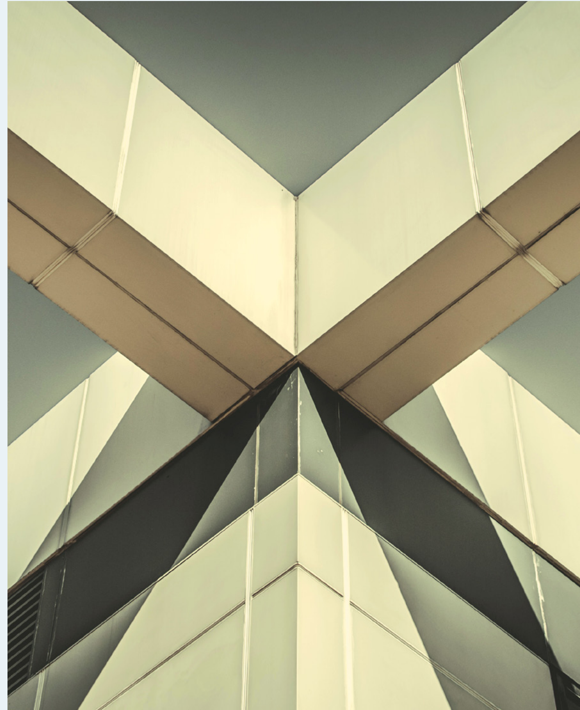
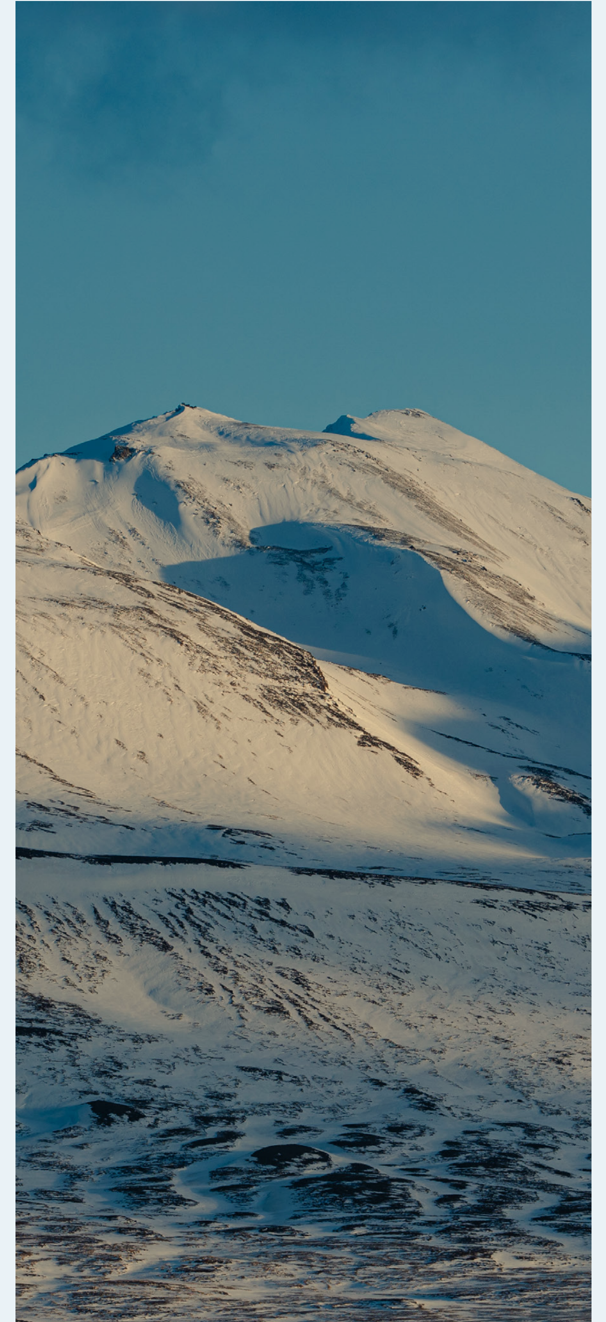


2025 Global Investment Outlook



A letter from Steve Peacher

Our 2025 Global Investment Outlook comes at a time of great change, uncertainty and opportunity across the world. In the previous year, we saw major shifts in the macroeconomic environment. In the U.S., Canada and other major markets, the conversation shifted from moderating inflation to buttressing economic growth. Central banks across the world went into easing mode, from the U.S. Federal Reserve to the Bank of Canada and European Central Bank.

On a geopolitical front, the globe also grappled with the grave consequences of armed conflict, several closely watched elections and the economic and human costs of significant weather- and climate-related disasters. At the same time, 2024 brought investors robust returns from a wide range of markets, including many fixed income asset classes.

However, several sources of uncertainty remain prevalent as we head deeper into the new year. These include those of a political nature, with an incoming U.S. administration raising expectations of both growth-friendly initiatives and the more sobering impact of tariff talk. The risks of ongoing global conflicts escalating even further remain top of mind as well. And observers are watching central banks closely, for signs of policymakers settling into a neutral rate or adopting a more stimulative mindset.

Consequently, questions remain as to what direction markets take from here. Will the above uncertainties translate into spread volatility in bond markets? Could the evolving rates environment affect market activity and volumes in public and private fixed income? Will we be seeing major shifts in other asset classes, such as real estate and infrastructure? What will be the impact on insurers and plan sponsors? And overall, where will asset managers be looking for opportunities in the months ahead?

That the events of 2025 could have varying effects on different investment types highlights the importance, in my view, of gathering the diverse views of our investment teams into one place. In the following pages, our specialists from SLC Management, BGO, InfraRed and Crescent Capital will share their perspectives. I hope you will find useful insights in our 2025 outlook, which can serve as a valuable tool for framing your investment and business strategies, engaging stakeholders and gauging what investors may be most concerned about in the new year.

On behalf of SLC Management, I wish you all the best in 2025.

Regards,

Steve Peacher

Executive Chair, SLC Management

SLC Management

Macroeconomic outlook

Market expectations caught between potential business-friendly initiatives and trade policy challenges

Dec Mullarkey

Managing Director, Investment Strategy and Asset Allocation

Unknowns heading into 2025

U.S. policy uncertainty is running high. A new president, whose party controls both branches of Congress, is championing an ambitious agenda. It contains the prospects of stimulus from tax cuts and lighter regulation. But it also comes with potential frictions and offsets from tariffs and an immigration crackdown.

That mix is hard to handicap, as some of the details remain vague, but markets are betting that growth will be prioritized and the net effect will be market friendly. The prospects of tax breaks and lighter regulation have already ignited a rally in equities. The potential for increased mergers and acquisitions has also led to an improved outlook for certain companies and sectors.

Nevertheless, the threat of tariffs, which typically lead to higher prices, could pinch consumers. Immigration reform is another issue that could prove inflationary, particularly if it materially shrinks labor supply. Undocumented immigrants comprise 40% of the agricultural work force, while in construction it is 20%. Both sectors struggle to attract domestic workers.

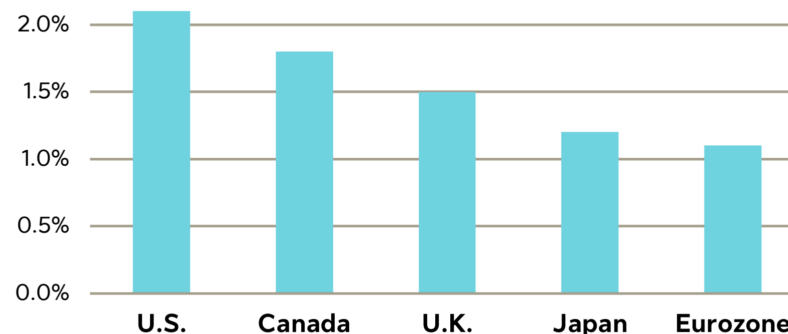
The market's confidence that President Donald Trump will be business friendly is supported by some of his cabinet recommendations. His nominees to lead the U.S. Department of the Treasury and U.S. Department of Commerce are both Wall Street veterans that can ably advise on crafting policies to avoid adverse market reactions. Opting for experienced hands from within the system certainly shows pragmatism. Similarly, he has nominated an industry CEO to lead the U.S. Department of Energy.

What are economists and markets expecting?

While the U.S. political backdrop certainly matters, the business cycle is generally more critical in the longer run. And right now, employment is expected to remain strong. This in turn should fortify consumer spending. Productivity is up, while business and residential spending is expected to be solid. Inflation continues to decelerate, and absent some trade or policy shock the U.S. Federal Reserve should continue to normalize rates. The Bloomberg consensus estimate for U.S. GDP growth is for above 2% this year.

