

For professional investors only

A wide-angle photograph of the Chicago skyline at sunset. The sky is a mix of light blue and orange, with soft clouds. The city's skyscrapers are silhouetted against the bright horizon, with their lights beginning to glow. The buildings are reflected in the calm water of Lake Michigan. In the foreground, a dark, curved concrete pier or breakwater extends from the bottom right towards the center, creating a sense of depth and framing the view of the city.

Investment Outlook 2026 Balancing at great heights

August 2025

Table of contents

Introduction	3
Economic outlook	5
Financial markets and capital market assumptions	16

Introduction



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Investment Outlook 2026

I am delighted to present our Investment Outlook 2026. This document provides our perspective on the global economy and for financial markets and contains our views on many of the investment themes that are likely to prove consequential in the months – and years – ahead. In addition, we have updated our forward-looking capital market assumptions, covering expected returns and volatilities for 22 asset classes.

So far, 2025 has seen a number of significant developments, with the unpredictable and inconsistent policies of US president Donald Trump, along with military action in the Middle East, causing substantial volatility in financial markets. Despite this, economic fundamentals remain reasonably strong, with greater – albeit incomplete – clarity around tariff policy and related impacts. Although US inflation is expected to remain above target, Federal Reserve (Fed) rates are expected to be cut by up to 1% by the end of 2026, while the European Central Bank (ECB) has scope for another cut in interest rates.

In terms of investment themes, an important consideration is the potential end of US ‘exceptionalism’. After well over a decade of excess returns from US assets, there are tentative signs of waning appetite from investors. The US dollar has seen pronounced weakness, we see scope for further downside, and the share of highly concentrated US equities in global market indices is at record highs. Strategically, we expect a broadening in market returns but remain mindful of the strong competitive positions of leading US companies in industries with high growth prospects.

Elsewhere, European equities have seen a good start to the year and the removal of the ‘debt brake’ in Germany, along with widespread plans to increase fiscal expenditure on defence and infrastructure, may see a better growth backdrop for the eurozone in the years ahead. However, a rising debt burden may cause challenges for the bond market, which has, thus far, remained relatively sanguine over record levels of government borrowings. Chinese policymakers are also renewing their focus on growth and there are some encouraging signs of a stabilising housing market and incremental stimulus from authorities.

There also remains the theme of the application of technological advancements, and artificial intelligence (AI). Industries are set to be transformed by AI, potentially enhancing productivity and gains to capital, and raising overall economic growth rates.

Commodities and especially catastrophe bonds (or cat bonds) continue to score well in our ‘capital market assumptions’ (CMA) model this year. Narrow spreads in corporate bond markets have reduced prospective returns and there remains little difference, in terms of prospective returns, between high grade credit and government bonds. Higher returns are expected from riskier credit instruments, such as high yield bonds, but better returns still are expected from equities. Within equity markets, rich valuations in developed markets, notably the US, suggest that attention may shift towards emerging markets, which have the advantage of lower valuations and have been out of favour with investors for much of the past decade or longer.

The outlook, as always, is uncertain and valuations in equity markets and credit spreads are high relative to history. While mindful of the risks, we are excited by the opportunities for investors.

AI presents tremendous challenges to policymakers, businesses and individuals, but should also drive meaningful improvements in productivity with the adoption of new technologies likely faster than has been the case historically.

We remain resolutely focused on helping our clients navigate both the risks and opportunities that will present themselves over the coming years and trust that you find our insights helpful and instructive in your strategic deliberations.

Economic outlook



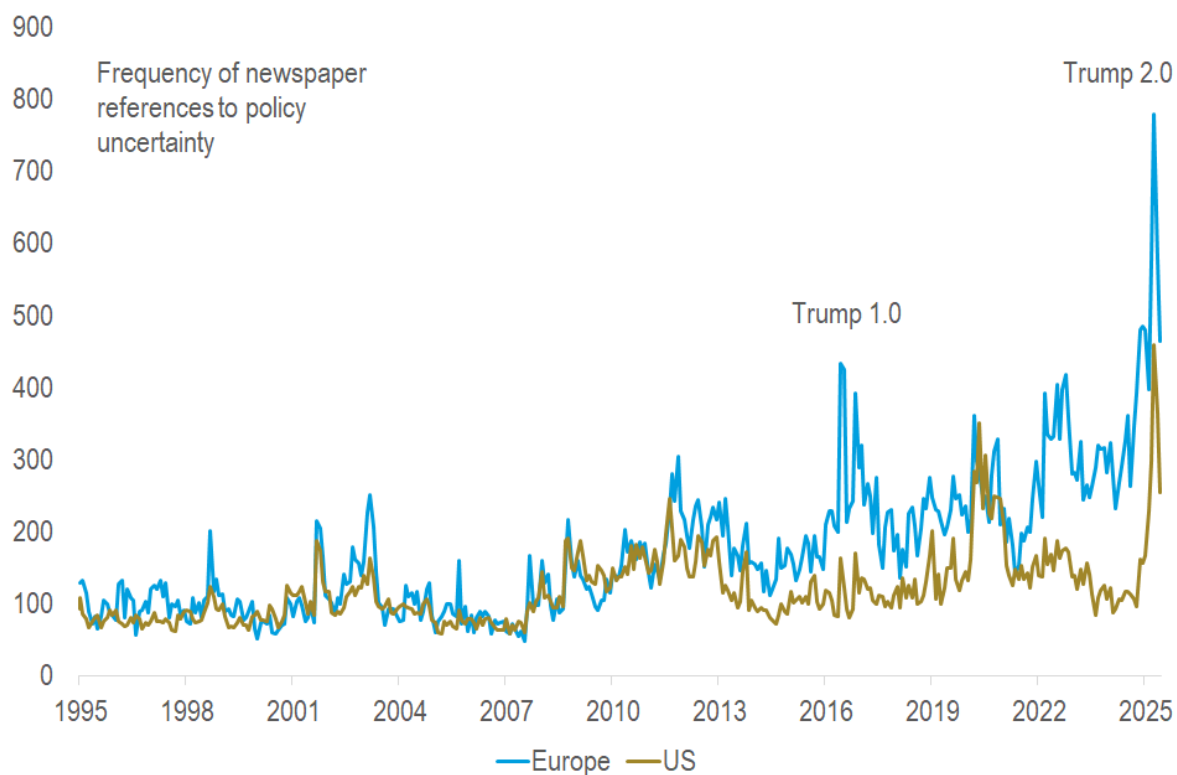
Anthony Willis
Senior
Economist

Everything everywhere all at once

So far, 2025 has been a particularly uncertain period for financial markets, driven by wider uncertainty in politics, economics and geopolitics. The principal source of this uncertainty has been the US administration under President Trump. Financial market participants were either hoping for, or expecting, a re-run of Trump's first term in office, which despite persistent trade tensions with China saw market-friendly outcomes with both deregulation and sizeable tax cuts boosting sentiment. However, since inauguration in January Trump has stirred both economic and political concerns, with heightened uncertainty over tariff policy and so called 'reciprocal tariffs' causing significant market volatility across equities, bonds and currencies.

The geopolitical backdrop has been equally turbulent, with ongoing tensions in the Middle East persisting, culminating in Israel, and then the US, attacking Iran, followed by swift de-escalation. Meanwhile, the Russia-Ukraine conflict continues. Trump has also called into question the 'Transatlantic alliance' with messaging that has undermined faith in the US as a guarantor of western security, prompting a seismic shift in thinking around the defence of Europe, and the need for higher spending to pay for it. We have seen a near overwhelming flow of news from the White House, though financial markets have begun to filter out much of the 'noise' based on the tariff relent seen in April when a dramatic sell off in equities and government bonds pushed the Trump administration back from some of their more extreme tariff policies. The rebound in financial markets, based on the assumption that we have seen the worst of the tariff threats and pragmatism will prevail, has been impressive. However, it leaves limited value in equities given the uncertain outlook and potentially softer economic growth.

Economic policy uncertainty indices



Source: Columbia Threadneedle Investments, Bloomberg, Baker Bloom Davis, June 2025

Geopolitics – a world in transition

Geopolitical concerns and unknowns are an ever-present risk to financial markets, the global economy and risk appetite, but it does appear we are at something of an inflection point in the international order. At the highest level, the original economic superpower, the USA, continues to seek to slow the rise of China as a competitor. Meanwhile, the threat of Russia weighs heavily on Europe, and specifically Ukraine, of course. Hopes that the war would conclude under US pressure for Russia and Ukraine to reach a peace deal are so far proving wide of the mark. Middle Eastern tensions have flared and for financial markets were most visible in volatility in the oil price. Financial markets are generally reasonably adept at pricing geopolitical risks, notwithstanding those 'shocks' that cause a market selloff. Providing the fundamentals have not changed, the recovery tends to be swift, which has been the case once again so far in 2025. As we look towards the next 12 months we face an increasingly fragmented world, with polarised politics and countries looking to ramp up their defence spending. An unstable world order is set to be the backdrop for some time to come.

Europe turning a corner

Amid an uncertain political backdrop, and uncertainty over the commitment of the US to defend its western allies, even under the NATO alliance, there has been a marked shift in behaviour by European politicians and the European Union (EU) towards higher defence spending. Nowhere is this more notable than in Germany. The new government under Friedrich Merz announced a significant increase in defence spending and, as a result, loosened the 'debt brake' that has held back German government spending – and the German economy as a consequence – ever since the 2008/09 global financial crisis. This looser fiscal regime in Germany extends beyond defence spending to fiscal stimulus via infrastructure spending under a 10-year plan, but a large amount of stimulus is 'front loaded' to boost growth sooner rather than later. A stronger Germany means a stronger Europe, and commitments from most (but not all) European countries to spend 5% of GDP on defence by 2035 implies a positive economic multiplier effect ahead. The key question for financial markets, and the continuation of recent stronger performance of European equities over their US peers, is whether this stronger economic outlook can translate into higher earnings.

Defence spending among EU countries, 2014 vs 2024

[NATO commitment was 2% of GDP, new commitment is 3.5%+1.5% of GDP]

	%GDP 2014	%GDP 2024	€bn 2024
Poland	1.9	4.1	24.80
Estonia	1.9	3.4	0.90
Latvia	0.9	3.1	0.90
Greece	2.2	3.1	6.30
Lithuania	0.9	2.8	1.40
Finland	1.5	2.4	5.70
Denmark	1.1	2.4	8.20
Romania	1.3	2.3	5.10
Bulgaria	1.7	2.2	1.30
Sweden	1.1	2.1	11.70
Germany	1.2	2.1	71.10
Hungary	0.9	2.1	3.10
Czechia	0.9	2.1	4.20
France	1.8	2.1	51.00
Netherlands	1.2	2	17.10
Croatia	1.8	1.8	1.10
Portugal	1.3	1.5	3.40
Italy	1.1	1.5	27.60
Belgium	1	1.3	6.40
Luxembourg	0.4	1.3	0.60
Slovenia	1	1.3	0.70
Spain	0.9	1.3	16.40

Source: Columbia Threadneedle Investments, NATO

How to pay for defence?

