

May 2025

## Insight into Fidelity's capital market assumptions

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# Fragmentation and global rewiring: Implications for risk and return across asset classes

For investment professionals only.



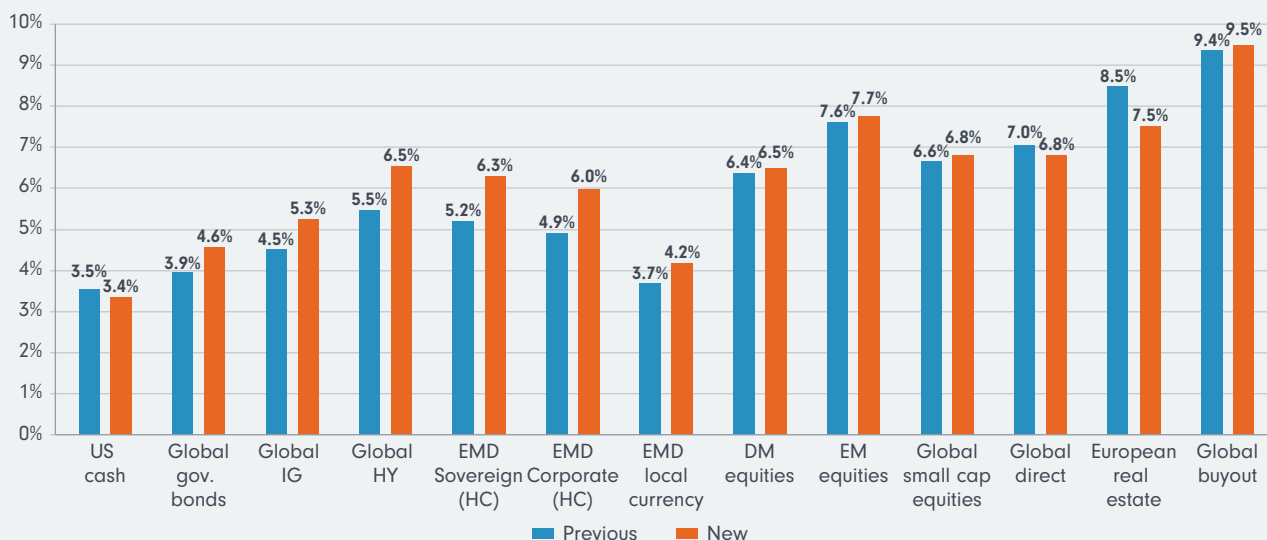
# Executive Summary

Capital Market Assumptions May 2025 update key points:

- Macroeconomics:** Over the next decade, inflation and policy rates are likely to remain structurally higher than they were through the 2010–2020 period. Macroeconomic risk will also remain elevated relative to the pre-2020 era, although we expect it to decline from the current levels over the medium-to-long term.
- Fixed Income:** Bonds remain a compelling option for long-term investors. However, we expect them to exhibit higher volatility and increased correlation with equity returns, due to greater inflation volatility and higher term premia.
- Equities:** Despite some parts of equity markets being overvalued, geographically diversified equity strategies still hold the potential to remunerate investors attractively over the long term. However, given elevated uncertainty, diversification across various segments of the equity market (regions, sectors, factors) will be important.
- Private markets:** Expected returns remain attractive for long-term investors willing to take on more illiquidity risk. That said, active manager skill will remain key to delivering positive portfolio outcomes, especially in a higher rate environment.
- Strategic Asset Allocation:** Over the past five years, we have transitioned to an investment environment defined by higher macroeconomic volatility, higher yields, higher equity/bond return correlations, and increased market concentration. This calls for greater diversification, utilising a broader set of tools than a simple (and concentrated) market cap equity/bond approach.

**Figure 1: Equities and bonds both offer attractive long-term return potential**

Projected ten-year average nominal returns, USD



For illustrative purposes only. Assumptions are based on proprietary modelling, reflecting the views of investment professionals at Fidelity International.

Source: Fidelity International, 30 April 2025.

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## Introduction

The global economic landscape has shifted with remarkable speed following the 'Liberation Day' announcements, which suggest a re-wiring of major trading relationships has begun. Uncertainty has increased and is likely to remain high, impacting global economic and financial systems, and spurring market volatility.

This compounds with structural forces that have defined the post-2020 era: higher inflation, elevated yields, and a shift in policy regimes. It also occurs at a time when the US holds a record share of global capital markets, with that dominance increasingly concentrated in a handful of firms, particularly within the equity space.

