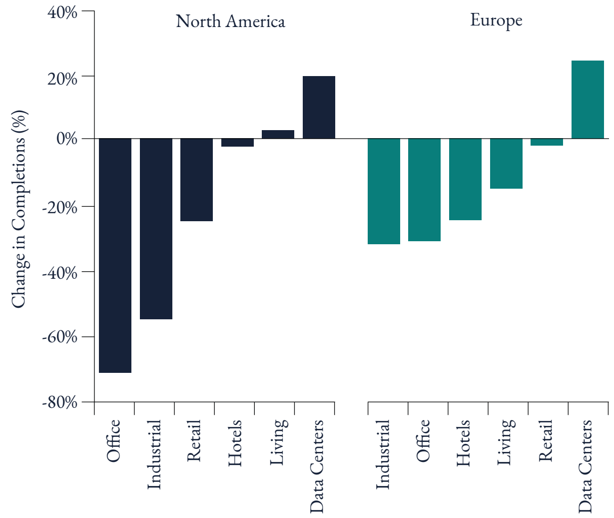


Source: MSCI Real Analytics

There has been a reduction in new supply in most property types driven by high financing costs, construction costs which have risen faster than inflation, and rents which have not kept pace. Exhibit 8 shows the decline in expected completions in 2025 in comparison to the 2021-2024 peak, where only data centres are expected to have increased compared to prior peak levels. These dynamics create a need for financing, not only in the recapitalisations of challenged structures, but also in the funding of new developments, redevelopment, rehabilitation, and change of use to meet what is likely to be a gap in supply across a range of sectors. Managers who can be opportunistic and provide capital solutions for idiosyncratic projects stand to benefit most.

Exhibit 8

Change in Expected 2025 Completions from 2021 Peak



Source: JLL Research

Golden Rules

1. Pursue a multi-strategy approach: a diversified portfolio of complementary risk exposures in Private Debt should offer a resilient source of long-term income and mitigate the risk of weakening risk adjusted returns in more commoditised areas of the market.
2. Target specialists in niche strategies: specialist providers of capital offer certainty of execution to borrowers, and can command a premium due to lower levels of competition and higher degrees of complexity.
3. Focus on downside protection: identify and partner with disciplined investors who i) take senior positions in the capital structure, ii) lend at low LTV ratios, and iii) maintain discipline on covenants and documentation. Identify investors that can protect capital and have the necessary skillset to directly manage assets in the event of a restructuring.
4. Generate outperformance through customisation and direct investment: seek structures which offer enhanced discretion, tax benefits, fee savings, and customised risk exposures. Partner on co-investments to benefit from more immediate deployment, lower fees and greater transparency.
5. Allocate selectively to uncorrelated strategies: these strategies can offer attractive diversification benefits and resilience in a market downturn. Given their esoteric nature, they can pose a unique diligence challenge, and it is critical to be aligned with best-in-class managers.

Sub-Strategy Attractiveness

Capital Solutions and Corporate Special Situations: Favourable view. A longer-than-expected period of higher interest rates is likely to drive a greater need for restructurings and transformational capital.

Specialist Lending: Favourable view. Target sector specialists in strategies that requires expert underwriting (e.g., life sciences, energy transition, agriculture, emerging technology) where a lower availability and attractiveness of equity financing are creating opportunities to offer non-dilutive financing with embedded equity upside.

Real Estate Lending: Favourable view. Persistently higher interest rates continue to put pressure on equity valuations and available capital remains constrained. This creates attractive opportunities for senior and mezzanine lending specialists with proven sourcing advantages and the ability to manage and restructure assets where necessary. Focus on more opportunistic transactions in an uncertain market environment.

Asset-Based Lending: Favourable view. Asset-based lending strategies are benefitting from a structural change in banks' appetite to lend in many areas, improving pricing and the available opportunity set. Asset based lending can provide an attractive yield base to a Private Debt portfolio.

Portfolio Finance: Selectively positive view. Increased capital raising and interest from large lenders have compromised the attractiveness of pricing in more mainstream transactions. Favour managers with a clear sourcing and structuring advantage.

Private Debt
continued

Large-Cap and Upper-Middle-Market Direct Lending: More negative view. While direct lending should represent a core holding for investors in private credit our overall favourable view of the strategy is tempered by new entrants affecting pricing and terms in the upper-middle market. This makes the strategy less attractive than smaller-cap, non-sponsor, and specialist strategies which may be more able to maintain pricing discipline. Continue to avoid commoditised strategies with limited credit protection and higher leverage. Favour lenders who maintain a controlling stake in their transactions.

Mezzanine and Junior Capital: More negative view. The proliferation of unitranche and stretch senior deals makes mezzanine and junior capital only selectively attractive at this point in the cycle and in the current spread environment. Consider an allocation on evidence that a default cycle is nearing a peak in order to capture upside benefits from a lower valuation environment.

Distressed for Control: Negative view. Dislike long and legally-intensive bankruptcy and recovery processes which culminate in full equity ownership and which can carry a high opportunity cost as compared with capital solutions and special situations strategies. Participate selectively where managers have a defined edge and market conditions are particularly favourable.

2025 Strategic Priorities

- **Diversify corporate direct lending exposures:** Upper-middle-market direct lending is becoming increasingly commoditised, and we see more attractive risk-adjusted returns in less well trafficked areas of the market. Seek exposures in lower-middle-market, non-sponsor and sector specialist lending, as well as capital solutions to obtain higher spreads and better downside protection.
- **Build asset-backed and real estate allocations:** Take advantage of long-term secular trends as the banks withdraw from hard- and financial-asset-backed strategies. Allocate to opportunistic real estate to take advantage of recapitalisations, rehabilitation and redevelopment. Add exposure to asset-backed securities to benefit from rapidly-amortising cash-flowing assets.
- **Position for dispersion with allocations to opportunistic credit and capital solutions:** Higher-for-longer interest rates and the legacy of aggressive lending in 2020-2021 are likely to drive an increase in restructurings. Allocate to capital solutions to benefit from potential recapitalisation and rescue lending opportunities and to opportunistic credit managers who are able to lean into dislocations created by geopolitical volatility. Consider a broad-based distressed allocation.

Uncorrelated Strategies

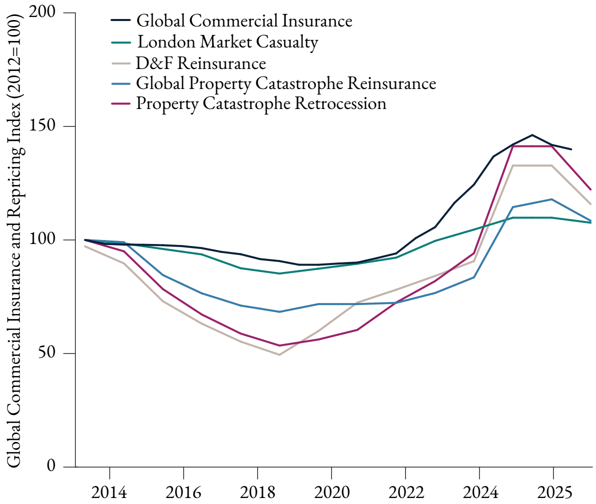
With interest rates remaining higher-for-longer, fundraising in uncorrelated strategies has slowed. This is likely to continue while less complex strategies offer compelling yields. The high growth in uncorrelated and more esoteric lending strategies in the early 2020s can be attributed to a reach for yield driven by the zero interest rate environment where there were few opportunities to generate attractive yields. With all-in yields in senior corporate direct lending remaining close to 10%, many uncorrelated strategies do not offer an adequate yield premium for taking on the additional complexity and higher expense burden. While we continue to view select uncorrelated strategies as complementary to Private Debt portfolios, offering attractive diversification, an alternative source of contractual returns, and, in some cases, material upside, we remain cognisant of the business risk that challenging fundraising conditions can create for those strategies, given what are often earlier stage or smaller managers. We remain highly selective about our exposures and maintain a high bar for manager investments.

2024 saw an increase in the number of investment managers in uncorrelated strategies adopting a fair valuation methodology for marking their portfolios. Valuations, including the strength and reliability of the valuation process, is an area of increasing focus for investors, auditors and regulators. Less easy-to-value strategies where assets might historically have been held at cost until reaching a milestone or an exit are now required to use a fair valuation which reflects the value of the assets were they to be sold at the valuation date. This better reflects the progress of the investment towards exit and ultimate crystallization of value, as well as a reasonable cost of capital. The move to this approach helps to mitigate the impact of the 'J-curve' which has affected longer-dated strategies such as clinical co-development and litigation funding, and smooths what were historically 'lumpy' return profiles, giving investors a more accurate assessment of value. Where we have seen secondary sales in uncorrelated strategies in the last year, the sale price has been in line with or slightly higher than the valuation implied by the fair valuation methodology, which gives some comfort that this valuation approach is valid. On the downside, this new approach can introduce a degree of interest rate exposure (via the use of discounted cash flow methodologies) and higher volatility in valuations as any change in potential future outcomes will immediately flow through to current valuations. This higher volatility in pricing may impact the sizing of allocations to these strategies and further constrain fundraising.

After a hardening in insurance markets in 2023, pricing moderated in 2024 on the back of increased capital availability (see Exhibit 1). We view property-catastrophe-related reinsurance strategies as challenging to underwrite given the disproportionate impact on pricing driven by the involvement (or not) of certain large market participants. While pricing has softened from the 2023 peak, there is evidence that reinsurers are becoming increasingly restrictive over the types of risks they will assume as losses to insurers from more frequent so-called 'non-peak' natural catastrophes (e.g. severe storms, floods, wildfires) continue to outstrip those from 'peak' events (tropical cyclones, earthquakes, European windstorms) (see Exhibit 2). This may result in pricing stabilizing at higher than historical levels over the longer term as reinsurers seek higher compensation for these less well-modelled risks. We continue to monitor the opportunity set but given the inefficiency inherent to the investment structures currently available we view this as a lower-priority opportunity.

Exhibit 1

Insurance pricing fell from a high base in 2024 across all categories

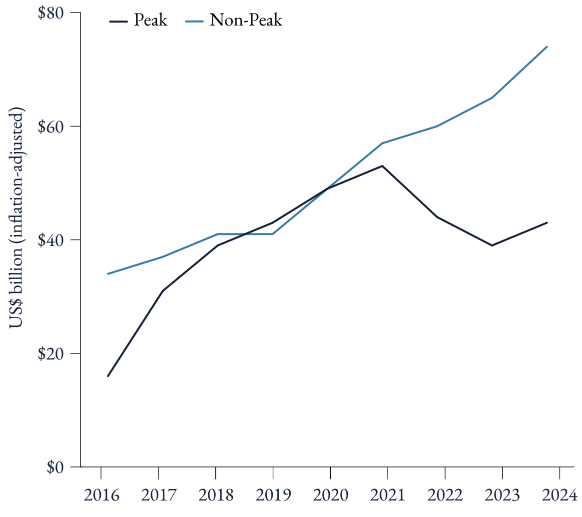


Source: Howden, NOVA

Uncorrelated Strategies
continued

Exhibit 2

Losses from non-peak natural catastrophes have outstripped those from peak losses each year since 2018



Source: Howden, NOVA

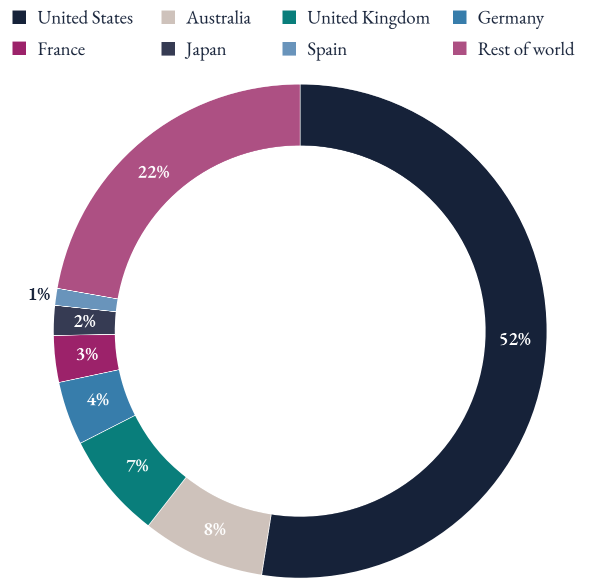
Other insurance categories provide easier-to-underwrite investment opportunities. Corporate liability and life run-off strategies can offer attractive uncorrelated returns with the benefit of embedded low-cost leverage. These opportunities are highly idiosyncratic and often best approached as co-investments alongside experienced market participants with differentiated sourcing capabilities.

Litigation-related investments have experienced strong recent performance. Within litigation-related assets, we allocate to both lending and direct single case investments. Litigation lending continues to offer additional compensation, even compared to other specialist lending strategies, targeting up to a 5%+ premium lending against a highly diversified collateral pool. Pricing has remained stable in all but the largest end of the litigation lending market, and it is our view that the excess yield and highly diversified nature of the collateral compensates for the idiosyncratic risk introduced by both duration extension within the collateral pool and the asset-light nature of the borrowers.

Single case funding has been, and remains, a core part of our litigation strategy. In common with other uncorrelated strategies, fundraising has remained challenging leading to stable pricing and a strong environment for long-term experienced LPs. Given our prominence and longevity as an LP in the space, we have become a strategic partner to our litigation GPs and achieve an average fee discount of c. 200 bps. Our experience within the market has also led us to refine our focus. The UK market, which is the third largest litigation funding market globally (Exhibit 3), is now structurally less attractive than other jurisdictions - it increasingly funds jurisdictionally or legally complex cases with long durations, has had regulatory issues with the recent PACCAR ruling, has demonstrably lower settlement rates and has seen legal costs increase significantly. By contrast, the US, Australia, Canada and, on a selective basis, Continental Europe remain attractive. We have significantly reduced our exposure to the UK market, concentrating our exposure in a predictable core of commercial cases whilst adding higher returning verticals such as intellectual property and class actions. We avoid long-duration, unpredictable portions of the market such as investor state arbitrations or uncompensated-for enforcement risks.

Exhibit 3

The US is the largest third-party litigation funding market, followed by Australia and the UK

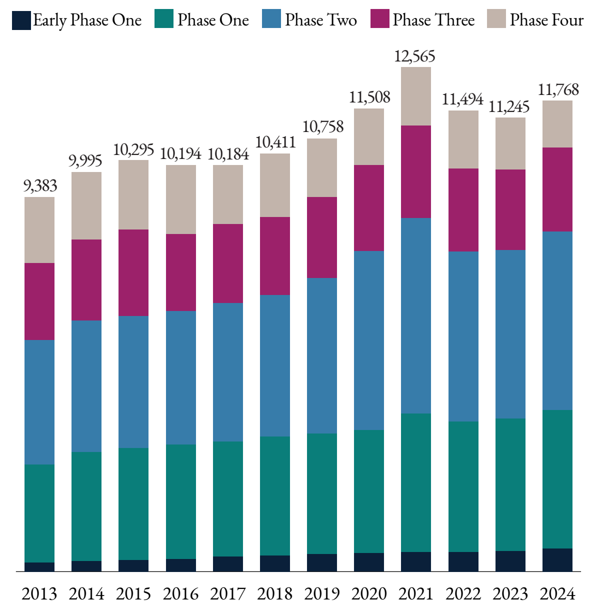


Source: Research Nester, Swiss Re Institute

Opportunities in life sciences continue to offer attractive risk-adjusted contractual returns and may benefit from a lower-regulation environment under the new US administration. In particular, we see an attractive opportunity set in clinical drug trial financing (clinical co-development). Global clinical trial starts have been negatively impacted (see Exhibit 4) by rising inflation and a rising cost of capital in recent years, with starts slowing in 2022 and 2023. This has made pharma and biotechnology companies open to alternative, non-dilutive (i.e., non-equity) sources of funding to allow them to fund trials and build out their asset pipeline. This opportunity set looks to be persistent, with the funding gap anticipated to be as much as $105B by 2028 (see Exhibit 5). Specialist funders that can provide significant operational support and clinical trial expertise can provide capital to close this gap in exchange for pre-agreed returns structured as fixed milestone payments, which have very limited correlation to broader markets, or royalty participations once a product receives FDA approval. This strategy meets our bar for uncorrelated strategies, generating returns at a premium to more conventional lending strategies in a sector with persistent secular drivers of growth.

Exhibit 4

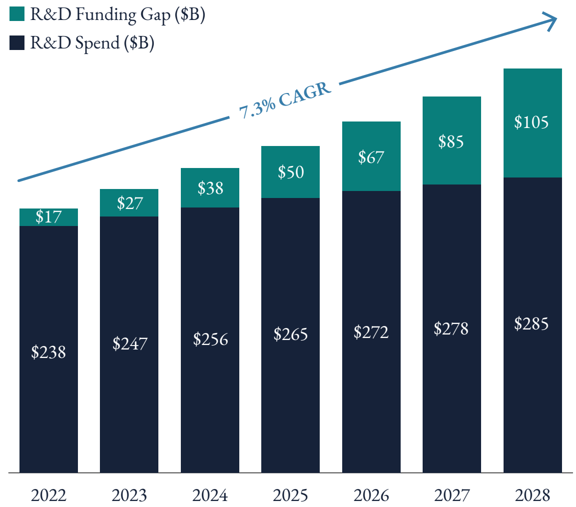
Global clinical trial study starts picked up in 2024 after declines in 2022 and 2023



Source: ClinicalTrials.gov

Exhibit 5

There is a growing funding gap in Pharmaceutical R&D, requiring alternative sources of capital



Source: Evaluate Pharma, October 2022

Golden Rules

1. Partner with specialist investors in niche strategies rather than opportunistic generalists: We believe a key differentiator in investment outcomes in uncorrelated strategies is manager expertise and familiarity in pricing niche assets. Generalists tend to suffer from adverse selection given their comparative disadvantage in sourcing and evaluation of transactions compared to specialists.

2. Establish close alignment not only with investment managers but also with other end-investors in those vehicles. In smaller, less liquid markets, a clear alignment of interests is essential and close relationships with other investors can deliver informational advantages that lead to better investment outcomes.

3. Seek contractual returns, rather than an equity exit: Limit investments where the ultimate return is contingent on an equity bid from a third party. Favour investments with a defined contractual return and embedded date of maturity.

4. Be sensitive to model risk: It is critical to fully understand the factors that influence investment pricing and to be sceptical of model-based valuation approaches.