Across Canada, inflation is quickly receding, and rates are dropping. After two years of subpar growth, Canada is rebounding. The Bank of Canada, after a rapid rate hiking cycle, has been one of the most aggressive in cutting rates. This is having a material impact on Canadian households, whose debt to income is the highest amongst G7 peers. With rates dropping, floating rate mortgage holders in particular are catching a break. While the Canadian economy has struggled to grow beyond 1% over the last few years, this year it is expected to get closer to 1.8%.

2025 GDP growth outlook for major economies



Source: Bloomberg monthly survey, 2024. The above forecast is based on estimates and there is no guarantee that the estimate will be achieved.

China has struggled to find its groove over the last several years. A housing slump that has lasted four years has resulted in a large number of unfinished properties and bad loans. Credit growth has slowed, and weak consumer confidence has sapped activity. Policymakers, worried about deflation, have been cutting rates. The market keeps waiting for some large bouts of fiscal stimulus while the government instead rolls out targeted programs. Faced with the threat of uncertain tariffs the government seems to be holding off until it can assess the full impact.

Any tariff reaction from China will likely be some mix of retaliation, currency adjustments, rate cuts and fiscal support. Fortunately, the country has the fiscal and monetary capacity to help buffer its economy from some trade disruption. Markets still expect the government to stimulate and deliver GDP growth levels, albeit below target, of 4.5%.

The eurozone is expected to deliver 1% GDP growth this year. Germany, usually the manufacturing engine for the region, has been flat as demand from China has been weak. Meanwhile France and Italy have also been in the slow growth lane as they need to bring fiscal spending under control. However, activity is picking up. Employment is growing, and wage growth is outpacing inflation. The European Central Bank (ECB) is expected to keep cutting rates and should continue to help the region recover.

A big shock to this baseline economic outlook would be U.S.-initiated universal tariffs. In particular, North America's cross border supply chains are very integrated. This makes it very difficult to quickly relocate and retool. While China and Europe have dealt with and adapted to U.S. tariffs before, every new episode invariably brings the risk of overreach and subsequent rounds of retaliation that could derail trade and economic growth.

SLC Management

Macroeconomic outlook (cont.)

Dec Mullarkey
Managing Director, Investment Strategy and Asset Allocation

Market expectations caught between potential business-friendly initiatives and trade policy challenges

Inflation calming down

Global inflation is returning to manageable levels. However, it is settling at different levels across regions. In the U.S., it is running a little hot, while Canada is right at target. The eurozone is also circling around target while China is at risk of seeing deflation.

Such divergences affect the pace of rate cuts. This in turn impacts exchange rates. The Fed has the luxury of time, delaying as needed. Meanwhile, Canada is trimming rates at a brisk pace. In Europe, as growth stays subpar, markets expect the ECB to continue to cut rates at a decent clip over the first half of the year.

Meanwhile, China needs more stimulus to arrest sluggish growth, stabilize housing and invigorate confidence. Looming tariffs are complicating that adjustment. The picture should become clearer as the new U.S. administration further cements its position.

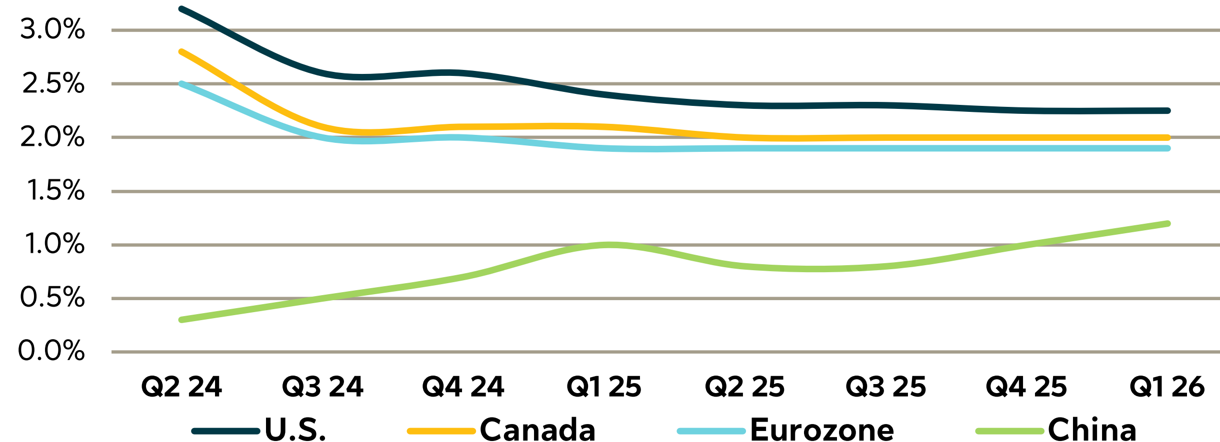
Landing on the neutral rate

One important question central bankers need to settle is that of their neutral rates. In other words, under stable conditions, at what level should they stop cutting rates to ensure their economies operate at a sustainable pace?

Before the pandemic, the neutral rate for the U.S. and Canada was estimated to be around 2.5%. For Europe it was closer to 1.75%, as long-term growth expectations are lower. Based on futures markets, the implied neutral rates for the ECB and Bank of Canada are still in line with pre-pandemic estimates. However, in the U.S., it is expected to be in the 3.5%–3.75% range.

A big part of that bump up is the demand for capital is intensifying as the U.S. reorders supply chains, shifts to alternative energy and spends more on technology innovation. U.S. federal deficits also seem to be running higher on a persistent basis. All this suggests more activity, more borrowing and higher U.S. rates relative to pre-pandemic conditions.

Headline inflation (consumer price indexes)



Source: Bloomberg, 2024. Consumer price index (CPI) measures for Q4 2024 and after based on Bloomberg survey of economists. The above forecast is based on estimates and there is no guarantee that the estimate will be achieved.

Key takeaways

- Overall policy uncertainty has been driven by potential tax cuts and lighter regulation on one hand and tough tariffs and immigration enforcement on the other.
- The U.S. is expected to remain in a robust stage of its business cycle.
- All eyes are on central banks, and where their neutral rates land in the new year.

Sources: Bloomberg, U.S. Federal Reserve, 2024–5.

Fixed income: investment grade

Randall Malcolm
Senior Managing Director, Portfolio Manager, Public Fixed Income

Policy shifts toward growth, but inflation pressures could still be a factor

Getting the balance right

With inflation appearing to have finally settled back into the Bank of Canada's (BoC's) target range, the policymaker's focus has now turned toward the lackluster level of growth in the Canadian economy. In the second half of 2024, the BoC made significant cuts to its overnight rate in the hopes of stimulating Canadian economic growth. This may be music to the ears of the many Canadians that are having their mortgages coming up for renewal this year, as interest rates further out the yield curve such as the 3- and 5-year terms remain very key to mortgage rates.

However, the ride down in yields has not been without bumps in the road. While government yields moved lower in 2024, they remain at elevated levels relative to the past decade. Part of the elevation is due to higher inflation levels, but real yields have also risen – likely in response to increased supply of government debt and poorer government fundamentals in terms of budgetary balances.

The yield outlook

As we move into 2025, we expect government yields to remain higher than usual. We see government budget deficits remaining stubborn, in spite of assurances of future balanced budgets at both the federal and provincial levels of government in Canada. Such deficits should keep governments' new bond supplies active. High supply levels, as well as a continuation of high wage settlements pressuring inflation upward, could also maintain upward pressure on bond yields. Pension derisking, as well as fund flows into fixed income exchange-traded funds, have been key to absorbing this additional bond supply.

However, it is uncertain as to how long these sources of demand will persist. The biggest wildcard for yields at this point is the changing of the U.S. administration and the potential effects that could have on global trade policies. With potentially more tariffs and other trade barriers on the horizon, we could see higher inflation, slower growth or both at the same time. These forces could conspire to not only keep yields elevated, but also to heighten the volatility of the bond market.

Corporates underpinned by favorable fundamentals, macro conditions

In the corporate market in 2024, the fundamentals of corporate bond borrowers generally improved, supported by a positive and stable macroenvironment, as well as central banks that became increasingly biased to support risk markets. New issue supply of corporate bonds in both the U.S. and Canada was elevated in 2024. However, the market remains conducive to supporting corporate bonds at both historically low credit spread levels, and with meager to negative new issuance concessions.

The FTSE Canadian bond indices will be evolving to include new issuances of maple bonds (issued by entities outside Canada but denominated in Canadian dollars) into their indices in 2025. This should eventually bring new supply and diversification into the Canadian corporate market, but not likely until later in 2025 as U.S. market richness currently favors issuing corporate bonds in U.S. dollars over the Canadian market.