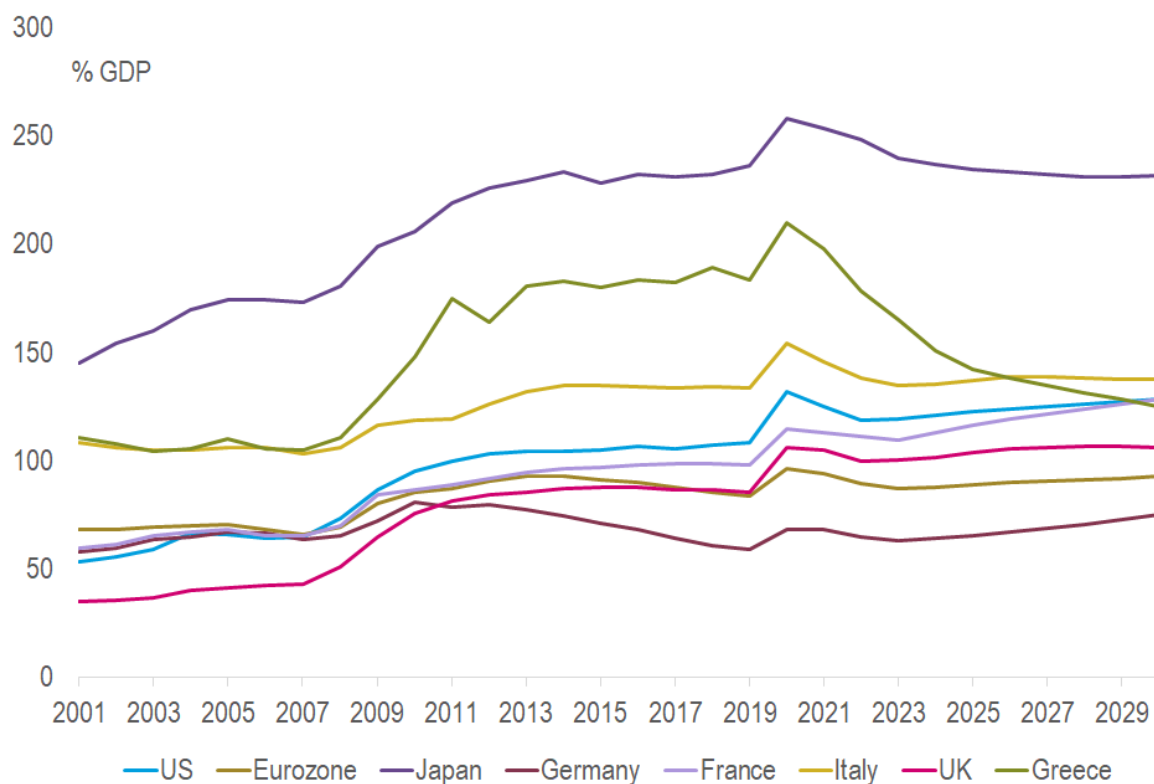
Governments globally face significant challenges in dealing with ever growing spending commitments without substantially risking their political fortunes by raising taxes to pay for them. With interest rates now 'normalised', having been at abnormally low levels for a great deal of the century so far, the cost of servicing debt for governments has become an issue in itself, with debt payments becoming an ever-larger part of overall spending. Bond markets have flexed their muscles on a number of occasions, bringing down a government in the UK in 2022 and causing a shift in US tariff policy in the spring of this year. With future defence spending set to be much higher than previously expected, the pressures on government budgets increase even further. We have already seen pragmatism from the EU to allow for higher defence-related spending. But will bond markets be so forgiving? Governments, particularly those well known for fiscal incompetence or profligacy, will have to walk a fine line to keep bond markets on side.

Will bond markets balk at the US government deficits?

It seems unlikely that fiscal restraint in the US will come from the Republican party or the current administration, so will the bond market finally scream 'enough' and give Trump a 'Liz Truss moment'? The 'big beautiful bill' passed by Congress will add an additional \$3.3 trillion to the national debt over the next decade, while the \$5 trillion increase in the debt ceiling only equates to two-and-a-half years of spending. US Treasuries still have the luxury of being seen as the ultimate risk-free asset (if you assume the US government won't default), while the US dollar remains the world's reserve currency.

This should mean that there is always a substantial level of demand for US debt. But it seems likely that investors will want higher rewards for owning this debt. US government bonds will be priced against a backdrop of the risk of higher inflation and a slowing economy thanks to tariffs, with the Fed in 'wait-and-see' mode, more concerned with the inflation side of their mandate rather than employment. In the past we have seen that the Fed is acutely aware of any stresses in bond markets and will intervene if necessary so that a bond crisis does not become a financial crisis. But the bar for intervention is high, and beneath that we may well see some volatility. Yields rising slowly over time are much easier to digest than a sudden spike, but the news backdrop lends itself to swift changes in market mood and the kind of spikes in yields that cause fallout across risk assets. The US may be in the spotlight given the size of their budget deficit, but this is an issue across many western economies. These countries are faced with a delicate balance of higher spending burdens not helped by demographic trends and higher defence spending, and the desire to boost economic growth without the need to significantly raise taxes.

General government gross debt % of GDP (IMF, 2025-2030 is forecast)

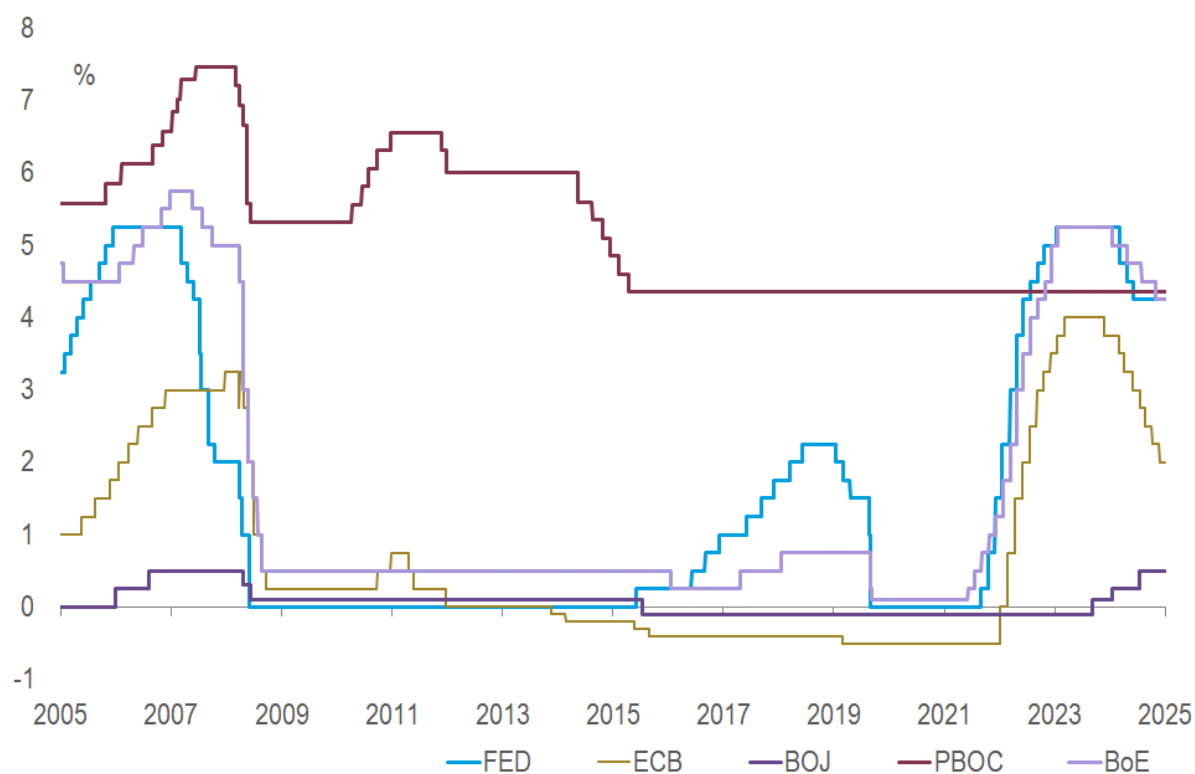


Source: Columbia Threadneedle Investments, Bloomberg, IMF, July 2025

Central bank policy rates set to diverge?

After an extended period of benign inflation, the inflationary 'shock' of 2021-22 in the aftermath of the pandemic and the energy price spike saw central banks belatedly, but aggressively, raise interest rates to counter what they initially believed to be 'transitory' inflation. We are now on the other side of the inflationary wave, in a period of more normal inflation and normalised interest rates. Inflationary pressures from tariffs remain an unknown, and the Fed would likely have already cut rates had tariffs not been introduced. But they are comfortable to 'wait and see' for some time yet. Political pressure is likely to build, but the Fed will emphasise their independence, at least until a new chair is appointed by Trump in the coming months. In Europe, with inflation already back to target, the ECB has scope to potentially cut rates one more time, while in China the People's Bank of China (PBoC) is likely to continue with incremental cuts to support economic growth. In Japan, ironically after decades of deflation, there seems to be a sticky inflation problem, and it appears likely that the Bank of Japan (BoJ) will need to further normalise interest rates over the coming months. The unwind of the yen carry trade has already caused some turbulence in financial markets over the past year, and further shifts in rate differentials have the scope to displace assets as central bank policies move out of alignment.

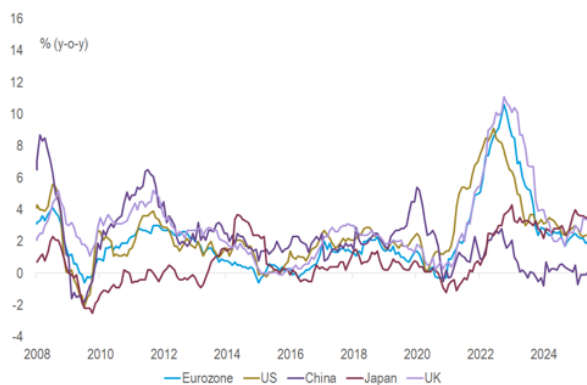
Central bank rates



Source: Columbia Threadneedle Investments, Bloomberg, July 2025

The forward path for inflation sees expectations easing, but only as far out as 2027. Bloomberg consensus shows US CPI above target at 2.4%, with 2.9% expected in 2025 and 2.8% in 2026. For the eurozone, inflation is expected to remain at or below the ECB's target with CPI at 2.0% in 2025, 1.8% in 2026 and 2.0% in 2027.

Headline inflation



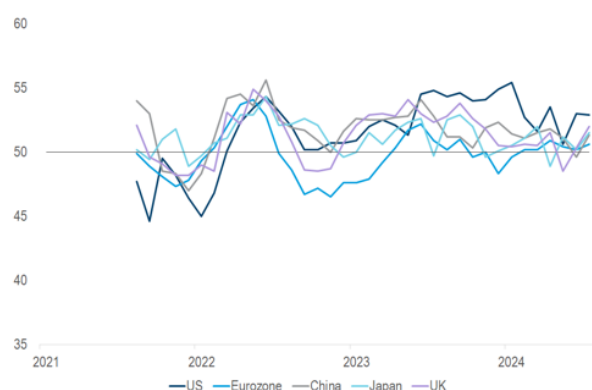
1-year inflation swap rates



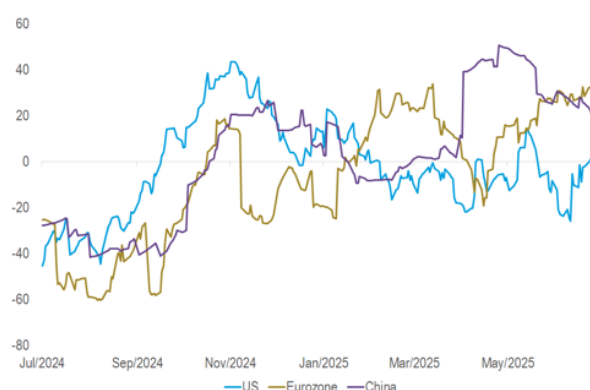
Source: Columbia Threadneedle Investments, Bloomberg, July 2025

Market expectations for the path of interest rates imply four rate cuts from the Fed over the next 12 months, starting with a 25 basis point cut in September 2025. For the ECB the expectation is one further 25 basis point cut in December 2025.

Composite PMI indices



Citi Economic Surprise indices

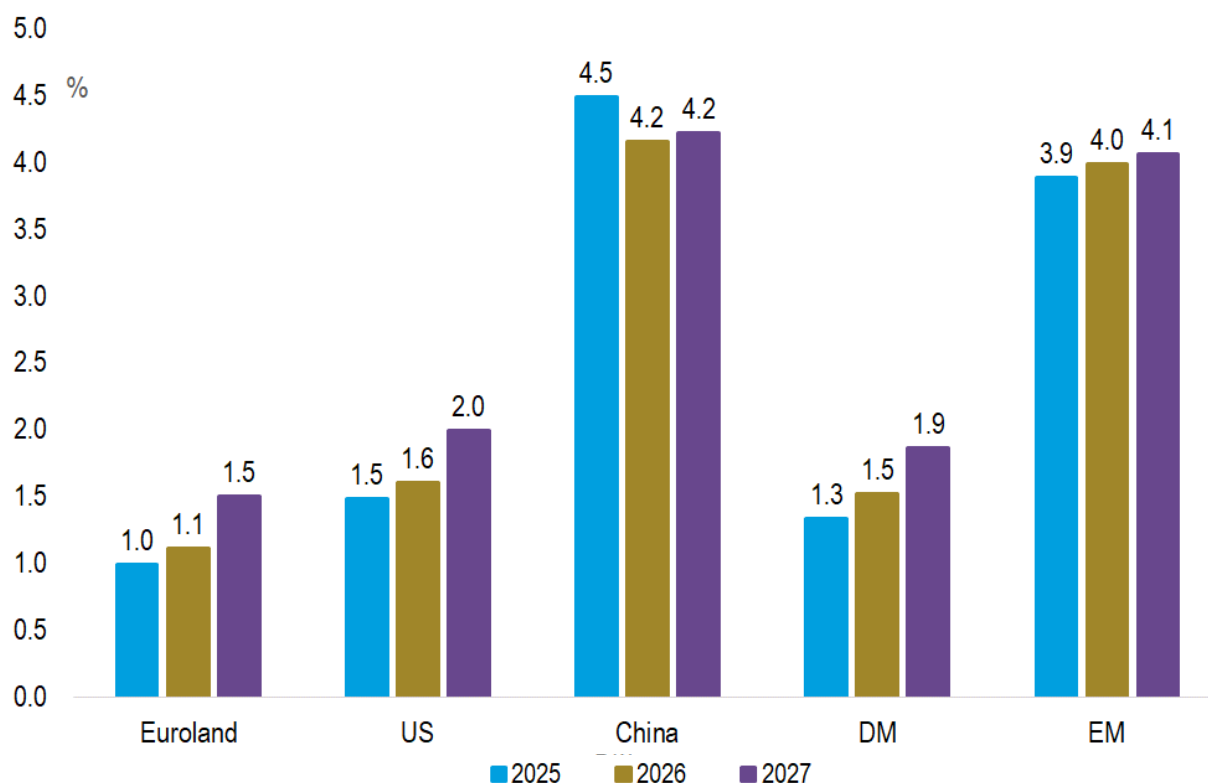


Source: Columbia Threadneedle Investments, Bloomberg, S&P, Citi, July 2025

Stagflation, recession or neither?