Uncorrelated Strategies
continued

Sub-Strategy Attractiveness

Litigation Finance and Intellectual Property: Favourable view. Financing portfolios of corporate litigation is an area that remains relatively underexploited and is attractive in our view. Companies are more likely to need to monetise their legal assets in an environment where interest rates are rising and financing options have narrowed. We also view opportunities in patent and IP litigation as offering attractive uncorrelated returns. Lending structures in litigation finance offer attractive opportunities given higher base rates and a spread premium to other specialist lending strategies.

Drug Trial Financing: Favourable view. Clinical co-development offers the opportunity to finance phase 3 drug trials in partnership with pharmaceutical companies, in exchange for a royalty stream or fixed cash payments. Given the specialisation required to assess trial outcomes, drug trial finance remains an underexploited opportunity with few participants. However, there are challenges in achieving deployment and adequate diversification, which mitigates our overall positive view of the strategy.

Pharmaceutical Royalties: Neutral view. Lending to life sciences companies continues to offer a premium to royalties in the current interest rate environment. However, pharmaceutical royalties are complementary to our healthcare lending and drug trial financing investments and can offer a low volatility, long-term source of realisable yield to our portfolios.

Life Insurance and Insurtech Strategies: Neutral view. Continued consolidation in corporate, life and health strategies offers potentially interesting opportunities, but natural catastrophe remains out of favour. Idiosyncratic corporate liability and life run-off opportunities can offer attractive potential for upside but are best accessed via co-investments.

Property and Natural Catastrophe Insurance Strategies: Negative view. We remain sceptical of catastrophe insurance strategies despite repricing given the binary nature of the strategy at the portfolio level (i.e., the high correlation of individual policies). We view the available investment structures to have significant drawbacks (specifically the trapped capital at the end of each investment period) and believe the risks of climate change to still be inadequately reflected in underwriting models.

Music Royalties: Negative view. Music royalties strategies have a high reliance on residual valuations to support expectations of forward-looking returns. It is our view that this is a more equity-driven strategy which currently does not generate contractual returns at a premium to conventional lending.

2025 Strategic Priorities

- **Invest only selectively in uncorrelated strategies given the more attractive opportunities in Private Debt investments.** We view many uncorrelated strategies as having insufficient expected return relative to traditional debt structures to compensate for the additional risk and complexity. We focus only on select uncorrelated strategies with attractive dynamics and investing in those alongside only the highest-quality specialist managers.
- **Complement specialist lending exposures with allocations to drug trial financing.** Pressure to expand product lines and the increasing funding gap for pharmaceutical and biotechnology companies are creating opportunities to generate contractual returns at a premium to conventional lending strategies with a lower correlation to the broader market.
- **Maintain allocations to litigation funding strategies.** An environment of constrained capital availability allows established specialist funders to generate attractive uncorrelated returns across a range of strategies and jurisdictions.

Absolute Return

Major Trends

Strong Excess Return in an Elevated Interest Rate Environment: The interest rate environment is anticipated to remain elevated, sustaining higher total return potential in the asset class. Our strategies were generally successful in capitalising on this environment to drive strong excess returns over cash rates in 2024. We have also seen this sustainability of excess return over cash in higher rate environments in long-term hedge fund index data. We expect interest rates in the United States to fluctuate within a range of 3.25% to 5%, creating trading opportunities for active managers to exploit.

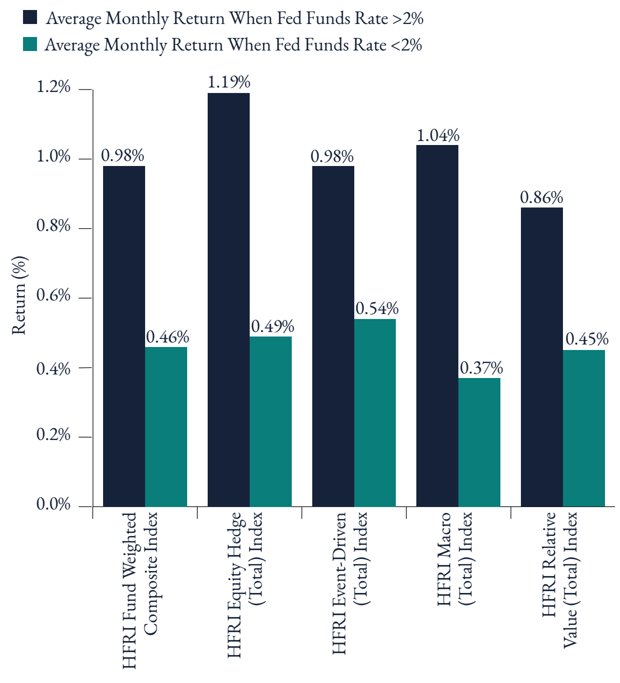
Market Dynamics and Opportunities: In the United States, the policies introduced by the Trump administration are expected to exert a substantial influence on financial markets, broadening the scope for alternative investments. Pro-business regulatory changes, particularly a more accommodative stance on mergers and acquisitions, are likely to enhance capital market issuance activity. Simultaneously, rising US debt levels and increased Treasury issuance to finance expanding fiscal deficits may heighten bond market volatility, presenting opportunities for relative value strategies. On a global scale, regional economic divergences are expected to create macroeconomic investment opportunities.

Multi-Strategy Platform Growth: Multi-strategy hedge funds continued to attract strong capital flows and grow market share. These firms as a group have successfully attracted talent and delivered consistent returns through diversified, market-neutral strategies in recent years.[1] However, this asset growth has been accompanied by increased trading volume in markets, greater dependency on leverage, rising look-through expenses, and deteriorating liquidity. While the model has proven resilient to-date, and we have selectively included these strategies in our portfolios, we are cautious in assessing individual managers and about the amount of exposure to these strategies in our portfolios.

The Role of Artificial Intelligence in Hedge Funds: Artificial intelligence (AI) is expected to play a significant role in the hedge fund industry in the coming years. AI technologies are increasingly utilized to enhance outperformance potential, optimize risk management and improve operational efficiency. Advanced machine learning algorithms offer the potential to identify complex market inefficiencies, analyse alternative data sources and respond dynamically to volatile market conditions. Furthermore, AI-driven sentiment analysis and predictive analytics are poised to refine market timing and asset allocation strategies. The automation of routine processes is also anticipated to reduce operational costs, enabling smaller funds to compete more effectively within the industry.

Exhibit 1

Average Monthly Return by Strategy



Source: Morgan Stanley, “Understanding Hedge Funds in an Evolving Market Environment”

Hypothetical return expectations based on simulated market conditions which has inherent limitations. Such returns are not a reliable indicator of future performance.

1 Bank of America Hedge Fund Report

Asset Class Investment Strategies

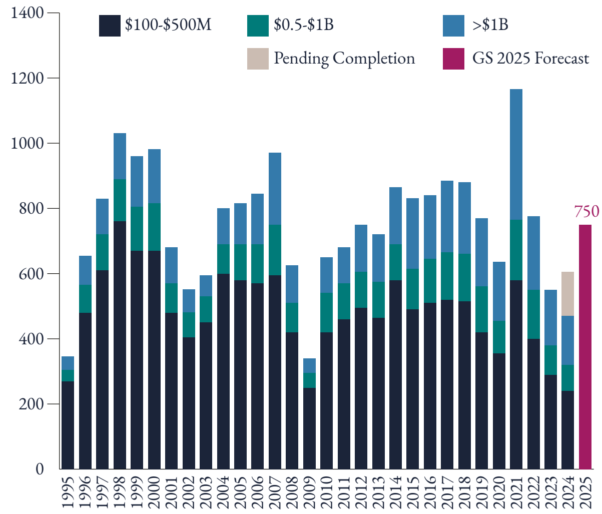
Absolute Return
continued

Golden Rules

1. Diversification across strategy, manager, geography and asset class is essential to deliver sustainable risk-adjusted returns across market environments.
2. Managers who have a proven track record of alpha generation from a discernible and sustainable edge should be core partnerships in the portfolio.
3. Emerging managers led by experienced portfolio managers can improve portfolio risk/return characteristics via mandate customisation, enhanced transparency and control, fee discounts and a focus on more capacity-constrained opportunities.
4. Investment strategies focused on niche, inefficient markets often provide the greatest potential for generating attractive, uncorrelated returns.
5. Accessing strategies through capital-efficient structures can significantly enhance the risk-return characteristics of the portfolio.
6. Use scale to drive aligned and strategic relationships with managers, passing through benefits directly to our clients.

Exhibit 2

Number of Completed US M&A Transactions by Deal Size



Source: Goldman Sachs, US M&A forecast based on US M&A Candidates: ''The Art of the Deal''

Sub-Strategy Attractiveness

Event Driven: Favourable view. As monetary and regulatory uncertainties normalise, CEO confidence is rising, creating a conducive environment for dealmaking. Companies are increasingly pursuing strategic growth and capability-enhancing acquisitions, while corporate simplification and spin-offs continue to unlock value. The surge in AI-driven opportunities is fueling sector-specific deals, particularly in technology and healthcare. Additionally, private equity sponsors, bolstered by abundant capital, are leveraging creative deal structures to drive activity.

Statistical Arbitrage: Favourable view. As noted above, elevated stock dispersion may provide a tailwind to active strategies. Within this space, we generally favour shorter-horizon, capacity-constrained strategies that we believe can capitalize most effectively on temporary mispricing.

Fixed Income Relative Value: Favourable view. Divergent monetary policies and persistent inflation differentials across regions create opportunities for relative value trading. With central banks adjusting rates at varying paces, yield curve dynamics and credit spreads are expected to remain in flux, offering fertile ground for exploiting security mispricing.

Macro: Neutral view. Shifting monetary policies, geopolitical uncertainty and divergent economic growth trajectories can create macro-driven trading opportunities across asset classes. However, markets are also susceptible to sharp reversals, which can undermine longer-term themes. We favour nimble strategies that can reposition quickly in the face of a rapidly changing market landscape and that make many diversified bets.

Convertible Arbitrage: Neutral view. The convertible bond market provides an attractive solution for liability management in a high-interest rate environment, which can translate into exchange opportunities for active managers. Elevated single stock volatility – driven by the growth of ETF and factor trading – may also increase the value of a convertible bond's optionality. Expected high issuance may, however, put episodic downward pressure on pricing.

Fundamental Equity Long/Short: Neutral view. The expectation of high divergence of individual company outcomes within broad indices at the sector and company-specific level should allow for managers to add value on both the long and short side. However, managers must remain careful when shorting, due to the expectation of a more buoyant M&A environment.

2025 Strategic Priorities

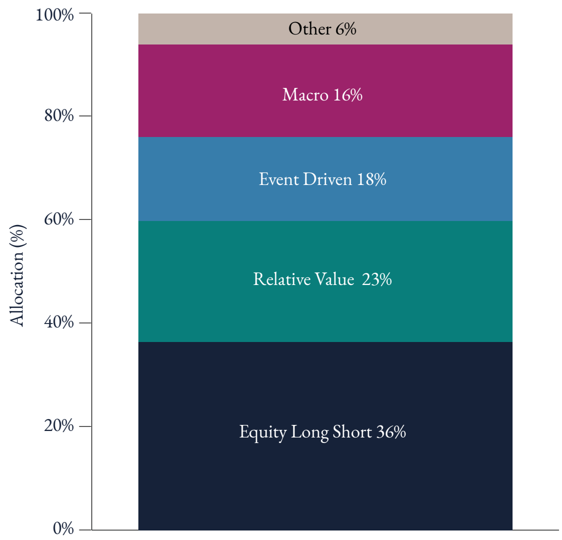
- **Maintain risk-balanced portfolio allocations:** Our investment philosophy emphasizes maintaining risk-balanced portfolios to navigate volatile market environments effectively. We ensure sufficient flexibility to adjust exposures modestly, allowing us to capitalise on short-term opportunities while adhering to long-term strategic objectives. To achieve this, we employ a dual-pronged strategy comprising of a core allocation to diversified multi-strategy funds complemented by selective satellite investments.
- **Access Multi-Strategy exposure in an aligned manner:** Multi-strategy funds will remain at the core of our portfolio, driven by our conviction in their ability to deliver stronger risk-adjusted returns amidst evolving market conditions. These funds offer a robust framework for achieving our investment objectives through their inherent diversification, dynamic adaptability, and efficient risk management. However, the increased capital flows and competition for talent have driven increased trading volumes, higher leverage, higher look-through fees and more onerous liquidity terms in the market. We have addressed this challenge through the creation of our Absolute Return Strategy MAP program. We believe this program provides several key benefits, including enhanced transparency, better asset control, reduced fees, increased liquidity and comprehensive risk management. We continue to invest in select external multi-strategy funds in addition to our internal platform.
- **Complement the core portfolio with select satellite investments:** For satellite allocations, we focus on identifying strategies with orthogonal and complementary return profiles to further enhance portfolio diversification. Leveraging the depth of our research capabilities, we actively source niche strategies that complement and extend the breadth of our portfolios. These targeted investments are designed to bolster the portfolio's risk-adjusted return potential while introducing exposures to innovative and differentiated investment opportunities.

Absolute Return
continued

Current Allocations

Exhibit 3

Flagship Absolute Return Vehicle Estimated Look-Through Risk Exposure as of November 2024

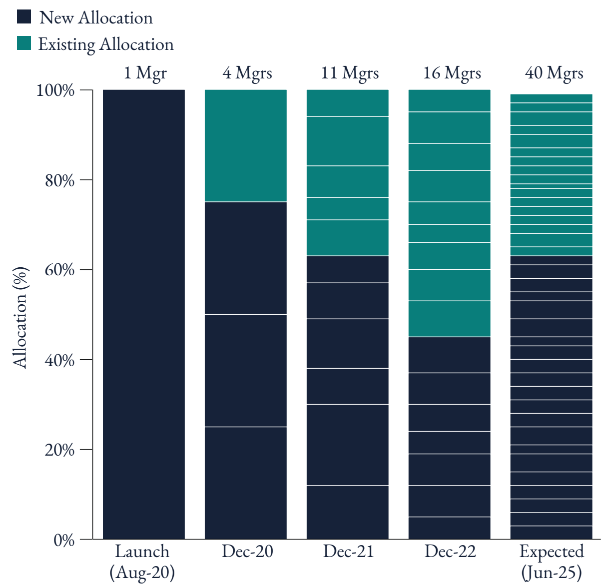


Source: Partners Capital Analysis

MAP Program Evolution

Exhibit 4

Absolute Return Strategy MAP Program Portfolio Evolution



Notes: Allocations use 31 December 2024 NAVs, excluding cash and sidepockets, adjusted for subsequent actions. Allocations less than 3% of estimated risk are not shown. Strategy look-through allocations shown based on estimated contribution to risk, as proxied by volatility. Underlying estimates are hypothetical based on Partners Capital analysis. Actual risk may differ from these figures. Other strategies include Trend, Volatility, Risk Premia and other strategies not captured elsewhere. Any forward-looking comments are hypothetical. Actual results may vary materially and there is no guarantee that Partners Capital will achieve its objectives within the asset class.

Public Equities

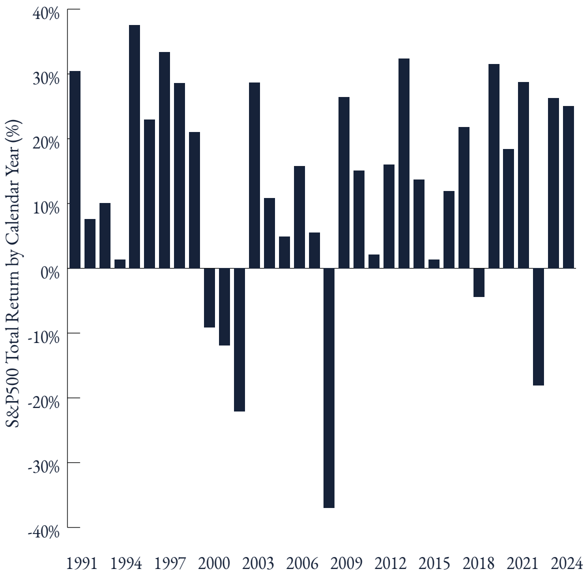
Major Trends

Back-to-back 20%+ return years in 2023 and 2024 leave equity markets at elevated valuation levels

Despite high starting valuation levels and significant interest rate volatility, equity market returns defied tempered expectations in 2024, delivering another year of exceptional returns. Global equity markets posted gains exceeding 20%, with positive returns recorded in nine out of twelve months. In the US, such a streak of robust annual returns has not been observed since the late 1990s.

Exhibit 1

2023 and 2024 have been an unusually strong 24 month stretch for equity markets, the best since the late 1990s



Source: Bloomberg

For multi-asset class investors, this period reaffirms the difficulty of predicting short-term market movements. Our investment philosophy, therefore, remains grounded in maintaining steady equity exposure over time, with only modest adjustments to asset allocations. For example, our tactical underweighting of Long Equities in 2024 (reducing from 30% to 28%) reflected a balanced approach amid valuation concerns, economic uncertainty and the relative opportunities available in other asset classes.

Heading into 2025, equity market prospects are influenced by similarly complex dynamics. While the US economic outlook remains able, the stretched valuations caused by the rally in 2024 introduce downside risks. Historically, elevated valuations have not been a strong predictor of short-term returns, but they can amplify losses if earnings growth expectations are not met and typically depress future returns over a longer time horizon. Consequently, the equity market's trajectory in 2025 will depend heavily on the ability of companies to deliver on forecasted earnings growth, and our long-term equity return expectations continue to compress.

A small number of large companies continue to drive headline index returns

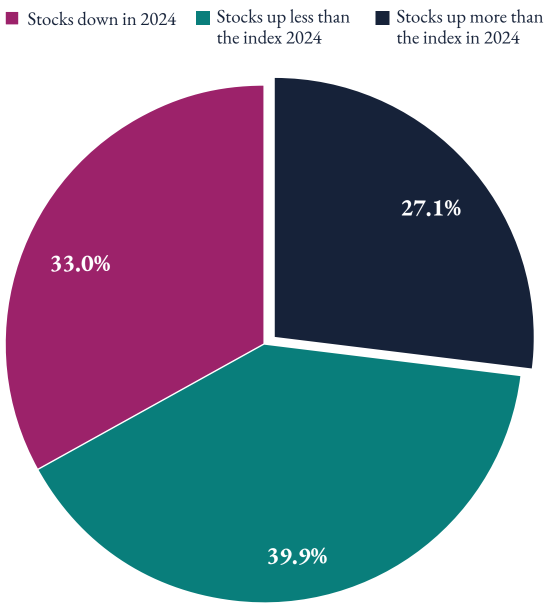
The strong equity market returns in 2024 were propelled by a handful of the largest global companies. In fact, the "Magnificent Seven" (Apple, Nvidia, Microsoft, Alphabet, Amazon, Meta, and Tesla) contributed 54% of the S&P 500's total return, despite accounting for only 30% of the index. This followed a similar pattern in 2023, when these companies contributed 60% of the index's return while representing 26% of the index. As a result, while the S&P 500 was up +25.0% in 2024, the average stock was only up +12.7%. In addition, one-third of index constituents realised a negative return in the year.[1]

1 Partners Capital Analysis

Public Equities
continued

Exhibit 2

Fewer than 30% of companies in the S&P 500 outperformed the index in 2024



Source: Bloomberg

This unusual concentration of performance can be attributed to two key factors:

1. **Market Capitalisation Dominance:** At the end of 2024, the ten largest companies in the S&P 500 comprised over 37% of the total index, one of the highest levels of index concentration on record.

