Muddling through structural shifts

Advanced Economies Outlook 2025

Triodos Investment Management

The global economy stands at a critical juncture, grappling with structural shifts that are likely to prevent a return to the pre-pandemic rhythm. Inflation is moderating, but challenges remain as advanced economies must balance easing monetary pressures with the reality of high debt levels and demographic headwinds. The energy transition, advancing digital innovation, and geoeconomic fragmentation are in the meantime reshaping economic foundations. Our expectation for another year of muted global growth and US outperformance thus by no means implies a return to calm waters. For investors, safeguarding long-term returns will require effectively navigating these complex forces, keeping in mind that sustainability transitions are inevitable.

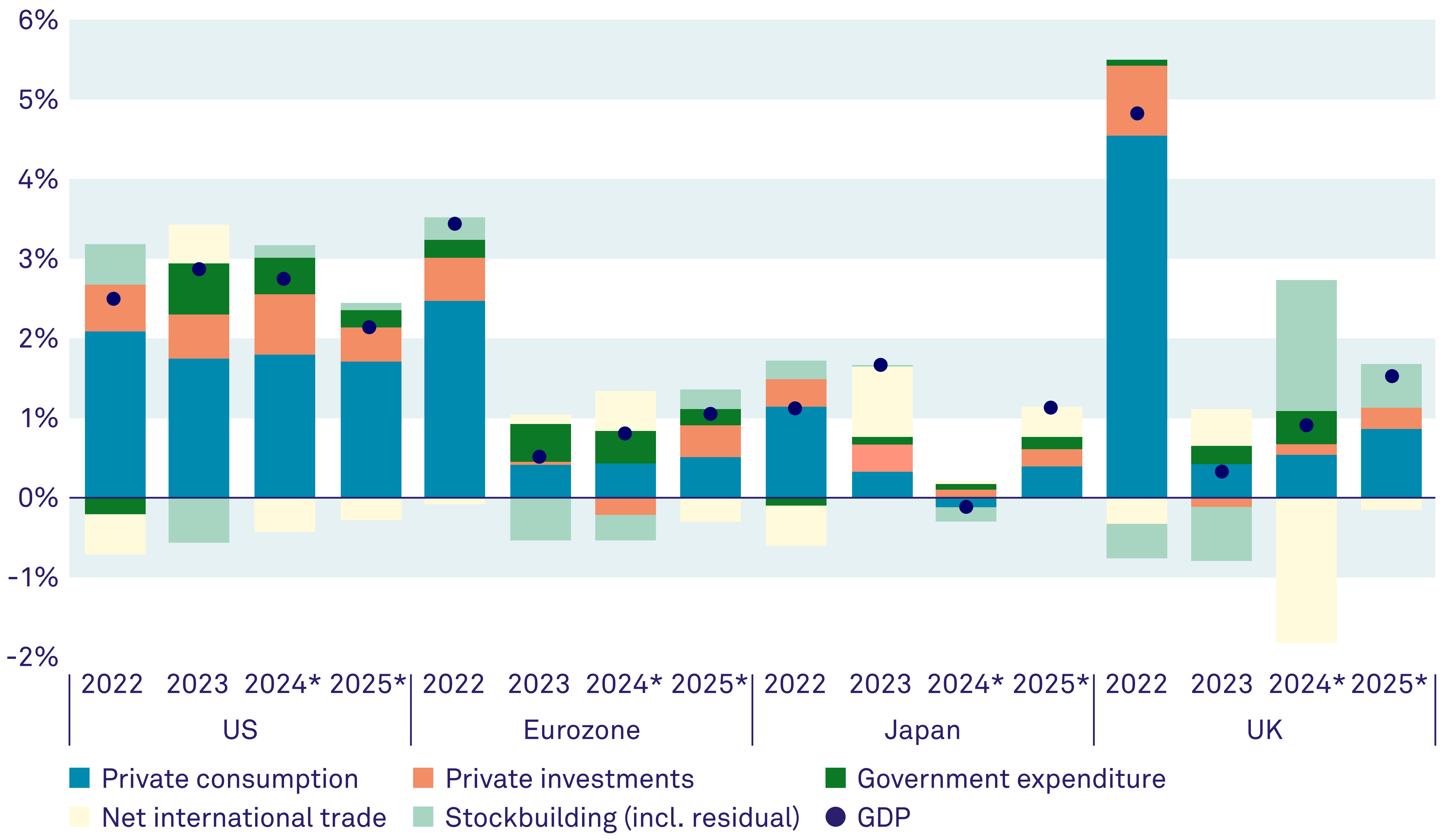
Muddling through structural shifts

Settling into a slower-growth regime

For 2024, we expect global economic activity to expand by 3.2%, similar to the year before and thus again below this century's historical average. The dust finally started to settle after several years of supply shocks and their aftermath, with inflation approaching central bank targets and most of the major central banks starting their rate cut cycles. 