With government fundamentals not poised for any improvement, corporate credit spreads may have some room to tighten compared to government bonds in 2025. To the extent government trade barriers and other changes in governments' policies continue to create uncertainty, we could see Canadian corporate credit spreads widen, but also become less correlated between sectors as different industries are targeted by sanctions or policies.

Key takeaways

- The BoC has shifted its stance toward encouraging growth in the Canadian economy.
- Robust supply and higher wages could apply upward pressures on inflation and on bond yields.
- Corporate credit spreads could see some tightening in 2025, but we also expect less correlation between sectors and industries.

Source: Bloomberg, 2024–5.

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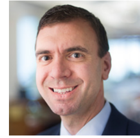
Fixed income: non-investment grade



John Fekete
Managing Director and Head of Tradeable Credit

Rate cuts in late 2024 could signal slower pace of easing for 2025; credit markets show growth

Inflation still a Fed concern

The U.S. Federal Reserve cut interest rates by a quarter-point on December 18, 2024, as expected, amounting to a cumulative full-point since September 2024. Instead of celebrating, the market reacted like it received a lump of coal in its Christmas stocking as Chairman Jerome Powell telegraphed a slower and shallower rate cut narrative for 2025. The Fed had done a lot to support the economy over the last 90 days of 2024 and policymakers wanted to see more progress on inflation before reducing rates further. The updated Statement of Economic Projections (SEP) indicated only 50 basis points (bps) of cuts forecast for 2025. Inflation, as measured by the Personal Consumption Expenditures Price Index (PCE), is now forecast to be much higher at 2.5% in December 2025, up from 2.1% as previously thought, as disinflation has stalled out. Investors may need to wait until 2026 for inflation to approach 2%, pushing out by a year the timeframe for inflation to get back to target.

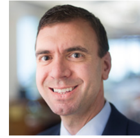
Fed rate cutting cycles typically drive Treasury yields lower, but that was not the case in 2024. Since September 18, 2024, the date of the first Fed rate cut, the 10-year U.S. Treasury yield has risen by 80 bps to 4.5%. This was because there had been no credible signs of an economic slowdown. The Fed deserves credit for executing a soft landing, in our view. Powell noted that "most forecasters have been calling for a slowdown in growth and it keeps not happening. There is no reason to think a downturn is more likely than it usually is."

Healthy activity levels in credit markets

This contrasts with what is happening around the world, particularly in Europe, which is near a recession. As we predicted in our September public statements, the Fed's rate cuts have been accompanied by looser financial conditions and strong credit growth. This was evidenced by the near-record level of primary market issuance in the high yield, syndicated bank loan and collateralized loan obligation (CLO) markets. We believe that strong investor demand for income enabled syndicated loan and high yield bond investors to earn attractive returns in the range of 8%–9% year to date through December 18.[1]

[1] Indices used as asset class proxies: Credit Suisse Leveraged Loan Index and ICE BofA US High Yield Index, with performance range based on data as of November 30, 2024. Public and private credit indices shown are widely used market benchmarks to generally assess the relevant risk profile of a particular investment strategy. Future fluctuations in valuations and performance may occur as a result of changing market conditions, among other variables. The comparison indices and asset classes presented set forth herein are provided for informational purposes only and should not be relied upon as an indication of Crescent's investment strategy or as an accurate measure of comparison, as there may be differences between the relevant Crescent fund and such indices due to varying fund vintages and strategies. The comparisons contained herein have inherent limitations and qualifications, such as limited sample size, imperfect access to information and other considerations. There are significant differences between the types of securities and assets typically acquired by a Crescent fund and the investments covered by the applicable index or benchmark. Certain indices may or may not reflect the reinvestment of dividends, interest or capital gains. Moreover, indices are unmanaged and are not subject to fees and expenses.

Fixed income: non-investment grade (cont.)



John Fekete
Managing Director and Head of Tradeable Credit

Rate cuts in late 2024 could signal slower pace of easing for 2025; credit markets show growth

The road ahead

Many investors are left to wonder what's next. Do we see 50 bps of cuts in 2025, or do we start the year with Treasury yields moving higher as they did in the first quarter of 2024? While many fear the new U.S. administration's policies could be inflationary, causing the Fed to stop cutting, new policies can take time to implement and work their way through the economy. We cannot help but notice the Fed cut rates by 100 bps within three months. As President-elect Donald Trump walks into the White House, the central bank may take a pause.

All this suggests Fed voters may be pre-emptively considering the impact of Trump's tariff, tax and spending proposals. Deregulation and tax cuts could potentially provide a boost to U.S. economic growth and benefit domestic companies, encouraging a risk-on environment for investing. For now, the economy remains resilient and labor productivity gains are providing a structural tailwind that supports growth. We believe this constructive fundamental backdrop, combined with a lack of material debt maturities for several years, should keep credit stress and default rates modest.

We expect 2025 to be similar to 2024 – with growth at 2.0%–2.5%, inflation running close to 3% and the Secured Overnight Financing Rate (SOFR) base rate at or north of 4.0% – resulting in default rates remaining stable and concentrated in a small group of industries. We continue to favor floating rate assets such as syndicated bank loans and CLO liabilities, in which investors could earn high single-digit coupons that are more than 200 bps higher than the average coupon in the U.S. high yield market.

We see three tailwinds that should be favorable for syndicated loans and CLOs throughout 2025:

1. The resiliency of the U.S. economy.

2. Potential inflationary pressure from tax cuts and deregulation following the November 2024 Republican victory.

3. Attractive yields relative to other credit asset classes.

Key takeaways

- The Fed executed a quarter-point cut in December 2024 as expected.
- Fewer cuts forecast for 2025 as inflation progress stalls.
- We are seeing attractive coupon income available for investors in syndicated loans and CLO liabilities.

Sources: Bloomberg, U.S. Bureau of Labor Statistics, 2024–5.

ABOUT CRESCENT CAPITAL

Crescent is a global credit investment manager with US$43 billion of assets under management as of September 30, 2024. For over 30 years, the firm has focused on below investment grade credit through strategies that invest in marketable and privately originated debt securities including senior bank loans, high yield bonds, as well as private senior, unitranche and junior debt securities. Crescent is headquartered in Los Angeles with offices in New York, Boston, Chicago and London with more than 220 employees globally. Crescent is part of SLC Management, the institutional asset management business of Sun Life. For more information about Crescent, visit www.crescentcap.com.

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Private credit: investment grade

Andrew Kleeman
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Co-Head of Private Fixed Income

Elaad Keren
Senior Managing Director,
Co-Head of Private Fixed Income

Nushi Kazemian
Managing Director,
Private Fixed Income

Robust activity, growing volumes could continue to drive markets in 2025

Record year of volume in a competitive landscape

The investment grade (IG) private debt market had a record year of new investment activity in 2024. According to data from Private Placement Monitor, volumes surpassed the prior record of US$108 billion set in 2021. As at the end of October, year-to-date 2024 volume was US$113 billion and expected to close the year far above the US$120 billion mark. While a number of issuers took a "wait and see" approach in 2023 for non-urgent financing needs, there were a higher number of issuances in 2024 as we saw the start of interest rate cuts and an issuer base that had come to grips with the fact that cuts in the U.S. Federal Reserve's rates might not move longer duration Treasury rates much at all.

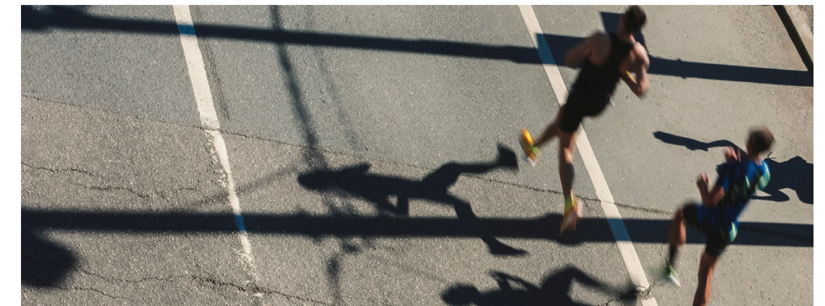
Volume growth in 2024 was driven by industrials, including several large investments in the manufacturing (e.g., chips and batteries) and energy (e.g., liquefied natural gas, pipelines) sectors, followed by the financial sector (e.g., asset managers, real estate investment trusts) and utilities. There were over 10 deals that raised more than US$1 billion, exceeding last year's number of large transactions. In addition, 2024 saw more transactions that were oversubscribed by multiple times, putting downward pressure on spreads throughout the year compared to 2023 as competition intensified, perhaps in part due to historically low spreads in public IG corporate bond markets. Nonetheless, investors generally remained disciplined in underwriting, with no material loosening on terms and covenants, demonstrated by several deals not getting circled this year due to credit or structural concerns.