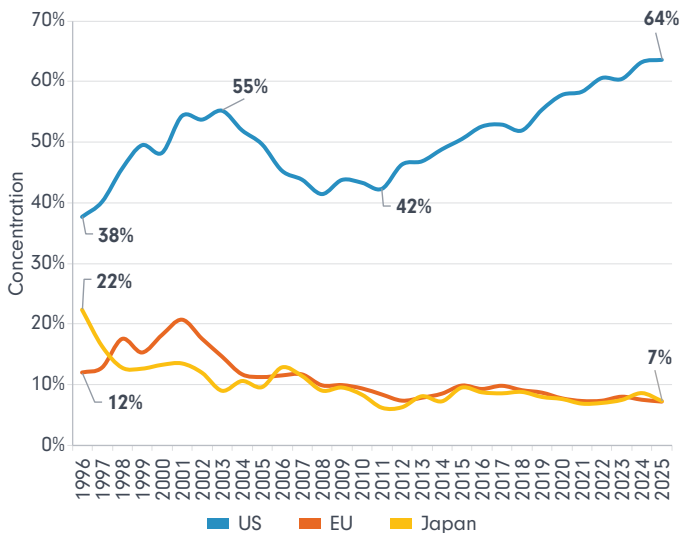
As a result, we believe we have entered a new economic environment, one in which historical averages no longer serve as reliable anchors for the future. The period from the global financial crisis through 2019 was marked by low volatility, low inflation, low interest rates, and stable low correlation between equities and bonds; that backdrop is no longer a realistic starting point for asset allocation strategies.

Our latest Capital Market Assumptions framework reflects this new reality. Rather than assuming that return drivers such as valuations or term premia will revert to historical averages, we are modelling them on a forward-looking basis using our macroeconomic forecasts. For example, in our November 2024 update we introduced a fair-value model for equity valuations based on real interest rates and macroeconomic volatility. In this latest update, we extend the framework to the term premium, modelling its fair value as a function of debt-to-GDP growth, the share of Treasuries held by price-insensitive buyers, macroeconomic volatility, and the convenience yield. These enhancements allow us to better assess how evolving macro conditions affect financial markets and to estimate equilibrium outcomes with a forward-looking lens.

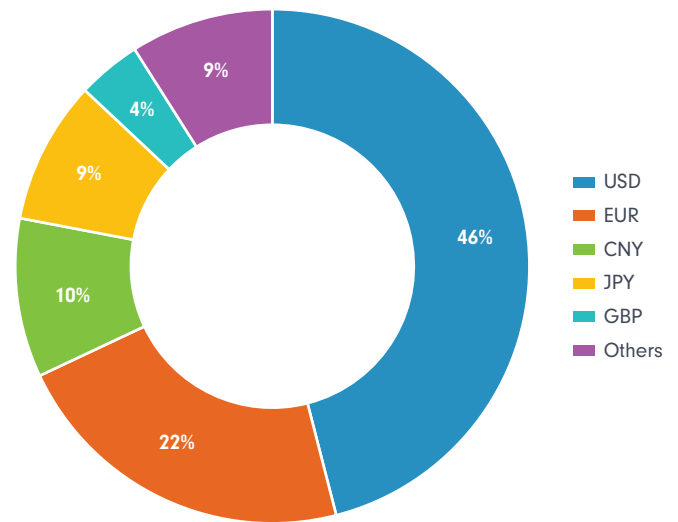
This paper outlines our latest medium-to-long term economic and market views. It includes our outlooks for equity, fixed income and private markets, which we examine through the durability of corporate earnings, the trajectory of valuations, and the direction of interest rates.

**Figure 2: US companies are still dominating both equity and fixed income markets**

Regional weights in the global equity (all country) market



Regional breakdown of global fixed income market



**For illustrative purposes only. Past performance is not an indication of future results.**

Source: Bloomberg, Fidelity International, 30 April 2025.

## Macro outlook: Global fragmentation

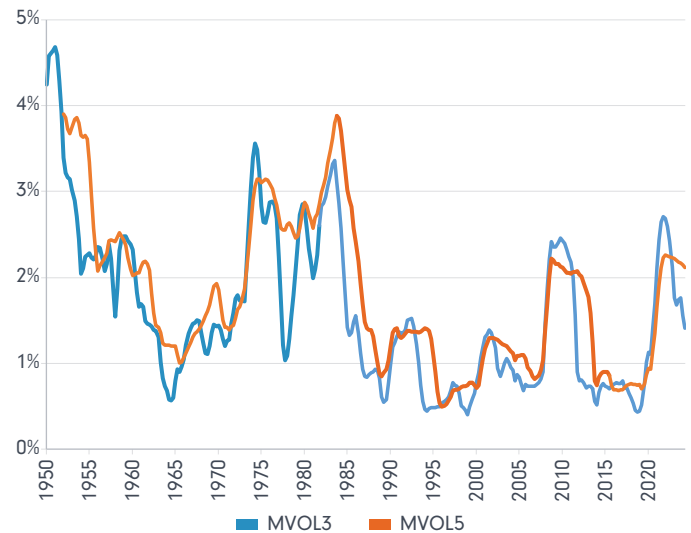
Many investors have started to wonder if current shifts in the geopolitical landscape could mark the beginning of a new era of international fragmentation rather than cooperation, where nationalism and protectionism actively shape economic policy. Such a shift could threaten to unwind pillars of the global economy that have remained largely intact since the end of World War II, with significant implications for financial markets.