2024 was also the year in which the divergence between advanced economies continued: the US economy continued to display a remarkable resilience, while UK economic growth only improved moderately compared to the year before and eurozone and Japanese growth slowed, showing lingering weakness. One important factor explaining this regional difference is fiscal policy, with the US continuing to outdo its peers by running a much larger fiscal deficit compared to its GDP. Productivity growth also differed markedly.

For 2025, we project global economic activity to again expand at a underwhelming pace of 3.2%. It thus seems as though the world is really settling into a slower-growth regime, indicating there is more at play than ordinary business cycle dynamics. Consumption, investment and trade are indeed all in their own way affected by lingering structural shifts in 2025. In some cases, forces become so strong they tip the economic balance, resulting in a new regime.

Figure 1 GDP growth (year-on-year) **- expenditure components**



* 2024 and 2025 are estimates Source: NiGEM, Triodos Investment Management

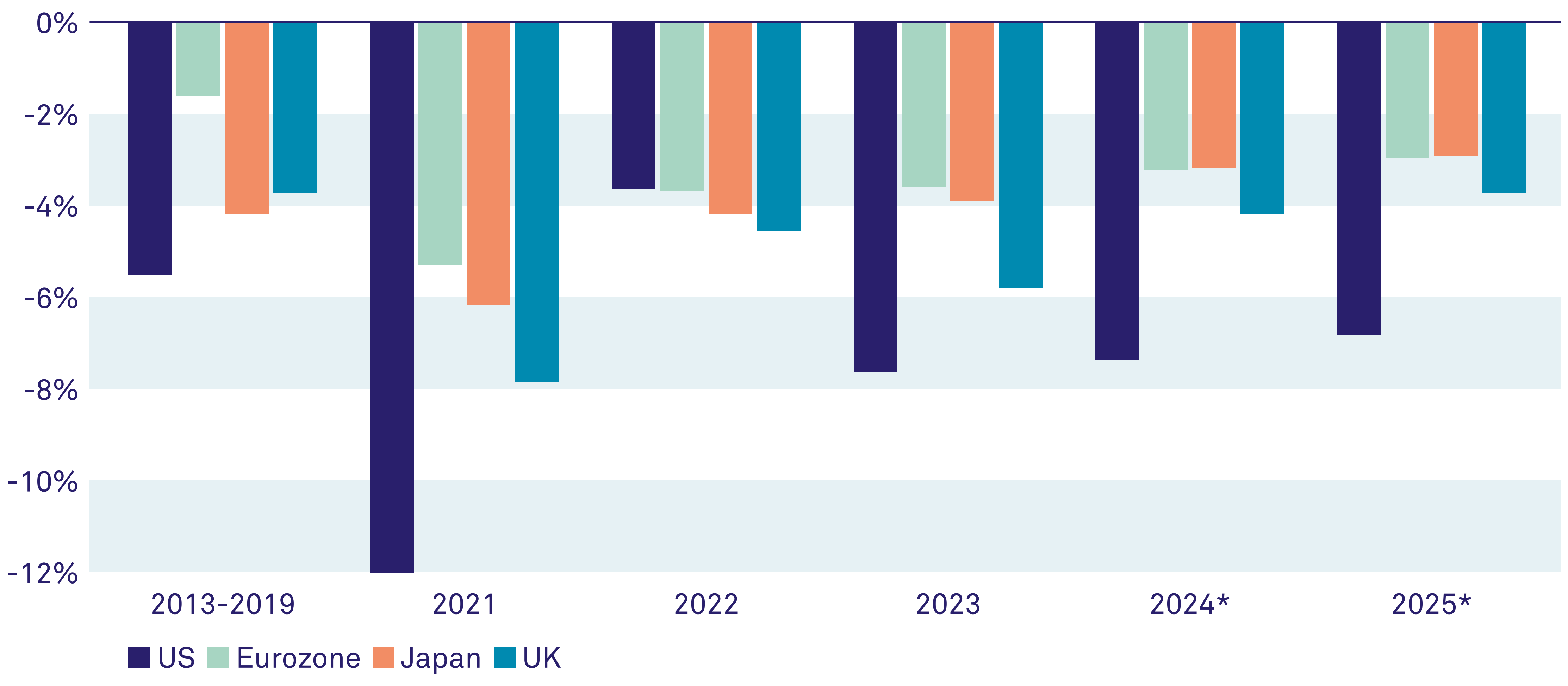
Households benefit from disposable income gains