Our 2025 outlook: "building on the momentum"

Last year, our outlook for 2024 predicted a robust year of activity buoyed by an expectation of declining interest rates, lower inflation and pent-up issuer demand from the previous year. At the time of this writing, 2024 is slated to be a record year of activity, and we believe 2025 is poised to build on this momentum. Geopolitical risk remains a concern, and the new U.S. administration's policy impacts on regulation, tax cuts and tariffs remain uncertain. However, the continued cycle of interest rate cuts across multiple geographies and further cooling of inflation is expected to boost corporate investment, merger-and-acquisition activity and deal flow in 2025. Also, we expect to see a stronger pipeline of deals in January and early February, as some issuers delayed entering the market around the U.S. election cycle in the last quarter of 2024.

Sector leaders for volume in 2025 should continue to include industrials, energy and financials, in our view. Growth areas such as private asset backed securities (ABS) should also add diversification and boost relative value opportunities. Capital investment in fast growing sectors such as digital infrastructure (e.g., data centers, fiber optics), which is needed to accommodate the evolution of AI, will create further financing opportunities. Of course, the year could bring challenges. We anticipate sustained headwinds in real estate markets, which are seeking greater stability and return to pre-COVID trading levels. Other sources of uncertainty include impacts of changing government investment priorities in public infrastructure and regulatory landscapes.

A number of key trends in 2024 are expected to continue into 2025, including more large transactions (greater than US$1B), strong investor appetite and a very competitive market. Barring any unforeseen macroeconomic market disruptions, spreads on average are anticipated to see continued downward pressure in 2025 across IG private credit markets. Nonetheless, we expect relative value to public markets to remain in line with historic trends. The attractive risk-adjusted returns that can be generated by experienced investors with scale and deep sector expertise will continue to anchor the growth of IG private credit activity in 2025.



Key takeaways

- IG private credit markets experienced robust volume growth in 2024.
- We believe 2024's positive momentum could carry into 2025.
- Growth in ABS and digital infrastructure investment could also drive markets.

Source: Private Placement Monitor, 2024–5. Investment grade credit ratings of our private placements portfolio assets are based on a proprietary, internal credit rating methodology that was developed using both externally purchased and internally developed models. This methodology is reviewed regularly. More details can be shared upon request. There is no guarantee that the same rating(s) would be assigned to portfolio asset(s) if they were independently rated by a major credit ratings organization.

CRESCENT

Private credit: non-investment grade

Chris Wright
President and Head of Private Markets

Chris Wang
Managing Director

Cycle-tested values key to capturing today's attractive private credit opportunities

Asset class well-positioned following the U.S. election

The private credit market remains highly attractive today, as its value proposition to both borrowers and investors remains clear and robust, in our view. Capital formation continues to shift on a secular basis to private credit as borrowers value the certainty of execution and ease of use that relationship lenders provide. Furthermore, investors continue to value the attractive yields, high current income and better lender protections in more conservative capital structures that can be found in private credit.

The asset class is poised to benefit from expectations of continued U.S. economic strength, lower taxes, market-friendly regulations and growth-oriented policies from a second Donald Trump presidency. These economic tailwinds, when combined with the significant amount of dry powder on the sidelines, aging private equity portfolios and a regulatory environment more conducive to dealmaking, are expected to create the conditions necessary for an attractive mergers-and-acquisitions (M&A) environment going forward.

At the same time, protectionist trade policies and immigration reform in an already-tight labor market should put upward pressure on inflation, likely resulting in a higher-for-longer rate environment. We view a higher rate environment as a positive for fundamental credit. President Trump's proposed economic policies are centered around driving economic growth in a more benign operating environment, which we expect to drive top-line growth across U.S. middle market companies.

It is important to remember that a higher rate environment can have a burdensome effect and pressure cash flows for borrowers, resulting in increased defaults and non-accruals. This potential for prolonged credit stress reinforces the importance of manager selection and the need for disciplined credit underwriting with a focus on capital preservation, strong free cash flow generation and robust debt service coverage. The growing dispersion of performance and returns across managers is expected to accelerate as rates stay elevated.

CRESCENT

Private credit: non-investment grade (cont.)

Chris Wright
President and Head of Private Markets

Chris Wang
Managing Director

Cycle-tested values key to capturing today's attractive private credit opportunities

Increasing importance, difficulty in evaluating private credit portfolios

Assessing the performance of private credit managers and their portfolios can be challenging. Most private credit managers have never invested through a cycle. This makes it difficult to underwrite how their investment returns, default rates and recovery rates would look through a recession or a prolonged period of elevated interest rates. Further compounding the issue is that default rates today may not reflect true underlying performance, as credit agreements can be amended to allow for payment-in-kind (PIK) interest or provide for a maturity extension before any default may occur.

Deteriorating underlying portfolio company performance can explain the increasing prevalence of PIK amendments and the growing presence of PIK interest income in private credit portfolios. For example, PIK interest represents on average 10.5% of investment income (and as high as 18.3% of investment income) for the largest publicly traded business development companies (BDCs)[1] today, up over 150 basis points from 8.9% just one year ago.

We believe rising defaults and non-accruals across private credit manager portfolios will also test the strength and quality of the underlying credit agreements that provide contractual rights and protections to the lender. Weak credit agreements lacking fundamental protections will expose investors to the possibility of liability management exercises, in which collateral and its associated value can be taken from the lender. Investors were stunned when one of the first sponsor-funded liability management exercises of a private credit-backed company occurred during a highly public faceoff between direct lenders and a financial sponsor over a private upper middle market annual recurring revenue (ARR) loan in 2024.

Outlook for opportunities in private credit

In this extraordinary period of market transition, private credit can capture the opportunity arising from the economic strength in U.S. middle market companies and a resurgence in M&A activity, providing investors with opportunities for strong relative value and risk-adjusted returns.

We believe a higher-for-longer rate environment should result in rising credit stress across portfolios. Consequently, manager selection will be key as cycle-tested managers with robust origination capabilities, disciplined credit underwriting and hands-on portfolio management expertise will, in our view, have a higher likelihood of generating strong returns with reduced risk.

Key takeaways

- Secular trends and expectations of a market-friendly U.S. administration have created sanguine conditions for private credit investment.
- We believe a higher-for-longer rate environment should result in rising credit stress across portfolios, underscoring the importance of manager selection.
- Private credit is poised to capture potential opportunities from strengthening U.S. middle market companies and increased M&A activity.

Sources: Bloomberg, Private Placement Monitor, 2024-5.

[1] Ten largest publicly traded BDCs by market capitalization as of December 16, 2024, excluding 2024 IPOs: ARCC, BXSL, FSK, GBDC, GSBD, MFIC, NMFC, OBDC, PSEC and TSLX.

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BGO

Real estate

Canadian commercial real estate: a constructive outlook for 2025

Phil Stone
Managing Director, Head of Canada Research

Michael Andrews
Managing Partner, Portfolio Manager

Christina Iacoucci
Managing Partner, Head of Canada and Canadian Chief Investment Officer

Lower interest rates provide supportive backdrop for CRE

Heading into 2025, there's growing optimism for Canada's commercial real estate (CRE) market, in our view. The challenges of the past few years, including high interest rates and pandemic-accelerated structural shifts, have given way to a more stable and constructive outlook. While risks remain, the road ahead appears brighter for this vital asset class.

Inflation is now largely under control, with further slowing expected as shelter costs – such as rents and mortgage interest expenses – continue to cool. The Bank of Canada (BoC) has shifted its focus toward revitalizing economic growth, which has languished under the weight of higher interest rates. While December 2024's 50 basis point cut may have marked the end of "jumbo" rate cuts, we expect the BoC is likely to continue easing rates to reach the lower end of its neutral range (2.25%) by mid-year 2025. Lower immigration levels and potential tariffs are two risks that the BoC is trying to get ahead of. As interest rates decline, we anticipate economic growth to pick up in the latter half of the year, creating a more supportive environment for CRE demand.

Signs of improving capital markets

CRE has been suffering through a capital markets recession, but property fundamentals have remained resilient. Investor sentiment is improving as well, and capital is gradually coming off the sidelines.