The outcomes of ongoing trade negotiations, particularly among the US, China, and the European Union, remain highly uncertain, further adding to a macroeconomic environment still grappling with the long-term effects of the COVID-19 pandemic. Our proxy for macroeconomic risk, MVOL (defined as the average of the realized standard deviations of real GDP and inflation), remains near the highest levels observed since 1990, as shown in Figure 3.

As detailed in our November 2024 update, the five-year version of this measure (MVOL5) is a robust empirical factor explaining medium- to long-term variations in equity valuations and, as demonstrated by our newly introduced fixed income fair value framework, the term premium. MVOL5 is likely to remain above the relatively subdued levels seen during the 2012–2019 period due to persistent inflation risk. However, we expect macroeconomic volatility to gradually ease over the next five to ten years, as indicated by the recent decline in the shorter-term MVOL3, primarily because of reduced GDP volatility (inflation volatility remains elevated). That said, downside risks remain: GDP volatility could rise again if renewed trade tensions or higher tariffs begin to weigh on economic growth.

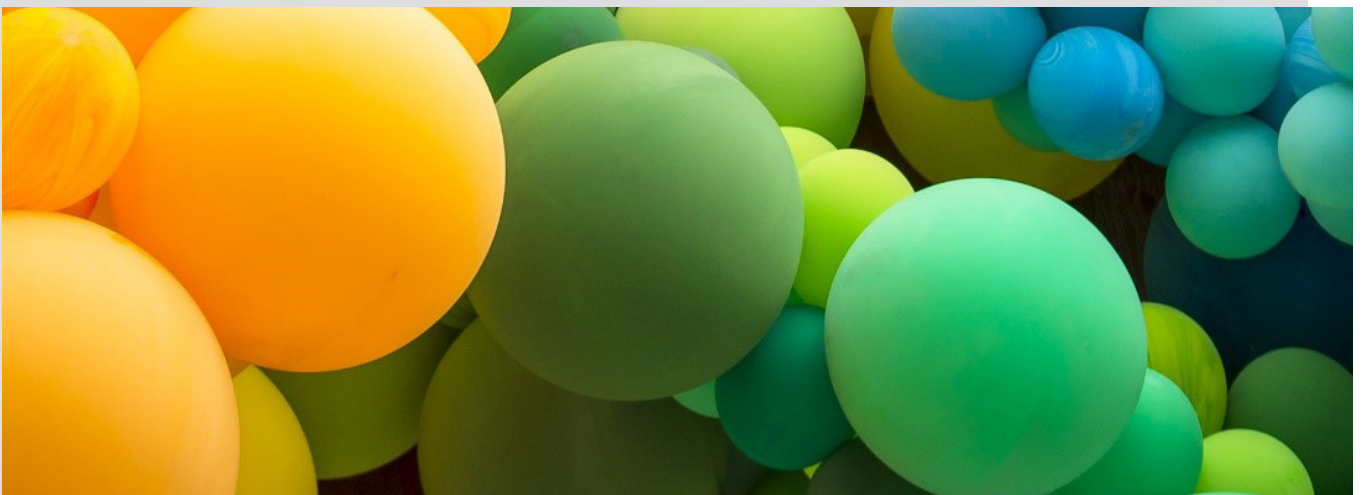
**Figure 3: US macroeconomic volatility is elevated and expected to settle at a level above that of the 2012-2019 period**

US macro volatility - rolling 3Y and 5Y



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Source: Fidelity International, 30 April 2025. Note: real GDP series in 2020 Q2 has been interpolated in order to avoid extreme noise in the time series.



## Growth impacts

Early signs of the negative impact of potentially higher tariffs and increasing global fragmentation are emerging not only in ‘soft’ macroeconomic indicators, such as sentiment surveys, but also in ‘hard’ data. A major factor was the surge in imports, as businesses and consumers rushed to front-run potential tariffs and build stockpiles. Focusing on the core components of US GDP, both consumption and fixed investments showed combined positive growth of 2.4%, however, consumption growth, a major contributor to GDP, slowed to 1.2%, which is almost half of the previous quarter’s growth rate. The growth in consumption and fixed investments are crucial variables to monitor over the coming months, as they could likely be impacted if uncertainty persists.

Overall, despite recent positive developments in US–China trade negotiations and a reduced probability of recession in the US, stagflation remains a likely short-term outcome. We project the combined probability of a stagflation or recession outcome to stand at 60%. It is worth noting that the tails of the distribution of potential outcomes are also becoming ‘fatter’, signalling increased likelihood of either very positive or negative events, as well as the fact that the situation could shift suddenly at any time.