The economic narrative has shifted significantly over the course of 2025, but the backdrop remains relatively supportive for global growth. Uncertainties over tariffs and their scope and duration have caused repeated upwards and downward revisions to growth forecasts in recent months. We have also seen notably weaker consumer and business confidence surveys, although this has not translated into actual weakness in spending. Indeed, there remains a gap between 'soft' data such as PMI and confidence surveys, and 'hard' economic data. Worst-case scenarios when tariff worries were at their peak had the US falling into recession, but with a more benign tariff backdrop the worst we now expect is a more stagflationary environment with growth easing and inflation remaining 'sticky'. This would still leave the US with positive growth. With European growth expected to pick up modestly and EMs on a more positive trajectory led by India and China, the global growth outlook remains positive – albeit held back somewhat by the prevailing and persistent policy uncertainty from the White House.

Bloomberg consensus GDP-growth expectations



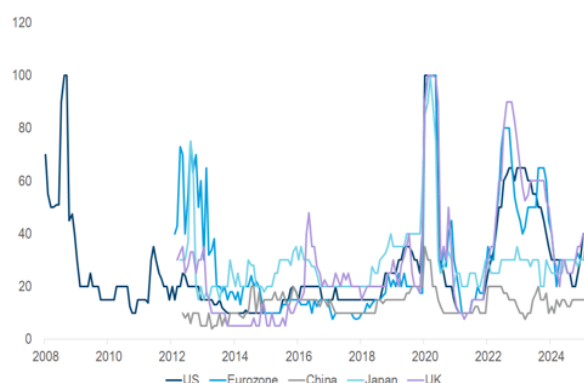
Source: Columbia Threadneedle Investments, Bloomberg, July 2025

The growth outlook for the west is moderately positive. The Bloomberg consensus for the US for 2026 is for slightly higher growth at 1.6% versus 1.5% in 2025. An improvement to 2.0% is expected in 2027. The eurozone is also expected to see stronger growth in 2027, at 1.5%, but 2025 and 2026 remain sluggish with growth of 1.0% and 1.1% respectively. China's government has set a growth target of around 5% for 2025, but consensus forecasts 4.5%, decelerating to 4.2% in 2026 and 2027. In 2025, developed economic growth is expected to be 1.3%, accelerating to 1.9% by 2027. Emerging economies are expected to be fairly stable, albeit at a significantly higher rate of growth: 3.9% in 2025 and 4.1% in 2027.

Consumer confidence (OECD)



1-year recession probability (Bloomberg)



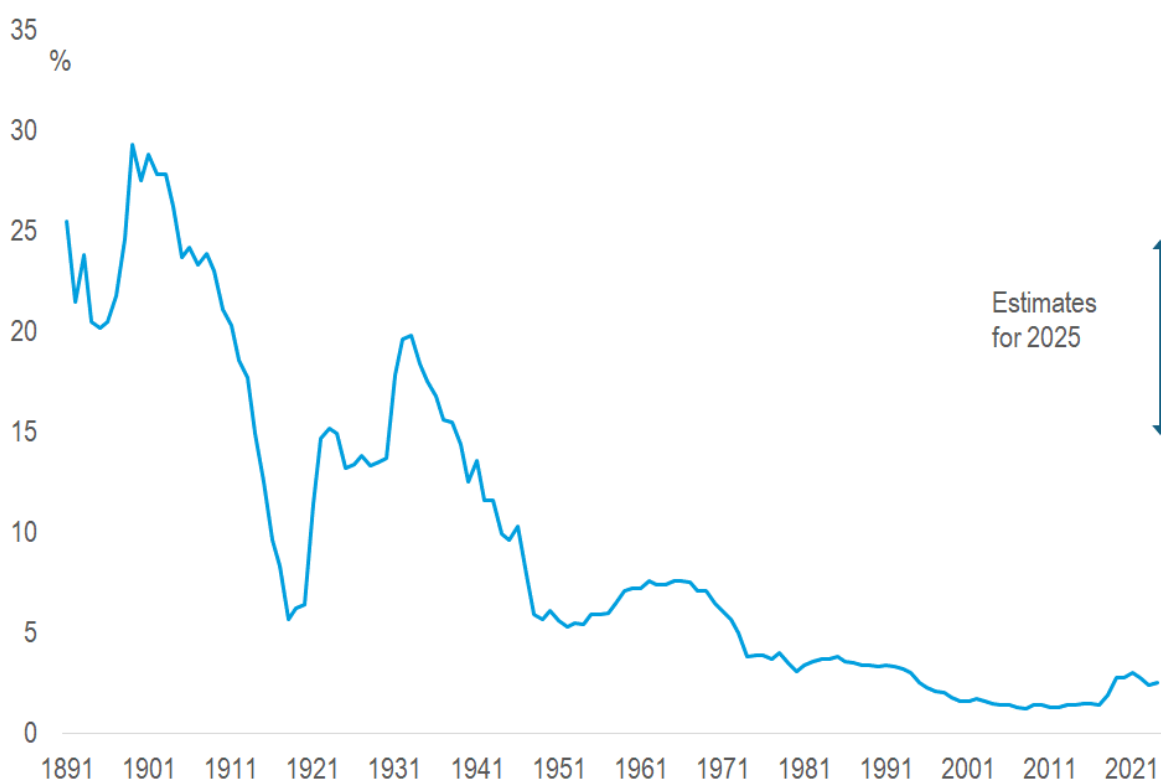
Source: Columbia Threadneedle Investments, Bloomberg, July 2025

The spectre of tariffs loom

While US tariffs may not impact as heavily as feared during the spring, a sense of uncertainty continues to prevail. With Trump using tariffs as his 'go-to' policy tool to exert influence or deter perceived unfair treatment, they are likely to remain on the agenda. While the US has been unable to achieve the '90 deals in 90 days' that Trump claimed would be agreed during the pause in reciprocal tariffs, there is an expectation that for countries seen to be negotiating in good faith, 'trade deal' talks will continue.

The 'deals' are simply a framework to manage the tariffs rather than actual trade deals, which normally take many years to agree and implement and are economically beneficial to both sides. However, if those agreed by the UK and China are an accurate guide, we would expect the 'baseline' 10% global tariff to remain in place. Frameworks agreed so far do mitigate some of the excess damage but still mean that intra-country trade is subject to higher tariffs than it was before April 2025. The 'effective tariff rate' – the average rate charged by the US on imports – will likely be in a range of 12%-13% if most countries end up with 'only' the 10% baseline tariff. This is far less deleterious than the 20%+ seen at the peak of the trade war with China in April/May, but it is also a long way above recent levels. For example, the effective tariff rate was 2.5% in 2024. Indeed, a tariff level of 12%-13% has not been seen since the 1930s. Time will tell how much of an impact this will have, but the burden will fall most heavily on the US, with consumers and companies set to see higher costs as a result.

Average effective US import tariff



Source: Columbia Threadneedle Investments, U.S. International Trade Commission, Bloomberg, July 2025

Can AI change the world?

Twelve months ago the excitement around AI was palpable. But while AI adoption continues to change industries and working practices globally, the 'winners' in terms of individual companies have been brought into question by cheaper, less energy intense rivals emerging from China. The introduction of the DeepSeek model caused brief turmoil among US technology stocks, calling into question their technological advantage as well as the tremendous amounts of capital invested in models that can be equalled by cheaper alternatives. In fact, it will take time for the AI 'winners' to fully emerge as companies seek to maintain their competitive advantage and ability to monetise their investments at a time when barriers to entry to the sector appear to be falling away.

The consensus view is that AI will boost economic growth via higher productivity, but it will also impact employment, with the International Monetary Fund (IMF) estimating that around 40% of global employment is exposed to AI. Historically, innovation in automation and technology has generally impacted routine tasks, but the IMF notes that AI will also affect high-skilled jobs. Predictions on the scope of impact on economic growth vary. Accenture estimate that by 2035 AI could double annual global economic growth through improved productivity, 'intelligent automation' and an acceleration in innovation. PwC estimate that global GDP has the potential to increase by 14% by 2030 thanks to AI, helped by a digital revolution with data generated from the 'internet of things', productivity gains in manufacturing and services as businesses complement and assist their existing workforces with AI technology.

The end of American exceptionalism?

An emerging narrative over 2025 has been a challenge to the concept of US exceptionalism. This is a theme that has gathered pace in recent years thanks to the dominant returns of US equities, the strength of the US economy, the rise of the US dollar and the emergence of the 'Magnificent 7' companies. However, with the US pursuing a more isolationist agenda the strength of the US has been questioned, along with a shift in the US being seen as a trusted trading partner. The US dollar has weakened significantly and concerns continue to mount over the trajectory of the US deficit, with successive governments running budget deficits usually only seen during times of recession or crisis. The US national debt has more than doubled since 2000 to more than 120% of GDP.

Investors have begun looking elsewhere given the more negative mood around US assets. European equities have seen a strong first six months of the year, helped by a much more positive narrative around government spending, predominately on defence but also on infrastructure. Pragmatism around budget deficits being extended to fund higher defence spending, and a seismic shift in German politics around the loosening of the debt brake to fund defence spending and fiscal stimulus has helped shift perceptions on Europe. A more positive 'self-help' story is emerging. China has also seen renewed focus, and while we have so far only seen incremental stimulus, including interest rate cuts, there is a perception that government policies have begun to stabilise the country's housing market, which should in time boost consumer sentiment and spending. With both European and EM equities looking cheap relative to the US, investors looking to diversify from US assets now appear to be broadening their horizons.

After a stellar few years of outperformance, policy confusion and recent underperformance from some of the 'Magnificent 7' stocks has led some investors to question whether this is the end of US exceptionalism. The near-term prospects for US equities are not just about tariffs – the direction of the S&P500 may well be influenced equally by the ability of some of the mega-cap tech companies to monetise their investments in AI and justify some significant gains over recent years. It has been foolish to bet against the US over recent years, and only time will tell if the Trump era is a definitive shift to a

much more isolationist America and a new world order. Despite all the noise, the US is still expected to see stronger economic growth than any other G7 country, both this year and next. Investors should expect something of a soft patch in the US economy following a period where many companies have tried to front-run the tariffs. But over the long term we expect the dynamism and entrepreneurial spirit of the US to prevail. US equities continue to trade at higher multiples over other countries, but we believe the stronger earnings potential over time goes some way to justifying this premium.

A world orbiting around Donald Trump

So, the outlook as ever is uncertain, and arguably this is heightened by the unpredictable and unusual nature of policymaking under the Trump administration. This impacts both economics and geopolitics, but the resilience shown by financial markets in the face of such uncertainty is encouraging. Economic fundamentals remain reasonable, and companies and consumers have adjusted well to the 'new normal' interest rate environment. Earnings growth appears reasonable and the path of interest rates in most economies is lower – albeit not much lower. If the first six months of the Trump presidency are a guide, there will be more policy surprises along the way, and this may mean further market volatility. However, provided the economic and earnings fundamentals remain supportive, then such volatility should be seen as more of a buying opportunity than a reason to take risk off the table.