Here are three key trends that underscore the market's potential recovery:

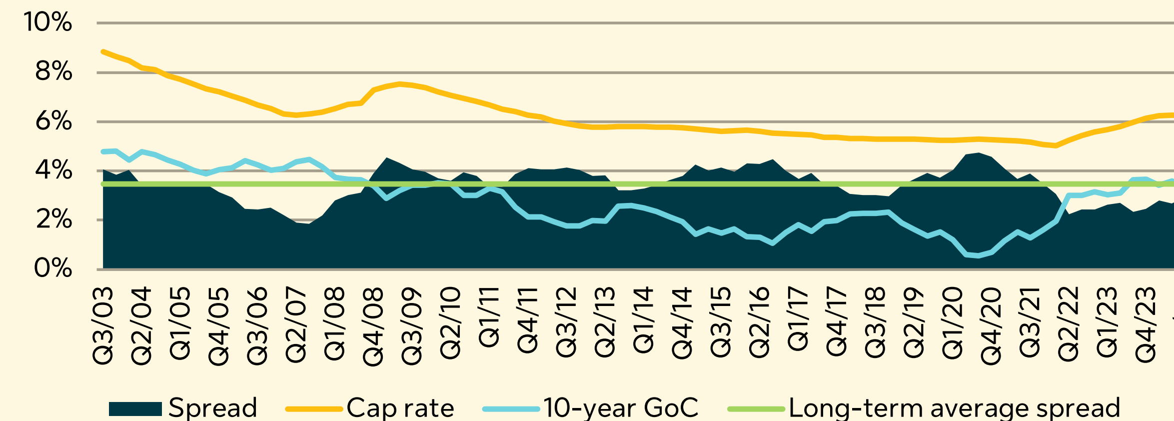
1.

Lower cost and greater availability of debt capital: Lenders became more active as 2024 progressed, with a surge of activity in the fourth quarter. Lower base rates and tighter spreads made mortgage debt accretive again, resulting in increased transaction and loan activity.

2.

Cap rate spreads more attractive: While we expect there is likely further price discovery to play out in the office sector in 2025, real estate values across all other property types have likely bottomed. As a result, cap rate spreads over risk free rates are looking attractive, and they are within range of their long-term averages. This is an important metric that demonstrates real estate's relative appeal across asset classes.

National cap rate spread over 10-year Government of Canada bond yield



Sources: Bank of Canada, CBRE, 2024.

3.

Transaction volumes have reached an inflection point: Deal activity began picking up through the mid-year point. Momentum is expected to carry into 2025 as bid–ask spreads between buyers and sellers should continue to narrow.

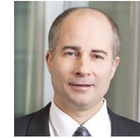
Additionally, history has consistently demonstrated that realized total returns for real estate improve during periods of declining interest rates. With that in mind, we are seeing increased appetite from equity capital moving off the sidelines to take advantage of this opportunity.

BGO

Real estate (cont.)

Canadian commercial real estate: a constructive outlook for 2025

Phil Stone
Managing Director, Head of Canada Research


Michael Andrews
Managing Partner, Portfolio Manager

Christina Iacoucci
Managing Partner, Head of Canada and Canadian Chief Investment Officer

Sector-specific dynamics

Tenant demand has slowed over the last year, but occupancy levels remain healthy outside of the office sector. Looking ahead to 2025, demand should grow throughout the year as economic activity increases, and fewer completions will help to reduce vacancy as the construction pipeline eases. Here's a look at the nuances at the sector level:

Multifamily

Rent growth is slowing, driven by affordability challenges and an influx in shadow rental supply from new condominium deliveries. Lower immigration targets and peak supply deliveries are expected to create headwinds for occupancy in 2025. However, the market could tighten significantly late in the decade, as the slowdown in project starts over the past 18 months – and the limited activity expected in 2025 – will likely result in a dearth of completions between 2028 and 2030.

Industrial

The national industrial availability rate rose to a seven year high of 4.4% in Q3 2024, still below the long-term average, but higher than the low of 1.5% in Q3 2022. Net asking rents are declining across most markets as new deliveries have outstripped tepid demand. While tariff risks may temper recovery, structural drivers like e-commerce growth, supply chain modernization, population growth and limited land availability continue to support strong industrial sector fundamentals over the medium term.

Office

Green shoots are emerging in office leasing just as the latest development cycle nears an end. Net absorption was positive in 2024 for the first year since 2019. The national vacancy rate remains high but has remained stable at just under 19% for the past year. As "return-to-office" mandates gain traction, demand is increasingly focused on high-quality, well-amenitized buildings, leaving vacancy rates for "class B/C" spaces (25.1%) far higher than "trophy" assets (10.1%), according to CBRE data at the end of 2024.

Retail

Needs-based retail, particularly food-anchored retail strip centres, remains the most sought-after asset type, driven by resilient fundamentals, steady rent growth and a significant supply–demand imbalance amid rapid population growth. We expect this segment of retail to outperform all other property types over the medium term, but it will be a more challenging acquisition environment with much competing capital.

Mortgage market is key to the recovery

Overall debt availability is expected to improve in 2025, providing liquidity for a sustained recovery. We also expect lenders to be more discerning by asset quality more than property sector as they underwrite occupancy and income projections more conservatively. This means that lending spreads for high quality assets should remain tight, supported by fierce competition among lenders and strength in the broader corporate credit environment.

With the right structure, lenders are expected to be more active in office and discretionary retail in 2025 to meet program requirements and diversify their loan portfolios. While multifamily and industrial properties are still in favor, lenders are expected to be more selective as fundamentals have softened.

Notwithstanding a more encouraging outlook, we believe lenders will need to navigate ongoing refinancing risk, collateral valuations and challenges in the land and development market. That stated, real estate credit continues to provide strong risk-adjusted opportunities.

With the Canadian CRE market entering a new cycle, 2025 holds promise for those ready to navigate its evolving landscape, in our view.

Key takeaways

- Canadian real estate is entering 2025 with a renewed sense of optimism, supported by healthy property fundamentals and improving capital market conditions.
- Repriced assets, lower cost and greater availability of debt capital, improving transaction activity and fair value metrics all point to a potential market recovery.
- History has consistently demonstrated that once interest rates start to decline, total returns for CRE improve.

Sources: Bank of Canada, Statistics Canada, MSCI, CBRE, 2024–5.

InfraRed Capital Partners

Infrastructure

Asset class proving resilient as market activity continues to recover; megatrends shape a growing mid-market

Jack Paris
Chief Executive Officer

Edward Hunt
Partner, Head of Core Income Funds

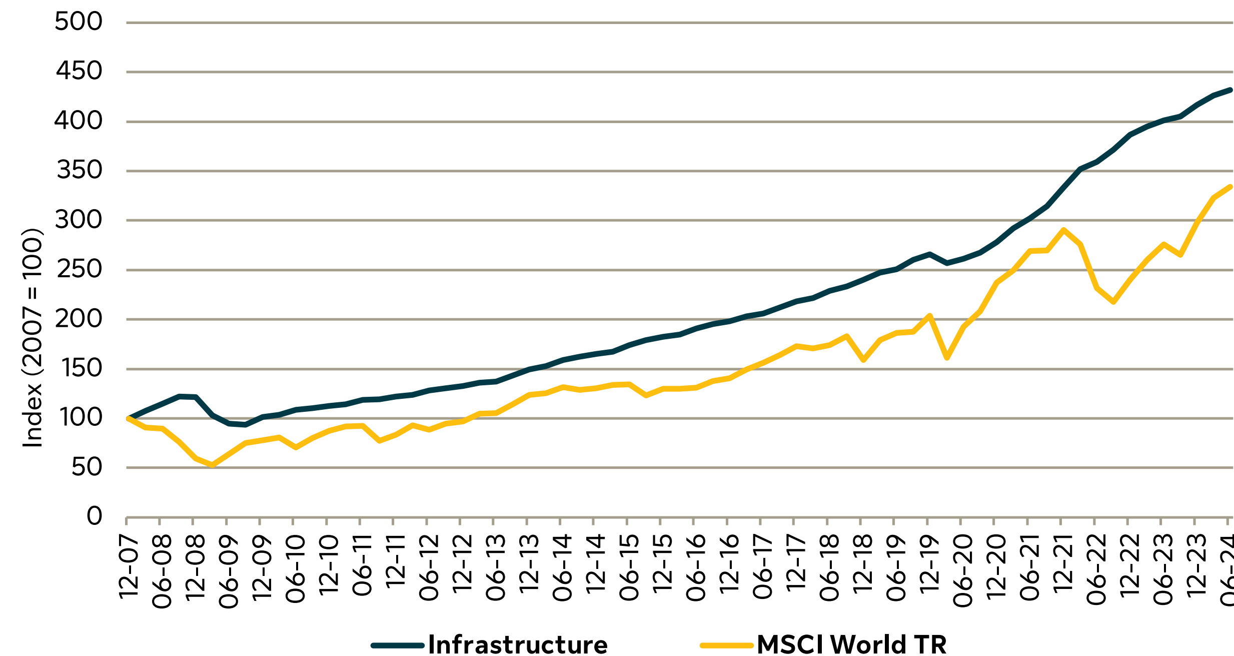
Stephane Kofman
Partner, Head of Capital Gain Funds

Macro environment shaping near-term performance and valuations

In 2024, economic growth has proven more resilient than anticipated in North America, while the European economy has continued to show signs of weakness. Inflation trended lower than in previous years but remained stickier than anticipated, contributing to a steepening of the yield curve across Europe and North America, with short-term interest rates trending down amid central banks cutting rates and long-term government bond yields holding at higher levels due to persistent inflation uncertainties.