For these reasons, we have revised slightly down our estimates of economic growth from our previous update in November, particularly in the US and China. Consequently,

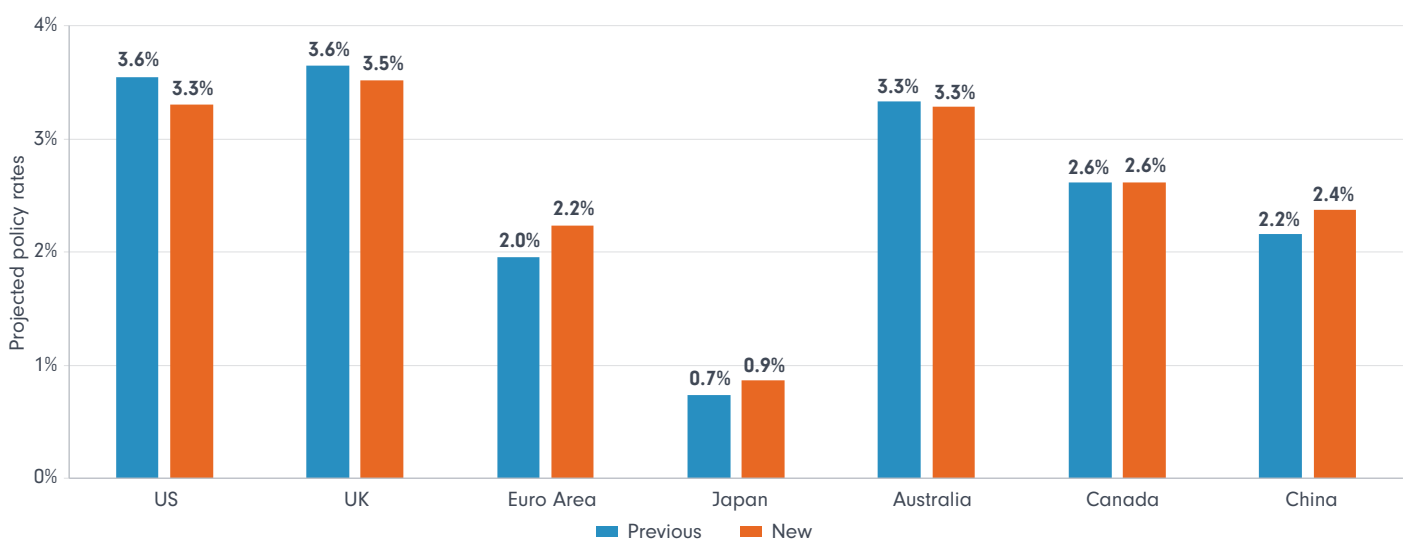
the forward-looking ten-year average of real GDP growth in both regions is now lower by approximately 0.1% on an annualised basis. At the same time, we continue to expect macroeconomic volatility to remain higher than pre-pandemic periods, as explained earlier.

## Inflation impacts

On the inflation front, price pressures remain sticky and above central bank targets, particularly in the US and the UK. This has been a core assumption in our outlook over the past few years and continues to underpin our medium-term view. We expect that inflationary forces such as deglobalisation and elevated debt levels will remain influential, with the latter likely to compel central banks to tolerate higher inflation, thereby keeping real interest rates suppressed.

Given persistent inflationary pressures, particularly in the US, we believe the Federal Reserve is unlikely to cut rates this year, unless there is significant economic deterioration or the onset of a recession, which would in turn help ease inflation. However, over the medium term, we expect interest rates to normalise toward approximately 3.25% in the US and 3.5% in the UK. In the euro area, we anticipate a more accommodative monetary stance, with three rate cuts likely this year and a long-term equilibrium rate around 2.25%, slightly above the projected inflation rate (Figure 4).

**Figure 4: We expect long-term average policy rates to remain higher than the pre-2020 decade**



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Source: Fidelity International, 30 April 2025.

## Equity outlook: Long-term return potential remains attractive

Global equity markets have experienced significant volatility in recent months, with the eurozone and UK outperforming the US through the Tariff Tantrum sell-off on a local currency basis. This reversed the narrative of US exceptionalism that dominated through 2024, which is perhaps understandable given the increased uncertainty about the direction of US policy and its potential impact on both the economy and corporate earnings.

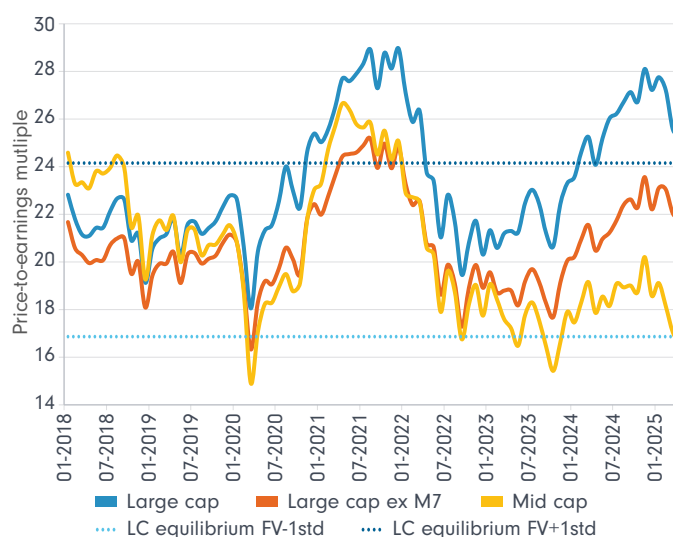
Tariff uncertainty is already influencing corporate behaviour, particularly in planning and guidance (notably, this quarter saw the highest number of S&P 500 companies citing “recession” during earnings calls since Q4 2022, highlighting growing unease). However, it is important to recognise that US corporate fundamentals appear to remain strong, with first-quarter earnings robust, especially in sectors such as technology, healthcare, communications, and utilities.

