Record Insights:

2025 – A Year of Overlapping Investment Risks

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As the year comes to a close our investment team turns its attention to the top investment risks for 2025. A key insight from this exercise is the challenge of isolating individual risks. While overlapping risks are not unusual, this heightened interconnectedness is telling of deepening macroeconomic and social trends. It highlights growing internal imbalances and international tensions, and the political movements borne from them—all of which increase the potential for contagion should perceived risks materialize.

This note does not aim to predict specific outcomes and refrains from speculating on unknown unknowns, but rather offers a broad perspective on the complex web of global macroeconomic and geopolitical risks shaping the investment landscape in 2025.

> "..intensifying economic and strategic competition (...) will exacerbate preexisting economic challenges in the global economy, and potentially amplify or redistribute geopolitical risks."

Andrew Bloomfield
Head of Macro Research

The incoming Trump administration could sustain “U.S. exceptionalism”

To start, much of the uncertainty in 2025 appears to stem from the incoming Trump administration, simply for the fact it stands to be a major policy shift in the world’s largest economy. Moreover, the proposed policy mix risks exacerbating several pre-existing vulnerabilities around the world. While there has been extensive discussion around President Trump’s fiscal, tariff, and deregulatory agenda, his unpredictable approach means that a translation of probabilities into practice could yet sustain the current period of exceptional post-pandemic US growth.

Principally, this stands to complicate the disinflationary process underway and could drive tighter monetary policy and a strengthening of the U.S. dollar. Historically, the U.S. dollar typically does well during these periods of U.S. economic outperformance and heightened risk aversion (Figure 1). Coincidentally, the U.S. dollar has closely followed the path of Trump’s election win in 2016, but subject to more aggressive tariff policies and further revisions to the U.S. rate outlook, it could begin to diverge as we approach inauguration day on the 20th January (Figure 2).

Figure 1 – US dollar performance in different economic regimes

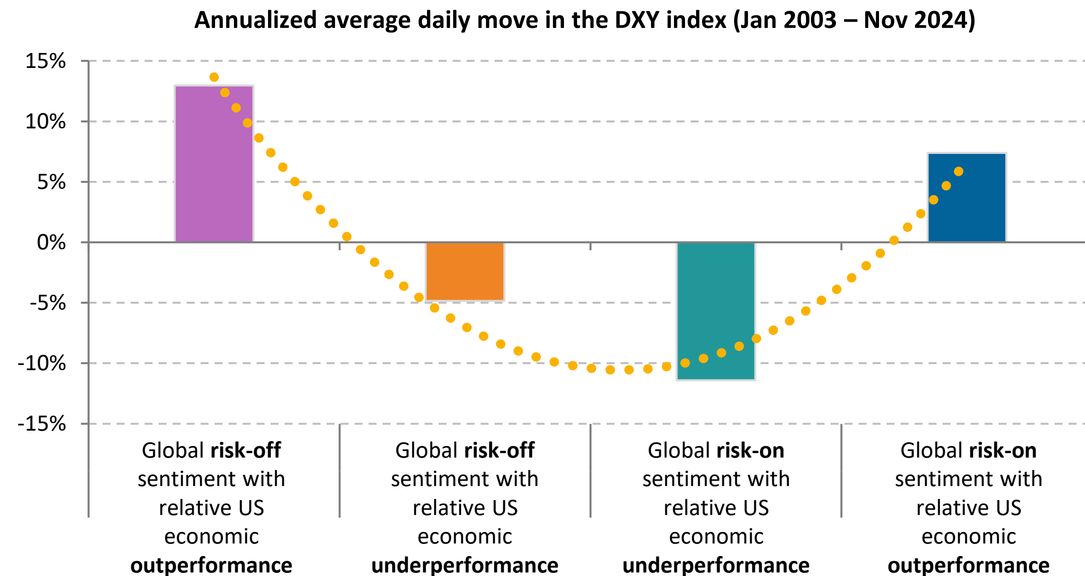
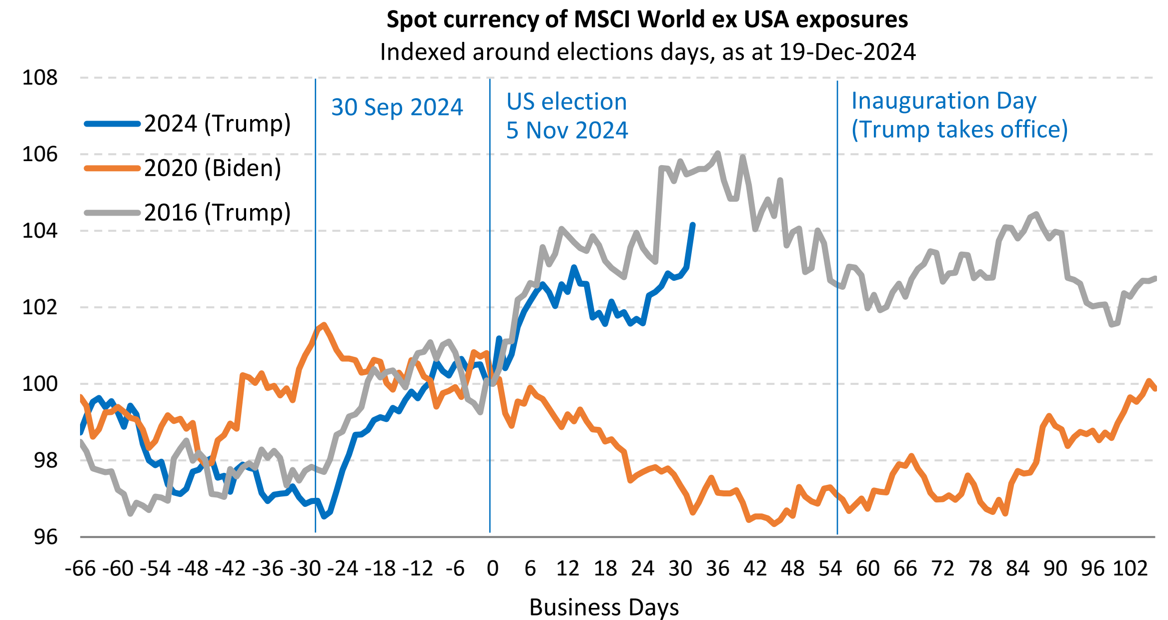