Within this macroeconomic environment, infrastructure performance has proven resilient, with robust earnings growth across transport, energy and digital infrastructure, underpinned by the ability of the asset class to recover inflation costs and the structural support of secular tailwinds accelerating demand. These factors contributed to largely offset the effects of a higher interest rate environment on valuations. In a slower economic environment anticipated for 2025, we anticipate infrastructure to continue offering a resilient proposition for investors across strategies.

Infrastructure's long-term performance, total return, 2007–H1 2024



Source: Preqin, Private Capital Quarterly Index rebased to 31 Dec 2007, as of June 30, 2024. Past performance is not indicative of future returns.

Capital flows and deal activity recovering

Infrastructure allocations remain below historical peaks with investors focusing on managers with a proven track record, but rebounding demand from investors drove a 91.2% year-on-year increase in commitments to private infrastructure fundraising the first nine months of 2024[1]. Transaction volumes are showing signs of recovery. With long-term rates stabilizing, valuations in the core infrastructure space are becoming more attractive, and we expect stronger deal activity in this segment.

Simultaneously, the value-add segment is entering a "supercycle" with a meaningful increase in opportunities coming to the market, underpinned by megatrends, including energy transition and digitalization, and an increased emphasis on selective dealmaking. In 2024, the number of transactions under US$250 million accounted for over two thirds of total market activity.

North America and Europe remain the most attractive geographies from an allocation perspective, and account for over 66% of total transaction volumes in 2024 year to date (as of September 30), underpinned by supportive policy environments driving decarbonization, increased demand for infrastructure modernization and strong deal pipelines ahead.

[1] Realfin, State of the Market – Global Infrastructure Q1-Q3 2024, October 2024.

InfraRed
Capital Partners

Infrastructure (cont.)

Asset class proving resilient as market activity continues to recover; megatrends shape a growing mid-market

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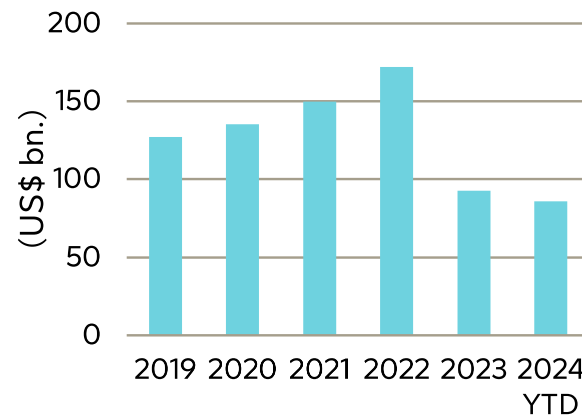
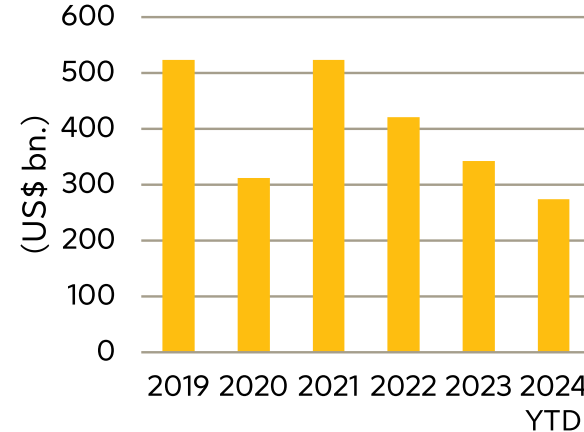
Partner, Head of Value Add Funds

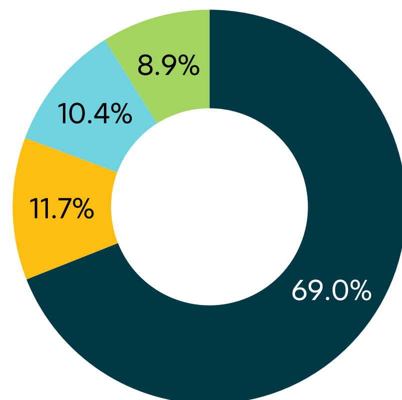
Infrastructure fundraising and transaction volumes (US$ bn.)



Aggregate capital raised (US$ bn.)



Aggregate deal value (US$ bn.)



Percentage of deals by size

- US$100M-US$249M
- US$250M-US$499M
- US$500M-US$999M
- US$1B-US$4.9B

Source: Preqin, as of November 2024. Past performance is not indicative of future returns.

Megatrends continue to shape the future of infrastructure

The pillars of decarbonization, digitalization, demographics and deglobalization continue to shape the long-term outlook for infrastructure and drive investment opportunities. The topics of energy security and affordability continue to shape the European policy debate amid sluggish economic growth and high energy prices. In the U.S., a new administration may implement some policy changes, including increased emphasis on oil and gas and lower funding to the electric vehicle sector. Despite fluctuating global policies, investment in energy transition remains a strong trend, with renewable capacity and battery storage anticipated to continue growing as electrification of transport and heating continue to drive power demand.

Moreover, the surge in global power demand, driven by new data centers and AI-related infrastructure, highlights the growing overlap between digitalization and the energy transition, and is further strengthening the case for investment in renewable energy and grid enhancements, reinforcing infrastructure's critical role in enabling the global transition to a sustainable, data-driven economy.

Amid rising trade barriers, and the new trend of "slowbalization," or the slowing of globalization, we see re-shoring of production capacity as a theme boosting demand for improved logistics infrastructure across North America and Europe. We also see a renewed public policy focus on leveraging public-private partnership models to support investment in new infrastructure and the modernization of existing, critical infrastructure, as public budgets remain tight amid historically high public deficit levels.

Long-term asset class growth

As macroeconomic uncertainty persists, we anticipate continued interest from both policymakers and private investors in infrastructure, making the sector integral to addressing global challenges. We therefore continue to believe that the asset class is positioned for long-term growth, underpinned by its resilience across market cycles and the structural need for long-term investment.

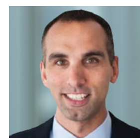
Key takeaways

- Infrastructure performance has proven resilient amid 2024's global economic uncertainty, underpinned by its inflation-hedging characteristics.
- Increased market activity, with core infrastructure valuations comparatively attractive, and the mid-market provide a continuous flow of new deals with solid return potential in the value-add space.
- Megatrends continue to drive the outlook for the asset class, as digitalization and decarbonization increasingly overlap.

Sources: Realfin, Preqin, 2024–5.

Insurance asset management

Attractive conditions for fixed income, credit allocations in changing landscape



Nitin Chhabra

Managing Director,
Head of Insurance Solutions

Steve Guignard

Senior Director, Client Solutions

The compelling case for fixed income

As 2025 begins, insurers are navigating a complex landscape marked by recent Bank of Canada rate cuts, historically high bond yields, record highs in equity markets, geopolitical uncertainties and evolving regulations. We believe there could be an attractive case for fixed income in the current market environment, as well as for credit allocations despite tight spreads. Furthermore, insurers should also be aware of recent developments in environment, social and governance (ESG) reporting requirements.

In fixed income markets, despite the Bank of Canada's rate cuts in 2024 – which resulted in a steepening of the yield curve – bond yields remain high across the term structure. In most cases they exceeded their end-of-2023 levels (and in all cases their 10-year averages).

Our assessment from last year remains relevant today: fixed income investments are offering attractive all-in yields, presenting strong return opportunities for insurers. Some fixed income asset classes continue to offer equity-like return potential with substantially lower capital requirements.

While all-in yields are appealing, tight credit spreads present a challenge for insurers as they balance return potential against risk in their investment decisions.