Looking ahead, changes in our return expectations are primarily driven by shifts in the projected paths of earnings per share (EPS) and valuations. In terms of valuations, price-to-earnings ratios, particularly in the US large-cap segment, exceed our forward-looking fair value, which is primarily driven by real interest rates and macroeconomic risk. However, it is important to note that much of this overvaluation is now concentrated in a small number of stocks, which introduces additional risk to the outlook for US large-cap valuations. In contrast, other segments of the US market, as well as in international markets, appear more fairly valued.

Both macroeconomic and microeconomic factors can help explain the valuation premium enjoyed by US equities, from the global shift towards more service-based economies to elevated profit margins. However, valuation spreads between different segments within the US market have now reached their widest levels of recent years (Figure 5). Price-to-earnings ratios for a) US large-cap equities, b) large-caps excluding the ‘Magnificent 7’ (Microsoft, NVIDIA, Tesla, Alphabet, Meta, Amazon, and Apple), and c) mid-cap stocks have diverged significantly. Large-cap valuations currently sit above our fair value range, while valuations for large-cap excluding the Mag-7 sit below it. Mid-caps are more discounted still. This is despite these three segments having traded broadly in line prior to the pandemic (and having moved upward together during the post-pandemic rally).

Therefore, although valuations are now lower than in our November 2024 update, we continue to expect a contraction in US large-cap valuations over the next ten years. Notably, approximately 70% of the expected valuation adjustment in the US large-cap market is attributable to just the Mag-7 stocks. Put differently, excluding those seven stocks would reduce the expected valuation drag by around 70%.

**Figure 5: US large-cap equities look overvalued, although this overvaluation is now more concentrated than it has been in the past**



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Source: Fidelity International, 30 April 2025.

On the EPS side, profit margins play a critical role, with the contribution of profit margins to future returns determined by a reversion to a fair-value equilibrium in our model (from current elevated levels). This equilibrium is based on our forward-looking assessments of economic growth, effective corporate tax rates, and interest expenses.

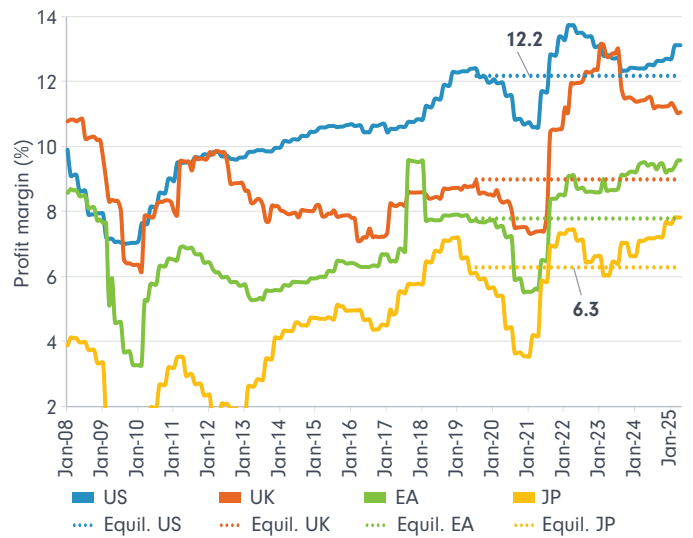
Historically, declining tax and interest expenses have been powerful tailwinds for global corporate profits, accounting for an estimated 40%-60% of the increase in profit margins across developed markets since 1995. However, we do not expect these trends to persist. A world characterized by high and rising debt levels will likely require higher taxes, while elevated interest expenses are also expected to persist as rates remain above pre-pandemic norms.

Moreover, growing global fragmentation is emerging as an additional headwind, particularly for multinational corporations, as it exerts downward pressure on their profit margins. As a result, we continue to anticipate a broad-based global decline in profit margins over the coming decade, as shown in Figure 6.

Taking into account our forward-looking views on earnings growth, valuations, and dividend yields, which we expect will remain a key long-term contributor to overall equity returns, the investment case for global equities has modestly improved since our last update. More attractive valuations, particularly in the US and Japan, have pushed our ten-year expected returns slightly higher, while contracting profit margins will likely be a drag for most developed markets.

For a market-cap weighted all country global equity portfolio we now expect annualised returns of 6.6% in USD, 5.5% in EUR, 6.8% in GBP, and approximately 4% in JPY. These figures underscore the importance of currency effects in shaping long-term returns for global investors.