Figure 2 – US dollar around the past three U.S. elections



Source: Record, MSCI, Macrobond, CBOE, Citi. US economy outperforming when US economic data surprise is rising versus G3 economic data surprise. Risk-off classified as CBOE implied volatility being greater than the long-run average.

U.S. exceptionalism stands to complicate Europe's challenges

The persistent outperformance of the U.S. economy poses significant challenges for other regions, particularly Europe. Europe is grappling with a widening innovation gap with the US, and the continued diversion of capital away from Europe threatens to entrench structural growth differences that would be reflected more permanently in asset prices (Figure 3). Additionally, the looming threat of tariffs, intensified competition from China in key export markets, and conclusion of the cheap energy era will challenge Europe's traditional business model. With the European political establishment in disarray (e.g. France, Germany) – hampering further fiscal integration – there is a risk that the European project is tested by certain member states under higher interest rates and lagging growth (Figure 4). In such a scenario, all eyes will undoubtedly fall on the ECB to address financial fragmentation.

Figure 3 – Widening projected productivity growth gap

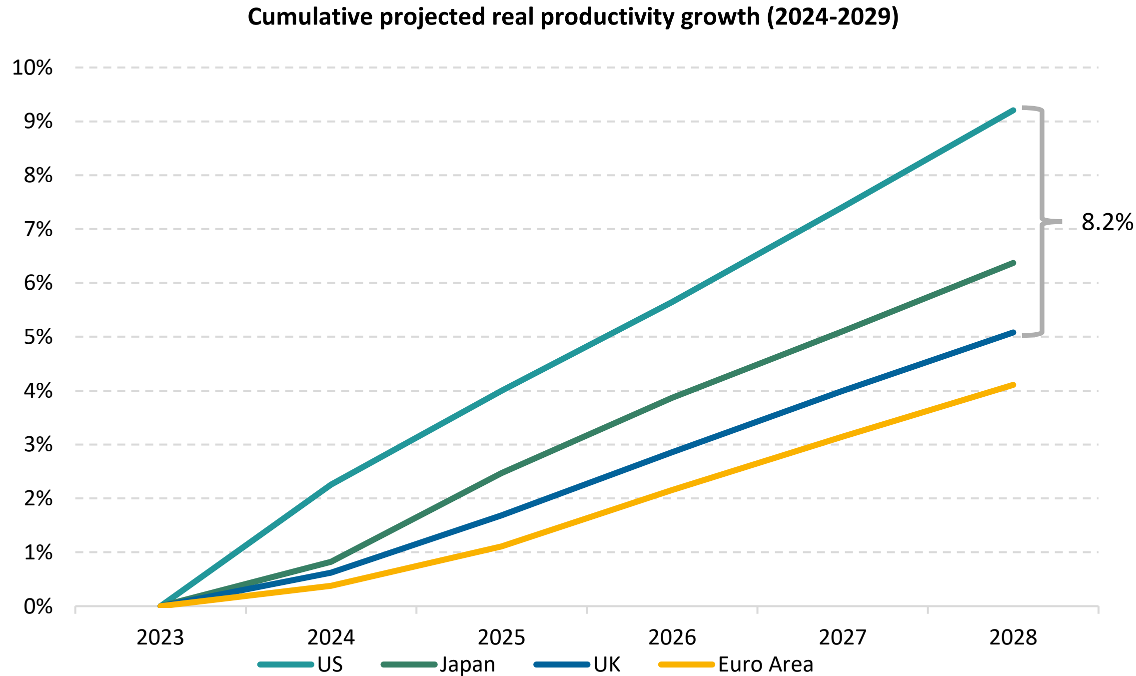
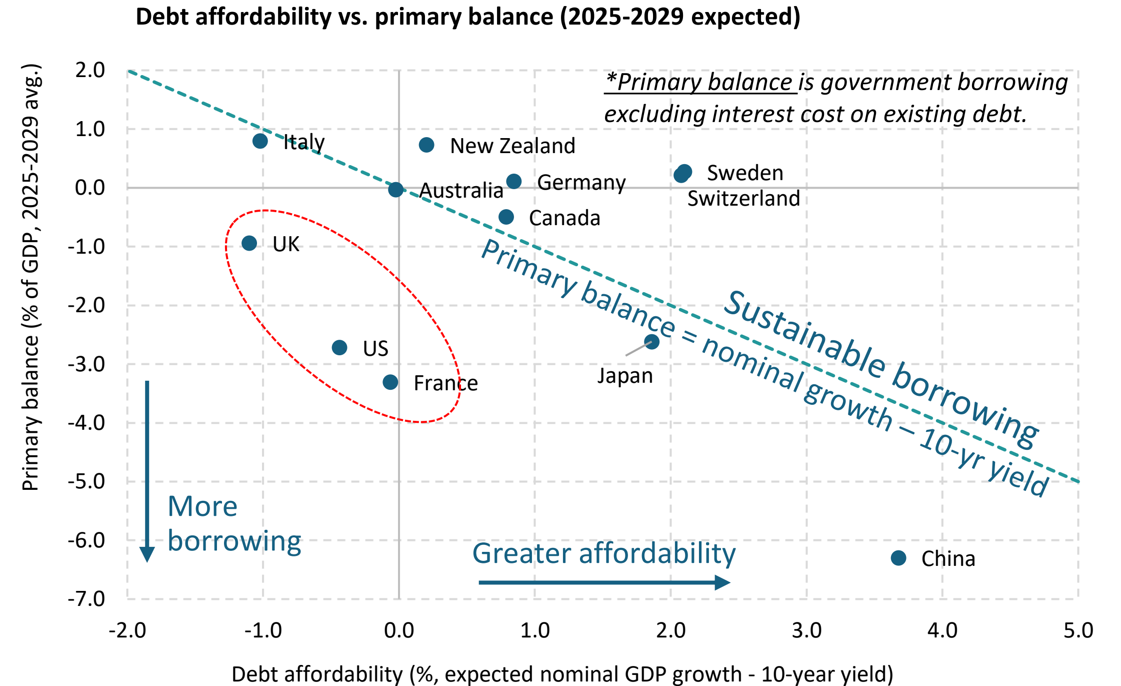


Figure 4 – Government debt affordability



Source: Record, Macrobond, International Monetary Fund. Euro Area productivity growth calculated as average of Germany, France, and Italy.