In both 2023 and 2024, household consumption was a dominant factor explaining the difference in economic performance between the main advanced economies. US consumers were happily riding the waves of enormous fiscal stimulus packages, while at the same time they felt confident enough to dip into their savings. This was not the case in the other major advanced economies, where consumers were far more careful, as indicated by elevated savings rates. Still, gains in European disposable income supported consumption, thanks to easing inflation and sizable wage growth. Going forward, we expect these regional consumption dynamics to continue in 2025 (see Figure 1), with risks mostly coming from the structural forces at play:

- **Wages likely keep outpacing inflation:** The supply shocks related to COVID-19 and the war in Ukraine have almost worked their way through the system. And for now, it seems as though the conflict in the Middle East will not affect energy prices. Headline inflation across advanced economies has come close to the 2% central bank targets. The final step is for services inflation to normalise, for which wage growth must continue its descent. Recent labour market data across advanced economies suggests this is likely, with non-temporary layoffs increasing and the number of vacancies per unemployed decreasing. Still, it seems to be a slow process, especially in the UK and the US, which means consumers are set to benefit from wage growth outpacing inflation (again) in 2025. More in the background, the general move across the US and Europe towards slowing immigration flows and ageing populations continues to be a lingering risk for the labour market and hence inflation. To which side the balance will tip is still not clear and will likely not become clear in 2025. Ongoing adaptation of digital innovation could be a force in 2025 that will (continue to) reduce unit labour costs, especially in the tech-heavy US economy.

- **Potential import tariffs mostly a concern for 2026:** Clearly, import tariffs imposed by the US and possible retaliation by its trade partners could ignite global price rises. We expect the US to raise tariffs on Chinese products in the first half of the year, and for Europe and elsewhere towards the end of the year. Moreover, we do not expect higher tariffs for all imports, as this would hurt many American companies.
- **Fiscal deficits could again be larger than expected:** Over the past few years, fiscal deficits were generally larger than their pre-pandemic averages (see Figure 2), so it makes sense to expect fiscal austerity in 2025. However, in the US the pre-election fiscal path already pointed to another sizable deficit, and with the Republicans having won both the Senate and House of Representatives, the risks are tilted towards an even wider deficit. Trump's victory also puts more pressure on austerity plans elsewhere, as his protectionist and anti-NATO stance could lead to higher defence spending in the eurozone and even more focus on building domestic industrial capacity and shielding households from potential negative trade war effects. Just before the US election, the new UK government already moved away from austerity, by announcing a significant increase in budget spending.

Figure 2 Government budget balance (% of GDP)