Financial markets and capital market assumptions



Introduction

In this section we describe developments in the financial markets and share our expected returns (geometric and net) and expected volatilities for 22 individual asset classes on a five-, 10- and 15-year horizon. Our expectations are current, market-based, consistent and incorporate the consensus expectations regarding economic growth and priced-in inflation as outlined in the previous chapter.

Jitzes

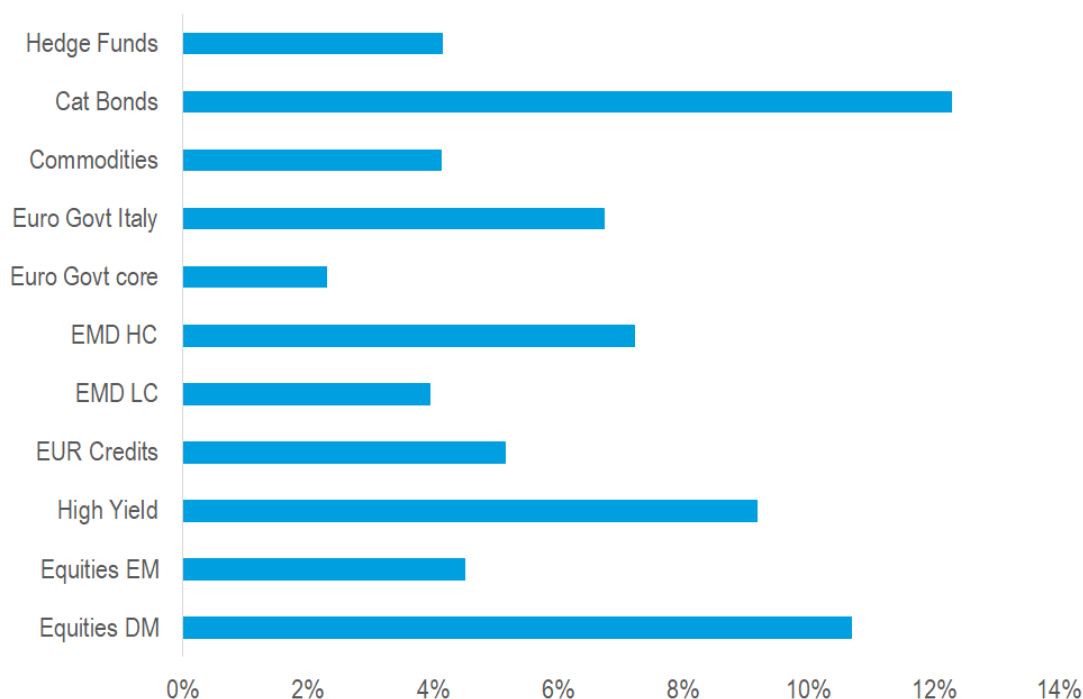
Noorman

Delegated CIO
& Investment
Strategist

Despite volatile swings in markets from time to time, and the geopolitical turbulence, in the year since our last Investment Outlook (July 2024-July 2025) all asset classes have generated positive returns in euro terms. This applies to both real assets and fixed income assets. Cat bonds yielded the highest return, followed by developed market (DM) equities and high yield.

Finally, it is striking that EM-related categories, whose currency risk is not hedged, underperformed slightly compared to DM equivalents, for both bonds and equities. The explanation is that EM currencies depreciated against the euro.

Returns in euros (hedged, EM & EMD LC unhedged), past 12 months of listed asset classes



Source: Columbia Threadneedle Investments, Bloomberg, 8 July 2025

As in the previous year, commodities and cat bonds are once again performing well in our capital market assumptions (CMA) model. The differences in attractiveness between equities, risky spread products and government bonds have not changed substantially. Similarly, for both equities and spread products the categories linked to EMs outperform those linked to developed markets in terms of the expected return/risk ratio.

Of course, our basic expectations are surrounded by the necessary uncertainty. The major drivers of financial markets in the coming year will include: the further course of the trade war; the sustainability of the national debt in many countries and especially in the US, Japan and France; the question of whether the Fed will succumb to pressure from President Trump; the ongoing geopolitical fragmentation; the course of the wars in Russia/Ukraine and in the Middle East; and AI.

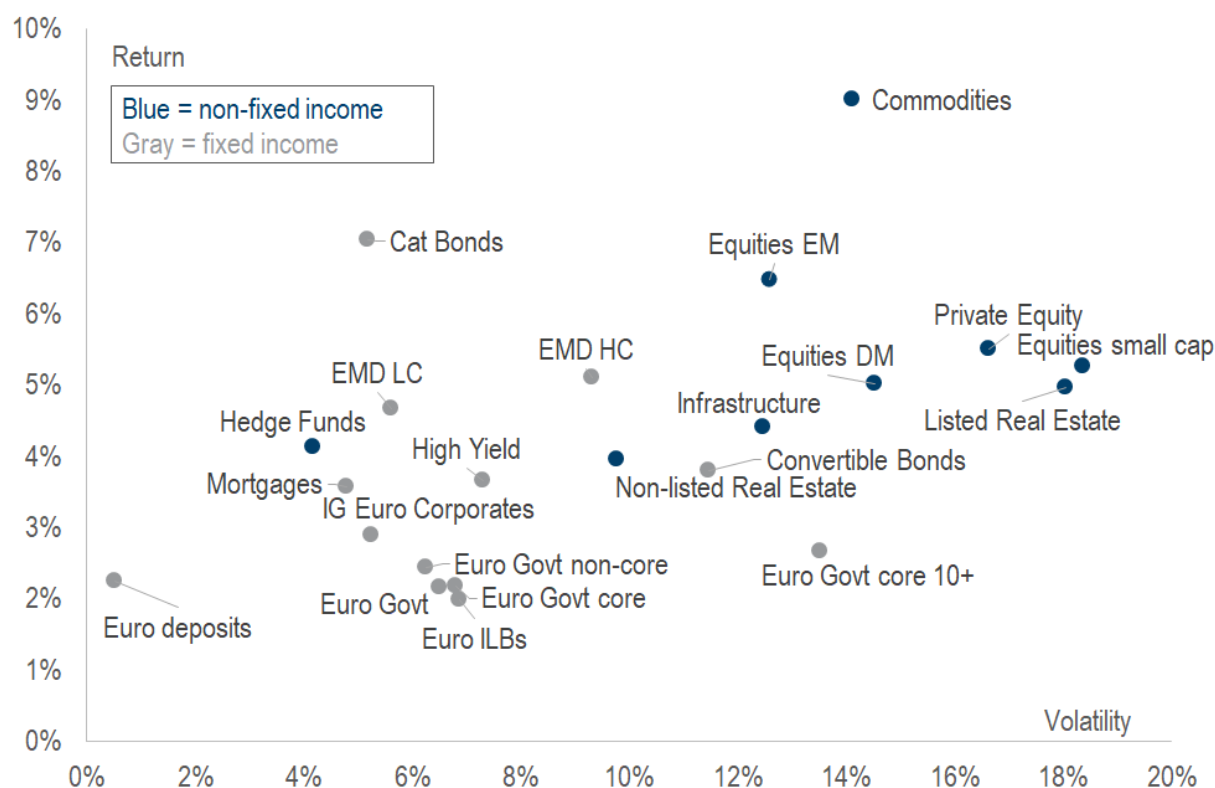
Given the baseline expectations are surrounded by a lot of uncertainty, we include a scenario analysis at the end of the chapter in which we calculate the impact on expected returns of higher inflation and lower growth than the consensus indicates.

Expected 5-, 10- and 15-year returns and volatilities (in euros)

		Return				Volatility		
	Asset classes	5 Year	10 Year	15 Year		5 Year	10 Year	15 Year
Listed Equity	Equities developed markets (EUR, hedged)	5.0%	5.5%	5.7%		14.5%	14.2%	13.2%
Listed Equity	Equities emerging markets (EUR, unhedged)	6.5%	7.3%	7.7%		12.6%	13.9%	13.8%
Listed Equity	Equities small caps (EUR, hedged)	5.3%	5.7%	5.9%		18.4%	18.1%	17.2%
Listed Alternatives	Listed real estate (EUR, hedged)	5.0%	5.4%	5.6%		18.1%	17.0%	16.3%
Listed Alternatives	Commodities (EUR, hedged)	9.0%	8.4%	8.4%		14.1%	13.8%	14.4%
Listed Alternatives	Convertible bonds (EUR, hedged)	3.8%	4.4%	4.7%		11.5%	10.7%	9.9%
Listed Alternatives	Catastrophe bonds (EUR, hedged)	7.0%	7.3%	7.6%		5.2%	4.6%	4.2%
Non-listed Alternatives	Private Equity (EUR, hedged)	5.5%	6.0%	6.2%		16.6%	14.7%	13.7%
Non-listed Alternatives	Non-listed real estate (EUR)	4.0%	4.4%	4.6%		9.8%	8.4%	8.1%
Non-listed Alternatives	Infrastructure (EUR, hedged)	4.4%	4.9%	5.1%		12.5%	11.7%	10.7%
Non-listed Alternatives	Dutch Residential mortgages (EUR)	3.6%	4.0%	4.3%		4.8%	3.7%	3.5%
Non-listed Alternatives	Hedge Funds (EUR, hedged)	4.1%	4.5%	4.7%		4.2%	4.7%	4.6%
Fixed Income	Emerging Markets Debt - HC (EUR, hedged)	5.1%	5.5%	5.8%		9.3%	9.0%	8.4%
Fixed Income	Emerging Markets Debt - LC (EUR, unhedged)	4.7%	5.6%	6.2%		5.6%	8.2%	8.4%
Fixed Income	High Yield (EUR, hedged)	3.7%	4.5%	5.1%		7.3%	7.9%	7.4%
Fixed Income	Investment grade Euro Corporates (EUR)	2.9%	3.2%	3.4%		5.3%	4.8%	4.5%
Fixed Income	Euro government bonds (EUR)	2.2%	3.0%	3.3%		6.5%	5.5%	5.3%
Fixed Income	Euro government bonds core (EUR)	2.2%	2.9%	3.1%		6.8%	5.8%	5.5%
Fixed Income	Euro government bonds core 10+ (EUR)	2.7%	3.1%	3.3%		13.5%	11.9%	11.5%
Fixed Income	Euro government bonds non-core (EUR)	2.4%	3.4%	3.6%		6.3%	5.9%	6.4%
Fixed Income	Inflation-linked Euro government bonds EUR)	2.0%	2.8%	3.1%		6.9%	6.0%	5.9%
Fixed Income	Deposits (EUR)	2.3%	2.6%	2.8%		0.5%	0.5%	0.4%

Source: Columbia Threadneedle Investments, CMA Model, July 8, 2025

5-year expected returns and volatilities (EUR hedged, EM & EMD LC unhedged)



Source: Columbia Threadneedle Investments, CMA Model, July 8, 2025

Equity markets

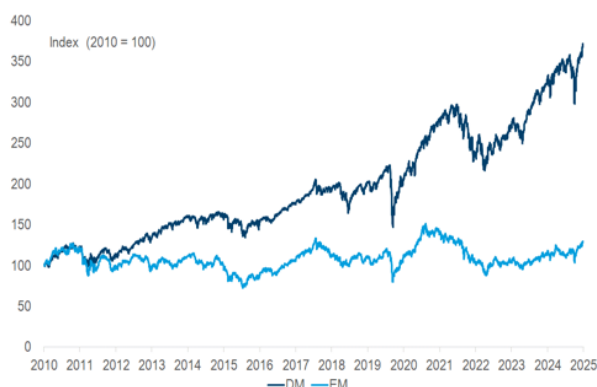
Over the past 12 months, equity markets have performed very well. The return on DM equities was 10.5% (euro-hedged) and the return on emerging market (EM) equities was 4.5% (euro-unhedged, up to and including 8 July 2025).

Developed market equities

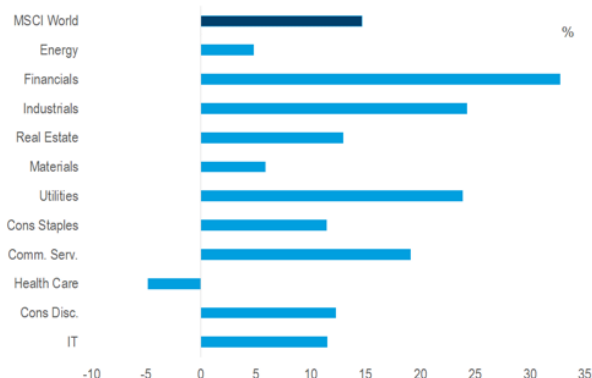
Explanations for the positive performance of equities are the better-than-expected economic growth, especially in the US; the investment plans in defence and infrastructure, especially in Europe and Germany; monetary easing; and Trump's US election victory and his plans for tax cuts and deregulation. AI optimism and investments also continue to be a driver of equity markets.