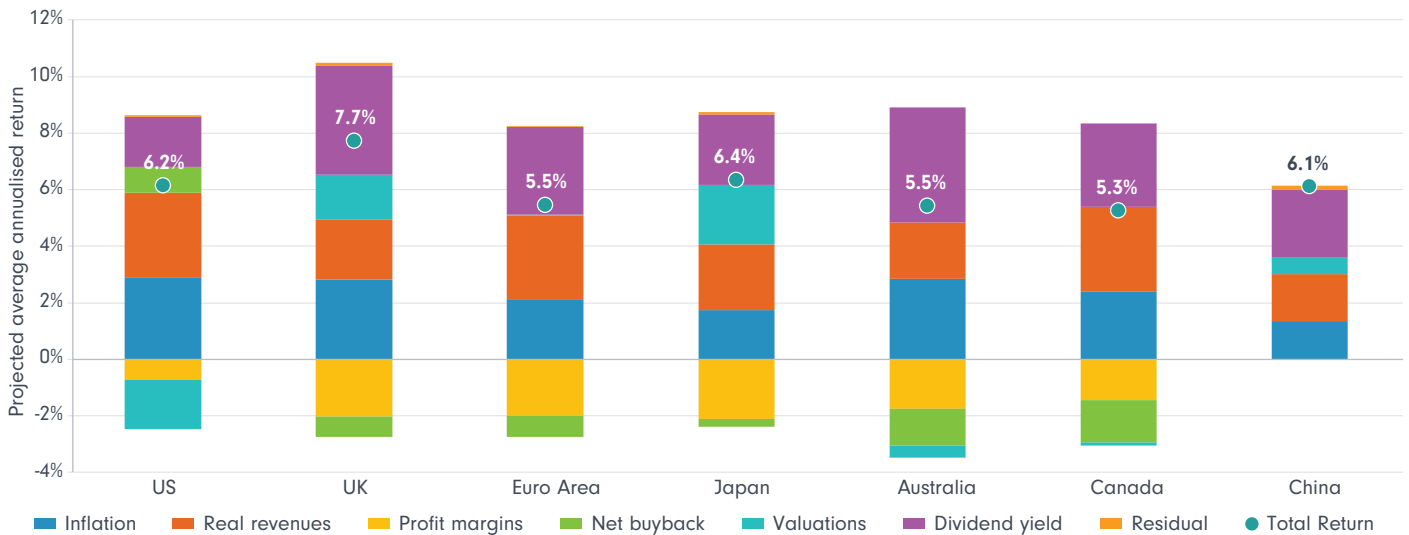
**Figure 6: Future profit margin growth is unlikely to match historical trends**



**For illustrative purposes only. Assumptions are based on proprietary modelling, reflecting the views of investment professionals at Fidelity International.**

Source: Bloomberg, Fidelity International, 30 April 2025.

**Figure 7: Projected average annualised ten-year equity returns, local currency: Long-term return potential remains attractive**



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Source: Fidelity International, 30 April 2025.

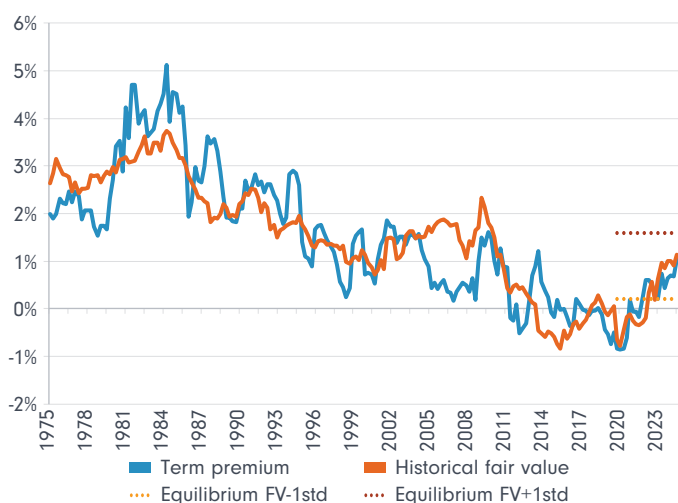
## Fixed Income outlook: Moderately increased risk and returns

The recent bout of market stress impacted fixed income markets, as it did equities. During the market sell-off, aggregate bond performance across major regions has hovered around 0%, with the US posting a modest gain of +1.2%. As a result, bonds offered somewhat smoother returns than equities, in aggregate, during the Tariff Tantrum. However, elevated volatility in government bond yields, particularly in the US, has limited the diversification benefits typically provided by bond allocations to balanced portfolios.

As anticipated in our previous update, yield curves across major markets are continuing to normalise and steepen, driven primarily by rising long-term yields. Indeed, ten-year yields have continued to climb and now remain well above pre-2020 levels.