* 2024 and 2025 are estimates Source: NiGEM, Triodos Investment Management

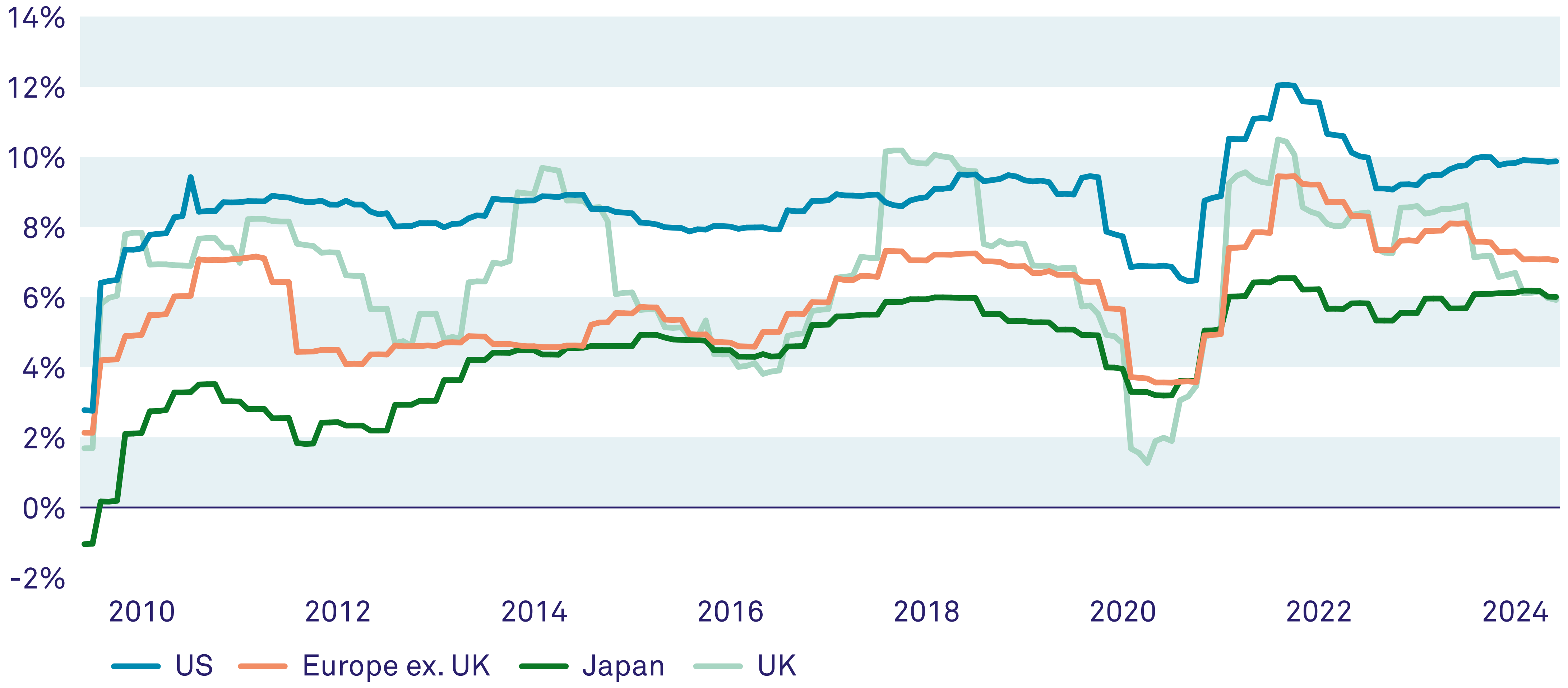
Investment supported by rate cuts

The global move towards more protectionism and the ongoing geopolitical instability could indeed push governments to stimulate domestic business investment. Over the last years, this happened on a large scale in the US, for example by subsidising clean energy and semiconductors. In the other major advanced economies, business investment has been more modest due to limited fiscal incentives. Mario Draghi's report on the EU's competitiveness in the meantime diagnosed structural problems related to innovation, energy costs and industrial policy, which became especially evident in German weakness as business investment contracted.

In 2025, private investments outside the US will at least be supported by the business cycle, as the further easing of inflation will allow most central banks to continue their rate cuts and move to a neutral monetary stance. US private investment growth will again be strong, as Trump's promise of less regulation and corporate tax cuts, in combination with the already elevated corporate profit margins, will outweigh any tariff-related uncertainty. Elsewhere, this uncertainty will likely weigh somewhat more on sentiment. In combination with lower profit margins (see Figure 3), this explains the in general more muted investment growth prospects for the other major advanced economies.