Geopolitical turbulence and wars in Ukraine and the Middle East failed to derail the equity market rally. However, Trump did with his announcement of 'reciprocal' import tariffs on 2 April ('Liberation Day'), which was followed by one of the biggest declines in decades. The S&P 500 saw a two-day 14.7% drop. The VIX index, an indicator of risk perception in the market, temporarily rose to 60%. The subsequent postponement of the import tariffs on 9 April caused a very strong rally, with the largest daily increase since 2008. Since then volatility has fallen back to a historical average level, a 'bull market' is back in place (more than a 20% rise from the low seen on 7 April) and the MSCI World Index has reached all-time highs in US dollar terms. A currency effect has also played a role, namely the depreciation of the dollar. Expressed in euro terms, the MSCI World Index is still about 8% lower than the peak in February.

MSCI stock indices (prices in USD)



MSCI World sector performance (USD, 1 year)



Source: Columbia Threadneedle Investments, Bloomberg, MSCI, 9 July 2025

The best performing sector in the past 12 months was financials. It benefited from a steeper interest rate term structure as well as Trump's deregulation plans. The healthcare sector was the loser, seeing a negative return. This can be explained by, among other things, Trump's plans to lower drug prices and the appointment of Robert F. Kennedy Jr – known for his doubts about vaccines – as the US Secretary of Health and Human Services.

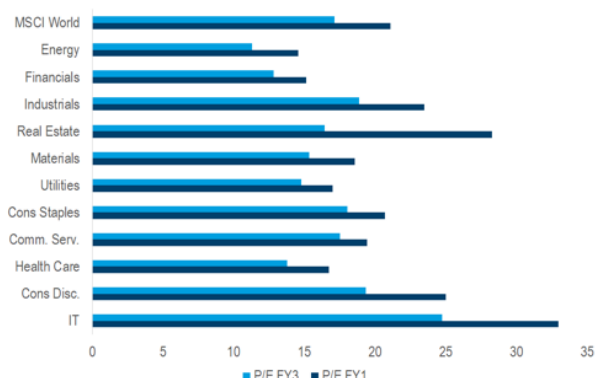
One of the best-performing stocks was the German defence company Rheinmetall with a price gain of 275%. The enormous defence investment plans of Germany and the EU (as well as NATO), with an increased spending target of 5% of GDP by 2035 (up from 2%), help explain this.

Regionally, Europe and Canada showed the highest equity returns in 2024, followed at a small distance by US equities. The laggard was Japan.

Price/earnings ratios DM and EM



P/E ratios sectors MSCI World Index



Source: Columbia Threadneedle Investments, Bloomberg, MSCI, based on expected earnings, 9 July 2025

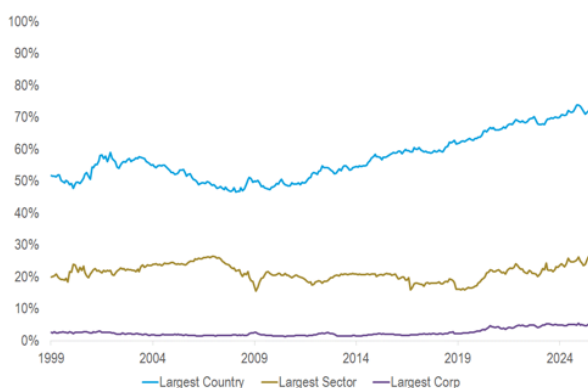
Among investors, we observe two concerns that are partly related, namely the valuation of equities and the large weight of the US in portfolios.

Valuations – still afraid of heights but with nuances

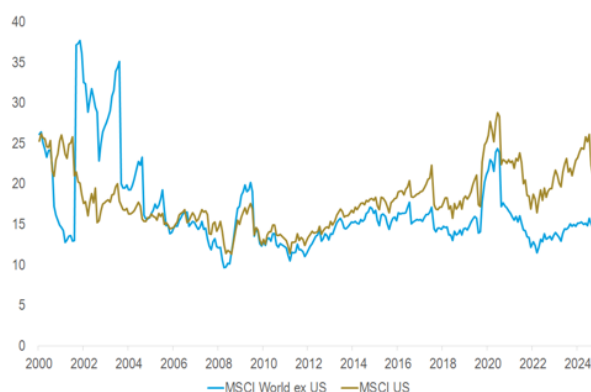
The title of our Investment Outlook 2025 was 'Fear of heights', which is still justified. Hence this year's title 'Balancing at great heights'. Although equity prices rose over the past year partly due to rising corporate earnings, some of the rally can be attributed to the further increase in the price-to-earnings (P/E) ratio of the MSCI World Index from 20 to 21 (based on expected earnings). This occurred while government bond yields continued to rise and government debt in Europe and especially in the US has increased. Furthermore, geopolitical risks have not diminished and government policy in the US has become more unpredictable and autocratic.

However, there are some nuances. For example, the market assumes revenue growth of +10% in the coming years. These high growth expectations can explain the current high valuations. For example, the P/E ratio based on expected earnings for the third fiscal year is 17 instead of 21, based on the first fiscal year. Another nuance is that government debt is increasing, and with it the credit risk. This justifies a lower equity risk premium compared to bonds and therefore a higher valuation. Furthermore, geopolitical risk is very high, as is inflation risk. In such an environment, real assets are preferable, which can also explain relatively high share prices. Finally, there is the necessary variation in terms of valuations. For example, the energy sector has a P/E ratio of around 11, while the information technology (IT) sector has a P/E ratio of around 25. The latter can be attributed to high growth expectations partly as a result of AI.

Weights MSCI World Index



P/E-ratios (based on expected earnings)



Source: Columbia Threadneedle Investments, Bloomberg, MSCI, 9 July 2025

Concerns about US exposure in equity portfolios

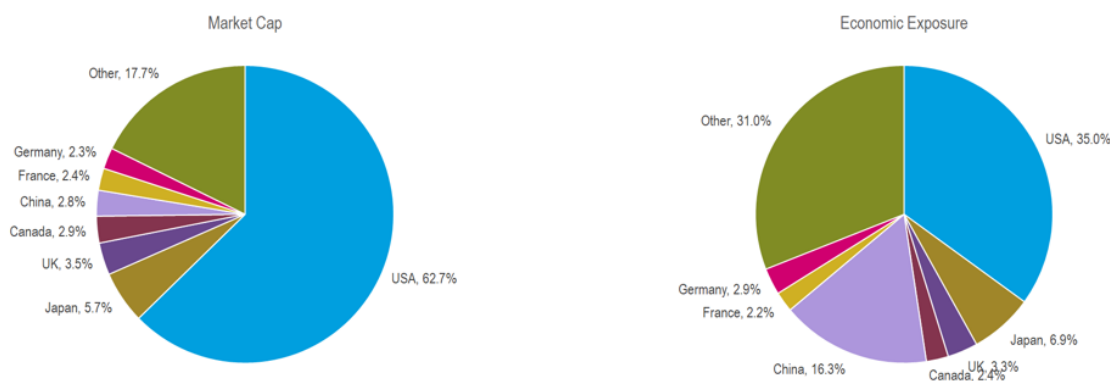
European investors are concerned about US exposure in their equity portfolios. There are three reasons for this from an investment perspective, all of which are valid, but there are also nuances.

Concentration risk

The weight of the US in the MSCI World Index is currently 71.9% (as of 30 June 2025). This is roughly equal to the weight a year ago, and slightly lower than the peak of 73.9% seen at the end of 2024. The current figure is such a high weight that there seems to be a concentration risk in terms of regional distribution.

However, this weight is not exceptional from a long-term perspective, and in the 1960s, for example, there was an even higher weight. Furthermore, in the MSCI indices, companies are allocated to countries based on legal establishment and primary share listing. This classification does not have to correspond to economic exposure. For example, many large US companies generate their revenues outside the US. Finally, within DM equities, sector allocation is more important than country diversification, as sectors have a lower correlation than countries. And as far as sectors are concerned, there is sufficient diversification (the largest sector has a weight of 26%). However, it should be noted that, looking ahead, the correlation between countries may decline as a result of geopolitical fragmentation.

Regional distribution of MSCI ACWI Index (DM+EM) based on two perspectives



Source: Columbia Threadneedle Investments, MSCI, May 31, 2025

High valuation

Looking at P/E ratios, US stocks at 24x have become 'more expensive' compared to the rest of the world (around 16x) in recent years. A P/E ratio that is approximately six points bigger is high from a historical perspective.

Part of the higher valuation can be explained by the fact that the US stock market has a different composition. For example, it has a significantly higher IT weight (33% versus 9%). But even if compensation is provided for sector allocation, US equities still have a higher P/E ratio. US bulls will argue that this is justified because the US economy is growing faster and because US mega-caps are better positioned to benefit from the AI boom.

Policy risk

President Trump's policies create a lot of uncertainty. This also raises questions about the exposure to US equities. His policies can have both a positive effect on growth (tax cuts and deregulation) but also a negative effect (trade wars). For the time being, the consensus assumes higher growth in the US than in the eurozone in the coming years. Although Trump is an uncertain factor, the Bloomberg Economic Policy Uncertainty Indices indicate that uncertainty in Europe is at least as high (see the graph in Chapter 1).

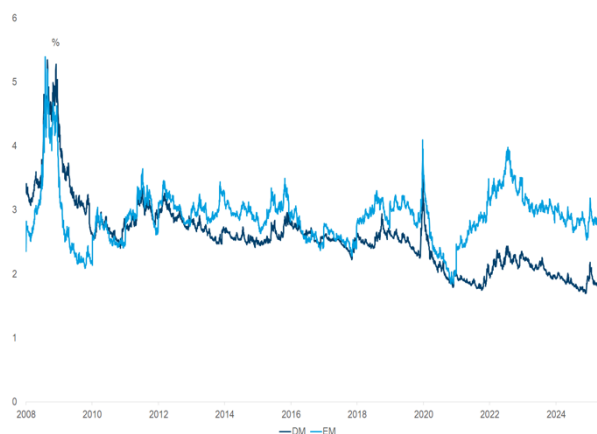
Possible adjustments

For investors who want to make adjustments to their US exposure, we see a number of opportunities. One way is for investors who do not yet fully hedge the US dollar exposure of their equity portfolio to do this by 100%. The stock market correction earlier this year was accompanied by a depreciation of the US dollar. Alternatively, the weight of US equities can be reduced, either through a country limit or through alternative weighting methodologies such as GDP-weighted indices. However, this must be in line with the investment beliefs of individual investors. It should also be borne in mind that deviations entail arbitrary choices ('height limit' and 'which methodology'), and may reduce the product availability (for example, from the perspective of climate indices).

Expected return on developed market equities

The assumption in our CMA model is that the return on shares is theoretically equal to the income return plus the price return.

Expected dividend yield MSCI Indices



Components 5Y expected return DM equities



Source: Columbia Threadneedle Investments, Bloomberg, MSCI, CMA model, July 8, 2025

We link the income return to the outlook for dividend yields and net buybacks. We also link the assumed price return and the assumed earnings per share growth to market-based expectations for economic growth and inflation. An adjustment is then made for hedging the currency risk. On a euro-hedged basis, this is currently resulting in a decline because US dollar rates are higher than euro rates. Finally, an adjustment is made for the valuation. This component can be positive or negative, and the contribution of it is theoretically zero in the long run. Our long-term target (modelled on volatility and forward rates) for the MSCI World Index's P/E ratio indicates that DM equities are currently overvalued. This valuation perspective therefore currently depresses the expected return.

Ultimately, this results in an expected return for DM equities of 5.0% on a five-year horizon and 5.7% on a 15-year horizon. These are nominal expected returns. Adjusted on the basis of inflation swaps, the five-year expected real return amounts to around 3.2%.