2. **Thematic Exposure:** Many of these companies share exposure to similar fundamental drivers, particularly artificial intelligence (AI). Excluding Berkshire Hathaway and JPMorgan, eight of the ten largest companies are significantly impacted by AI-related trends. Similarly, the largest non-US company in global indices, TSMC, is exposed to these same dynamics. In contrast, previous periods of very concentrated indices, such as the "Nifty Fifty" era, featured companies across diverse sectors, which reduced the likelihood of simultaneous outperformance.

This level of market concentration poses challenges for traditional stock pickers. In 2024, fewer than 30% of 400 global long equities managers outperformed their benchmarks, according to data from eVestment. Many institutional portfolios remain underweight these mega-cap companies relative to capitalisation-weighted indices, primarily due to the reluctance of most active managers to hold such stocks at or above index weight, even if they were top holdings. As a result, Long Equities portfolios generally faced performance headwinds in recent years due to this structural underweight.

This dynamic begs the question: should the underweight to these mega-cap stocks be closed by actively increasing exposure to these companies, either through more passive investments or direct holdings? We believe this is not the optimal approach. While concentrated index performance has created headwinds for allocators over the past two years, part of the outperformance by mega-cap companies is attributed to expanding valuations, which are unlikely to be sustainable. Furthermore, meeting elevated revenue and earnings growth expectations will become increasingly challenging for these firms.

Nonetheless, we have become more discerning in evaluating underweight positions in mega-cap companies. Strategies that assess positions relative to index weights, rather than absolute terms, offer a potential solution. By reallocating capital to such strategies, we have reduced, though not eliminated, our portfolios' underweight to these companies. This approach balances the potential for outperformance with a measured approach to market concentration risks.

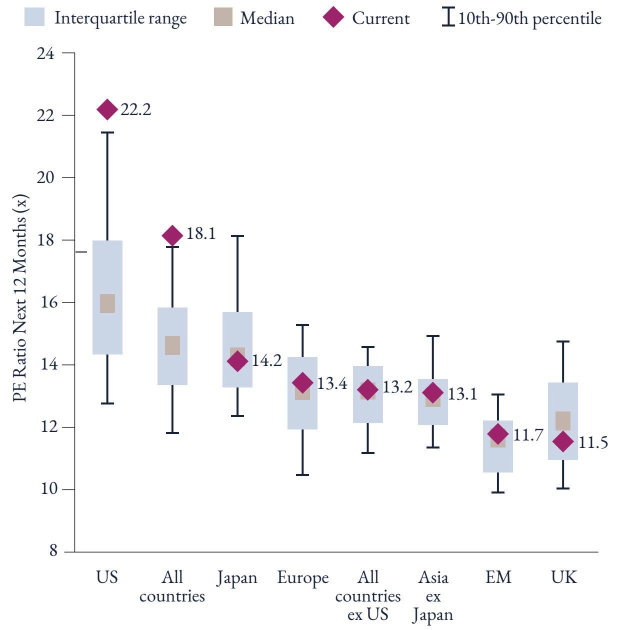
US outperformance continued, making US equities among the most expensive in the world

In 2024, the United States once again ranked among the strongest regional equity markets. This outcome reflects the dominant performance of US mega-cap companies, particularly those benefiting from the AI megatrend, tying relative regional performance back to the issue of market concentration discussed above. US "exceptionalism" was not limited to 2024, as US equities (proxied by the S&P 500 Index) outperformed non-US equities (proxied by the MSCI EAFE Index) in four of the last five years and eight of the last ten.

While US companies have delivered stronger earnings growth compared to their global peers, a significant portion of this outperformance has been driven by valuation expansion. Currently, US equity market valuations rank in the top 10th percentile over the past two decades. In contrast, valuations in Japan and Europe are only slightly above their historical medians, while those in the UK are below the median as illustrated in Exhibit 3.

Exhibit 3

US equity market valuations are high compared to their own history (last 20yrs) and relative to other regions



Source: Bloomberg

This disparity underscores possible long-term benefits of regional diversification. Lower valuation starting points in non-US markets offer greater potential for upside, particularly if earnings growth were to exceed expectations. Conversely, the elevated valuations in US equities increase sensitivity to earnings disappointments, amplifying downside risks.

Our investment approach emphasises avoiding significant structural overweights or underweights to specific regions unless supported by robust, data-driven analysis. We continue to search for managers who invest outside the US with a strong focus on company valuation. We believe these managers are well-positioned to capitalise on the more attractive valuation dynamics in non-US markets, where opportunities for strong returns may exceed those in the US market.

Strong year for equity long/short alpha generation

Equity long/short strategies delivered robust performance in 2024, underscoring their role as a valuable component of diversified portfolios. It surpassed the broader industry benchmark, the HFRI Equity Hedge Index, in what many Prime Brokers described as one of the strongest years for equity long/short alpha generation in the past decade.[2]

Performance attribution data indicates positive alpha generation on both the long and short sides of portfolios, though their contributions varied throughout the year. Short positions performed well in the first half of 2024, aided by the concentrated nature of market indices. Long alpha generation was more subdued in the early part of the year but gained momentum in the second half.

The return to a more normalised interest rate environment was a notable tailwind for equity long/short managers. During the period of ultra-low interest rates that began in the early 2010s, short positions faced technical challenges, as proceeds from short sales generated minimal income. Fundamentally, low rates enabled underperforming companies to prolong their lifespans through cheap financing. The increase in interest rates to levels more comparable to the late 1990s has coincided with improved alpha generation, particularly on the short side.

2 Morgan Stanley Hedge Fund Recap

Public Equities
continued

We continue to maintain an allocation to Hedged Equities as part of our strategic asset allocation. However, we place a strong emphasis on partnering with managers who demonstrate research specialisation and portfolio construction expertise. This focus on portfolio construction often leads us to build higher conviction in Equity Market Neutral managers rather than traditional mid-net Equity Long/Short managers as the former tend to have a higher appreciation for the importance of building well-balanced portfolios that focus exposure on idiosyncratic rather than factor risks.

Golden Rules

1. Focus on stock selection as the main driver of sustainable outperformance in public equities. Our experience suggests that market timing, sector rotation or factor exposures are not reliable sources of risk-adjusted returns.
2. Capture a diverse set of idiosyncratic sources of return with limited market, sector and style skews at the portfolio level.
3. Partner with managers possessing: a) differentiated research capabilities and expertise in their strategy area, b) a disciplined process for investment diligence and portfolio management, c) strong alignment with investors.
4. Size manager allocations based on active risk contribution, strategy/alpha source weightings and portfolio-level skew minimisation. Grow into investments with new managers over time. Rebalance regularly.
5. Diversify sources of active risk across investment strategies and approaches. No strategy works all the time. Do not try to time strategy exposures but monitor environment for changes in fundamental strategy attractiveness.

Sub-Strategy Attractiveness

Long Equities: Favourable View. Aligned with our philosophy of maintaining consistent portfolio risk levels, we do not plan to tactically reduce equity market exposure at this time. While starting valuations have historically influenced medium-to-long-term returns, we believe their impact on short-term (12-month) performance remains limited.

This approach reflects our commitment to maintaining stable equity exposure as a core component of strategic asset allocation, balancing growth opportunities with prudent risk management.

Portable Alpha and Alpha Extension: Favourable view. We began increasing our allocation to portable alpha and alpha extension strategies in 2023 and continued this trend in 2024. These strategies, which are typically benchmark-aware, offer the potential for medium-to-long-term outperformance while mitigating active risk exposure to the largest companies in the index. Depending on the degree of leverage deployed, these strategies can deliver returns comparable to traditional concentrated stock selection approaches. The market concentration seen in 2024 further highlighted the importance of alpha extension and portable alpha within institutional portfolios.

As the terms "portable alpha" and "alpha extension" are often used without standard definitions, we wanted to clarify how Partners Capital defines these strategies:

Portable Alpha: Combines a market-neutral alpha strategy (such as equity market neutral or non-equity strategies like fixed income arbitrage) with typically derivatives-based equity index replication to deliver outperformance relative to an equity index.

Alpha Extension: Utilizes a leveraged long portfolio (e.g., 130% of fund assets) paired with a short portfolio (e.g., 30%) to maintain a net exposure of 100%, such as in a "130/30" strategy.

Our ongoing research has reinforced several key considerations in evaluating these strategies:

- **Portfolio Construction:** We prefer alpha extension strategies that holistically manage long and short exposures to minimise style, sector, and regional mismatches. Independent construction of these portfolios can amplify unwanted risks without delivering commensurate rewards.
- **Diversification of Signals:** Investors in portable alpha and alpha extension strategies should diversify their exposure to strategies with different underlying investment signals, incorporating a mix of factor-oriented, non-factor quant, alpha capture, and fundamental approaches.
- **Whole-Portfolio Perspective:** Portable alpha strategies introduce market-neutral hedge fund exposures into the Long Equities portfolio. Given that these exposures may also be present in Absolute Return allocations, a comprehensive view of portfolio-level risk is critical to avoid overconcentration in specific strategies.

Equity Market Neutral: Favourable view. Equity market-neutral strategies continue to play an important role in our portfolios due to their ability to generate idiosyncratic alpha while minimising dependency on market direction or the performance of other systematic factors. By balancing long and short positions, these strategies can effectively mitigate systematic risk and capitalise on stock-specific dispersion.

We see attractive opportunities in both specialised and diversified approaches within equity market-neutral strategies. Our specialists tend to focus on market segments with high levels of dispersion and complexity, rewarding deep domain expertise. While these strategies can exhibit elevated volatility, careful sizing and risk management ensure their optimal integration into portfolios.

Diversified strategies, on the other hand, allocate capital across multiple portfolio managers (PMs), each specialising in specific sectors or industries. This broader diversification typically results in a lower volatility profile and a higher proportion of idiosyncratic risk, and reduces reliance on a small number of positions. We favour managers who demonstrate a strong ability to attract and retain talented PMs, robust support infrastructure, and disciplined portfolio construction practices. These attributes are critical to achieving superior risk-adjusted returns at the overall portfolio level.

Traditional Long Only Generalists: Neutral view. While we believe that portable alpha and alpha extension strategies offer better risk-adjusted return potential, traditional fundamental long equity managers continue to play an important role in portfolios. These strategies are particularly valuable for their ability to enhance diversification, especially when managed by teams with longer-term investment horizons.

Both alpha extension and portable alpha strategies involve leverage, with portable alpha strategies further increasing exposure to approaches already present in Absolute Return portfolios. Traditional long equity managers, by contrast, can provide a stabilising influence, particularly in environments where other strategies may exhibit higher volatility or leverage-related risks.

Given the lower risk-adjusted return potential of traditional long equity strategies, we place a strong emphasis on cost efficiency in this area of the portfolio.

Hedged Equities: Neutral view. As discussed above, equity long/short and equity market-neutral strategies delivered strong performance in 2024, reaffirming their value within a diversified portfolio. A normalised interest rate environment, coupled with greater economic dispersion across sectors and regions, created favourable conditions for long/short spread generation.

We maintain strategic allocations to Hedged Equities as a core component of our investment portfolios. Our emphasis remains on partnering with managers who exhibit strong research specialisation, robust portfolio construction capabilities, and disciplined risk management. This approach aligns with our broader goal of diversifying alpha sources and mitigating directional exposure in complex market environments.

Generalist Equity Long/Short: Neutral view. Generalist equity long/short managers delivered strong alpha in 2024, leveraging their ability to invest opportunistically across diverse market segments. Their longer investment horizons provide diversification benefits compared to multi-PM equity market-neutral funds.

We remain selective in allocating to this group, favouring managers with specialised research capabilities and disciplined portfolio construction. While long and short portfolios are built independently, we expect managers to actively review the resulting portfolio for its sources of non-idiosyncratic risks.

Specialists: We continue to allocate to high-quality specialist managers in strategy areas where we see strong return potential and clear benefits to expertise.

These strategies align with our broader goal of achieving robust, risk-adjusted outperformance while maintaining prudent exposure across asset classes. As we continue to evaluate and refine our allocations, diversification and manager selection will remain key priorities.

Public Equities
continued

Life Sciences: Favourable view. We maintain a favourable view of life sciences, as the structural investment thesis for biotech remains intact. M&A activity is critical to the sector for two reasons:

- It acts as a key catalyst for realising the value of innovative drugs, alongside drug trial data readouts.
- It provides portfolio managers with liquidity from acquisitions, enabling reinvestment into new opportunities, thereby supporting stock prices.

Several factors suggest a likely uptick in M&A activity in 2025:

- Strong Demand and Financial Capacity: Large pharmaceutical companies continue to seek innovative drugs to offset declining revenues from patent expirations and have the financial resources to pursue acquisitions.
- Abating regulatory headwinds: The new US administration has signaled a more positive stance on M&A. Despite initial market concerns over Robert F. Kennedy Jr.'s appointment as Secretary of Health and Human Services, experts expect limited impact on biopharma. Efforts to defund the FDA would require congressional approval, which is unlikely given the pharmaceutical lobby's influence. Furthermore, his priorities are expected to focus more on food and beverage standards than on biopharma. FDA leadership changes and continuity at the Center for Biologics Evaluation and Research are also viewed favourably by our managers.

Johnson & Johnson's recent $14B acquisition of Inter-Cellular Therapies is a positive signal, reinforcing competitive pressures among companies vying for a limited number of attractive biotech assets.

While the sector's sensitivity to interest rate volatility remains a potential headwind, we believe that the value of breakthrough drugs with large addressable markets often outweighs the impact of rate fluctuations. Our managers note that while interest rate moves can influence short-term market sentiment, the long-term investment case for successful biotech innovations remains compelling.

Advances in AI are beginning to influence the sector in divergent ways. On one hand, AI has the potential to reduce drug discovery failure rates, currently estimated at 90%, thereby lowering development costs across the industry. On the other hand, the strong performance of AI-driven technology stocks in 2024 diverted generalist growth investors' attention and capital away from life sciences, creating a headwind for the sector.

We remain confident in our managers' stock selection skill to identify companies with scientifically and commercially attractive drugs. A more conducive environment for the industry overall should translate into attractive returns not just relative to the biotech market but also relative to broader global equity markets.

Emerging Technology: Favourable view. We maintain a favourable view of emerging technology, driven by the rapid pace of innovation in AI. In 2024, the AI investment narrative expanded beyond the "Magnificent Seven" to include upstream infrastructure, such as data center components and electricity supply chains. Companies like Meta demonstrated early success in monetising AI by enhancing user engagement and ad effectiveness.

As we enter 2025, the focus is shifting to AI applications, creating both long and short opportunities. Key debates center around which software companies can increase value through AI integration and which risk being displaced by AI-driven alternatives. These dynamics demand significant expertise to identify winners and avoid potential losers.

The market volatility caused by the release of the Chinese Deep Seek LLM model in late January (discussed in more detail in our broad equity market outlook earlier in this publication) serves as a reminder of the fast-evolving nature of this space. To us, this reinforces the importance of partnering with managers with the true specialisation in the space that is required to distinguish between signal and noise in such volatile markets. We remain confident in our technology specialists' ability to navigate this evolving landscape, leveraging their domain expertise to capture opportunities in one of the most transformative areas of the market.

US Small Caps: Neutral/negative view. Our view on US small caps remains neutral to negative. In 2024, small-cap companies underperformed large caps again, with the Russell 2000 returning +11.5% compared to the S&P 500's +25.0%. This underperformance was largely driven by the dominance of mega-cap stocks, as the spread between the S&P 500 Equal Weight Index (+13.0%) and the Russell 2000 Equal Weight Index (+9.0%) was narrower.

While small caps continue to trade at a valuation discount to large caps, structural challenges persist, including declining profitability and rising leverage. Additionally, the trend of companies staying private longer reduces the flow of high-growth opportunities into the small-cap universe.

2025 Strategic Priorities

- **Increase Allocations to Risk-Managed Beta-1 Strategies in Long Equities.** We aim to expand allocations to strategies more explicitly managing benchmark-relative risk to achieve a more stable outperformance profile without sacrificing long-term return potential. Our approach intentionally diversifies across portable alpha and alpha extension strategies including both fundamental and quantitative research approaches. As capacity with some current managers tightens, we are prioritising research on new quantitative strategies to enhance portfolio diversification. Additionally, we are focused on evaluating whether to introduce non-equity alpha portable alpha strategies into our Long Equities program or keep these limited to our Absolute Return asset class.

- **Identify Opportunities Outside the US with Attractive Valuations and Fundamentals.** While US equity valuations remain elevated, certain international markets offer more attractive entry points. However, we recognise that low valuations alone are insufficient for a compelling investment case. We maintain a high bar for selecting managers in this space, emphasising differentiated research processes and robust organisational setups. In Asia, we are evaluating opportunities in Japan, looking at both activist strategies and traditional stock pickers given the potential tipping point for corporate reforms requiring less active engagement, and in Korea, a market that is seeking to replicate Japan's success in reducing the "Korea discount" in its equity markets.

- **Optimize Asset Management Costs and Align Fees with Alpha.** To enhance after-fee returns, we are focused on reducing fee burdens while maintaining manager quality. This includes leveraging our scale to negotiate better terms, partnering with high-calibre new launches at attractive stages of their lifecycle, and collaborating with managers to shift fee structures toward performance-based compensation. Our primary focus is on reducing fixed management fees in of structures that tie compensation better to long-term, risk-adjusted outperformance.

- **Continuously Upgrade and Broaden Our Manager Lineup.** Maintaining a high-quality, well-diversified manager lineup requires ongoing re-evaluation and sourcing. We regularly reassess investment theses and evaluate manager execution relative to peers. Breadth remains a priority, with exposure spanning regions, sectors, and styles. Sourcing strategies that have recently been out of but present opportunities for long-term alpha generation requires a specific intentional effort.