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The war in Ukraine enters a new phase of escalation or appeasement

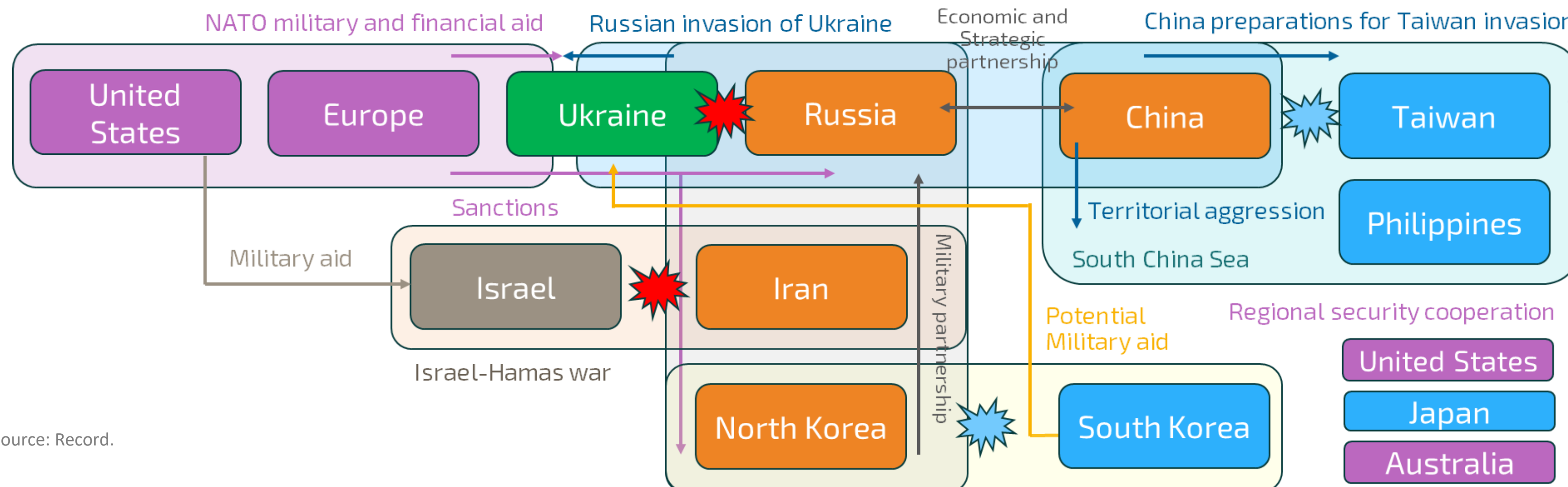
To the east, war in Ukraine is gradually escalating from a simmering conflict to something potentially more serious. Russia is bolstering its military, economic, and strategic partnerships with North Korea, Iran, and China, while U.S. ballistic missiles and U.K. Storm Shadow cruise missiles are now striking targets within Russian territory. Increased nuclear posturing by Russia, sabotage of undersea internet cables in Europe, and a cold start to winter drawing on Europe's gas reserves are all reminiscent of 2022. However, we now appear at a crossroads with more binary risks ahead.

President-elect Trump is confident in his ability to de-escalate the war in Ukraine, and he may well be successful, but it would likely involve a softening of the U.S. stance on Russia. Yet, with both leaders posturing from positions of perceived strength – Trump viewing Russia's military losses, Putin viewing gains in Ukraine's east – relations are unpredictable, and a new game of brinksmanship remains a distinct possibility.

Geopolitical interconnections make global de-escalation improbable

In the event of a de-escalation in Ukraine, this would provide a significant boost to risk assets, particularly in Europe. However, this must be viewed within the context of the broader geopolitical landscape (Figure 5). An appeasement of Russia in Ukraine could plausibly embolden China as it considers the prospect of a possible more forceful intervention in Taiwan. Coupled with a shift towards a more hawkish U.S. policy on China, this heightens the risk of confrontation, though such tensions are more likely to escalate closer to 2027 than in 2025. For now, the more immediate concerns in China centre on its struggling property sector, mounting debt burdens, and weak domestic consumption. On the other hand, the direction of travel is escalatory in the Middle East given Trump's pro-Israel cabinet, which poses its own risks to energy price volatility.