For both the Federal Reserve and the Bank of England, the risk to our 2025 year-end rate forecast (3.75%-4.00% and 3.75%) is to the upside, considering

Figure 3 Net profit margins (%)



Source: LSEG, Triodos Investment Management

the potential US import tariffs, the relatively stubborn wage growth and recently announced accommodative fiscal plans in both countries. We expect an ECB year-end policy rate of 2%, with risks more to the downside, given the ongoing economic weakness and potential growth implications of tariffs. The Bank of Japan will likely continue its slow move up, away from the zero bound.

Fragmentation picks up pace

Interestingly, global trade as a share of global GDP has not further deteriorated in 2024, following the decline in 2023. At first sight, this suggests that the heightened geopolitical tensions and increased trade restrictions had no impact on trade. However, IMF research shows that trade increasingly takes place within geopolitical blocs, rather than between them. This could negatively affect the world in different ways, for instance by driving up the prices of minerals critical for the energy transition.

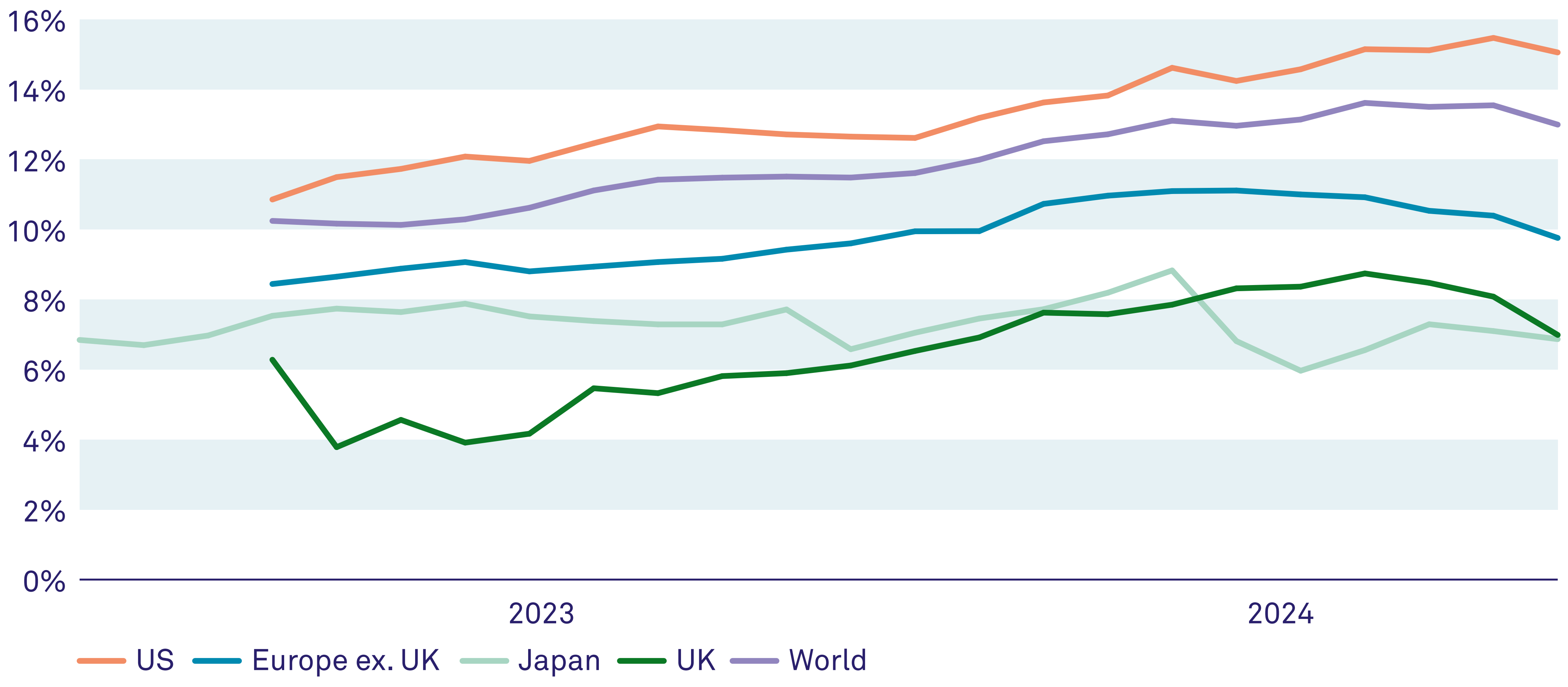
For 2025, we expect more fragmentation between economic blocs, with ongoing conflicts and a move towards more trade barriers. On top of that, the risks are clearly towards less global trade, even within friendly blocs, if Trump imposes his complete tariff plans and does this earlier than we expect. In that sense, it is likely that 2025 will be the year where global trade definitively breaks away from globalisation and shifts into a new fragmentated global order. Eurozone economic growth would in that case be disproportionately impacted, as the region is the most export-dependent amongst advanced economies and has the largest trading surplus with the US. We now already expect a negative contribution of net trade to economic growth in 2025, primarily due to waning demand from partners like the US and China and weakened competitiveness due to ongoing high energy prices.