Private Equity

Buyouts

Major Trends

The buyout market stabilised in 2024 with a gradual lowering of interest rates and less volatility in broader private markets. We believe sponsors now have more clarity around the forward-looking deal environment and we anticipate a continuation of the trends observed over the last twelve months. These include strong earnings growth, higher transaction volumes and increased exit activity as buyer and seller expectations continue to converge. Nevertheless, we maintain our view that an economic paradigm shift is underway, and while debt markets have largely re-opened, persistently high interest rates and limited multiple expansion will likely constrain the broad-based industry beta that accounted for more than half of buyout returns over the past decade.[1]

We believe that the best performing firms of the future will be those that generate the most earnings growth in their portfolio companies via organic and inorganic revenue growth and margin expansion, rather than leverage or multiple arbitrage. Many firms, in our view, have not yet developed the in-house operating capabilities necessary to succeed in this new paradigm. Notably, fundraising continues to be driven by record capital commitments to mega-cap funds – a segment of the market we view as particularly vulnerable to these market dynamics.

Our approach positions us to identify the firms that will deliver above-average outcomes. This approach is characterized by a broad sourcing strategy, a rigorous manager evaluation framework that emphasises both qualitative and quantitative attributes and proprietary tools and data that enables us to understand how managers create value.

Transaction volumes and exit activity normalized. Global buyout transaction volume and value increased by +12% and +22%, respectively, in 2024 – c. $1.75T across over 19,000 transactions – as seller price expectations adjusted to the new market environment. There was clear bifurcation across sectors, with business, financial services and technology performing well, while industrials experienced their worst year since 2011 and healthcare remained 60% below its 2021 peak. Globally, exit activity increased by 20% to $900B in 2024. We believe that the continued momentum around Private Equity transaction volume and exit activity will continue into 2025. Factors likely to drive a robust deal market in 2025 include the $3.5T of dry powder, pressure on sponsors to generate liquidity for their investors, continued convergence of buyer-seller expectations and an improvement in financing conditions.[2]

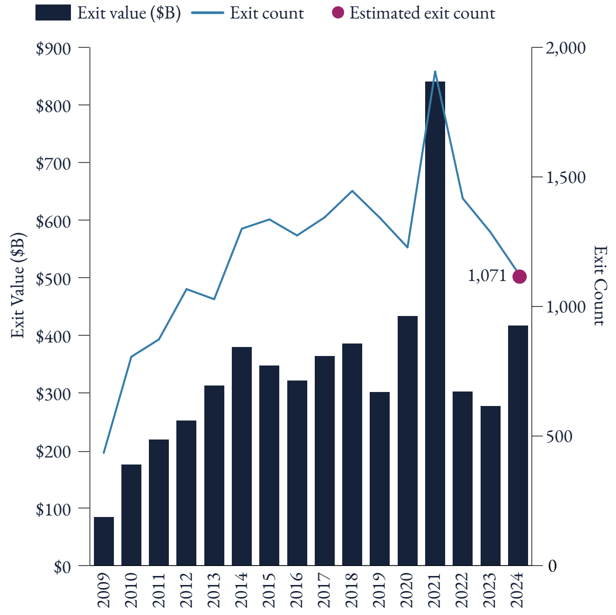
1 DealEdge

Holding periods declined in 2024 as sponsors worked through their exit backlog. Deal activity decoupled sharply in 2022, with transaction value exceeding exit value by 3.1x in the US. This ratio improved to 2.0x in 2024 as deal volume and exit activity continued to recover. Deal activity in the US was strong at $829B across c. 8,500 platform and add-on transactions, representing a 22% increase from the pre-pandemic peak.

The US led the rebound in exit activity, increasing by 50% to $417B.[3] We believe that sponsors will continue to work through their exit backlog, which saw positive momentum in 2024 evidenced by median exit holding periods declining from an all-time high of 7.0 years in 2023 to 5.8 years in 2024.[4] The normalization of exit activity is shown in Exhibit 1.

Exhibit 1

2024 saw improvements in exit activity



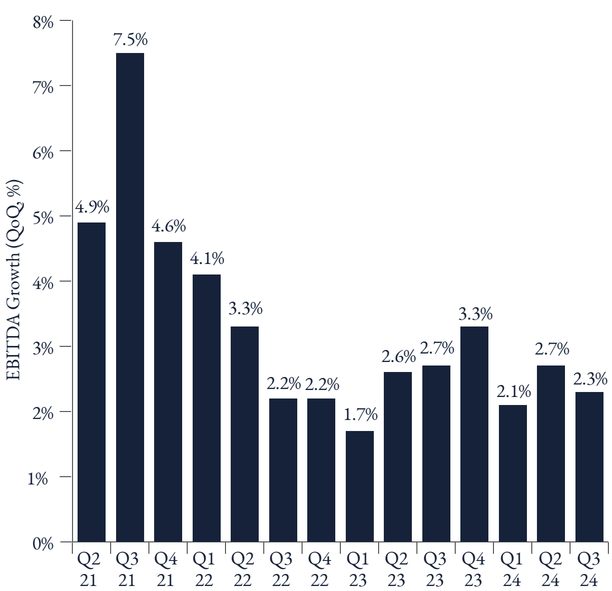
Source: Pitchbook

2 PitchBook Q3 2024 Global Fundraising Report
3 Ibid
4 Ibid

Private equity-backed businesses continue to exhibit healthy operating performance. As we reported last year, US buyout assets have consistently generated earnings growth above that of the public markets. Since 2000, the median middle market business has seen EBITDA compound at c. 9% per annum relative to c. 6% for the Russell 2000. We view this as indicative of the fundamental durability of PE-backed businesses. Across a middle market sample of more than four thousand companies, PE firms have generated positive earnings growth in 19 of the past 20 quarters and between +1.7% and +3.3% EBITDA growth in each of the past 8 quarters (even while holding flat or marking down companies in each quarter since Q3 2021), as shown in Exhibit 2. Within the same sample, PE-backed businesses exhibited c. 11% EBITDA growth from Q3 2023 through Q3 2024, which compares to 13% growth in operating earnings for the S&P 500 over the same period. Despite comparable earnings growth, PE returns lagged that of the public markets driven by -4.3% multiple compression as shown in Exhibit 3. This contrasts with c. 25% multiple expansion of the S&P 500.

Exhibit 2

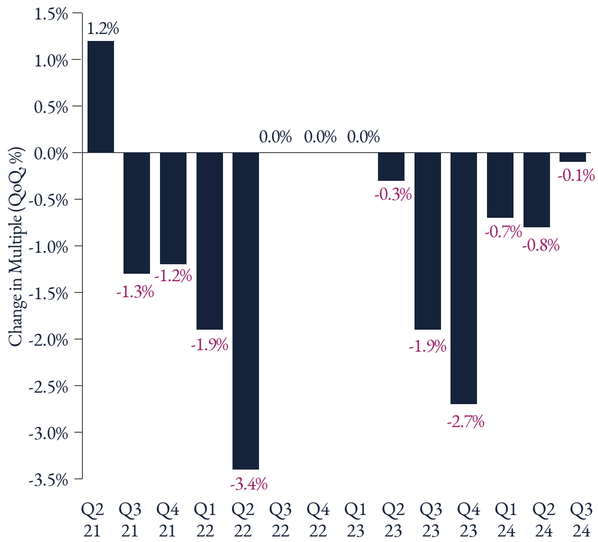
PE portfolio companies continue to generate strong earnings growth



Source: Lincoln International, Q3 2024 Private Market Index

Exhibit 3

PE portfolio company carrying values have seen 13 consecutive quarters of multiple compression



Source: Lincoln International, Q3 2024 Private Market Index

Purchase price multiples and leverage multiples stabilised and trended higher. After declining 15% from the peak in 2021, transaction multiples trended higher in 2024. Global PE transaction multiples increased c. 16% from a median of 11.2x EBITDA to 13.1x EBITDA. The headline data does not reflect what we see as a clear bifurcation across the Private Equity market. Median US large cap valuations have surged from 12x to 15x this year, well above the ten-year median of 12.2x. Conversely, lower middle market assets LMM[5] remain consistently priced at 6-9x EBITDA, in line with the ten-year median of 8.5x. In Europe, multiples are up slightly by 10% from 11x to 12x, higher than the ten-year median of 10.5x.[6] Equity contributions for buyouts remain elevated above 50% of total enterprise value after surpassing that threshold for the first time in over a decade in 2023 due to the continued impact of higher interest expenses and a tighter financing market, while leverage multiples increased c. 6% from 4.8x to 5.1x.[7]

5 LMM: businesses under $200M TEV
6 DealEdge
7 Axios, Pitchbook LCD

Private Equity
continued

Mega-cap sponsors continue to drive fundraising, masking a challenging environment for emerging managers. Fundraising is taking longer but remains robust in terms of dollars raised, with fundraising in each of the last three years hovering between $300B and $400B.[8] However, this number is disproportionately driven by mega-funds and obfuscates a challenging environment for emerging managers. The number of funds raised declined by -54% in 2024, or a -69% decline from the peak of 2022, an unprecedented drop and the lowest total number of funds raised in a calendar year in over a decade. Mega-cap funds (>$5B) accounted for c.40% of capital raised, representing a record high percentage.[9] Throughout the year, we continued to observe a barbell dynamic whereby the most attractive managers closed funds in less than six months while most others continued to struggle with multi-year fundraising timelines or failing to achieve their targets. The median time to close a private equity fund in the US in 2022 was 11 months; as of November 2024, the median fundraising time extended to 17 months, the highest on record since 2010. There are signs this dynamic is beginning to shift, as 29% of funds failed to achieve their target, representing an improvement from 34% in 2024.[10]

Golden Rules

1. Invest with managers who have demonstrated post-acquisition operational value-added capabilities.
2. Invest in lower middle market strategies where the greatest market inefficiency resides and where there is greater potential for asymmetric returns.
3. Invest with sector specialists who have competitive advantages in sourcing and value creation due to deep industry insights.
4. Invest with young, hungry teams trained by top-tier private equity firms or who are former business owner-operators.
5. Co-invest with those whom we believe to be best-in-class managers to increase returns through avoiding fees and carry, to mitigate the 'J-curve' and to concentrate exposure in what we view as exceptional investments.

8 Ibid
9 Ibid
10 Ibid

Sub-Strategy Attractiveness

Lower middle market (LMM) buyout: Favourable view. We believe earnings growth derived from revenue growth and margin expansion will be critical if PE firms wish to generate a consistent and compelling premium over public equities. LMM buyout investors have a greater opportunity to grow and stabilise the earnings of smaller companies that generally have not benefitted from professionalising management, cost rationalisation, investments in institutionalising processes (IT, sales and marketing, automation, etc.) or strategic M&A. We believe more deals in this segment can be sourced on an advantaged basis, reducing auction competition and purchase multiples. We also see a more durable opportunity for multiple arbitrage created from growing LMM companies into middle market companies, which can often be sold at higher multiples to larger buyout firms or strategic buyers. Since 2000, LMM companies have delivered higher earnings growth and top-quartile return potential, with comparable observed risk, as shown in Exhibit 4. LMM companies have grown earnings 60% faster than large/mega caps (8.1% vs. 4.9% p.a.), rely less on leverage or multiple expansion to drive returns (43% vs. 32% of value creation from EBITDA growth) and have stronger top quartile returns (+39.2% vs. +33.8%).[11] At the same time, North American LMM buyouts have had lower loss ratios and comparable or smaller drawdowns during major downturns. We believe this combination of higher earnings growth, top quartile returns and return contributions from operational improvements supports greater alpha potential through manager selection. We do note that LMM funds have a wider distribution of performance outcomes, are often led by less experienced investment professionals and in some cases focus on lower quality (margins, market share) companies.[12]

11 Deal level information sourced from Bain & Co DealEdge, consisting of C. 15k Unrealized and realized deals with value creation data between 2000 and 2021. LMM as <$200M of TEV, MM as $200-500M of TEV, large cap as $500M-1.5B, and mega cap as >$1.5B. Accessed as of Jan 2025 with Q3 2025 data
12 Ibid

Large market buyout (Large and Mega Cap Buyout): Cautious view. We continue to believe that the combination of lower availability of debt, high levels of competition among PE firms, and limited anticipated multiple expansion fundamentally alters the math of a large cap LBO. Despite the secular headwinds in the space, we do believe select large cap buyout managers – both generalist and specialist – can play a role in portfolios, specifically 1) greater levels of experience in both stronger and weaker markets, 2) higher organisational stability / lower levels of key person risk, 3) in our view, improved recession resilience, given they are generally higher quality assets (defined by margins, customer concentration, and market position) and 4) what we view as a stabilising effect as they exhibit meaningfully less dispersion than LMM funds (15.2% interquartile range for the LMM versus 8.8% for mega cap and 11.0% for large cap).[13] However, given the headwinds, we expect to make only limited commitments going forward.

Distressed/turnaround: Cautious view. We prefer to allocate to complex situations generalist buyout managers through market cycles to obtain comparable exposure. We believe these managers can flexibly invest into restructuring/turnaround investments in a cyclical dislocation but have generated far stronger performance in solid and strong markets. Distressed debt has generated returns ahead of buyouts in certain periods of pronounced market dislocation (e.g., 2007-2010).[14] However, distressed debt has underperformed c. 80% of vintages raised since 2000, and in the vintages it has underperformed, it has lagged broader buyouts by c. -6% per annum).[15]

Growth equity: Positive view. (Upgraded from neutral view). We define growth equity narrowly, with three core criteria: 1) non-control or control investments in high-growth tech or tech-enabled companies that are breakeven or approaching profitability (i.e., companies that sit between late-stage venture capital and buyouts), 2) focus on first institutional capital opportunities sourced through proprietary and/or proactive sourcing and 3) a value creation approach more equivalent to buyout than VC (hands-on engagement by dedicated operating professionals). We view growth equity (particularly in tech companies) as an attractive risk-reward opportunity, as they do not have the capital requirements of higher growth venture-backed companies or the debt burden of software buyouts. Tech Growth Equity has been a clear outperformer post-GFC, with an aggregate gross return of +26.5% vs. +25.4% for tech buyouts and +21.3% for buyouts in general.[16] Moreover, we believe the disruptive potential of AI represents a possible tailwind, acting as an additional catalyst for top-tier sponsors to accelerate growth and margin improvement at portfolio companies.

LP Secondaries: Neutral view. Average discounts in private equity secondary transactions tightened over the past year, from 15% in 2022 to 12% in 2024. This is broadly consistent with the longer-term average of 11% (2018-2024). This datapoint does not capture the considerable variability between strategies. Venture Capital secondaries transacted at an average discount of 30% vs. the longer-term average of 24%. Real Estate also traded wider than longer-term averages, at an average 26% discount vs. 22% historically. On the other hand, pricing for Buyout transacted at an average 6% discount, marginally tighter than the longer-term average of 8%. Industry dry powder (including access to credit facilities) relative to annual deal volume stands at 1.8x, below the average of 2.2x since 2018.[17] We expect secondary deal volume to continue increasing due to the growth of assets in mature private equity funds, and the increasing familiarity of both GPs and LPs with the secondaries market.[18] We believe the environment is attractive for certain targeted secondaries strategies (for example, tail-end secondaries). However, with pricing for the largest and most competitive segment of the market – mid-to-late life buyout funds –elevated relative to historic levels, we are cautious on strategies targeting these interests.

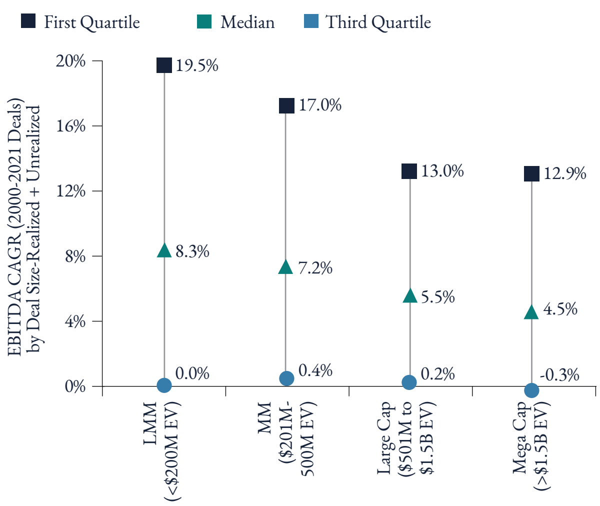
13 State Street Buyout Index; Interquartile range defined as the difference between the top quartile return and third quartile return
14 State Street Buyout Index; State Street Distressed Index; as of 30 June 2024
15 Ibid
16 Deal level information sourced from Bain & Co DealEdge, consisting of C. 16k Unrealized and realized buyout and growth deals with performanc e data between 2009 and 2021. Accessed as of Jan 2025 with Q3 2025 data
17 Ibid
18 Ibid

Private Equity
continued

GP-led Secondaries: Neutral view. The GP-led secondaries market continued its strong growth trajectory in 2024. Lazard estimates that there was $72B of GP-led transaction volume in 2024, exceeding the prior record of $63B in 2021. Most deals continue to close at par value, i.e., in line with the GP's prior carrying value for the assets. 72% of deals priced at 95% of NAV or higher. The market continues to mature, and investors have converged upon certain favoured terms, including GP alignment through carry rollover, reduced management fees and tiered carry. We believe GP-led secondaries can play a role in private equity portfolios, providing exposure to mature private equity-owned businesses, typically with shorter duration and less J-curve than a new private equity transaction. We are cautious that the market continues to attract new entrants, including traditional buyout firms such as Leonard Green. However, with growing GP utilisation of this market, we believe there will continue to be attractive opportunities for investors with a differentiated focus, such as the lower mid-market, which remains an underpenetrated segment of the market.

Exhibit 4a

LMM / MM buyouts have c. 4% higher per annum EBITDA growth than Mega Cap deals or public markets...

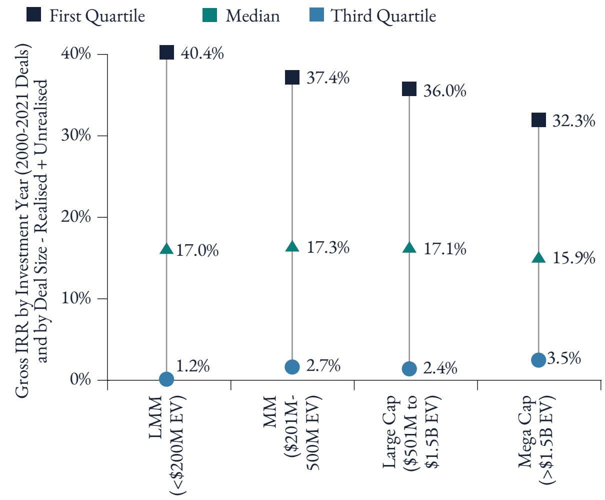


Source: Bain DealEdge

Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future returns.