Figure 5 – Key geopolitical interlinkages

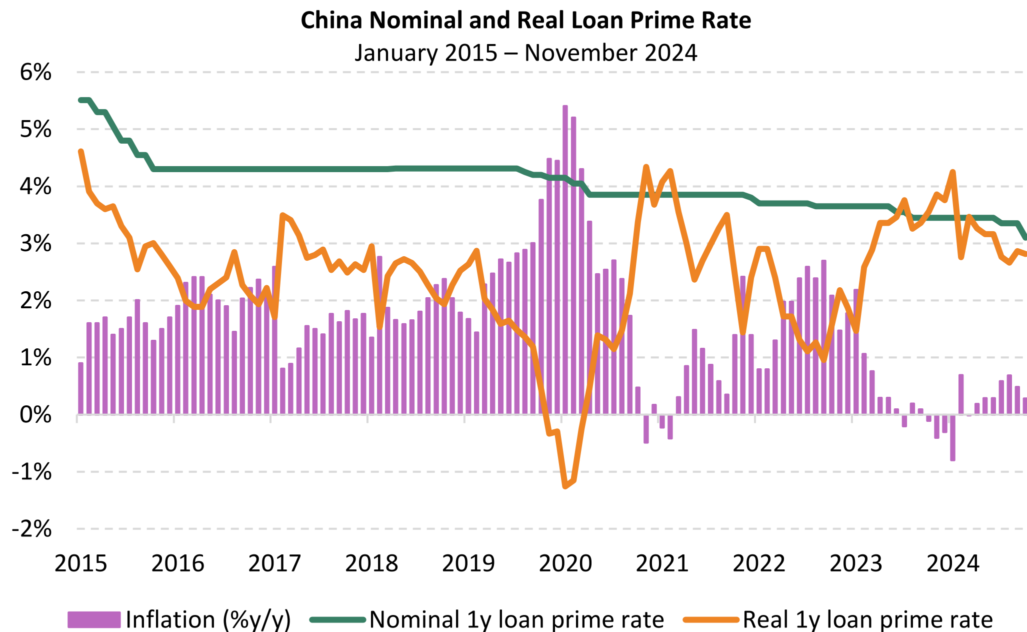


Source: Record.

China to prioritise domestic economy in 2025 amid potential renminbi depreciation

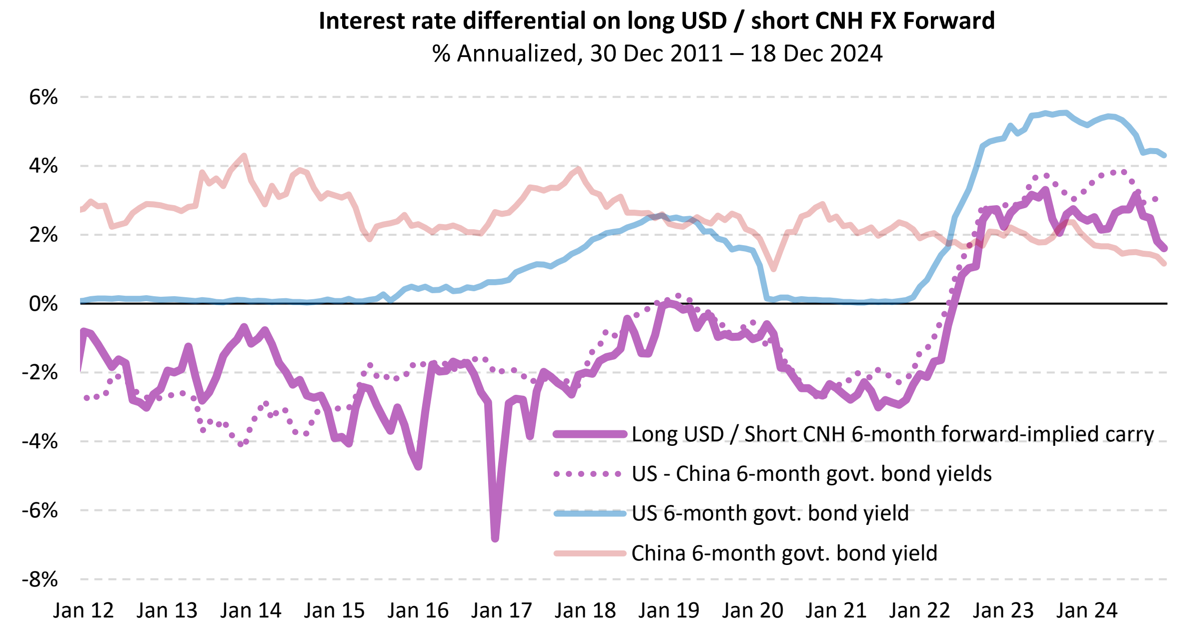
Chinese policymakers are focused on a complex balancing act to stabilise the exchange rate, maintain capital account liberalisation, and set independent monetary policy (Figure 6). Stabilising the exchange rate while partially importing U.S. monetary policy now necessitates fiscal easing to counteract the effects of tighter real policy rates (under low inflation) and the economic pressures from potential U.S. tariffs (Figure 6). The composition of stimulus has been disappointing to investors, though officials may be seeking clarity on Trump's tariff policy before committing to "more proactive" stimulus at the March National People's Congress meeting. This could support the outlook for China's trade partners and form a partial counterbalance to U.S. exceptionalism. However, concerns over moral hazard (i.e. incentivising poor decisions by local governments and state-owned enterprises) may constrain the scale of future stimulus. Since the U.S. election, the renminbi has seen only a modest decline compared to the 10% drop in 2018 in response to Trump's initial tariffs. This may suggest complacency regarding tariff risks or confidence in the People's Bank of China to stabilise the renminbi. In our assessment, a devaluation of the renminbi remains a key risk to consider managing in view of a positive carry when hedging the currency risk (Figure 7).

