



Fenyx Capital

1st annual strategic outlook

2025 long-term capital market assumptions



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Introduction: navigating the new economic times

This report, prepared by Fenyx Capital, synthesizes the collective long-term capital market assumptions (LTCMAs) derived from leading global institutional strategists, including J.P. Morgan Asset Management, Northern Trust, BNY Investment Institute, AQR, and EFG. Our mandate is to draw upon these quantitative frameworks and qualitative overlays to establish a foundation for generating superior, risk-adjusted returns over the next decade.

We explicitly acknowledge that this report is a **congregation of diverse forward-looking assumptions**, intended to guide strategic asset allocation (SAA) toward resilience and enduring value creation, rather than providing proprietary short-term forecasts. These forecasts span a typical 10-year horizon (2025–2034)

The prevailing consensus points to the definitive end of the post-2009 paradigm defined by low investment, low growth, and ultralow interest rates. In its place emerges a fundamentally healthier economy, characterized by **stronger nominal growth, robust capital investment trends, and structurally higher interest rates**. This environment provides an opportunity for the traditional 60/40 portfolio to once again generate diversified returns.

While recognizing the inherent uncertainty in forecasting (humility is required, as historical results show forecasts can be too optimistic or conservative), we view risk not merely as a hazard to be avoided, but as an avenue for opportunity when properly managed. Success will hinge on diversification and active management capable of extracting alpha from a more volatile, yet richer, terrain.



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1. Macroeconomic and thematic drivers

The foundation of our outlook rests on several powerful thematic forces that will shape returns:

A shift to fiscal activism and higher neutral rates

The global economic structure is transitioning from a regime dominated by monetary activism (quantitative easing) toward **fiscal activism**. This transition is underpinned by structurally higher neutral cash rates across key economies, suggesting that short-term policy rates will remain higher than in the previous cycle. This shift has critical portfolio implications:

1. **Increased volatility:** Aggressive fiscal policy, coupled with deteriorating global debt-to-GDP ratios, suggests that government borrowing risk is elevated. This trend may foster greater bond market activism, potentially **steepening yield curves globally** and pushing the volatility of sovereign debt higher.
2. **Equity-bond correlation:** The long-run correlation between global equities and core government bonds is projected to be near zero. This represents a definitive departure from the firmly negative correlations that benefited traditional portfolios from 2006 to 2022. While bonds remain essential diversifiers, portfolios must integrate assets that hedge against inflation shocks, such as real assets.

AI-Enabled productivity

Artificial Intelligence (AI) is expected to act as a significant catalyst, providing a **boost to corporate earnings primarily through improved profit margins**. Developed markets are generally better positioned to capitalize on this trend due to higher investments in R&D and infrastructure, and greater exposure to relevant sectors like software and pharmaceuticals. The benefits of AI will likely accrue disproportionately to the largest and most diversified hedge funds that can skillfully deploy these technological resources.

Globalization is bent, but not broken

Although geopolitical tensions are morphing supply chains and increasing economic nationalism, globalization has slowed but not reversed. The world remains highly integrated, reinforcing the importance of being highly selective in investment choices. Economic nationalism influences foreign exchange forecasts; for instance, U.S. dollar depreciation is expected to be more muted than in prior years, partly because inflation forecasts for ex-U.S. regions are converging toward U.S. levels, reducing the expected inflation differential.



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2. Equities: growth vs. valuation

Our forecasts for equities are nuanced, balancing solid macroeconomic growth prospects against challenging starting valuations.

Valuation and performance outlook

The starting point for assessing equity markets remains valuations. On average, current valuations hover around fair value globally, with some sectors (notably technology) appearing expensive. This valuation backdrop suggests that equity market returns will be slightly below average over the long term, with **limited room for further multiple expansion**.

Key U.S. large cap expected returns over the long term (in unhedged U.S. dollar terms, nominal) range, for example, from 5.7% (Deutsche Bank) to 7.5% (Northern Trust/BNY Mellon). These returns are expected to be driven by robust revenue growth, supported by higher nominal GDP, and potential profit margin expansion linked to AI-Enabled Productivity.

Strategic diversification and emerging markets

Emerging market (EM) allocations warrant thoughtful construction, as the expected growth premium has declined relative to historical assumptions. Expected EM equity returns range up to 7.7% (BNY Mellon, unhedged U.S. dollar).