Exhibit 4b

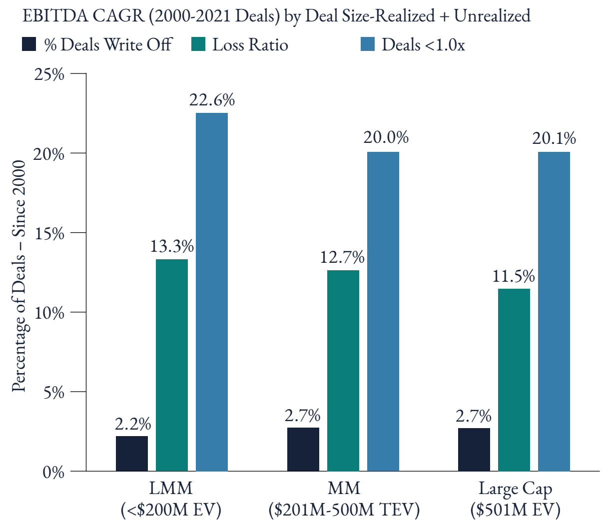
...and greater scope for manager alpha (top quartile return potential...



Source: Bain DealEdge

Exhibit 4c

...without meaningfully higher levels of observed risk



Source: Bain DealEdge

By Strategy

Complex situations buyout (LMM / MM): Favourable view. Within the lower middle market / middle market, we retain our conviction in our 'buy complexity' theme articulated in 2022. We define these situations where weak operating performance, capital intensity, or process dynamics (e.g., broken auctions, mispositioned businesses) enable PE sponsors to acquire fundamentally strong businesses at discounted valuations. Within our 'buy complexity' theme, we have a favourable view of both value-focused and 'growth at a reasonable price' managers. These managers are typically overweight 'old economy' end-markets (industrials, consumer, and business services), but we have selectively allocated to technology and healthcare managers with this approach. In a sample of c. 1,300 LMM / MM deals acquired for <7x EBITDA with <20% EBITDA margins at entry, median gross returns were +24.5%, more than +8% higher than the broader market.[19] The core opportunity in this space is asymmetric return relative to risk by improving underperforming companies, achieving a multiple re-rating with high levels of gearing enabled by lower entry prices. Despite comparable rates of write-offs/impairments, a top quartile deal generates a +55.7% gross return versus +34.5% for the broader market.[20]

Sector specialists: Favourable view. We continue to believe that specialist capabilities in sourcing, due diligence and post-acquisition value creation will lead to the acquisition of higher quality companies with higher earnings growth potential, which we believe to be particularly important in the current environment. Our specialist allocations target five sectors: technology, healthcare, industrials, consumer and energy transition. We have a particularly favourable view of technology, healthcare and energy transition specialists. For technology, we continue to believe in 1) outsized end-market growth in software and 2) the advantage of portfolio group driven value creation in the category. In healthcare, provider and payor businesses (c. 50% of the market) are under regulatory pressures, but we see clear advantages of specialism, demographic tailwinds and significant opportunity persisting in LMM companies across categories such as value-based care, life sciences outsourcing, healthcare IT and the biopharmaceutical supply chain. We also believe there are strong secular tailwinds behind the 'mega trend' of industrial decarbonisation. Given this trend is well known and potentially crowded from an investment perspective, we prefer to invest in second order beneficiaries providing the products, services and technologies (e.g., battery and energy storage, grid infrastructure and components, services to wind and solar energy providers) enabling the broader energy transition rather than investing directly in wind, solar, or other direct renewable energy products.

By Region

US Buyout: Favourable view. We continue to prioritise US buyouts given what we view as more able supply-demand dynamics around innovative technology and healthcare deals, as well as a larger total addressable market and a more actionable emerging manager pipeline.

19 Ibid
20 Ibid

Private Equity
continued

European buyout: Neutral view. Post-GFC, Europe LMM investments have generated lower median returns (+11.6% gross versus +18.7% gross in North America) and lower top quartile returns (+28.1% versus +41.9%) with greater probability of impairment (28.4% of deals marked at <1x MOIC versus 16.6%).[21] However, given the valuation reset and the continued growth of LMM fund offerings, we see a sufficient opportunity set to find two to three managers per year who we believe to be top tier and aligned with our core themes.

Asia/emerging markets buyout: Cautious view. We believe we can generate comparable or better returns in US or European buyouts with less currency, regulatory, and/or geopolitical risk. There are specific sub-segments, such as value-oriented generalists investing in Japan and growth equity firms based in India, where we continue to opportunistically evaluate allocations.

2025 Strategic Priorities

- **Prioritise buyout firms with extraordinary operating (PAOVA) capabilities.** We will retain our longstanding focus on identifying and investing in managers with demonstrated success in driving operational improvements in their portfolio companies, leveraging our 10+ years' experience sourcing and evaluating those managers that we believe truly excel in this area. Over the past decade, we estimate that we have completed c. 100 assessments of post-acquisition operational value add (PAOVA), and we leverage a data base with >45k companies to derive what we view as proprietary insights into manager effectiveness in this area. As other LPs become increasingly interested in this skillset, we must ensure that Partners Capital is top tier in identifying those rare managers with the greatest ability to generate PAOVA and in being a value-added partner to those GPs. We most commonly identify managers with strong PAOVA capabilities in the lower middle market and sector specialists in technology, healthcare, business services and industrials.
- **Exploit the current environment to gain access or increase allocations to managers with scarce capacity.** We believe that fundraising headwinds will persist for managers in our target sectors. We are actively working to source new relationships with 1) high-performing managers who were previously capacity constrained or 2) high-potential emerging managers. We believe most of these managers will either be sector specialists in our five core verticals (technology, healthcare, industrials, consumer, and energy transition) or value-oriented LMM buyout managers. We aim to invest in at least three high conviction emerging managers each year, focusing on opportunities where we can be a top five investor and support our firmwide goal of normalising the frequency and scope of client cutbacks.
- **Co-invest alongside high-conviction managers in the sub-sectors and value-creation strategies in which they excel.** We plan to further increase our co-investments primarily alongside high conviction investors with whom we have made a fund commitment. We constantly work to increase deal flow by positioning Partners Capital as the co-investor of choice in an environment of consolidating sources of capital, as well as proactive engagement with intermediaries and non-approved sponsors. Co-investing provides an excellent source of returns by increasing our exposure to what we believe to be top buyout assets and managers in a fee-advantaged manner. In addition, co-investing strengthens our primary funds program by deepening our insights into managers' diligence approach and analysis in live transaction situations.

21 Bain DealEdge; LMM defined as deals < $200M of total enterprise value at entry; includes realized, partially realized, and unrealized investments made between 2009 and 2021

- **Bring our US buyout playbook to Europe.** Our US buyout portfolio is organised around two core archetypes: 1) lower middle market generalists (often with a value orientation) and 2) sector specialists in specific verticals, both with high conviction PAOVA capabilities. Our Europe portfolio has historically been more concentrated in upper middle market or large cap generalists that could invest across geographies and sectors. We now see a growing opportunity in Europe to invest in LMM generalists and specialists with strong PAOVA capabilities as the market has matured and our sourcing has deepened. Themes we are particularly excited about include:

  1. Spinouts of approved sponsors executing comparable strategies at smaller equity investment sizes.
  2. Generalists focused on value-oriented industrials and business services across geographies.
  3. Industrial decarbonisation funds and those executing PE-like approaches to infrastructure.
  4. Software in the Nordic, Benelux, and DACH regions.

- **Revamp Our Technology Portfolio.** Given the competitive advantages of scale in software, we historically focused our technology specialist portfolio on larger enterprise software specialists. These managers tend to focus on vertical market leaders and are top contributors to our co-investment program. Our current view is that smaller managers, as well as growth equity managers, are better positioned to accelerate earnings growth at their portfolio companies. LMM and MM technology managers have generated a pooled gross return of +29.4% versus +25.3% for large cap and mega cap, with +6% higher top quartile returns.[22] Over the past 18 months, we have made commitments two middle market technology specialist and one lower middle market technology growth buyout specialist. For 2025, we plan to sustain our efforts to revamp and diversify our technology portfolio. Given the disruptive potential of artificial intelligence to drive dispersion of results across technology specialists, we also plan on focusing our diligence, in part, on finding managers best positioned to leverage the technology to augment their value creation capabilities.

22 Bain DealEdge

Venture Capital

Major Trends

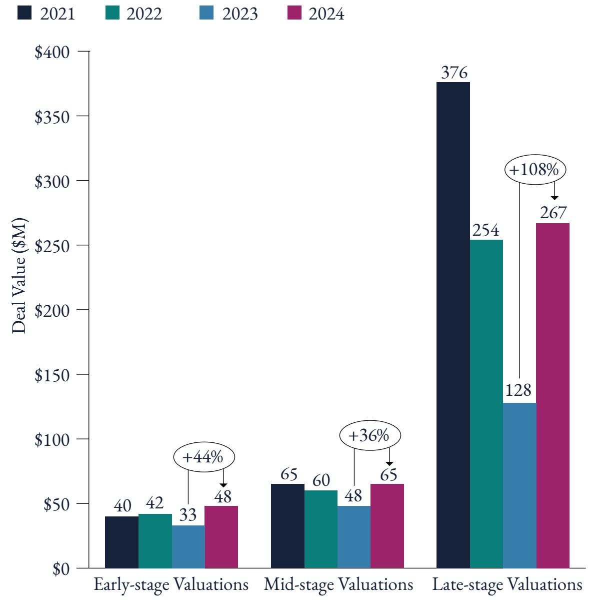
The global Venture Capital correction that began at the end of 2021 appears to have bottomed during 2024. Following seven consecutive quarters of negative performance for the Venture Capital Index from Q1 2022 to Q3 2023, leaving the index with a -22.4% loss over that period and representing the most significant venture correction since the Dot Com Crash, the index has posted a gain of +2.4% over the past 12 months through September 2024.[1] Pooled returns for global venture capital over a 3-year, 5-year, and 10-year basis are -2.27%, +14.9%, and +14.8% annualized, respectively.[2] Over the same periods the MSCI ACWI returned +8.0%, +12.2% and +9.4%.

Venture investment activity and valuations recovered during the year. Venture capital investment in the US totalled $209B in 2024, a +29% increase relative to 2023 and c. 68% of the 2021 peak of $355B. Through the first nine months of 2024, deal activity was tracking to a similar pace as 2023. However deal value totalled $75B in Q4 alone, which represented the highest level of quarterly dealmaking since Q2 2022.[3] Exhibit 1 shows that following the reset observed in 2023, median valuations also appear to have turned the corner, although the extent of the correction and subsequent recovery varies by stage. Median valuations for early-stage companies, which experienced only a moderate reset in 2023, now exceed levels recorded during the venture peak. In the aftermath of the market correction, many investors shifted their focus from mature start-ups to early-stage opportunities, which is likely supporting valuations at this end of the market. Late-stage companies experienced a much steeper -65% valuation decline in 2023 relative to the 2021 peak, reflecting the correction experienced by public technology companies, higher interest rates which decrease the relative attractiveness of venture, and limited public markets appetite for high-growth, unprofitable companies leading to concerns around exit prospects. Fast-forward to today, several of these factors have improved; the Fed's widely anticipated easing cycle commenced during Q4 2024, IPO markets appear to be improving with a handful of high-profile venture-backed IPOs during the year and public technology companies have also put in strong performances. This appears to have driven the recovery in late-stage valuations.

1 Cambridge Associates Ventures Capital Index, Q3 2024
2 Ibid
3 Q4 2024 Pitchbook-NVCA Venture Monitor

Exhibit 1

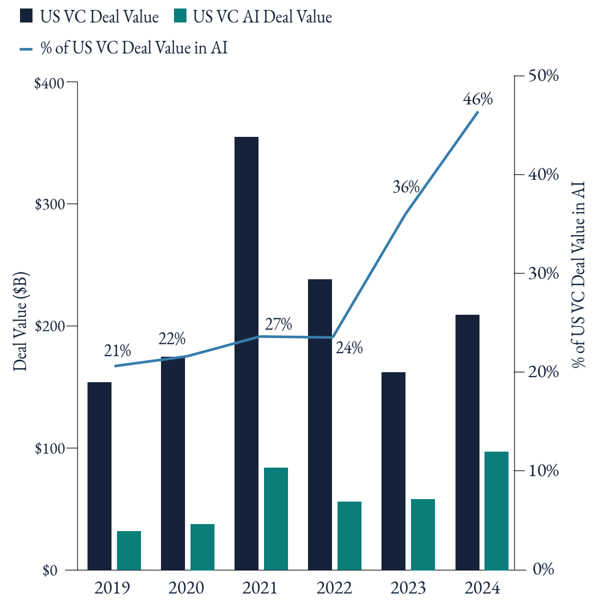
Median valuations have recovered across all stages following a correction in 2023



Source: Pitchbook

Exhibit 2

AI Investment as a Share of US VC Activity



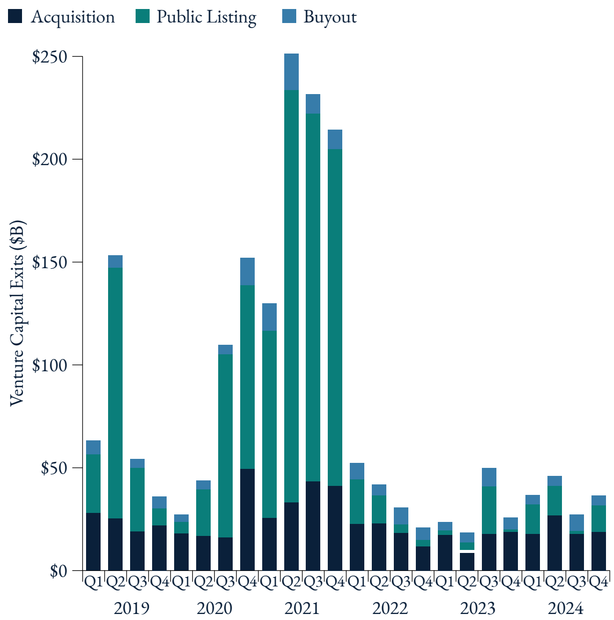
Source: Pitchbook

The venture recovery is being disproportionately driven by the artificial intelligence ("AI") revolution. Investor enthusiasm for AI technology, sparked by the breakout success of OpenAI's ChatGPT in 2022, is driving the venture recovery. AI start-ups raised a total of $97B in 2024, capturing 46% of all US venture capital funding during the year.[4] Venture capitalists are exploring opportunities across the three core layers of the generative AI technology stack: 1) the infrastructure layer, 2) the model layer and 3) the application layer. The infrastructure and model layers are the most capital-intensive sub-sectors, and VC activity within AI is being driven by an arms race between the foundation model-builders, several of whom raised multi-billion-dollar funding rounds during the year. OpenAI raised $6.6B in Q4 2024 at a post-money valuation of $157B, making it the third highest valued start-up globally after SpaceX and ByteDance.[5] Elon Musk's xAI raised two separate $6B funding rounds during the year, while Anthropic, the creator of ChatGPT competitor Claude, raised $4B. While we are excited about the potential for innovation and company creation presented by advances in AI, we are also cautious about the velocity and scale of investments that have been made recently in the model and infrastructure layers.

Exits, or lack thereof, remain a key bottleneck to a more sustained venture recovery. The exit market remains sluggish, with only $149B of value generated in the US during 2024 (Exhibit 3).[6] Public listings have been the primary driver of exit value in venture capital historically, and the IPO drought in recent years has led to an aging population of venture 'unicorns' (start-ups whose valuations exceed $1B). According to data from Pitchbook, venture unicorns account for more than $2.5T in aggregate value today and nearly 40% of these companies, which account for more than $1T in value, have been held in portfolios for at least nine years.[7] The market for venture-backed IPOs appears to be re-opening; one prominent example was ServiceTitan's December IPO, which priced above its range and rose 42% on its debut, while historical data indicates that US IPO activity tends to be 39% higher in post-election years compared to election years.[8,9] While this might initially be viewed as cause for optimism, we believe the effects of the venture peak of 2021-22 and subsequent correction are still working their way through the industry. A subset of the growing universe of venture unicorns includes companies that previously raised capital at lofty ZIRP-era (zero interest rate policy era) valuations. A handful of blockbuster IPOs in 2025 may be enough to support the venture recovery. However, in an uncertain environment for public markets, the most sought-after late-stage companies have ample funding available to them (more detail on this below) which may delay the long-awaited arrival of distributions.

Exhibit 3

The IPO market remains sluggish



Source: NVCA Venture Monitor, As of September 30, 2024

4 Ibid
5 CB Insights
6 Q4 2024 Pitchbook-NVCA Venture Monitor
7 Q3 2024 Pitchbook-NVCA Venture Monitor
8 Reuters
9 EY Global IPO Trends Q2 2024

Venture Capital
continued

The top venture firms are weathering the otherwise challenging fundraising environment. The recent venture correction and the lack of distributions materialising from existing commitments are leading to more caution among LPs and a challenging fundraising environment for GPs. During 2024, US venture fundraising totaled $76B (a -22% decrease relative to 2023) across just 508 funds, which is the lowest fund count since 2014.[10] LPs are choosing to concentrate capital in the large, established multi-stage firms at the expense of emerging managers. Pitchbook estimates that just nine firms were responsible for $35B or 49% of funds raised in 2024, and the top 30 firms comprised c. 75% of all US fundraising last year.[11] These deep-pocketed VCs are participating in multi-billion-dollar rounds for companies that may previously have IPO'd to raise such large amounts of funding. Databricks, a data management platform at the centre of the AI trend that was expected to go public as early as 2023, raised $10B in a series J round in December 2024 that was reportedly oversubscribed.[12] This dynamic of successful start-ups staying private for longer may further delay the arrival of distributions for LPs in the near-term.