Figure 6 – China's nominal and real policy rates



Source: Record, Reuters W/M, Macrobond.

Figure 7 – FX Carry when hedging the Chinese renminbi



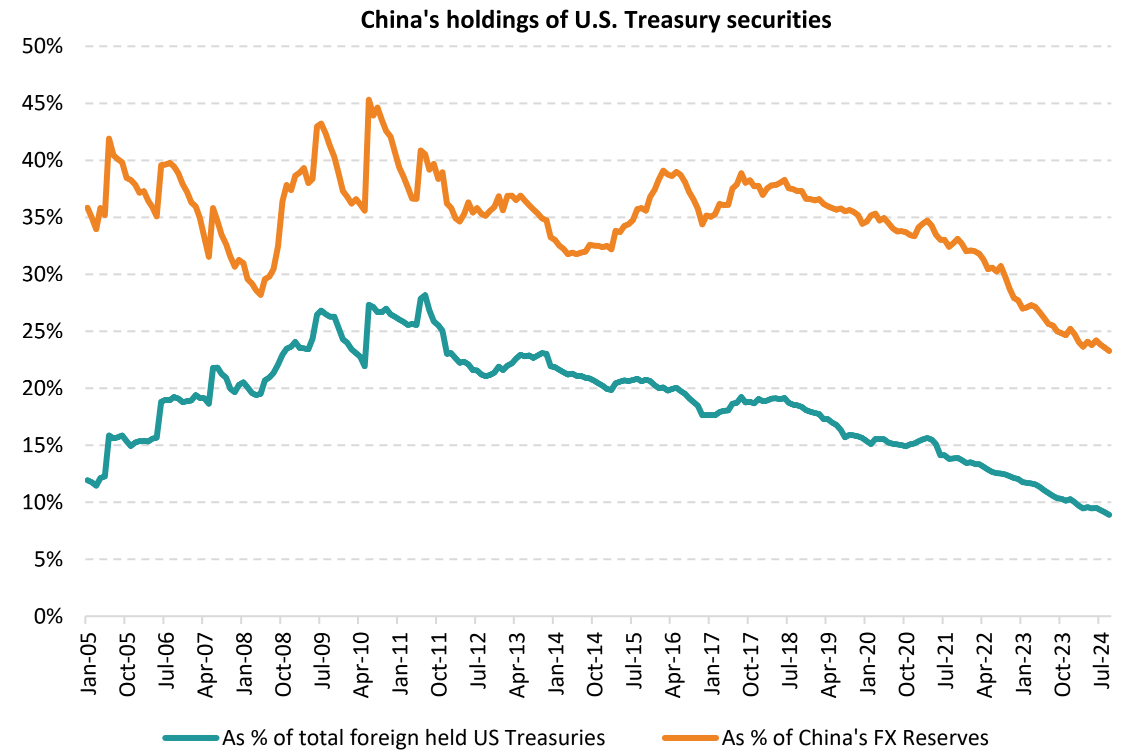
Assertive U.S. trade policies to address imbalances raise questions around dollar dominance

Some argue that the trade threats levied on China and the U.S.'s allies alike could backfire on the U.S. dollar, threatening its reserve currency status. While the risk remains low in our assessment, it cannot be dismissed outright. Dollar dominance rests on two key factors: the ideological alignment of most reserve-holding countries with the U.S. and the absence of a viable alternative country willing to run large deficits and issue external liabilities at scale.