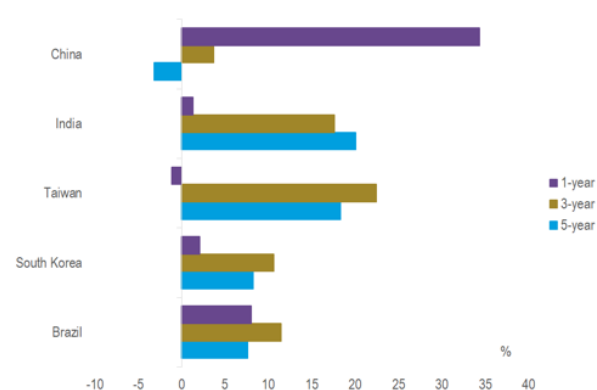
Emerging market equities

EM equities returned 4.5% in the past 12 months on a euro-unhedged basis. That was lower than the return on DM equities. This can be attributed to the fact that the currency risk on EM currencies is not hedged, and that over that period there was a depreciation of these currencies versus the euro of a few percentage points. Another explanation is that EM equities on average had no monetary stimulus, as central bank interest rates were raised on average, while developed countries saw interest rate cuts by central banks.

Relative return EM versus DM



Performance MSCI EM countries (local terms)



Source: Columbia Threadneedle Investments, Bloomberg, MSCI, DM yield = euro hedged, EM yield = euro unhedged, 8 July 2025

EM performance varied widely between countries. In local terms, the Taiwanese (-1%), Indian (+1%) and South Korean (+2%) equity markets were the laggards over the past 12 months. After years of underperformance, the Chinese stock market was the outperformer with a return (in local terms) of 34%. Forces behind this rally were government stimulus and the IT sector. Finally, Brazil was a mid-ranking performer with a return of +8%.

The consumer discretionary sector was the best performing sector in emerging markets in the same period, and utilities the worst. One of the best performing companies was Xiaomi Corporation, a Chinese manufacturer of smartphones, tablets and wearables, and since 2023 electric vehicles.

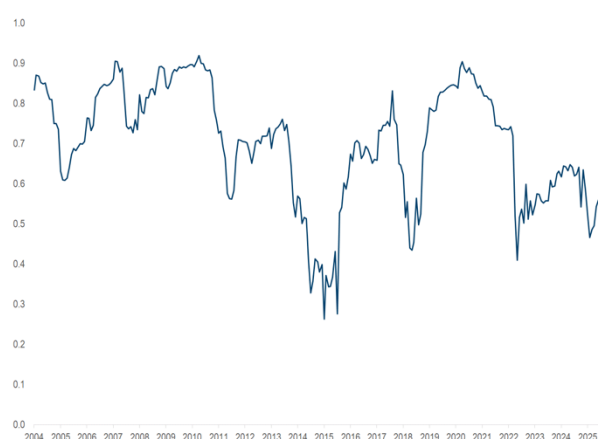
In terms of regions, the MSCI Emerging Markets Index is significantly more diversified than the MSCI World Index. The largest country in the EM index is China with a weight of 28%. The largest sector (financials) has a weight of 24%.

Despite, or because of, several years of underperformance, emerging markets are expected to outperform developed markets. First of all, the consensus assumes an economic growth of around 1.5 to 2 percentage points higher for emerging countries. In addition, the valuation gap has widened in recent years in favour of emerging markets. The difference in (expected) P/E ratios between emerging markets (13.5x) and developed markets (21x) is currently 7.5 points, while the expected dividend yields also imply that emerging markets are relatively attractive. Incidentally, the MSCI EM Index average P/E hides large differences. For example, the Indian market has a P/E of 25x while China currently only has a P/E of 12x.

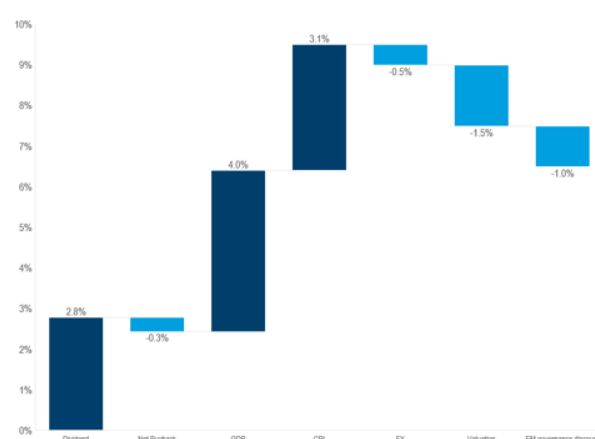
Another perspective that favours EM equities is that the current correlation between DM and EM equities is relatively low (0.55) from a historical perspective, so EM equities offer diversification from a portfolio perspective.

The main risk for EM equities are the import tariffs imposed by Trump and a further escalation of the trade war.

Correlation between DM and EM shares MSCI



Components 5Y expected return EM equities



Source: Columbia Threadneedle Investments, Bloomberg, MSCI, CMA model, July 8, 2025

Expected return on emerging market equities

The methodology for the expected return for EM shares is very similar to that for developed markets. The only difference is that we also apply a discount (-1%) to EM equities due to a lower governance score, highlighting the difference between the two markets.

The expected dividend yield is 2.8%. This is significantly higher than for developed markets. On the other hand, the net buyback yield is negative (-0.3%) because in emerging markets – in line with expectations and the phase of development – more shares are issued than are bought back. Meanwhile, the expected price return (linked to the growth and inflation outlook) comes in at 7.1% and is higher than the assumption for developed markets. In terms of valuation, our CMA model indicates that EM equities are also overvalued. Finally, there is an FX exit for the conversion to euro unhedged returns.

Ultimately, our CMA model generates an expected return for EM equities of 6.5% on a five-year horizon and 7.7% on a 15-year horizon (expressed in unhedged euros). The difference in expected returns between EM and DM on a five-year horizon is 1.5 percentage points (in our previous outlook the difference was 1.3 percentage points).

Fixed income

Government bonds and swap rates

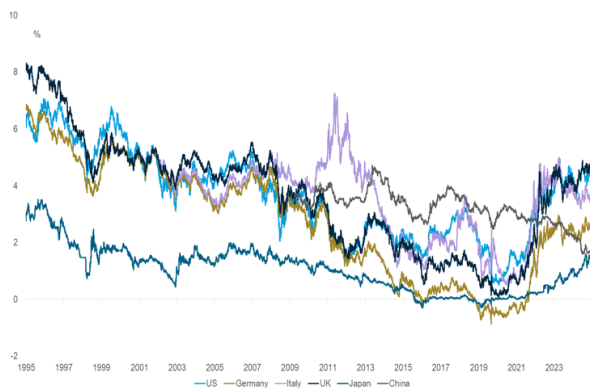
Interest rate developments varied by country and maturity over the past 12 months. For example, short-term interest rates in the eurozone and the US fell in line with interest rate cuts by central banks. Capital market interest rates, on the other hand, rose in many countries, especially in very long maturities. Whereas in 2024 there was still an inverted curve in the eurozone, the interest rate term structure now has a positive steepness. For example, the 30-year euro swap rate is +84 basis points higher than the one-year rate, while a year ago the 30-year rate was about 1 percentage point below the one-year rate.

The US 10-year Treasury yield rose by about 0.1 percentage points to 4.4% and the 30-year Treasury yield by almost 0.5 percentage points to 4.9%, with a temporary peak above 5%. The reasons behind this are a still well-functioning US economy, and the partial pricing of interest rate cuts by the Fed. The 'exceptional' status of US Treasuries was also affected by Trump's policies, deteriorating international relations and rising US national debt.

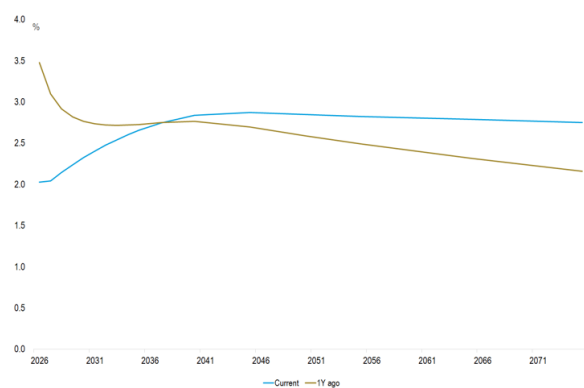
In Europe the picture was mixed. The German 10-year government yield rose on balance by 15bps to 2.68%. This was prompted by the substantial investment plans in infrastructure and defence. France also saw its 10-year yield rise by 20bps to 3.36%. In Spain and Italy, on the other hand, interest rates remained the same or fell; growth optimism reduced the risk premium compared to the core countries. In the United Kingdom, interest rates rose by around 0.5 percentage points to 4.63%, partly due to budget concerns.

In Japan, the 10-year government yield rose by 40bps to 1.49%, boosted by tighter monetary policy and higher inflation. Finally, long-term interest rates in China fell by around 60bps to 1.64%, driven by PBoC rate cuts, ongoing economic concerns and easing inflationary pressures.

10-year government interest rates

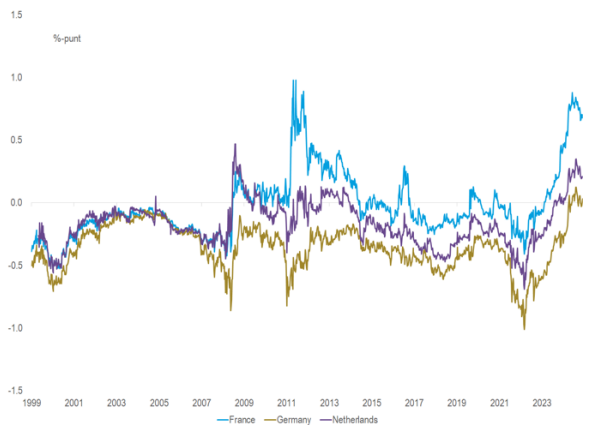


Euro swap curve

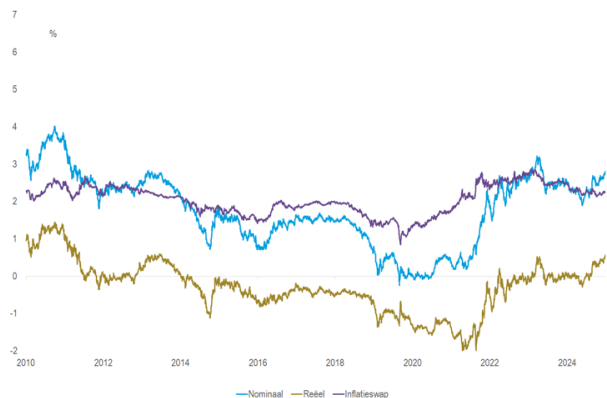


Source: Columbia Threadneedle, Bloomberg, July 9, 2025

10-year interest rate gap: state minus swap



30-year euro swap rate including components



Source: Columbia Threadneedle Investments, Bloomberg, July 9, 2025

The 30-year euro swap rate has risen by 28bps in a year to 2.80%. Behind this are opposing developments: for example, the 30-year real euro swap rate component increased by 52bps to 0.55%, while the 30-year euro inflation swap fell by 24bps to 2.25%.

Interest rate differentials between core euro government bonds and interest rate swaps have risen over the past year. The causes are the increasing public debt and the extensive infrastructure and defence plans in Europe, in combination with a further tapering of the ECB's purchase programs. For example, the German 10-year government swap spread has risen by about 0.3 percentage points and the 10-year German government yield is 3bps above the swap. The Netherlands and France also saw swap spreads rise further to 20bps and 70bps respectively. In particular, there is a significant swap spread increase in long maturities. The fact that Dutch pension funds have increased their interest rate hedges in recent years may also have played a role, mainly through interest rate swaps.

The markets are pricing in a moderate rise in interest rates for the eurozone. On a five-year horizon, the forward figures point to an increase of only 10bps in the 30-year euro swap rate. For long-term government interest rates the market is pricing in more increases. Combined, this means the market is pricing in a further increase in state-swap spreads. Nevertheless, we think swap spreads in the eurozone could narrow again next year as a result of the transition of Dutch pension funds to the new pension system and the forced phasing out of long-term interest rate swaps.

In terms of interest rates, we see several forces that can lead to divergent paths. For example, the development of the public debt per country and the extent to which markets think it is sustainable will play an important role. Countries such as the US and France have large budget deficits and rising government debt ratios. They have also seen their creditworthiness downgraded within the past eight months. At the same time, there are countries with declining debt-to-GDP ratios whose ratings are being upgraded or have a positive outlook, such as Portugal and Spain. These countries can show different interest rate developments. Another factor is the trade war. If Trump does eventually introduce hefty import tariffs, it could lead to higher inflation in the US and therefore higher interest rates, while in exporting countries it could lead to lower inflationary pressure and therefore lower interest rates.