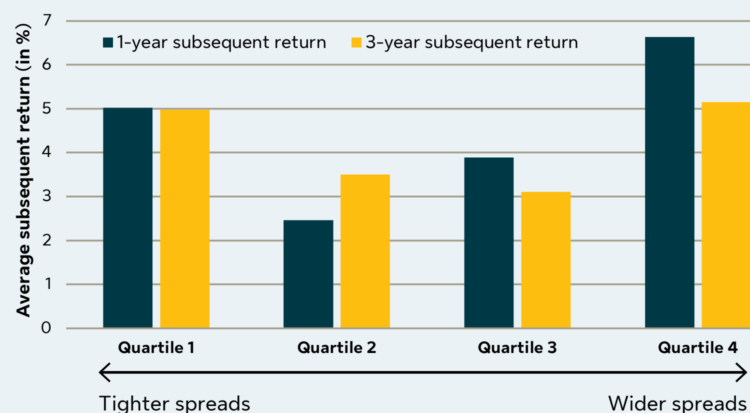
The credit conundrum: balancing attractive yields and tight spreads

How should insurers approach their credit allocations in today's high-yield, tight-spread environment? We examine this question from three perspectives: total return, excess return and liability-driven frameworks.

Total return

Tight spreads don't necessarily mean lower total returns. Spreads are actually a poor predictor of future returns – historical data show yield is a more reliable measure, especially for investment grade credit. Interestingly, when spreads are at their tightest, forward 1- and 3-year returns often exceed those when spreads are in the second and third quartiles, when spreads are wider, or at more "normal" levels, as illustrated in the following exhibit. From a total return perspective, given the higher-yield environment, we believe fixed income investors shouldn't dismiss credit exposure solely due to tight spreads.

Tight spreads do not equal lower subsequent total returns



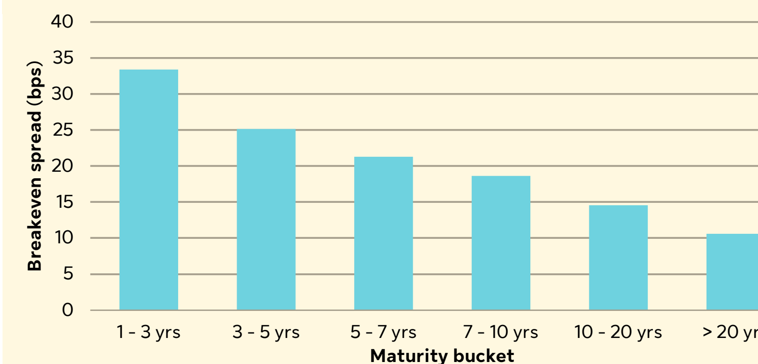
Sources: SLC Management, Bloomberg, as of November 2024. The Bloomberg Canadian Corporate Index was used to obtain return and spread information. Averages were computed using monthly data spanning from October 2002 to November 2024. Return for periods greater than one year are annualized.

Excess return

Here we defined excess return as the performance difference between credit-sensitive securities and duration-matched risk-free (Government of Canada) alternatives. For credit-sensitive securities to outperform, their credit spreads and spread fluctuations must generate higher returns than risk-free options.

The 1-year breakeven spread change indicates how much spreads must increase to yield a 0% excess return over the next 12 months. Despite currently tight spreads placing this measure below historical averages, a margin of safety remains. We believe that short- and mid-term spreads generally offer better protection than longer-term ones due to lower spread duration.

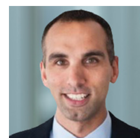
One-year breakeven spread change going into 2025: a decreasing margin of safety



Sources: SLC Management, Bloomberg, as of December 3, 2024. The Bloomberg Canadian Corporate Index was used to obtain the spread and duration information required to calculate the breakeven spread change.

Insurance asset management (cont.)

Attractive conditions for fixed income, credit allocations in changing landscape



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Head of Insurance Solutions

Steve Guignard
Senior Director, Client Solutions

Liability awareness:

International Financial Reporting Standard (IFRS) 17 has decoupled asset and liability valuations, requiring insurers to consider corporate spread movements' impact on liabilities. Maintaining some credit exposure can serve as a natural hedge, potentially justifying credit investments even when spreads are tight, to ensure balance sheet stability

As the previous discussion illustrates, there's no one-size-fits-all solution. However, from our perspective, the current market environment presents compelling reasons to maintain, or even increase, credit allocations.

Sustainability and regulatory considerations

On the ESG front, Guideline B-15 from the Office of the Superintendent of Financial Institutions (OSFI) requires Canadian insurers to integrate climate risk management into their governance, strategy and operations. The Guideline took effect fiscal year-end 2024 for internationally active insurance groups, and will be in effect fiscal year-end 2025 for other insurers. It is worth noting that similar guidance has been issued by many provincial regulators.

As climate risk reporting gains importance, we believe insurers should focus on:

1. Familiarizing themselves with the Partnership for Carbon Accounting Financials (PCAF) standard for measuring financed emissions, the standard OSFI expects insurers to use.

2. Understanding limitations of financed emissions metrics, including market-driven fluctuations and reporting challenges.

3. Documenting methods for providing financed emissions data to OSFI, including gaps and assumptions.

Insurers should ensure asset managers are prepared to support these requirements, focusing on understanding risks, implementing proper governance and maintaining financial resilience.

Navigating uncertainty: The fixed income advantage

Insurers face a complex investment landscape in 2025: uncertainties persist regarding the effectiveness of central bank policies, the impact of potential U.S. tariffs on economic growth and inflation, geopolitical tensions and the sustainability of the equity market rally. Amid these challenges, elevated bond yields can offer attractive return opportunities for insurers seeking stability in uncertain times.

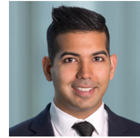
Key takeaways

- Fixed income continues to offer attractive all-in yields, presenting strong return opportunities for insurers.
- Return characteristics and liability awareness make credit allocations attractive despite tighter spreads.
- New regulations mean insurers should pay closer attention to ESG reporting and to how asset managers can support such requirements.

Sources: Bloomberg, SLC Management, 2024–5.

Retirement plan solutions

De-risking appears attractive as yield curves normalize and equity valuations remain elevated



Ashwin Gopwani
Managing Director,
Head of Retirement Solutions

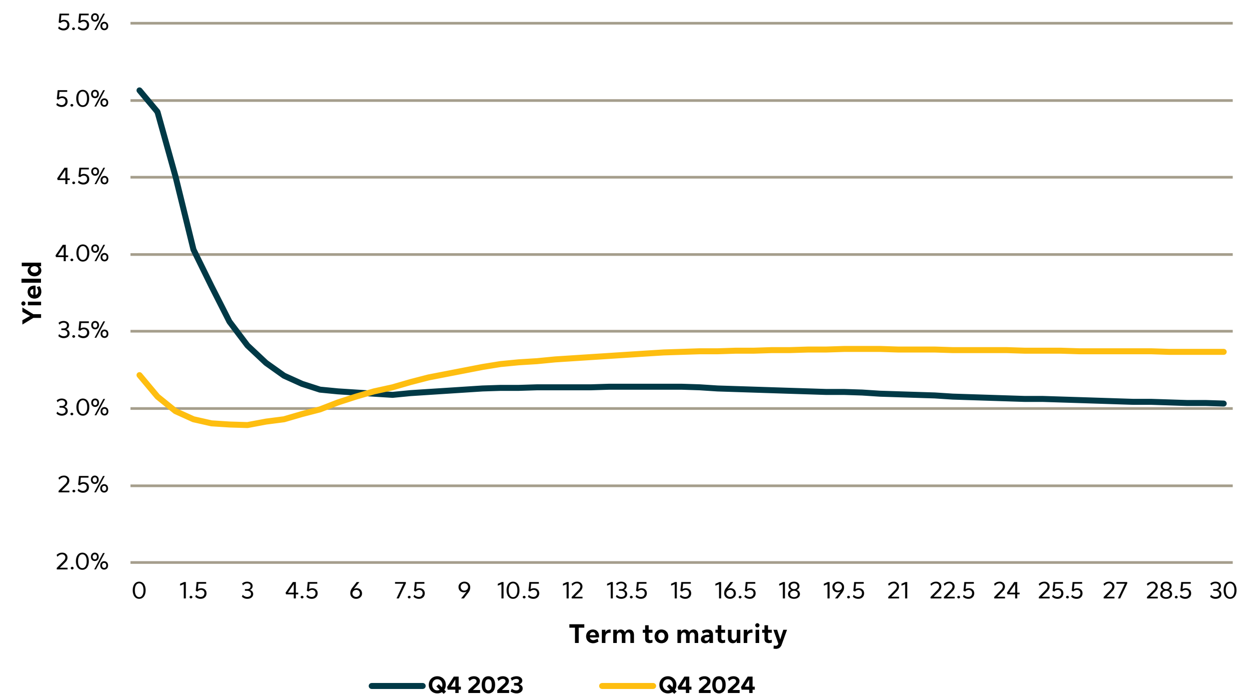
Neil Tai-Pow
Senior Director, Client Solutions

Current markets suggest favorable conditions for de-risking

In June 2024, the Bank of Canada commenced its first rate cut cycle in over four years, with a 25-basis point (bp) interest rate cut. This was followed by a series of four additional rate cuts over the year, and more cuts are anticipated in 2025. This has prompted many plan sponsors to contemplate the question: is now still a good time to make changes to reduce risk, or has the opportunity passed? In our view, reducing risk has become more compelling compared to recent history.