China's divestment of U.S. treasury securities has been underway for some time and accelerated following Russia's invasion of Ukraine, likely to avoid making the similar mistakes (Figure 8). However, alienation of U.S. allies may prompt other reserve managers to diversify holdings incrementally. Additionally, the incoming administration's efforts to close the trade balance with China would mechanistically reduce global dollar flows.

A potentially offsetting factor to consider would be the asset allocations of U.S. based institutional investors. Here we see evidence (though yet to show up meaningfully in the data) of political pressure to divest from Chinese assets and U.S. equity market outperformance driving smaller international allocations and rebalancing back towards the U.S. Overall, a wholesale shift away from the dollar remains unlikely, but its dominance could gradually erode over time.

Figure 8 – China's declining U.S. Treasury holdings



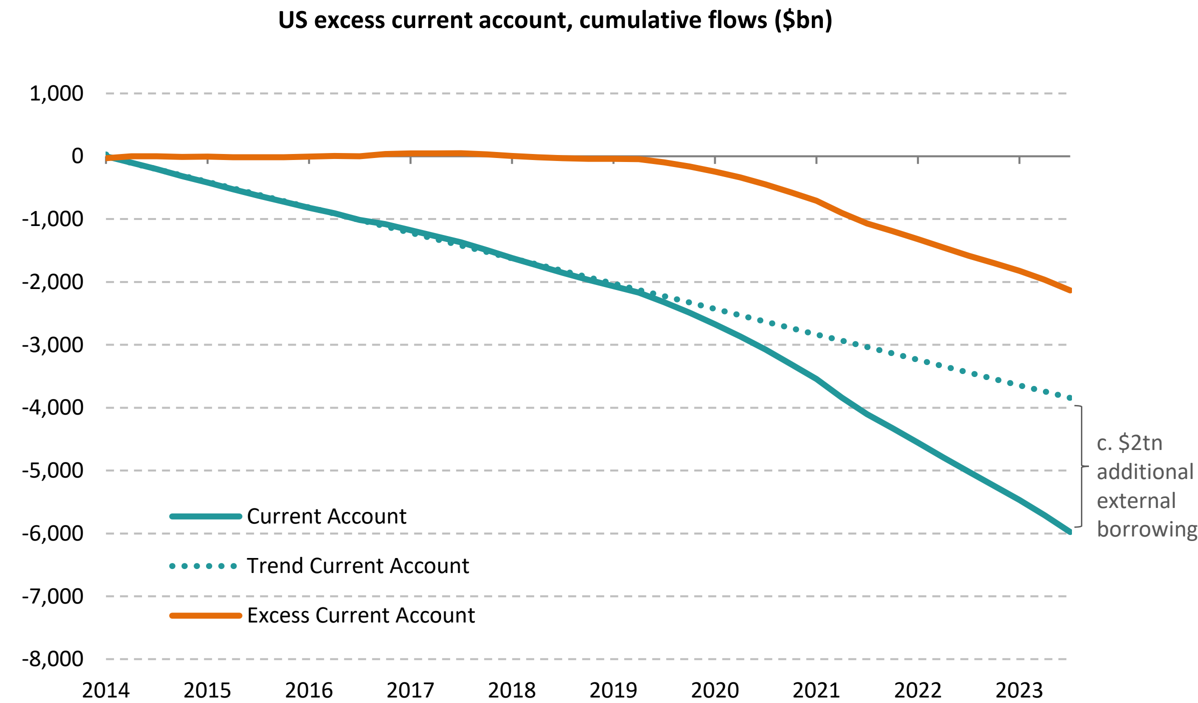
Source: Record, Macrobond, U.S. Department of Treasury, China SAFE