In our view, this new plateau is partly justified by persistently higher inflationary pressures. Our inflation expectations, particularly in the US and UK, remain above central bank targets, justifying a higher fair value for ten-year yields in those markets. Another important factor that will likely continue to put upward pressure on longer yields is the term premium, which our research suggests should remain at around 90 basis points in both the US and UK, while staying 25 basis points lower in Europe and Japan. This difference reflects demographic trends and weaker fiscal expansion capacity in those regions.

**Figure 8: US term premium is likely to remain around 90 basis points over the medium-to-long term**



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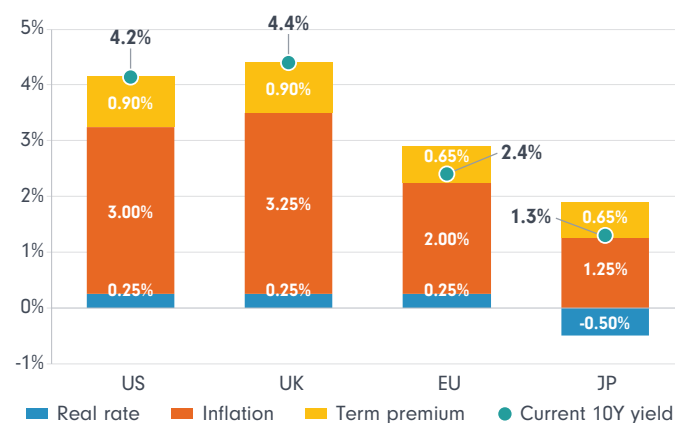
Source: Bloomberg, Fidelity International, 30 April 2025.

Our term premium estimates are derived from a newly introduced fair value model, based on four macroeconomic and financial drivers: debt-to-GDP growth, the share of Treasuries held by price-insensitive buyers, macroeconomic volatility, and the convenience yield.

This approach offers a clear forward-looking perspective: the term premium is likely to be structurally higher in the coming years than it was during the 2012–2019 period. The fiscal stance remains expansionary, with no meaningful reduction in debt growth in sight. Simultaneously, the Federal Reserve and other central banks are scaling back their asset purchase programs, removing a major source of demand. While future interventions by the Fed, such as yield curve control, could theoretically limit upward pressure on long-term yields, such measures remain highly uncertain. At the same time, inflation uncertainty is also more persistent, which erodes the hedging utility of Treasuries and therefore its demand by investors.

Although this does not imply a return to the term premium levels of the 1980s, the balance of macroeconomic forces points to a normalisation of the term premium above its post-GFC lows. Investors should not expect the ultra-accommodative backdrop that defined the previous decade to continue. Instead, they should prepare for a regime where higher term premium levels play a more central role in shaping long-term yields and potentially higher volatility of longer duration bonds. Combining these forward-looking views for real rates, inflation, and term premium in various regions, current ten-year yields in major markets appear close to our fair value estimates.

**Figure 9: Ten-year yields are close to our estimates of long-term fair value**



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Source: Bloomberg, Fidelity International, 30 April 2025.

On the credit side, spreads have widened, although they remain well below historical peaks, likely reflecting the continued strength of corporate balance sheets and resilient economic growth trends, particularly in the US. From a long-term perspective, they remain tight and below our estimated equilibrium levels. Given relatively high government bond yields, high-yield bonds can therefore be considered as among the more attractive segments within the fixed income space. However, high yield's compelling return prospects should be carefully weighed against the risk of credit losses in the event of a recession.

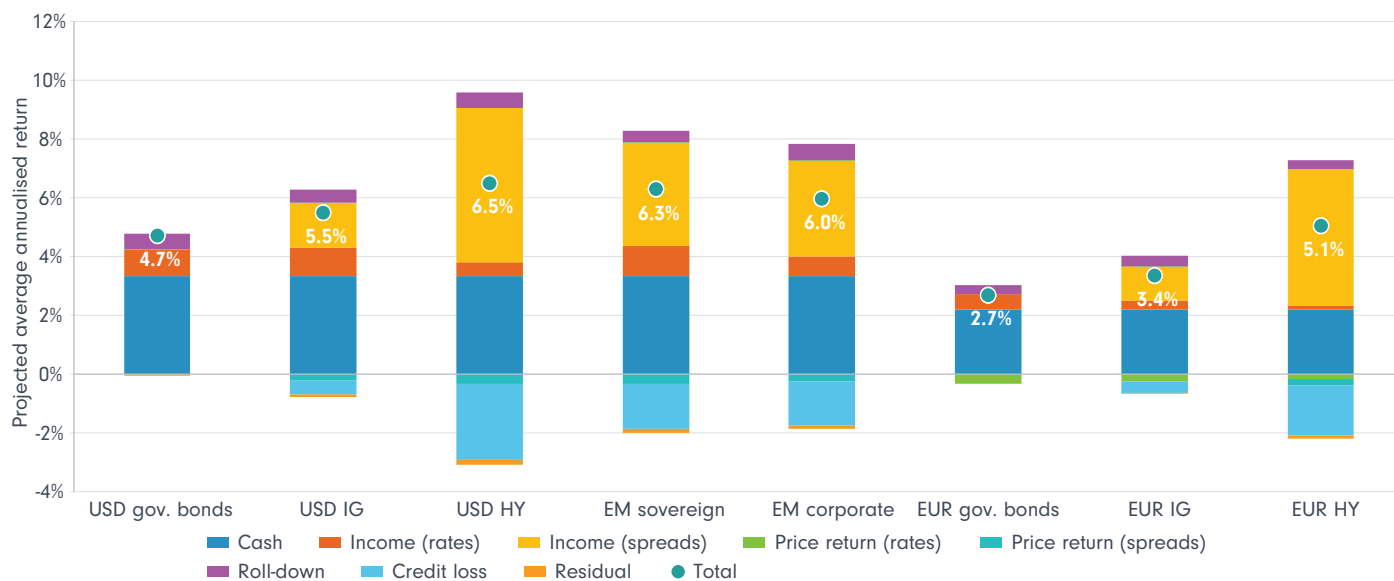
With this in mind, we have increased our expectations for ten-year global bond returns, primarily due to higher starting yields and term premia. Global aggregate bonds are expected to return around 4.6% in USD, 3.4% in EUR, 4.8% in GBP, and 2.1% in JPY. Within this, the breakdown of return expectations indicates that the cash component will continue to play a meaningful role in contributing to overall returns.