A critical observation concerns correlation shifts: The correlation between **China and Emerging Markets excluding China (EM ex-China) has decreased significantly** (from nearly 0.8 in 2019 to 0.6 today on a 15-year rolling basis). Conversely, the correlation between EM ex-China and the U.S. remains elevated. If this dynamic persists, there is a **potential diversification benefit from establishing a stand-alone China equity allocation** separate from broader EM exposure, allowing for more dynamic tactical decisions based on valuation extremes.

We advocate for exploring non-U.S. markets, which often trade at discounts to their U.S. peers despite being geared toward strong secular themes.



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3. Fixed income: elevated yields and credit challenges

The outlook for fixed income is notably favorable over the next decade, primarily due to the elevated starting point of current yields. The most reliable predictor of long-term bond returns is the current yield-to-maturity (YTM).

Yield curve and sovereign debt

We anticipate **steepening yield curves**. The forecast for the fair value cash-to-10-year yield curve slope has been raised, reflecting expectations of persistently higher rates across the yield curve due to active fiscal policy and capital investment needs. For the U.S. Aggregate Index, returns are forecasted around 4.8% (BNY Mellon) or 4.6% (AQR, nominal USD).

Credit spread normalization

Credit markets currently exhibit unusually tight spreads in both Investment Grade (IG) and High Yield (HY) sectors. The normalization of these spreads over the 7–10 year horizon is expected to lead to returns that are below current yields.

We project that U.S. IG credit spreads will widen from 70 basis points (bps) to 110 bps, and U.S. HY spreads will widen from 310 bps to 470 bps. Investors should be mindful of the potential for increased credit risk, as global debt-to-GDP ratios are deteriorating across most economies, signaling higher volatility in sovereign bond markets.



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4. Alternatives: the pursuit of alpha

Alternative investments are essential for providing diversification and specialized risk exposures. The current market environment (characterized by higher base rates and greater macroeconomic volatility) is highly conducive to generating alpha and is expected to drive increased return dispersion.

Hedge funds: strategic flexibility

Hedge funds are expected to deliver solid risk-adjusted returns and exploit market inefficiencies that are unavailable to long-only strategies. The aggregate annualized expected return for hedge funds over the next 10 years is generally projected around 5.3% to 5.5% (U.S. dollar, net of fees).

Macro funds are identified as the most promising strategy, historically generating the largest amount of alpha. Their unconstrained ability to invest across equities, fixed income, currencies, and commodities positions them well to exploit geopolitical issues stemming from *globalization being bent* and capitalize on momentum from *AI-enabled productivity*. We expect alpha to contribute approximately 60% of returns for diversified hedge fund strategies.

Private markets: headwinds and opportunities

- **Private equity (PE):** PE forecasts have modestly improved (J.P. Morgan cap-weighted composite at 9.9% U.S. dollar, net of fees) due largely to methodological adjustments that better incorporate the impact of leverage. However, PE faces notable structural headwinds, including a higher cost of capital and historically high levels of uncalled-yet-committed capital, or **dry powder**. Competition to deploy this dry powder will likely detract from alpha generation at the average manager level.
- **Private credit (direct lending):** Expected returns remain attractive (e.g., 8.2% U.S. dollar, J.P. Morgan). However, the sector is challenged by the combination of the global easing cycle and growing amounts of dry powder (estimated at \$250 billion in the U.S. market). This imbalance risks pressuring managers to lower credit standards to achieve target internal rates of return (IRR).
- **Real assets (inflation hedge):** Real assets, such as commodities and natural resources, serve as essential diversifiers against left-tail supply shocks and inflation volatility. Commodities (expected 2.2% return, BNY) and global natural resources equities (expected 6.9% return, BNY) are highlighted for their positive correlation to inflation, providing critical diversification precisely when the equity-bond correlation rises.



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Conclusion: the path to resilient portfolios

The journey ahead, characterized by higher growth and higher rates, requires a fundamental shift in portfolio construction away from the passive strategies that dominated the "lower for longer" era.

Pragmatic realism must guide our decisions; we are neither overly bullish nor pessimistic, but focused on refining existing best practices. We must adopt active management and robust diversification strategies to insulate portfolios against inflation and fiscal risks. Bonds remain crucial diversifiers against growth shocks, but alternatives (especially macro funds and real assets) are now vital to mitigate inflation risks and enhance alpha capture in this complex, evolving financial climate.