The expected returns for euro government bonds from core countries is positive on all horizons: +2.2% on a five-year horizon and +3.1% on a 15-year horizon.

These expectations are based on the starting interest rate levels and the forward paths of the various governments over the next 15 years. This results in a yield return, a roll-down return and a price return for each calendar year. To illustrate this, the forwards for the Dutch 10-year interest rate assume an increase of 0.8 percentage points on a five-year horizon, and a fall of 0.7 percentage points to slightly above the current level in the subsequent 10 years. So, there is virtually no price loss expected given this forward path over the entire 15-year period, but a price loss in the first five years. Across the horizon, the income return (interest rate level and roll-down) is the most important factor.

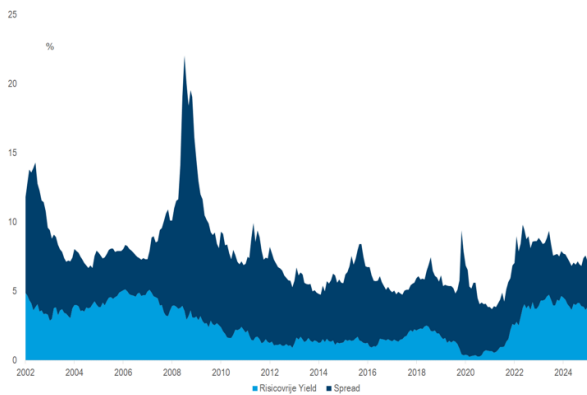
The methodology for A-BBB-rated euro government bonds in our CMA model is almost identical to that for core countries, with the addition of a small discount applied for credit losses for this category based on creditworthiness and historical default statistics. Euro government bonds from non-core countries are attributed an expected yield of 2.4% on a five-year horizon and 3.6% on a 15-year horizon. The forwards do point to a slightly higher interest rate rise for peripheral countries, but that is more than made up for by the higher starting yields.

Spread products

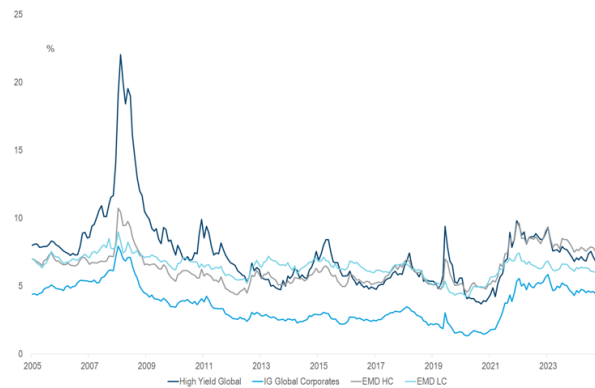
The performance of higher risk bond categories over the past 12 months has been positive for all categories in euro terms. High yield bonds yielded a return of 9% (euro-hedged), followed by emerging market debt (EMD) hard currency (HC) with 7% (euro-hedged). Coupon income and price gains as a result of falling spreads – in line with the positive sentiment on equity markets – explain the good performance. The return on euro investment grade corporates (5%, euro) and EMD local currency (LC) (4%, euro-unhedged) was also positive but slightly lower than HY and EMD HC. In the case of IG corporates, this is due to lower interest rates and the fact that the spread decline was less significant than on other categories. In the case of EMD LC, the explanation is that the currency exposure is unhedged and emerging market currencies depreciated against the euro.

Spreads on high yield and EMD HC decreased by -0.3 percentage points to 3.96% and -0.8 percentage points to 3.10% respectively. The spread on euro IG corporates narrowed by 22bps to 0.85%. Spreads are therefore significantly below the 10-year average. This is particularly true for spread products linked to developed markets (high yield and IG corporates).

Composition of global high yield interest rate



Yields on spread products



Source: Columbia Threadneedle Investments, Bloomberg, JPMorgan, July 2025

Essentially, the outlook for spread products is positive. For example, positive economic growth in the US and Europe is assumed, and central banks have started to pursue a more accommodative policy.

Yet there are risks. For example, policy uncertainty is high and the further course of the trade war is uncertain. Furthermore, the percentage of defaults is expected to increase, partly because companies that financed themselves with low interest rates a few years ago will see these costs increase in the event of refinancing. Finally, spreads are already low from a historical perspective, limiting the scope for further decline.

Returns for spread products are modelled in a similar way to those for government bonds. Based on starting interest rates, expected interest rates and durations, income, carry and exchange rate returns are calculated for the various calendar years. The only addition is the interest rate path, which consists of a separate path for the risk-free interest rate component (based on the forwards) and for the spread component, which moves from the prevailing level to the long-term average at that time. Reductions are also applied for credit losses, based on long-term statistics from credit rating agency Moody's per rating category. The reductions used are higher than the historical averages if the VIX index is also higher than average.

Finally, the yields are translated into euros for categories not yet denominated in euros. In line with the 'interest parity' theory, we do this on the basis of interest rate differences between the various currencies and the euro. Given the current differentials, this is resulting in a lower expected return expressed in euros.

On a five-year horizon, the CMA model currently results in expected returns of 2.9% for euro IG corporate bonds, 3.7% for high yield (euro-hedged), 4.7% for EMD LC (euro unhedged) and 5.1% for EMD HC (euro-hedged). The expected returns for spread products linked to developed market currencies (corporate, high yield, EMD HC) are lower than the past 12 months. The expected return for spread products linked to emerging market currencies (EMD LC) is almost the same. From a return/risk perspective, EMD LC bonds are currently the most attractive spread category, according to our CMA model.

Alternatives

Real estate¹

The European real estate market will continue to show a mixed picture. After the sharp value corrections of 2022 and 2023, and subsequent recovery in 2024, we are seeing signs of stabilisation in several segments, particularly in residential and logistics real estate. Investors are showing themselves to be more active again, supported by the expectation of further interest rate cuts. In the first half of 2025, core real estate valuations increased slightly, although transaction volumes remain below the long-term average.

European housing performs relatively well, especially in urban areas with persistent scarcity. The demand for affordable rental housing remains structurally high. In the logistics segment, fundamentals remain robust with solid demand from e-commerce, but the period of explosive rental growth seems to be behind us. New developments are being delayed by increased construction costs and stricter sustainability requirements, which can support occupancy rates and rents in the long term.

Office real estate remains the weakest segment. Although rents for prime offices in prime locations sometimes grow strongly, elsewhere we see higher vacancy rates, falling rents and write-downs. The structural shift to hybrid working continues, making secondary objects challenging. Within retail real estate, the picture is mixed: convenience retail and food-anchored locations continue to retain interest, while high street retail locations in less attractive cities remain under pressure.

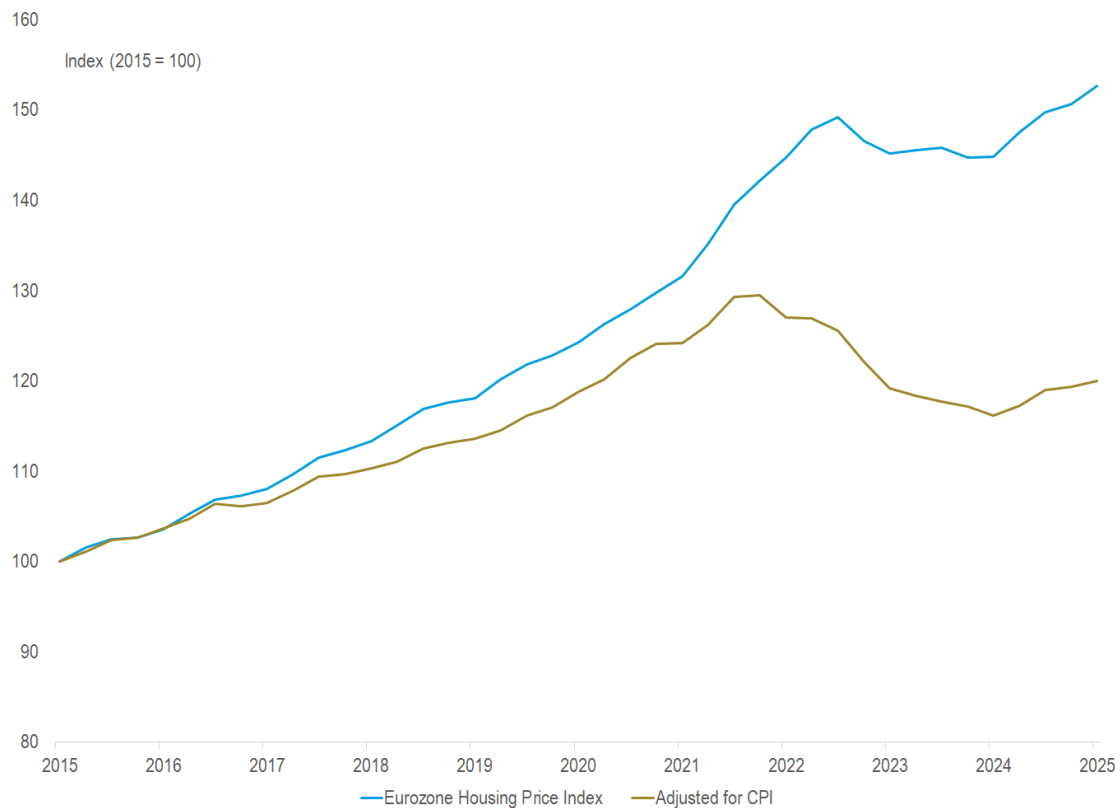
Alternative real estate sectors have continued interest because they are highly dependent on demographic trends. Student housing, healthcare real estate and data centres are showing robust performance, with higher occupancy rates and strong rental growth. Europe's ageing population is supporting demand for healthcare real estate, while the growing student population in countries such as the UK, Ireland and Spain is putting continued pressure on student housing. These sectors appear to be more resilient to economic fluctuations due to their focus on structural needs.

Returns and prospects also vary significantly by country, with Spain, Ireland and the UK being relative outperformers for 2025, while countries such as Germany and France have weaker growth prospects. These differences are driven by different economic structures, political circumstances and demographic developments. For example, the Spanish economy is benefiting from strong growth in the services sector and an expanding manufacturing industry.

Looking ahead, the recovery in the European real estate market remains dependent on the path of interest rates, inflation expectations and economic growth. Institutional investors remain cautious but are showing more interest in high-quality, sustainable real estate with long leases. In many sectors, the correction phase is over. Selectivity remains crucial.

¹ Thank you to Yno van Haaster, Director, Multi-Manager Solutions, Alternatives, for his input on this section.

Eurozone house price index



Source: Columbia Threadneedle Investments, Eurostat, Bloomberg, Q1 2025

The starting point in our CMA model for listed real estate is our expectation for regular listed equity developed markets. However, the returns are adjusted for the greater interest rate sensitivity of real estate and are based on forward rates and an estimated sensitivity.

For non-listed real estate we structurally apply a 1% lower risk premium than listed real estate, given the lower risk profile and relatively low leverage. For this category too, a possible interest effect is taken into account.

On a five-year horizon we use an expected return for listed and non-listed real estate of 5.0% and 4.0% respectively.²

Commodities

With a positive return of 4% (euro-hedged), commodities have been a mid-ranking performer over the past 12 months. The spot return – or change in commodity prices – made a positive contribution. Precious metals such as gold showed the largest price increases. Geopolitical turbulence, inflation fears, distrust in the traditional financial system and the dollar, and central bank purchases all contributed to this.

The roll yield on commodity futures made a negative contribution, but this was offset by a positive return on collateral.

² To support clients with the design of real estate portfolios, we also developed CMAs specifically for individual real estate sectors in Europe.

Commodity futures return by category (total return in USD)



Source: Columbia Threadneedle, Bloomberg BCOM Index, July 8, 2025

Commodities are one of the most volatile and difficult to predict asset classes. With this in mind, commodities futures are currently assigned an expected return of 9.0% on a five-year horizon in the CMA model.

We use three expected sources of return for commodities in our CMA model. The expected spot return is significantly positive, based on positive expected global inflation in combination with a multiplier. The roll yield is still negative, which is based on a long-term average. The expected return on collateral is positive and is assumed to be equal to the forward path for the US money market interest rate (currently 4%). Finally, an adjustment is made for the conversion to a euro-hedged basis.

However, a very important disclaimer with these CMAs is that good performance of commodities is not a guarantee. Inflation must be driven by commodity prices. If, however, future inflation is driven by second-order effects such as higher wages or rents, commodities will not benefit.