Golden Rules

1. Prioritise manager selection, as venture capital has greater performance dispersion than any other asset class.
2. Focus on skilled investors with a demonstrated proficiency in sourcing, selecting, accessing, and supporting start-ups poised for venture-scale outcomes. The key attributes we seek in venture managers are deep subject-matter expertise, strong network/brand with founders and demonstrated success identifying winning companies as an angel or venture investor. It is also important that venture funds be sized and structured appropriately.
3. Construct a portfolio that allocates capital to established and emerging managers. Aim to capitalise on the persistent outperformance observed in funds managed by market leaders and the alpha potential of smaller, more specialised funds.
4. Invest across early- and late-stage funding rounds to concentrate capital in companies with potential asymmetric outcomes and to leverage the informational advantages inherent in multi-stage investing.
5. Maintain a steady commitment pace given the ineffectiveness of market timing strategies and the lack of correlation between innovation and macroeconomic cycles.

Sub-Strategy Opportunities

By Stage

Early-stage: Favourable view. We expect early-stage investments to exhibit lower correlation with macroeconomic risks, as outcomes are dependent upon innovative technologies and product-market fit, rather than interest rates or the corporate earnings cycle. History has shown that successful companies can be founded in virtually any environment. Recent advancements in the application and accessibility of artificial intelligence should also act as a positive force for entrepreneurs aiming to disrupt the offerings of established incumbents. Finally, investment information and access are opaque at this end of the market, and these inefficiencies create a compelling opportunity for alpha generation.

10 Q4 2024 Pitchbook-NVCA Venture Monitor
11 Pitchbook
12 Financial Times

Late-stage: Neutral view. Short-term challenges persist, including a lingering excess of overcapitalised businesses and an uncertain exit environment. The late-stage market demonstrated signs of improvement in the latter half of 2024, with a growing cohort of companies successfully raising their first new round of financing since 2021. A persistent trend has emerged where high-growth technology companies, such as Databricks, SpaceX, or Stripe, are choosing to raise capital in the private rather than public markets. Investors will need to carefully navigate this opportunity set, as many companies may still have inflated valuations and/or challenged business models. We are also mindful that our long-term outlook on interest rate volatility is a potential headwind for late-stage investors. We multi-stage investment platforms in this environment, which benefit from clear information and access advantages and tend to skew towards earlier entry points.

By Region

US: Favourable view. The US remains the largest venture capital market globally with the deepest pool of founder and investor talent. The regulatory environment in the US also remains supportive of innovation and entrepreneurship. While the change of administration presents some near-term uncertainty, President Trump has named several high-profile venture capitalists to the new administration, suggesting an improving policy and regulatory environment. Certain sub-sectors within venture, such as defence technology and government technology, may stand to benefit from the new administration's plan to address Federal spending by looking to innovative, low-cost alternatives to 'cost-plus' incumbent defence contractors. We see compelling opportunities to invest in both established and emerging managers in the US and expect it to remain a core focus of our program. Competition and valuations are likely to remain at a premium to other markets, underscoring the significance of manager selection despite the able backdrop.

Europe: Neutral view. The European market has evolved over the past decade and now commands a larger share of global funding and start-up value creation. Greater support for entrepreneurship in the region and increased interest from investors overseas have contributed to the market's maturation. Key considerations for investors in this region include the distribution of opportunities across countries with distinct cultural and language barriers, the more challenging economic outlook relative to the US, a more complex regulatory environment, and a limited pool of managers with evidence of persistent outperformance. We remain focused on building relationships with the handful of market-leading GPs in Europe while obtaining exposure via our global multi-stage platform relationships.

China: Cautious view. China remains a global technology leader; as evidenced by the recent AI advancments from DeepSeek. However, regulatory actions on both sides of the Pacific squeeze China's technology industry and create uncertainty for investors. VCs in the region have shifted their focus away from consumer internet towards sectors such as energy transition, enterprise software, healthcare, and consumer services that better align with China's stated policy objectives. We have significantly reduced our commitments to the region.

Venture Capital
continued

By Sector

Enterprise technology: Favourable view. We continue to view enterprise technology as a core allocation within our venture capital program. Historically, there are more realisations at valuations greater than $1B in enterprise technology compared to other segments of the market. Furthermore, the transition to the cloud and the growing adoption of artificial intelligence have driven a need for new infrastructure and presented an opportunity to develop innovative new applications. Key challenges for this segment include persistently high valuations, particularly in categories such as applied and generative artificial intelligence, and low barriers to entry investors with deep domain expertise and the ability to support product commercialisation.

Consumer technology: Neutral view. The consumer segment has produced many of the largest outcomes in the venture capital market over the last 20 years; however, value tends to be concentrated in a smaller number of companies making it a more challenging category for generating consistent outperformance. Many consumer businesses are experiencing a slowdown in growth, as conditions that propelled growth in 2020/21 have diminished. While the category faces headwinds, the opportunity set has expanded into healthcare, financial services, and real estate in recent years, significantly expanding the value creation opportunity for investors. Advancements in generative AI may also catalyse new, or more efficient, business models and consumer experiences.

Deep technology: Neutral view. Industry participants broadly categorise opportunities that carry a greater level of technological and market risk as "deep tech" investment. Our definition of this market segment includes opportunities in hardware (e.g. robotics, semiconductors, computing), climate technology and blockchain technology. We are approaching opportunities across these categories with caution, given the incremental technology risk and the capital requirements associated with scaling many of these technologies. We have selectively backed specialists in climate and blockchain technology in the past, and we will continue to support a limited number of investors in these categories, as long as the end market and potential return dynamics remain able.

Life science: Cautious view. The rapid pace of innovation and the strong demand for new assets from large pharmaceutical companies support investments in start-ups developing novel therapies and infrastructure. However, the capital requirements of drug development, combined with the funding pullback and the prolonged time to exit, pose imminent challenges for investors in early-stage, venture-backed companies. We also remain cautious given the weaker performance relative to technology-focused venture capital funds historically.

2025 Strategic Priorities

- Continue to expand exposure to early-stage venture capital: The core focus of our venture capital program remains unchanged. We seek to combine the persistent outperformance of established venture capital platforms with the alpha potential of smaller, more specialised investors focused on early-stage (generally Seed and Series A) investments. We continue to view this as an attractive segment of the market, due to the sustained trend of accelerating innovation and the inherent inefficiencies within this space given over 15,000 companies raised venture funding in 2024.[13] We believe that early-stage managers investing from $100 million to $500 million size funds are best-positioned to capture power law returns based on our analyses of return distributions and portfolio construction models. Furthermore, we believe the key drivers of performance in early-stage venture capital are less correlated with macroeconomic cycles, as previously discussed. We aim to allocate c. 40%-50% of our venture capital focused pooled investment vehicle to early-stage managers. We reserve another c. 40%-50% of the vehicle for multi-stage managers which allocate c. 50% of capital to early-stage investments. The vehicle's approach to portfolio construction results in c. 55%-70% total exposure to early-stage investments.

- Opportunistically co-invest in late-stage rounds of category leading technology companies: We plan to selectively increase our co-investment alongside our top-conviction managers, on a fee-advantaged basis, in a sub-set of late-stage, US- and Europe-based technology companies that have demonstrated product-market fit and attractive unit economics.

- Evaluate the late-stage opportunity set: As previously discussed, the late-stage segment of VC has undergone a pronounced correction since the peak observed in 2021. While valuations appear to have recovered somewhat, we believe this may be an attractive environment to deploy new capital into late-stage investments that can generate a compelling IRR with a shorter overall duration than early-stage venture capital. We have not made a dedicated late-stage commitment for at least two years, but we are presently tracking an attractive pipeline for 2025 comprised of managers who we view as top-tier GPs raising dedicated late-stage funds and late-stage specialists.

- Continue to leverage our commingled pooled investment vehicle to scale program and facilitate client exposure to venture capital: Since launching our inaugural venture capital-focused investment vehicle in 2022, we have strategically expanded key manager relationships by aggregating client commitments and capitalizing on our growing scale. This vehicle addresses a critical need for investors who may lack the scale to build a well-diversified venture capital portfolio consisting of four-to-six annual venture capital fund commitments. Additionally, direct commitments to venture capital managers often result in under-allocation to early-stage and specialist managers. By providing targeted exposure to these opportunities across diverse themes, sectors, and geographies, this vehicle helps to overcome capacity constraints and other investor restrictions.

13 PitchBook-NVCA Venture Monitor, January 2025

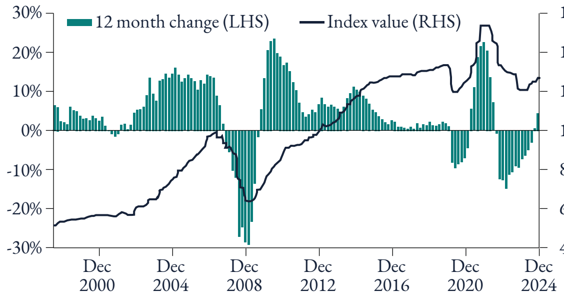
Real Estate

Major Trends

Valuations have stabilised (Exhibit 1). Valuations in most Real Estate sectors began to stabilise in 2024. REITs rose c.+5% during the year, while private real estate, which typically lags public markets, declined c.-5%.[1] Valuations across public and private markets look comparable today. Traditional public real estate sectors trade at a 5.2% cap rate, compared to a 5.4% cap rate for private real estate. By comparison, 12 months ago, REITs were valued at an aggregate cap rate of 6.0%, while private real estate was estimated to be valued at 5.5%.[2]

Exhibit 1

Green Street Commercial Property Price Index



Source: Green Street

Transaction volumes remain low, but some signs indicate that they may improve in 2025. Transaction volumes remain significantly below peak levels in 2021 (Exhibit 2).[1] Several factors contribute to this trend. Many traditional buyers of Real Estate such as REITs and core funds remain out of the market. More than half of REITs trade at a discount to NAV, making equity issuance a challenge, while most core funds are managing redemption queues, though REITs and core funds focused on the industrial and data centre sectors have been notable exceptions. The average discount to NAV for REITs was -5% in January 2025.[3] For core funds in the ODCE Index, the redemption queue equates to c. 20% of aggregate NAV.[3] Most funds are managing redemption queues equal to 5-10% of their NAV, and certain outliers such as the UBS Trumbull Fund, are managing larger queues. Additionally, Private Equity Real Estate fundraising is down c. -47% over the past two years.[4]

1 REIT returns sourced from FTSE NAREIT, Private Real Estate from Cambridge Associates Real Estate Index
2 CenterSquare REIT Cap Rate Perspective Reports, Q4 2024 and Q3 2024
3 Green Street Real Estate Alert January 2025
4 Pitchbook H1 2024 Global Real Estate Report

While there are few signs of recovery in aggregate transaction volume data, we note two potential indicators that 2025 may see growth in deal activity. Firstly, investor sentiment has improved, and for the first time in three years, most Real Estate investors believe values are likely to be stable or increase over the next 12 months. Secondly, 2024 saw the return of certain large opportunistic investors, most notably Blackstone, which made several sizable real estate acquisitions across residential, industrial, data centers, and retail. Examples include Blackstone's take-private of Tricon a single-family rental REIT, in Q1, and their take-private of Retail Opportunity Investments Corp, a grocery-anchored retail REIT, in Q4. These opportunistic buyers are often the first movers following periods of volatility.

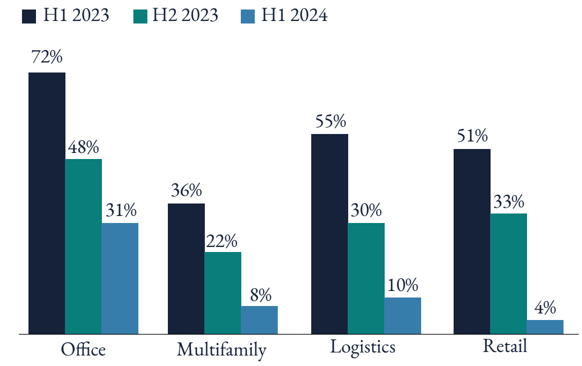
Exhibit 2

Real Estate Transaction Volume: 2024 vs. 2021

Source: Green Street

Exhibit 3

% of Investors Expecting Cap Rates to Increase (CBRE Semi-Annual Survey)

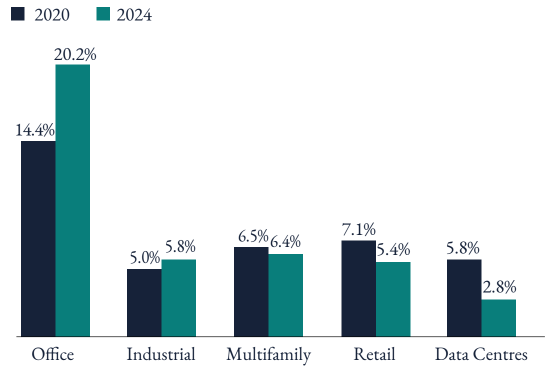


Source: CBRE

Operating performance has exceeded expectations. Although capital markets are challenged, most Real Estate sectors continue to perform well on an operating basis. Vacancy rates are c. 6% or lower in all major sectors except office. Strong occupancy is likely to be supported by the sharp drop in new construction over the past 24 months. This can be seen in the data for net operating income growth. Green Street data shows positive net income growth in 2024 for all asset classes excluding office and self-storage.

Exhibit 4

Vacancy rates by sector: 2020 vs. 2024

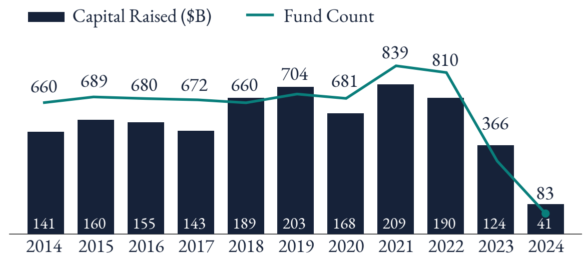


Source: Federal Reserve Bank of St. Louis

LP sentiment remains weak, potentially creating opportunities for investors with disciplined deployment across vintages. Capital flows to real estate are sharply down. Private Equity Real Estate fundraising declined c. -47% over the past two years and real estate construction is down -30-40% in most sectors. Although lending markets have improved, the capital markets environment remains challenging for most real estate owners, particularly those that acquired assets with high leverage at peak valuations in 2020 and 2021. Many of the loans for those transactions will mature over the next 24-36 months. In evaluating partners for this environment, we look for managers with strong sourcing networks, a track record of disciplined deployment and both capital markets and operating expertise.

Exhibit 5

Real estate fundraising activity



Source: PitchBook

Golden Rules

1. Aim to build Real Estate portfolios at stabilised unlevered yields 1-2% above prevailing market cap rates. This can be achieved through acquisition discounts and/or identified net income growth during the hold period. This creates upside in normal market environments and provides a margin of safety against declining market valuations and rising debt costs.
2. Partner with vertically integrated managers with excellent operational capabilities and local knowledge.
3. Focus on a "Buy, Fix, Sell" approach within Private Equity Real Estate. For a core-plus, pursue a "Buy, Fix, Hold" approach in high-conviction markets.
4. Focus on sectors and regions with the strongest fundamentals, where institutional demand creates liquid property markets; be wary of tertiary and emerging markets.
5. Be prudent on the level and structure of leverage.
6. Consider tax benefits or disadvantages, depending on investor type and market.

Real Estate
continued

Sub-Strategy Attractiveness

By Strategy

Private Equity Real Estate ('PERE'): Favourable view. For new investments in real estate in 2025, we believe making new acquisitions remains more able than entering an existing portfolio at appraised valuations. Although appraised values for private real estate are generally in-line with public real estate valuations, our PERE managers have been acquiring assets at cap rates 100-200bps wider than the market. Due to their structure, PERE funds can typically take on more complex business plans, including distressed loan workouts or portfolio acquisitions. We believe this flexibility and ability to lean into stressed and distressed situations is valuable in the current real estate environment.

Infrastructure: Favourable view. We believe there are compelling opportunities in several areas of the infrastructure market. While we have not previously broken out infrastructure as a distinct asset class, we have built conviction in several infrastructure sub-sectors over the past 18-24 months, in particular digital infrastructure and power/energy infrastructure, resulting in several fund commitments and co-investments on behalf of our clients. These sectors have many of the attributes we target: 1) strong secular demand tailwinds, 2) supply constraints, 3) a high degree of specialization and 4) durable and inflation-protected cash flows. We are most focused on 'value-added' infrastructure investments that target higher opportunistic real estate returns and take some development risk.

Core and Core-Plus Real Estate: Neutral view. While we believe core-plus funds serve an important role in our strategic asset allocation, for investors making new commitments to Real Estate in 2025, we recommend prioritising new acquisitions through PERE funds over investing in core funds. While valuations for core funds have moved in line with public REITs, the capital position of these funds, whereby most funds are managing redemption queues, means they are net sellers as opposed to net buyers of assets today. We think the current environment, with more limited availability of real estate capital, s buyers over sellers.

By Industry

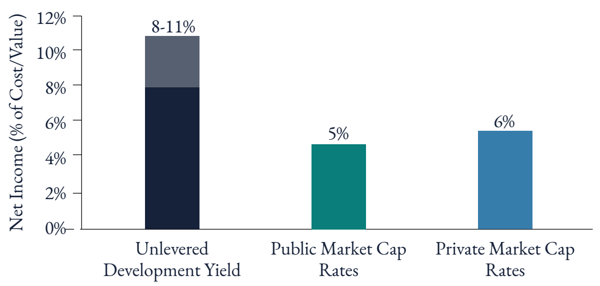
Industrial: Favourable view. Vacancies remain at or below 6% in most major markets. Ongoing e-commerce penetration growth and 'near-shoring' supply chains continue to drive demand. Our preferred method of accessing the space is through owner-operators executing a portfolio roll-up strategy in small (100-250K square feet) last-mile assets. There is an opportunity for those operators to create additional value by re-positioning and re-leasing older properties. While the sector is not immune to the challenging capital markets environment, our managers have had success sourcing financing from insurance companies. In certain cases, our managers have opted to acquire assets on an unlevered basis where they believe unlevered returns of 14-16% IRR are achievable.

Hypothetical return expectations do not represent actual trading and are based on simulations with forward-looking assumptions, which have inherent limitations. No representation is being made that any investor will or is likely to achieve returns similar to those shown. Such forecasts are not a reliable indicator of future performance.