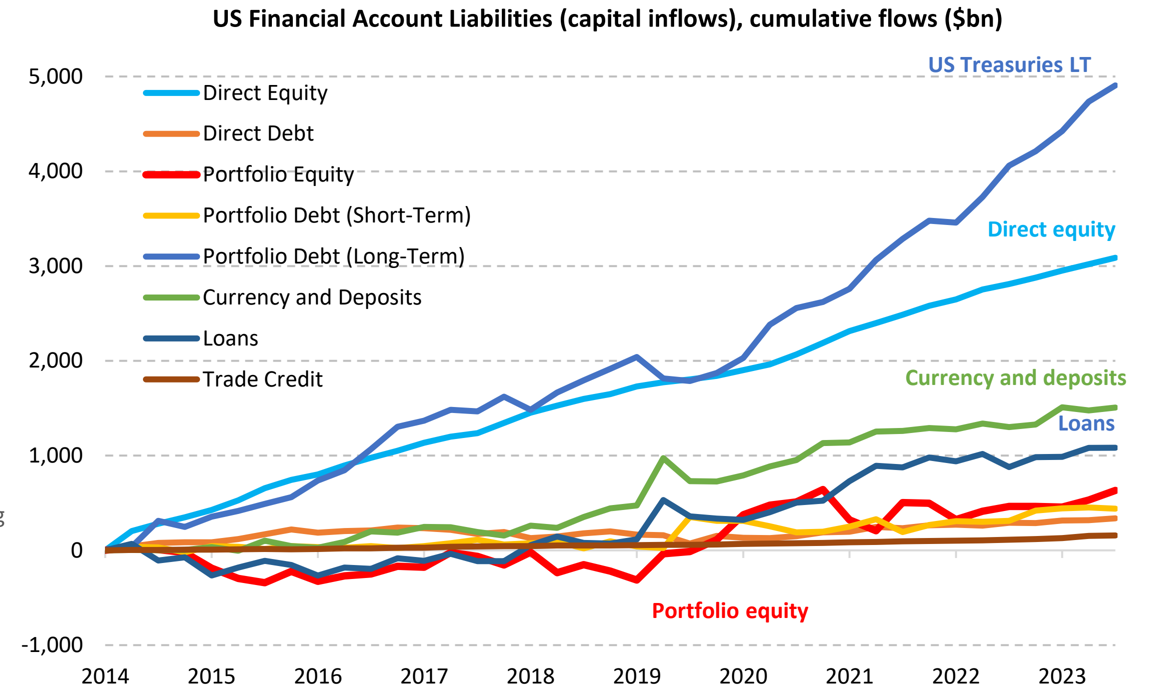
Yet there are more immediate risks to lofty U.S. dollar valuations

The more immediate risks to the U.S. dollar's elevated valuation, however, are domestically driven. Despite optimism about the U.S. economy, national debt is rising towards an unsustainable debt level. Any interference with the Federal Reserve's independence therefore remains a concern, especially if the President seeks to remove the Chair "for cause" in the event of economic underperformance.

While the courts would likely intervene, such a challenge could undermine U.S. institutional credibility, driving up term premia and alarming the external investors whose capital sustains the US dollar's value amid a widening dual deficit (Figure 9). Furthermore, the impact of other policies such as mass deportations are less studied and potentially underappreciated as a source of stagflation in the U.S. economy.

Figure 9 – US current account deficit financing





Source: Record, Macrobond, U.S. BEA

Other regions face turbulence while navigating their own challenges

Other regions will need to navigate their own unique challenges amid broader global trends. The UK's new Labour government offers relative political stability but its ability to address structural issues is unproven. In Japan, the minority government will struggle to pass reform, while the Bank of Japan cautiously forges ahead with rate hikes, contingent on economic and market conditions. This continued policy shift introduces upside risk to the yen, especially if market volatility intensifies. Meanwhile, Switzerland reminds us that deflation is still an outside risk, as it faces mounting disinflation pressures and will be contending with the zero lower and negative bound of interest rates again by mid-2025. In Emerging Markets, the tone will largely be set by US trade and relative monetary policy, China's growth impulse through trade channels, and geopolitics in Europe and the Middle East via energy prices. As ever, there is wide scope for political surprises to drive idiosyncratic performance as demonstrated by budget upsets in Brazil, surprise election results in Mexico, and momentary martial law in South Korea.

Conclusion

In 2025 the investment landscape will first and foremost be shaped by the incoming Trump administration's desire to correct trade imbalances blamed for domestic ills. This sees the U.S. and China locked in intensifying economic and strategic competition which will exacerbate preexisting economic challenges in the global economy, and potentially amplify or redistribute geopolitical risks. While the risks outlined here are far from exhaustive, they offer a framework for understanding the broader forces that could shape asset performance and market sentiment in the year ahead.

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Risk Warnings

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