Other alternatives

Expectations for small caps and private equity are simply defined as the expected return on equities including a premium of 0.25 percentage points and 0.5 percentage points respectively (as explained in our Investment Cases). On a five-year horizon this results in an expected return of 5.3% and 5.5% respectively.

For infrastructure, a discount of -0.5 percentage points versus equities is used, as well as an adjustment for higher interest rate sensitivity. On a five-year horizon this results in an expected return of 4.4%.

For convertible bonds we apply 'mapping'. For example, the expected return is a combination of the assumptions for IG corporate bonds, high yield and DM equities, minus a discount for the implicit option that is purchased. On a five-year horizon, this results in an expected return of 4.1%.

For hedge funds we use a weighted average of the expected return on equities and cash+premium as the expected return. On a five-year horizon this results in an expected return of 3.8%.

Finally, the expected return for cat bonds is based on forward projections for US money market interest rates in combination with a 'mean-reversion' approach for the spread on the cat bonds, minus a discount for the expected loss due to natural disasters. An adjustment is also made for hedging the currency risk. On a five-year horizon this results in an expected return of 7.0%. That is high given an expected volatility of only 5.2% on this same horizon. Why? First of all, this category is structurally characterised by a low standard deviation compared to the return (the 'cliff risk' is not included in this risk measure). The innovative and complex nature also plays a role, as it means investors demand a higher risk premium. Finally, the money market interest rate as a remuneration on the collateral currently contributes about half to the high expected return.

Scenario analysis

As outlined in this outlook, economic uncertainty is currently very high. Therefore, in this section we carry out a scenario analysis in addition to the baseline outlook.

The main economic risks of geopolitical turbulence are higher inflation and lower growth. Our CMA model is able to calculate the impact of immediate and permanent inflation shocks and/or economic growth shocks on the expected returns of the different categories and on different horizons (five-year, 10-year and 15-year). The scenarios are relative and expressed as the difference versus the consensus expectation for inflation and economic growth.

In the fixed income categories, higher inflation or higher economic growth, via higher nominal interest rates, initially have a negative price effect and vice versa. The extent depends on the duration per category. At the same time, a higher nominal interest rate will also result in a permanently higher income and higher coupon income, and vice versa. Over time this income effect compensates for the initial price effect, so that on a longer investment horizon there may ultimately be a higher expected nominal return. The shorter the duration of a fixed income category, the sooner this effect occurs.

There is an initial negative effect for shares. There is also a positive relationship between bond yields and earnings yields (the inverse of the P/E ratio). Higher interest rates therefore go hand in hand with higher (required) earnings yields for equities or lower P/E ratios. Because profits do not immediately rise with rising interest rates, this means lower stock prices, and therefore lower expected equity returns, in the short term. Then there is the long-term effect of expected higher (nominal) corporate profits and higher dividend income that will lead to higher expected equity returns.

So, the short-term and long-term effects are also opposite for equities. DM equities are more sensitive to yield changes than EM equities due to the higher P/E ratio and therefore the lower earnings yield (the inverse of the P/E).

For most other categories, inflation and GDP scenarios affect the expected return in a similar way, or via a so-called 'mapping' method in which the calculations for one category are derived from a combination of outcomes for other categories.

Impact of the 'high inflation' scenario

The following graphically shows the impact of a +1% inflation scenario (a permanent +1% shock on top of inflation in the baseline scenario) on the expected returns over a five-year, 10-year and 15-year investment horizon.

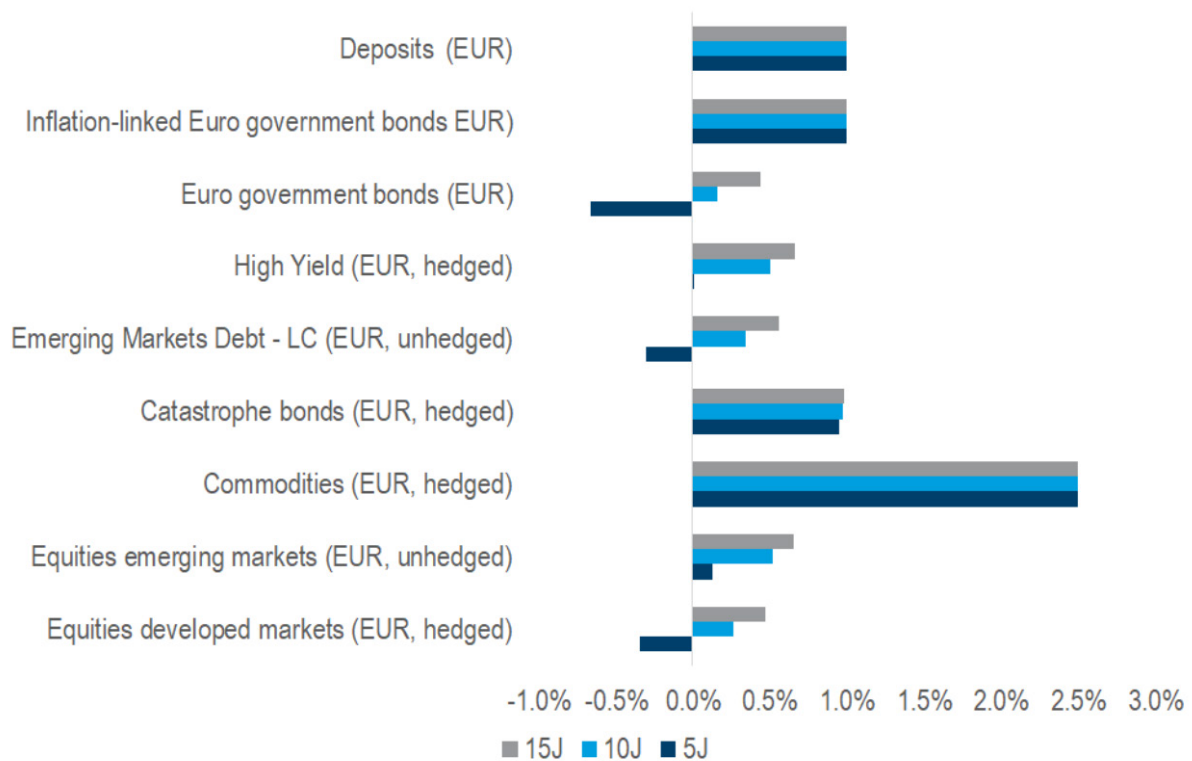
The main observations are as follows:

- Most categories react negatively on a five-year horizon due to negative price effects around higher inflation
- Ultimately, in nominal terms at least, almost all categories react positively on a 10-year and 15-year horizon. In real terms, returns are lower in almost all cases, with the exception of inflation-linked bonds (ILBs), deposits, cat bonds and commodities (the only category with a higher excess return than the excess inflation)
- Euro government bonds in core countries react most negatively, as a result of the long duration
- Spread products react less negatively than risk-free government bonds. Within the spread products, high yield bonds are initially the least affected and the positive effect on a 15-year horizon is the greatest. The explanation is the relatively short duration of high yield
- Within equities, EM equities are less affected than DM equities. The explanation is the lower price sensitivity due to a lower P/E ratio, which means the positive income effects tend to dominate.

A number of asset classes deserve special attention, as the initial price effects are less strong and the impact on income quickly dominates:

- **Inflation-linked bonds** – higher inflation does not lead to an initial negative price effect due to the inflation indexation of the principal (only changes in real interest rates affect the price of these bonds). However, income will increase immediately. This ensures that even on a short investment horizon, the (nominal) expected return of this category will increase, while that of other categories will decrease
- **Commodities** – here, too, higher inflation directly results in a higher expected return (even with a multiplier) without a negative price effect. Because of the multiplier, this is the only category where not only the nominal return increases, but there is a higher expected return in real terms
- **Absolute return categories** such as deposits, hedge funds and cat bonds, all with a variable money market component, are less affected by any initial price effects.

Impact on the nominal expected annualised return (difference compared to baseline on different investment horizons) due to 1%-point higher inflation



Source: Columbia Threadneedle Investments, July 2025

Impact of the 'low growth' scenario

The following graphically shows the impact of a -1% growth scenario (a permanent -1% shock compared to real economic growth in the baseline scenario) on the expected returns on a five-year, 10-year and 15-year investment horizon.

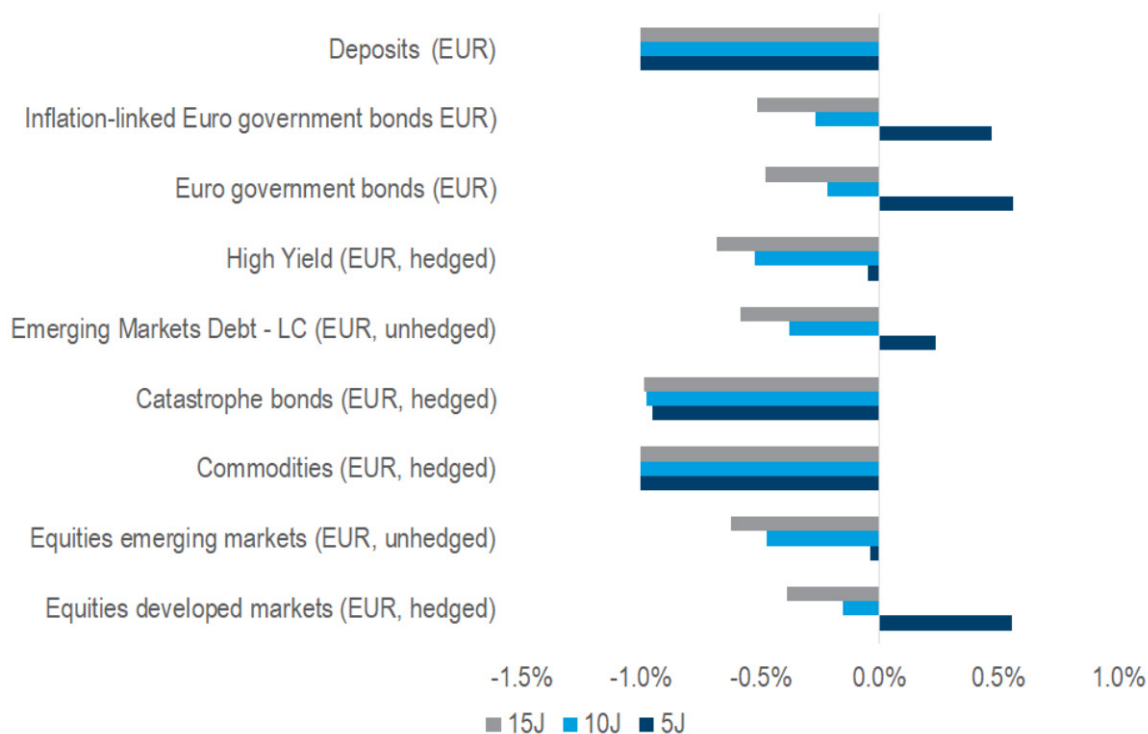
The main observations are as follows:

- There is no difference between the nominal and the real perspective. A change in growth has an identical effect on nominal and real interest rates
- Most categories react positively on a five-year horizon due to positive price effects around lower interest rates due to lower growth. This applies in particular to euro government bonds in core countries
- In the end, almost all categories react negatively on a 10-year and 15-year horizon, both from a nominal and a real perspective
- Spread products react less positively than risk-free government bonds due to a shorter duration, so the negative income effects quickly dominate
- Within equities, EM equities are affected more than DM equities. This is due to lower price sensitivity due to a lower price/earnings ratio, as a result of which the positive price effects (due to lower discount rates) are less able to compensate for the negative income effects.

A number of asset classes deserve special attention:

- **Inflation-linked bonds** – in this scenario ILBs react identically to nominal government bonds, as it is fixed real interest rates that change
- **Commodities** – the impact is negative due to lower money market interest rates on the collateral, and there are no positive price effects that compensate for this
- **Absolute return categories** such as deposits, hedge funds and cat bonds, all with a variable money market component, perform relatively poorly in this scenario. Variable interest income is falling in line with lower growth, without any one-off positive price effects.


Impact on the nominal expected annualised return (difference compared to baseline on different investment horizons) as a result of 1%-point lower economic growth



Source: Columbia Threadneedle Investments, July 2025

Depending on the scenario, the impact on returns is either positive or negative for most categories. One of the few categories that performs relatively well in both the higher inflation scenario and the lower growth scenario are ILBs.

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