Digital Infrastructure: Favourable view. The rapid growth in data consumption driven by internet usage and cloud adoption is set to further accelerate as AI adoption becomes more widespread. Hyperscalers, the largest users of data center assets, have made several large scale capex announcements over recent months; Microsoft announced plans to spend $80B while Meta announced plans to spend $60B+. While demand drivers are well understood, supply remains constrained due to challenges accessing appropriate sites with ability to secure the right zoning and sufficient access to power. We believe there is an opportunity to partner with experienced managers, with the network and execution capabilities to take advantage of long-term secular growth, driven by growing demand for compute and storage. We are seeing the opportunity to develop assets at unlevered yields on cost of 8-11%, which compares to private market cap rates of c.5.5% and public market cap rates of c.4.8% (Exhibit 6).

Exhibit 6

Strong demand and finite supply in data centers is creating the opportunity to generate attractive yields for experienced developers



Source: CenterSquare Investment Management

Sustainable Energy and Power Generation: Favourable view. Power demands are growing due to data consumption growth, reshoring of industrial manufacturing, and adoption of EVs. The 5yr forecasted electricity growth in the US is now +16%, after being essentially flat for the past 15 years (+0.2% CAGR from 2010-2022).[5] We believe there is an attractive opportunity to acquire and develop assets which generate or transmit sustainable power. These assets offer an attractive risk/return profile with good downside protection (generating stable, inflation-linked cashflows, often used for essential services), strong market growth and scope to drive upside through clear levers such as development, M&A growth and building platform value.

Multifamily: Favourable view. Multifamily has outperformed expectations over the past two years. Due to strong investor sentiment and low cost of debt, multifamily development spiked in 2021/22. We have seen these developments completing and coming to market over the past 12-18 months, and we believe supply is likely to remain elevated for a further 12 months. Against this backdrop, most expected rents in multifamily to decline, and while certain of the most oversupplied markets, such as Nashville and Phoenix, have seen declines, at the national level, rents have been flat. This was due to stronger-than-expected demand, driven in part by a more robust economy and the sharply rising cost of home ownership. We expect long-term supply-demand fundamentals to remain positive. Additionally, we view multifamily as a compelling sector for investors, given the defensive nature of the cash flows, and the repeatability of business plans. This is an attractive set-up for sector specialists with strong operating expertise and in-house asset management capabilities.

Real Estate Credit: Favourable view. As described more fully in our Private Debt section, we have a favourable view on the opportunity set in real estate lending, driven by ongoing capital constraints in the market. Financing and refinancing options are more limited for real estate owners today, due primarily to the pullback of regional banks. Exit options are also reduced in an environment with low transaction volume, reduced fundraising activity, and limited core capital being deployed. This creates attractive opportunities for specialist lenders with ability to provide flexible capital solutions.

5 Source S&P IQ, EIA

Real Estate
continued

Retail: Neutral view. Having been a difficult asset class for many investors for the past 10 years, the environment for retail has improved. Capital flows out of retail and into other sectors have resulted in valuations declining, increasing going-in cash yields, and vacancy rates falling, due to the limited development pipeline. On that basis, large investors are becoming more active in retail again. Notable transactions include Blackstone's c.$4B take-private of Retail Opportunity Investments Corp., a portfolio of 93 grocery anchored retail properties. While the environment has improved, we do not see the same opportunity for rent growth as we see in our preferred sectors, and we believe there remains the risk of further e-commerce disruption.

Office: Negative view. Vacancy rates in the US are at or above 20% in most major US markets. Sentiment has marginally improved, in part due to back-to-office mandates from large companies such as Amazon and JP Morgan. Nonetheless, leasing remains highly concentrated in a small number of trophy properties. There remains significant uncertainty around achievable market rents in most office properties. While there may be selective opportunities for conversions, this is a narrow opportunity set. Moodys estimated that of the 1,100 office buildings they track, only 35 were viable candidates for conversion based on structural and cost considerations. The relative strength of the trophy office market is well-understood by the market and that segment has been stable, meaning opportunities to invest at attractive valuations are limited.

Hospitality: Negative view. Hospitality is the most economically sensitive Real Estate sector, reflecting its short-dated income profile, and correlation to business and leisure travel. An economic slowdown in consumer spending would create headwinds for hospitality, particularly in an environment where inflation remains sticky, impacting expenses and interest rates remain high, impacting borrowing costs.

2025 Strategic Priorities

- **Invest in digital and power infrastructure opportunities.** As described in the section above, we believe there is a compelling opportunity set in these sectors today. We made several commitments and co-investments in these sectors in 2024, and we expect to identify at least one high conviction opportunity in each sector in 2025.
- **Partner with experienced opportunistic GPs.** We believe the next three years will be an attractive environment for opportunistic real estate managers. We expect certain capital markets challenges to remain, in particular access to and cost of debt capital. Against this backdrop, fundamentals in many real estate sectors remain solid and are likely to further improve given the limited development pipeline. In partnering with managers for this environment, we look for several critical criteria: 1) strong sourcing networks with a broad top-of-the-funnel, 2) a track record of disciplined deployment in past cycles, 3) capital markets expertise, required for complex transactions with debt issues and 4) operating expertise, as the most attractive buying opportunities may be from less sophisticated owners who undermanaged assets.
- **Continue to drive fee discounts, co-investments, and other able economics.** Fundraising in real estate declined c. -47% in 2023-24 compared to 2021-22, with many LPs taking a broad-brush approach to reducing their exposure.[6] Despite headwinds, we believe there are attractive opportunities to deploy capital, and with a relative scarcity of LP capital, we are in a strong position to drive fee discounts and other able economics. For investments made in 2023, we secured a weighted average management fee discount of 0.4%.

6 Pitchbook

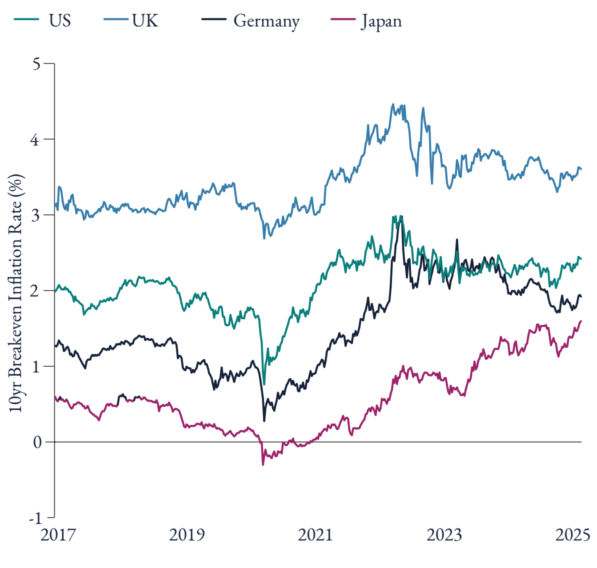
Inflation-Linked Bonds

Major Trends

Long-term inflation expectations remain stable (see Exhibit 1): The difference between the yield on a nominal fixed-rate bond and the real yield on an inflation-linked bond ("ILB") of the same maturity provides the breakeven inflation rate, a measure of investors' inflation expectations over the life of the bond. This was 2.4% in the US at the end of January, only modestly above the Fed's 2% target rate. In Germany, inflation expectations have gradually declined to 1.9%, reflecting the easing of post-pandemic and Ukraine war pressures. The opposite is true in Japan, where inflation breakevens have steadily increased to 1.6% from near zero over the last three years. The UK breakeven at 3.6% is structurally higher, but this is mainly because UK ILBs are indexed to RPI, which is typically 1% higher than CPI.[1]

Exhibit 1

Market inflation expectations remain stable

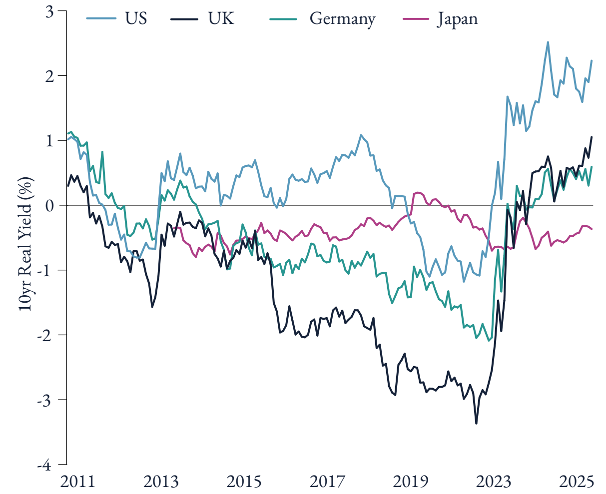


Source: Bloomberg

Rising real yields: With inflation expectations relatively stable as nominal yields have increased, the real yields on ILBs have risen (see Exhibit 2). Investors in the US are now able to "lock in" a real return of roughly 2% p.a. above inflation over the next decade, irrespective of how the CPI changes over the period.

Exhibit 2

The real yield on TIPS is close to the highest in a decade



Source: Bloomberg

Shorter-duration ILBs provide better protection against near-term inflation surprises: Inflation-linked bonds provide both inflation protection and interest rate duration. However, in periods where near-term inflation rises sharply while long-term inflation expectations remain anchored, the impact of the interest rate duration will typically outweigh the benefit of the inflation protection. One way to mitigate the duration risk, and therefore more effectively hedge near-term inflation risk, is to hold shorter maturity inflation-linked bonds which are less sensitive to changes in interest rates but are more exposed to near-term inflation shifts. This is especially true in the UK, where the market-weighted ILB benchmark has significant exposure to the 30-year breakeven rate which is largely insensitive to near-term inflation pressures.

Golden Rules

1. Inflation-Linked Bonds provide a degree of inflation protection, interest rate duration, portfolio diversification and liquidity.

1 The Retail Price Index (RPI) is a statistically poor inflation index that typically overstates inflation. For example, it does not account for the possible substitution of goods in the basket as prices rise. The calculation of the RPI will be aligned with Consumer Prices Index (CPI) including owner occupiers' housing costs (CPIH) in 2030.

Inflation-Linked Bonds
continued

2. We would recommend investors to hold the bonds that are indexed to the basket of goods that best matches their consumption, which will typically be their home currency bond.
3. The asset class beta should be accessed at the lowest possible cost. For taxpayers, this may be direct ownership of underlying bonds due to potentially favourable capital gains treatment. Alternatively, exposure can be achieved via swaps market in an overlay structure to further improve cash efficiency.

Disclaimer: Partners Capital are not tax advisors. Tax treatment will depend on the individual circumstances of each client and is subject to change. You should consult your own tax advisor to understand the tax treatment of a product or investment.

2025 Strategic Priorities

- We continue to actively monitor the optimal source of portfolio duration, and the relative attractiveness of nominal and real yields. Current long-term inflation expectations priced into ILBs appear modest relative to the risks of structurally higher inflation from protectionism, populism, and remilitarization or the scale of investment associated with AI development and the energy transition. This should make ILBs relatively attractive over the longer-term. However, as inflation expectations would likely fall in a recession, exposure to nominal duration is likely to provide better protection in a protracted downturn. Given these factors, we recommend a combination of nominal bonds and ILBs, favouring nominal bonds at current yields.

Commodities

Major Trends

Central bank reserve diversification remains the key driver of Gold.

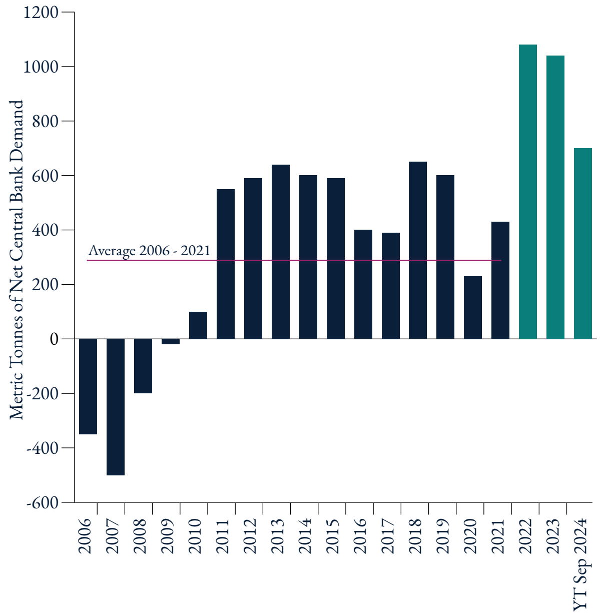
The long-standing inverse relationship between gold and real interest rates has broken down. Central bank purchases, in particular by China , have boosted gold prices as many diversify their reserves away from USD and EUR and into gold. The World Gold Council estimates that monthly gold purchases by central banks have been 3.6x higher since February 2022 (when sanctions on Russia were introduced) than they averaged in the previous 15 years. 2022 and 2023 were record years for central bank purchases of gold and demand in the first three quarters of 2024 continued to be strong as illustrated in Exhibit 1.

Gold is benefiting from investor concerns about inflation and monetary debasement.

In addition to geopolitical drivers, gold is benefitting from declining confidence in fiat money. In the wake of the recent US election, near-term (1yr1yr forward) inflation expectations have risen to their highest level since the pandemic at 2.7%. Experts suggest that the policies being persued by the new administration will likely result in structurally higher fiscal deficits (c. 7% of GDP). Net bond issuance by G7 nations will reach the highest level since 2010 in 2025. However, there are structural risks to holding gold, including: 1) the opportunity cost of holding an asset with no income in a world where real interest rates are above 2%; and 2) questionable diversification and/or safe-haven benefits as the correlation with global equities has turned positive since 2021.

Exhibit 1

Central bank demand for gold has surged since 2022



Source: World Gold Council

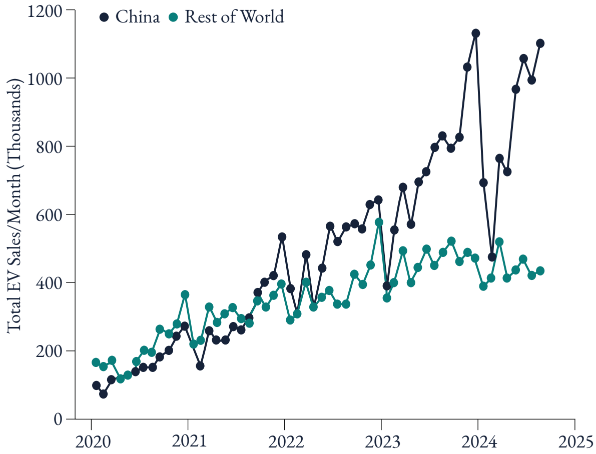
Oil markets are expected to experience a rare surplus of supply in 2025. This is being driven by several factors:

- **Chinese demand peaking.** China has accounted for more than half of all the growth in global oil demand over the last three decades. A combination of the sharp contraction in their property sector and the booming domestic electric vehicle market (Exhibit 2) has caused China's demand for oil to fall by -2% in 2024, the first decline in the last two decades outside the COVID lockdown.[1]

1 Financial Times

Commodities
continued

Exhibit 2
EV sales in China have surged, reducing demand for oil



Source: Morgan Stanley

- **Spare capacity increasing.** As a result of self-imposed production cuts in an effort to boost market prices, OPEC+ spare capacity has reached 5.5m barrels/day, a record outside of COVID (Exhibit 3). This excess capacity has served as a shock absorber to global markets, preventing a spike in prices despite numerous geopolitical events in 2024. Subdued pricing has not prevented a surge in US oil production with shale breakeven prices[2] (c. $50/barrel[3]) having fallen precipitously in recent years. This has resulted in OPEC's market share falling to c. 33%,[4] its lowest level since the 1990s. This loss of market share has prompted OPEC+ to increase output targets by c. +2m barrels/day over the next two years. This increase in supply will be coupled with President Trump's pledge to ease US domestic oil production regulations in order to lower oil prices further. Analysts are, however, sceptical that the US can increase production, given that output already expanded significantly under the Biden administration.

Exhibit 3
OPEC+ has over 5.5M barrels of spare production capacity, a record outside of the COVID period

Source: S&P Global

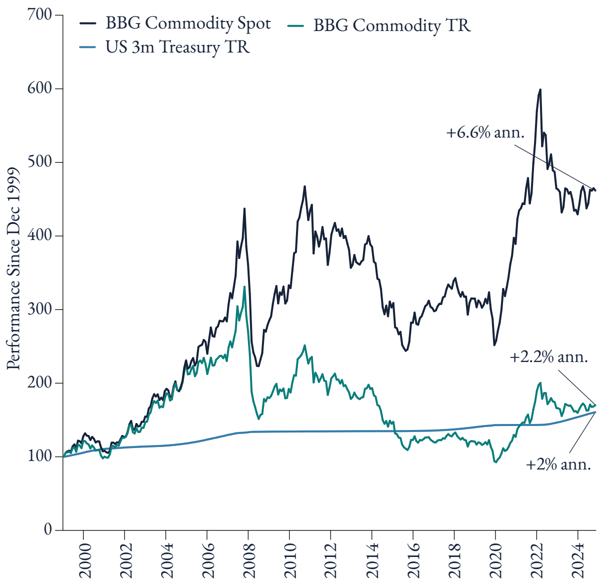
Golden Rules

1. Commodity markets are generally efficient. Profiting from commodity price movements requires a differentiated view from the broad market. For example, the fact that there is a green energy transition underway is well understood, hence it will already be reflected in prices to some degree. To profit further, one needs to believe the market has under- or over-estimated the scale or speed of the transition and the resulting demand/supply imbalance. This is illustrated by the difference in the performance of the Bloomberg Commodity Spot Price Index and its Total Return Index. While spot prices have compounded by c. +6.6%/annum on average since 2000, the actual total return accrued by investors after storage, insurance and contract roll yield has averaged only+2.2%/annum, comparable to 3-month Treasuries (Exhibit 4).

2 Cost of production
3 Rystad Energy
4 IEA

Exhibit 4

Total return from commodity investments is far lower than what is reflected by changes in spot prices (Dec 1999 - Dec 2024)



Source: Bloomberg

2. Both supply and demand are prone to unpredictable exogenous shocks from politics, weather, natural disasters, technological disruption and substitution. This makes fundamental research particularly difficult.
3. Commodities do not provide an income stream and thus there is no long-term risk premium to be harvested or fundamental anchor to valuation beyond demand and supply speculation.
4. The above factors mean that it is exceptionally difficult to generate alpha from trading commodities. This is borne out by the lack of any persistent alpha from active commodities managers.
5. Commodities do typically provide some portfolio diversification benefits and may provide some inflation protection in certain environments.

2025 Strategic Priorities

- As noted above, any tactical positioning in Commodities requires a high confidence level that our macro views are not being adequately reflected in market pricing. Likewise, strategic positioning is complicated by the lack of structural income streams and diversification benefits. However, as we have seen in past occasions when we used gold as a safety asset, there may be opportunities in which some level of tactical positioning is warranted. For 2025, our most likely candidate for a potential tactical tilt would be gold, if and when we believed that current pricing did not reflect any meaningful risks to the US dollar, and more broadly to the global fiat currency system. We are not at that point yet but will communicate if our outlook changes materially. In the meantime, we are continuously monitoring and optimising our models as the underlying dynamics evolve.