## The evolving role of bonds in Multi Asset portfolios

Persistently elevated inflationary pressures and structurally higher term premia mark a departure from conditions that prevailed during the 2010-2020 decade, when bonds generally exhibited low volatility and low or negative correlation with equities.

Investors will therefore need to think more flexibly about diversifying equity risk, including through the active management of bond duration risk and via sources of uncorrelated return (e.g. absolute return strategies).

**Figure 10: Projected average annualised ten-year fixed income returns, local currency: Expect modestly higher returns, supported by the contribution of cash rates**



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Source: Fidelity International, 30 April 2025.

## Private Assets Outlook: Attractive compensation for illiquidity risk

Expected returns of private assets remain attractive for long-term investors willing to take on additional illiquidity risk. However, manager skill continues to be a critical factor in achieving successful portfolio outcomes, particularly in the current environment of tighter financial conditions and elevated uncertainty.

### Private Equity (Global Buyout)

Long-term return expectations for global buyouts remain unchanged from our previous update, at 9.5% (net of manager fees, in US dollars). This stability reflects the close link between private equity returns and those of public markets, augmented by an asset-specific risk premium. As public market return expectations have increased modestly, so too have private equity forecasts. However, the rising cost of capital, especially relevant for highly leveraged strategies, and the still-elevated levels of dry powder add complexity. While abundant capital may support deal activity, it also underscores the importance of skilled managers in sourcing and executing quality investments.

### Real Estate (European ex-UK)

European real estate remains relatively attractive over the long term, though performance will be shaped by the macroeconomic backdrop and market-specific supply and demand dynamics. Both inflation and economic growth influence nominal rental value growth, with slower and uncertain economic activity posing a potential headwind for revenues. A less restrictive monetary policy stance could support property prices going forward, but much will depend on how inflation, growth, and supply-demand factors evolve over time. Additionally, increasing demand for sustainable or 'green' real estate may represent a compelling long-term structural opportunity.

### Direct Lending (Europe)

Returns for European direct lending remain compelling for investors with a longer-term horizon and a tolerance for illiquidity. Starting spreads are broadly in line with our previous projections, supporting a ten-year expected return of 6.3% (net of manager fees, in euros). The current environment offers solid income potential, but, as always, careful manager selection remains key to risk management and return realisation.

## Conclusion

The investment landscape is undergoing a fundamental shift, marked by a structurally higher level of uncertainty. This will have far-reaching implications for long-term portfolio construction and asset allocation decisions, but our ten-year return projections continue to support the case for both equities and fixed income as sources of long-term investment growth. Regarding the latter, we have moderately increased our return outlook since our November update, reflecting improved starting yields and higher term premia.

Despite this, expected returns tell only part of the story. Shifting correlation patterns between asset classes have become a defining feature of this new regime and the traditional assumptions underpinning asset class relationships can no longer be taken for granted. Recent market behaviour has demonstrated that investors should not necessarily expect consistent or repeatable behaviour from any single asset class, that diversification can require more than a static 60/40 portfolio, and that there is no longer a universally reliable 'safe haven'.

This evolving context demands a more nimble and sophisticated approach, one which goes beyond simply holding equities for growth and bonds as diversifiers. Successful long-term investing will require flexible, active exposure management across a broader set of asset classes, incorporating uncorrelated return streams and leveraging a wider toolkit to enhance protection.

Overall, the new investment environment calls for a more dynamic approach, one which emphasises true diversification and can adapt to economic regimes changes amid elevated uncertainty. Within this environment, investors may also have to revisit their strategic asset allocations more regularly to ensure that their portfolios remain resilient in today's increasingly complex world.

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