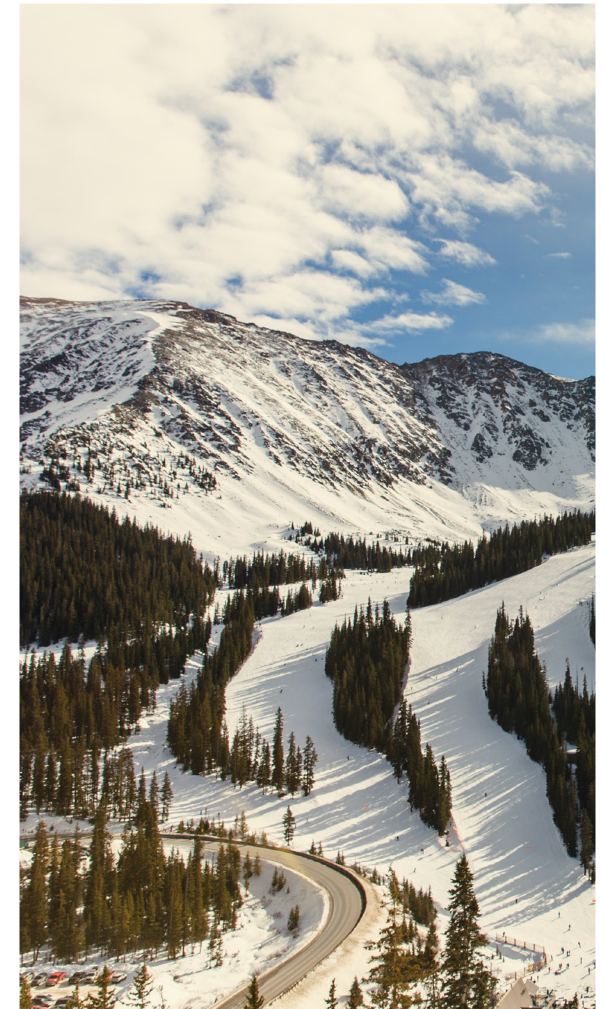
At year-end 2023, the yield curve was deeply inverted, with short rates significantly exceeding long bond yields. For plan sponsors using leverage to extend duration, this led to high carry costs. By the end of 2024, short rates were at a significantly lower point while longer-term yields were higher than year-end 2023. This steepening of the yield curve has positioned liability driven investing (LDI) portfolios for higher net yields, as these portfolios often receive longer-term yields as they seek to hedge long-dated liabilities. We are now seeing many plan sponsors consider increasing leverage within their portfolios.

Steepening yield curve positioning LDI portfolios for higher net yields



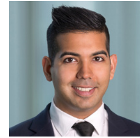
Source: BlackRock Aladdin, Canadian nominal government yield curve data.

Long bond yields are down from their peak in October 2023, but have not decreased at the same pace as short rates. In fact, Government of Canada long-term bond yields experienced a net increase of approximately 31 bps over 2024, and are approximately 103 bps above their 10-year average level as of year-end 2024, suggesting an attractive entry point for longer-term fixed income.



Retirement plan solutions (cont.)

De-risking appears attractive as yield curves normalize and equity valuations remain elevated



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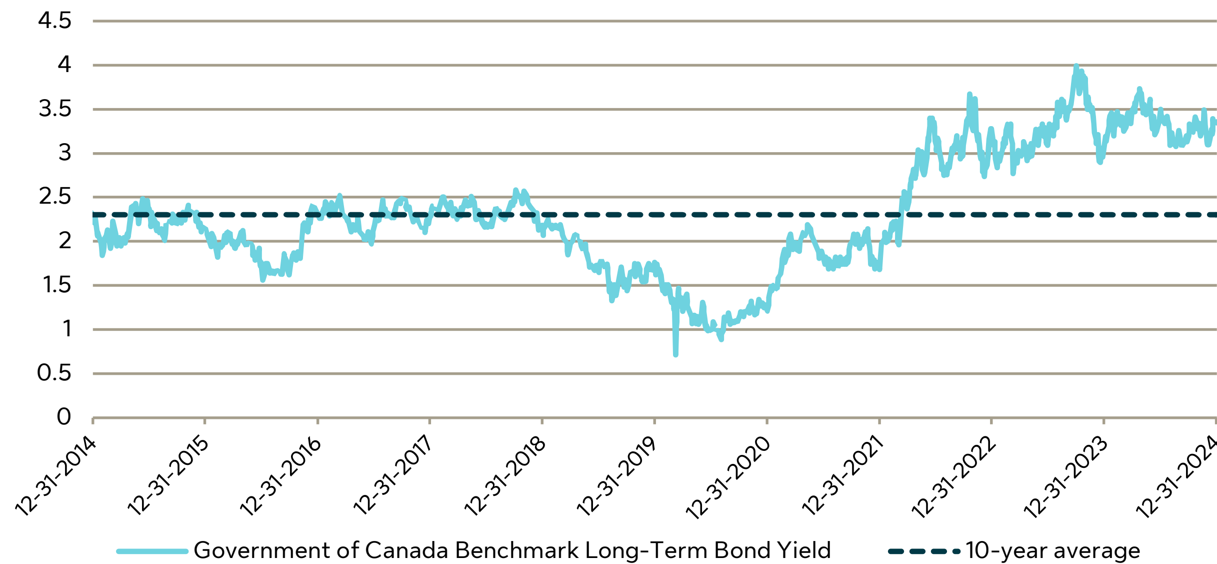
Long bond yields significantly exceed long-term averages



Source: Bank of Canada, daily data for V39056: Government of Canada benchmark bond yields – long-term.

Plan sponsors seek further yield and diversification within fixed income portfolios

As funded statuses remain healthy and fixed income plays a larger role in many plan portfolios, plan sponsors are looking for ways to boost yields to keep up with liability growth and achieve sufficient diversification of credit exposure to mitigate default risks. Strategies that utilize U.S. long corporate bonds and investment grade private credit have seen increased interest from many plan sponsors, and the use of cross currency swaps can help mitigate foreign interest rate and foreign exchange risks.

As equity valuations remain high, plan sponsors look to lower-risk alternatives

Equity markets have persistently rallied since the start of 2024, hitting record highs. Concerns have been building as valuations far exceed forward earnings, meaning that equities appear expensive compared to historical standards. As a result of these concerns, many plan sponsors are considering reallocating from equities into less risky asset classes, while hoping to preserve some return potential.

Real estate equity continues to garner interest from investors as an alternative asset class with a stable income profile and strong diversification potential. Non-investment grade private credit can provide returns that rival other return-seeking asset classes, has low correlations to traditional asset classes and historically exhibits low default rates. Finally, narrowly syndicated credit can offer some of the advantages of private credit with the liquidity that comes from publicly traded instruments.

What does 2025 have in store?

While many pension plans are on track to close 2024 with strong funded positions, plan sponsors should remain wary of potential risks in the new year. For example, there remain many unknowns surrounding whether central bank policy will achieve a soft landing, how U.S. tariffs may impact economic growth and inflation, and whether the equity market rally will persist.
We expect continued strong activity from plan sponsors in diversification and de-risking to protect their hard-earned gains from any adverse surprises.

Key takeaways

- Short rates decreasing due to central bank rate cuts could be a potential tailwind for leveraged strategies as financing costs decline.
- Longer-term bond yields rising could provide an attractive entry point for mid- to long-duration fixed income.
- Equity valuations have hit new highs, reflecting a market consensus that equity markets are richly valued.

Sources: BlackRock Aladdin, Bank of Canada, 2024-5.

Disclosure

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Unless otherwise stated, all figures and estimates provided have been sourced internally and are as of December 31, 2024.

Unless otherwise noted, all references to "$" are in CAD dollars.

All data are subject to change.

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