FX

Major trends

Monetary policy paths will diverge. Interest rate differentials are diverging across major economies, broadly supporting the US dollar. The US Federal Reserve, European Central Bank and Bank of England will all likely ease rates further if inflation continues to subside. However, US rates will remain higher given the stronger US economic growth prospects (IMF 2025 US GDP forecast 2.7%) than in Europe (1.0% Eurozone, 1.8% UK). In Asia, China is easing while Japan is tightening monetary policy. This degree of regional dispersion is also likely to create volatility in FX markets. Higher volatility and uncertainty traditionally benefits the USD.

Strategic ambiguity on tariffs. The imposition of higher tariffs by the new US administration is viewed as a tailwind for the USD. Since the November election, the USD index[1] has appreciated by c. +4% in anticipation of policy changes. In our US growth section we have outlined three potential trade scenarios, from targeted tariffs on specific sectors in specific countries to across-the-board universal tariffs. It has become clear in the initial weeks of Trump's presidency that some form of tariffs will be implemented, but their magnitude and duration remain uncertain. Regardless, experts believe that the US administration will employ a policy of strategic ambiguity, utilising the threat of tariffs as a negotiation tactic. In the event of universal tariffs being implemented, analysts see a further +5% upside in the USD index.[2]

Golden Rules

1. Currency markets are highly efficient and rapidly adjust to new information. The innumerable factors affecting FX prices mean they can be very volatile and are largely unpredictable.

2. Investors are not compensated for the incremental currency risk they bear, and seldom have any knowledge that would give them an advantage in predicting future currency directions. As such, investors should seek to hedge as much foreign currency as is practical to minimise the differences between the currency mix of the portfolio's assets and the currency of the portfolio's liabilities, on the basis that they wish to narrow the potential range of portfolio outcomes.

3. Investors should view hedging as a means to reduce currency risk even though this may come at a small cost. However, reasons to not hedge all foreign currency exposure include:

   i. Currency hedging requires additional portfolio liquidity as forward contracts require the posting of collateral and the funding of potential hedge losses.

   ii. Many of the underlying foreign currency investments, primarily public and private equity, will be in companies whose financial prospects are internationally dispersed already, so hedging 100% may result in over-hedging.

   iii. Beyond a certain level, the marginal reduction in portfolio volatility from additional hedging becomes less significant.

   iv. Certain currencies tend to appreciate in a crisis, such as the US Dollar, Japanese Yen or Swiss Franc. Having an allocation to these currencies may potentially act as a diversifying safety net in a large market drawdown for those clients with a different home currency.

   v. Most emerging market currencies are difficult and expensive to hedge. The additional risk should thus be incorporated into any consideration of investing in emerging markets.

2025 Strategic Priorities

- We recommend that international investors with large non-home currency exposure adopt a hedging policy in which the home currency accounts for 60- 80% of the portfolio's overall look-through FX exposure. Some foreign currency exposure is appropriate within a portfolio due to the benefit of diversification, liquidity constraints and elevated cost of hedging certain currencies.

1 DXY Index

2 Average of Deutsche Bank, Morgan Stanley, Goldman Sachs (as at 31 Dec 2024)

Crypto

Major trends

A more supportive regulatory backdrop. As of early February, the market cap of all cryptocurrencies has risen to $3.5T from c. $2.5T (+40%) prior to the US election in November 2024.[1] Analysts suggest that a significant proportion of this move has been fuelled by the administration's commitment to provide a more supportive regulatory framework. The administration has already taken several steps to implement that pledge:

- Paul Atkins, known for advocating market-friendly policies, has been nominated as the head of the SEC, replacing Gary Gensler.
- The SEC has announced a task force charged with providing a clear regulatory framework for crypto.
- President Trump has signed an executive order to explore the feasibility of a strategic crypto reserve.
- The SEC has rescinded SAB 121, replacing it with the more crypto-friendly SAB 122. This will reduce the regulatory burden imposed on banks for holding or banking crypto-related assets.

Stablecoins could disrupt traditional financial rails. Proponents of cryptocurrency argue that with increased regulatory clarity, stablecoins (cryptocurrencies whose value is tied to a national currency) could see significant growth, potentially even replacing the current structure of the Eurodollar market[2] (US dollars held in banks outside of the United States).

- Stablecoins could provide increased accessibility as they can be held by anyone with internet access as opposed to being tied to the institutional banking system.
- Traditional financial rails extract a significant rent from cross-border transactions, stablecoins could lower these frictional costs by functioning without intermediaries. In theory, this should boost productivity and economic growth.

The proliferation of meme coins suggests the presence of some irrational exuberance in the short term. Meme coins are digital assets with no cash flow, business model or practical use case. The market capitalization of meme coins has risen to over $90B, up from c. $20B at the beginning of 2024. Dogecoin accounts for just over 50% of the meme coin universe with a market cap of $47B.

Quantum computing is a long-term threat. The peer-reviewed journal, Nature, suggested that Google's Willow chip was "a truly remarkable breakthrough," removing one of the biggest remaining hurdles to quantum computing. Goldman Sachs note that this could play out over a 10yr+ timescale and presents a terminal risk to Bitcoin as quantum computing could break the cryptography underlying the blockchain.

Golden Rules

- For now, we view cryptocurrencies as a purely speculative investment, albeit one that has some potential technological use cases. This is based on the following:
  1. Cryptocurrencies do not generate reliable cashflows that can be modelled or forecast to generate a meaningful estimate of value.
  2. The diversification benefits they bring to a multi-asset portfolio are not evident, as of yet.
  3. The data so far, while limited, does not suggest that cryptocurrencies provide a reliable hedge against inflation or deflation.

2025 Strategic Priorities

- We do not currently recommend an allocation to bitcoin or cryptocurrency within our multi-asset class portfolios. However, we can provide clients with a menu of suitable implementation options that provide exposure to Bitcoin should they wish to do so.

1 Coinmarketcap.com
2 Professor Austin Campbell, NYU Stern

Disclaimer

Disclaimer

Within the United Kingdom, this material has been issued by Partners Capital LLP, which is authorised and regulated by the Financial Conduct Authority of the United Kingdom (the "FCA"), and constitutes a financial promotion for the purposes of the rules of the Financial Conduct Authority. Within Hong Kong, this material has been issued by Partners Capital Asia Limited, which is licensed by the Securities and Futures Commission in Hong Kong (the "SFC") to provide Types 1, 4 and 9 services to professional investors only. Within Singapore, this material has been issued by Partners Capital Investment Group (Asia) Pte Ltd, which is regulated by the Monetary Authority of Singapore as a holder of a Capital Markets Services licence for Fund Management under the Securities and Futures Act and as an exempt financial adviser. Within France, this material has been issued by Partners Capital Europe SAS, which is regulated by the Autorité des Marchés Financiers (the "AMF").

For all other locations, this material has been issued by Partners Capital Investment Group, LLP which is registered as an Investment Adviser with the US Securities and Exchange Commission (the "SEC")and as a commodity trading adviser and commodity pool operator with the Commodity Futures Trading Commission ("CFTC") and is a member of the National Future's Association (the "NFA").

This material is being provided to clients, potential clients and other interested parties (collectively "clients") of Partners Capital LLP, Partners Capital Asia Limited, Partners Capital Investment Group (Asia) Pte Ltd, Partners Capital Europe SAS and Partners Capital Investment Group, LLP (the "Group") on the condition that it will not form a primary basis for any investment decision by, or on behalf of the clients or potential clients and that the Group shall not be a fiduciary or adviser with respect to recipients on the basis of this material alone. These materials and any related documentation provided herewith is given on a confidential basis.

This material is not intended for public use or distribution. It is the responsibility of every person reading this material to satisfy himself or herself as to the full observance of any laws of any relevant jurisdiction applicable to such person, including obtaining any governmental or other consent which may be required or observing any other formality which needs to be observed in such jurisdiction. The investment concepts referenced in this material may be unsuitable for investors depending on their specific investment objectives and financial position. This material is for your private information, and we are not soliciting any action based upon it. This report is not an offer to sell or the solicitation of an offer to buy any investment. While all the information prepared in this material is believed to be accurate, the Group, may have relied on information obtained from third parties and makes no warranty as to the completeness or accuracy of information obtained from such third parties, nor can it accept responsibility for errors of such third parties, appearing in this material. The source for all figures included in this material is Partners Capital Investment Group, LLP, unless stated otherwise.

Opinions expressed are our current opinions as of the date appearing on this material only. We do not undertake to update the information discussed in this material. We and our affiliates, officers, directors, managing directors, and employees, including persons involved in the preparation or issuance of this material may, from time to time, have long or short positions in, and buy and sell, the securities, or derivatives thereof, of any companies or funds mentioned herein.

Whilst every effort is made to ensure that the information provided to clients is accurate and up to date, some of the information may be rendered inaccurate by changes in applicable laws and regulations. For example, the levels and bases of taxation may change at any time. Any reference to taxation relies upon information currently in force. Tax treatment depends upon the individual circumstances of each client and may be subject to change in the future. The Group is not a tax adviser and clients should seek independent professional advice on all tax matters.

Within the United Kingdom, and where this material refers to or describes an unregulated collective investment scheme (a "UCIS"), the communication of this material is made only to and/or is directed only at persons who are of a kind to whom a UCIS may lawfully be promoted by a person authorised under the Financial Services and Markets Act 2000 (the "FSMA") by virtue of Section 238(6) of the FSMA and the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (including other persons who are authorised under the FSMA, certain persons having professional experience of participating in unrecognised collective investment schemes, high net worth companies, high net worth unincorporated associations or partnerships, the trustees of high value trusts and certified sophisticated investors) or Section 4.12 of the FCA's Conduct of Business Sourcebook ("COBS") (including persons who are professional clients or eligible counterparties for the purposes of COBS). This material is exempt from the scheme promotion restriction (in Section 238 of the FSMA) on the communication of invitations or inducements to participate in a UCIS on the grounds that it is being issued to and/ or directed at only the types of person referred to above. Interests in any UCIS referred to or described in this material are only available to such persons and this material must not be relied or acted upon by any other persons.

Within Hong Kong, where this material refers to or describes an unauthorised collective investment schemes (including a fund) ("CIS"), the communication of this material is made only to and/ or is directed only at professional investors who are of a kind to whom an unauthorised CIS may lawfully be promoted by Partners Capital Asia Limited under the Hong Kong applicable laws and regulation to institutional professional investors as defined in paragraph (a) to (i) under Part 1 of Schedule to the Securities and Futures Ordinance ("SFO") and high net worth professional investors falling under paragraph (j) of the definition of "professional investor" in Part 1 of Schedule 1 to the SFO with the net worth or portfolio threshold prescribed by Section 3 of the Securities and Futures (Professional Investor) Rules (the "Professional Investors").

Within Singapore, where this material refers to or describes an unauthorised collective investment schemes (including a fund) ("CIS"), the communication of this material is made only to and/or is directed only at persons who are of a kind to whom an unauthorised CIS may lawfully be promoted by Partners Capital Investment Group (Asia) Pte Ltd under the Singapore applicable laws and regulation (including accredited investors or institutional investors as defined in Section 4A of the Securities and Futures Act).

Within France, where this material refers to or describes to unregulated or undeclared collective investment schemes (CIS) or unregulated or undeclared alternative Investment Funds (AIF), the communication of this material is made only to and/ or is directed only at persons who are of a kind to whom an unregulated or undeclared CIS or an unregulated or undeclared AIF may lawfully be promoted by Partners Capital Europe under the French applicable laws and regulation, including professional clients or equivalent, as defined in Article D533-11, D533-11-1, and D533-13 of the French Monetary and Financial Code.

Certain aspects of the investment strategies described in this presentation may from time to time include commodity interests as defined under applicable law. Within the United States of America, pursuant to an exemption from the US Commodity Futures Trading Commission (CFTC) in connection with accounts of qualified eligible clients, this brochure is not required to be, and has not been filed with the CFTC. The CFTC does not pass upon the merits of participating in a trading program or upon the adequacy or accuracy of commodity trading advisor disclosure.

Consequently, the CFTC has not reviewed or approved this trading program or this brochure. In order to qualify as a certified sophisticated investor a person must (i) have a certificate in writing or other legible form signed by an authorised person to the effect that he is sufficiently knowledgeable to understand the risks associated with participating in unrecognised collective investment schemes and (ii) have signed, within the last 12 months, a statement in a prescribed form declaring, amongst other things, that he qualifies as a sophisticated investor in relation to such investments.

Disclaimer
continued

This material may contain hypothetical or simulated performance results which have certain inherent limitations. Unlike an actual performance record, simulated results do not represent actual trading.

Also, since the trades have not actually been executed, the results may have under- or over-compensated for the impact, if any, of certain market factors, such as lack of liquidity. Simulated trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any client will or is likely to achieve profits or losses similar to those shown.

These results are simulated and may be presented gross or net of management fees. This material may include indications of past performance of investments or asset classes that are presented gross and net of fees. Gross performance results are presented before Partners Capital management and performance fees, but net of underlying manager fees. Net performance results include the deduction of Partners Capital management and performance fees, and of underlying manager fees. Partners Capital fees will vary depending on individual client fee arrangements.

Gross and net returns assume the reinvestment of dividends, interest, income and earnings. The information contained herein has neither been reviewed nor approved by the referenced funds or investment managers. Past performance is not a reliable indicator and is no guarantee of future results. Investment returns will fluctuate with market conditions and every investment has the potential for loss as well as profit. The value of investments may fall as well as rise and investors may not get back the amount invested. Forecasts are not a reliable indicator of future performance.

Certain information presented herein constitutes "forwardlooking statements" which can be identified by the use of forward-looking terminology such as "may", "will", "should", "expect", "anticipate", "project", "continue" or "believe" or the negatives thereof or other variations thereon or comparable terminology.

Any projections, market outlooks or estimates in this material are forward –looking statements and are based upon assumptions Partners Capital believe to be reasonable. Due to various risks and uncertainties, actual market events, opportunities or results or strategies may differ significantly and materially from those reflected in or contemplated by such forward-looking statements. There is no assurance or guarantee that any such projections, outlooks or assumptions will occur.

Certain transactions, including those involving futures, options, and high yield securities, give rise to substantial risk and are not suitable for all investors. The investments described herein are speculative, involve significant risk and are suitable only for investors of substantial net worth who are willing and have the financial capacity to purchase a high risk investment which may not provide any immediate cash return and may result in the loss of all or a substantial part of their investment. An investor should be able to bear the complete loss in connection with any investment.

All securities investments risk the loss of some or all of your capital and certain investments, including those involving futures, options, forwards and high yield securities, give rise to substantial risk and are not suitable for all investors.

Private Investment Fund Risk

Investors should be aware that investments in private investment funds involve a high degree of risk. Investors could lose the entire amount of their investment or recover only a small portion of their investment if the fund suffers substantial losses. The principal risk factors associated with an investment include the following. Please refer to Private Placement Memorandums of funds for full disclosure of risk factors:

Market & Economic Risk – Changes in factors like interest rates, inflation, monetary policy, economic growth, investor sentiment, time horizons and exogenous events (like terrorism or pandemic) can undermine the investment strategy temporarily or for a long period.

Currency Risk – Investors will be subject to currency market risks associated with fluctuations in the value of the foreign currencies in which their investments are denominated. Dramatic fluctuations could have an adverse impact on the profitability of the client account.

Availability of Investment Opportunities – Identification of investment opportunities involves a high degree of uncertainty and is based on a subjective decision making process and there is a risk that opportunities will not achieve targeted rates of return.

Counterparty Risk – Investor's assets may be exposed to the credit risk of the counterparties with which, or the dealers, brokers and exchanges through which, Partners Capital deals, whether in exchange-traded or off-exchange transactions.

Limited Operating History – Certain private funds have no operating or performance history for investors to consider and there is no guarantee the fund's investment strategy will be successful.

Limited Diversification – Private funds are not limited in the amount of capital that may be invested in one industry, sector, geography or similar category of asset class. Non diversification would increase the risk of loss if there was a decline in the market value of any security or category of asset class in which a private fund has invested a large percentage of their assets.

Limited Liquidity Risk – Many investments are not readily liquid, and may lock up capital for several years. Investors may be unable to dispose of investments at the most advantageous time because of limited withdrawal rights, which could result in significant loss of capital.

Limited Regulatory Oversight – Private companies are not likely to be Regulated Investment Companies. Investors may not be provided various protections offered to more regulated or registered funds.

Management Fraud – Investment managers can commit fraud It is our job to try and avoid those that appear to have the potential to commit fraud or otherwise misappropriate client funds but it is not always ascertainable from any amount of due diligence.

Operational and Organisational Risk – All asset managers bring some risk that they will fail to execute their investment strategies effectively. Past performance is not indicative of future results.

Multiple Level of Fees Risk – Paying excessive fees is a significant risk in any asset class. Investment management fees and performance fees are sometimes charged by both Partners Capital and the Manager used. Investors might bear multiple levels of fees.

Disclaimer

Private Investment Fund Risk
continued

Valuation Risk – Valuation of the securities and other investments may involve uncertainties or judgmental decisions. Independent pricing information may not always be available.

Side Letters – Private funds may enter into agreements (“Side Letters”) with certain prospective or existing investors, under which those investors receive advantages.

Hedging Transactions – While the use of hedging techniques can reduce the risks associated with particular investments, the transactions themselves entail risks. If there is an imperfect correlation between a hedging instrument position and a portfolio position that is intended to be protected, the desired protection may not be obtained, and result in greater risk of loss.

Derivatives – Risks include but are not limited to: changes in the market value of securities held, and of derivatives relating to those securities, might not correlate perfectly; the market to sell a derivative could be illiquid; certain derivatives magnify the extent of losses incurred; and derivatives traded over the counter are subject to counterparty credit risk.

Small Capitalisation Stocks – Securities of small capitalisation/financially distressed companies tend to be more volatile than the securities of larger and more stable companies. The securities of such companies are generally less liquid.

High Yield Securities – Funds may invest in high yield bonds that are more risky than investment grade bonds. Yields and prices of high yield securities may be more volatile. Lower rated securities may include securities that have the lowest rating or are in default, so involve risks in addition to those associated with higher-yield securities (i.e. high degree of credit risk).

Partners Capital