Overall, we expect another year of US economic growth outperformance, with further significant growth of the fiscal deficit and ongoing consumption and investment. It is worrying that this will likely go hand in hand with an attempt to revive the old brown economy. We expect only a modest recovery in the eurozone, mostly because lower interest rates will allow some pickup in business investment. But the underlying weakness related to structural forces will keep confidence low and growth sluggish. The UK will see a more pronounced pickup in growth, as the additional fiscal spending plans will support consumption. Finally, Japan will leave behind a very difficult year as gains in disposable income result in a pickup in consumption. Its ageing population will, however, continue to be a limiting factor.

Short-termism likely to prevail in equity markets

Global equity markets had a strong year in 2024, as investors focused on corporate profit resilience and the promise of a potential economic upheaval related to Artificial Intelligence. In the meantime, the conflict in the Middle East escalated, the war in Ukraine continued, and it became again less likely that the world would limit global warming to well below 2 degrees Celsius, as agreed in the Paris Climate Agreement. On top of that, Trump's election win could mean the US leaving the Paris Climate Agreement again. The Trump-administration will likely also push for more fossil fuel drilling. In the short term, this is bad news for renewable energy stocks, while fossil fuel-related equities will likely benefit. US deregulation will likely also boost the large tech and financial

Figure 4 EPS consensus forecasts 2025 - IBES MSCI (year-on-year growth)



Source: LSEG, Triodos Investment Management

sectors, while Trump's resentment towards NATO could boost defence stocks.

In general, earnings per share expectations for next year are very healthy (see Figure 4), which contrasts with an increasingly unhealthy world. It appears market valuations are immune to business cycle dynamics and climate worries, as they count on monetary and/or fiscal stimulus to save the day. Next year is in that sense shaping up to be a good year again for investors, with significant fiscal deficits and more rate cuts in the cards. The equity markets cannot, however, continue to ignore the structural forces that are at play. These ultimately point towards a further greening of the global economy.

How eurozone rates will respond to next year's turbulent environment is everything but clear. A trade war would hurt the eurozone disproportionately, meaning lower growth and inflation and more interest rate cuts. However, as it stands, longer-term eurozone bond yields have moved up, in line with their US counterparts (but to a lesser extent). This shows that at least in the near term, movements in the US bond market are decisive for longer-term eurozone yields, irrespective of potential eurozone growth and inflation outcomes. Short-term eurozone bond yields do seem to be driven down by expected lower growth and hence an increased likelihood of more rate cuts.

Sustainability transition inevitable

Since Trump's previous term, the renewable energy market has matured. Greening the economy has become economically advantageous, making the sustainability transition more resilient to political shifts. If the US wants to compete, it will to some extent have to continue its climate efforts. At the same time, large corporations and financial institutions are globally trying to live up to heightened sustainability standards set by EU regulators. This is certainly a positive tipping point that we have crossed. The sustainable transition will carry on, meaning that impact investing is more than ever a relevant and advantageous long-term investment strategy.

Real GDP growth (%)

	2023	2024	2025
Global	3.4	3.2	3.2
US	2.9	2.8	2.2
Eurozone	0.5	0.8	1.0
UK	0.2	0.9	1.5
Japan	1.7	-0.1	1.2
China	5.2	4.9	4.6
India	8.1	6.8	6.6

Source: NiGEM, Triodos Investment Management

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Investing in positive change

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