Calculated risks

L&G

Stay agile, stay humble

Emiel van den Heiligenberg,
Head of Asset Allocation

When writing these introductions, it can be useful to look back at the previous quarterly to take stock of what has changed.

Last time around, markets had just endured the biggest falls since the pandemic in the wake of April's tariff announcements.

In dynamic portfolios, we had added equity risk around the bottom, but this only took our overall risk asset position back to neutral as we maintained an underweight in credit. Markets then had a sharp rebound when President Trump announced a pause in reciprocal tariffs. We were preparing to buy dips, believing that recession risks remain elevated, but the dips and recession have not materialised. As the rally continued we reduced our equity position to neutral shortly after the US trade deal with China, taking our overall risk asset position back to underweight. With hindsight, this move has proven premature.

The rebound has morphed into a bull run with strong returns across virtually all asset classes year to date. But with our underweight entirely in credit and spreads already relatively tight, this defensive posture has not been too costly.

US remains on track to deliver growth

Despite the tariff uncertainty, global growth has been slightly stronger than expected in H1. Some of this growth reflects a front-running of tariffs and inventory build, so there is likely to be some payback heading into year-end as trade and industrial production slow. Nonetheless, consensus still expects 1-2% US growth in the second half of the year.

For the UK and the euro area, sluggish growth is projected. Growth is expected to pick up next year, though the risk is the UK gets left behind as fiscal policy is further tightened.

China growth has recently disappointed with housing taking another leg down, but with some policy support the 5% growth target remains within reach.

Gauging the impact of tariffs

There remains uncertainty around US trade policy, which is exacerbated by legal challenges to tariffs. Reciprocal tariffs only went into effect in August, and sector-specifics tariffs are still not settled, so the full extent of tariff passthrough is still to be determined.

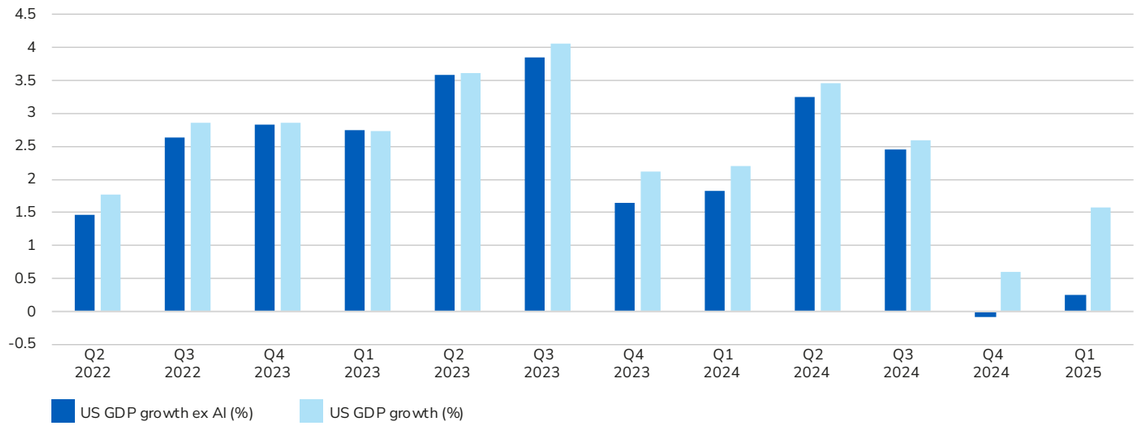
There is little evidence of foreigners cutting their export prices to the US. As tariffs work their way through US supply chains, US inflation should edge higher and squeeze real incomes in the months ahead. That impact is particularly pronounced at the bottom end of the income distribution, where some signs of credit distress are already emerging.

Following downward revisions to US employment, it seems that tariffs had a negative effect on business hiring decisions. Unemployment might stabilise as companies anticipate rate cuts from the US Federal Reserve (Fed) and some support from fiscal policy in 2026. However, the weakness in hiring now leaves the economy vulnerable to additional shocks, in our view.

Tackling the big questions: this quarter's articles

One of the main reasons the US has weathered the tariff shock is that surging AI investment spending across software, computer hardware and data centres has supported overall business investment, even as firms delayed spending in other areas. As shown in the chart, stripping the effect of AI from US GDP growth would present a very different trajectory.

AI contribution to US GDP growth



Source: L&G calculations, Macrobond, Artificial Analysis. AI spend includes computer, software, data centre and electricity investment. Investment not adjusted for import component as at 30 June 2025.

Q4 2025 | Asset Allocation outlook

Looking ahead, a potential upside risk to growth next year is an AI-driven boost to productivity. This is a theme James Carrick, Senior Economist, explores in his article in this outlook. He focuses on the impact of AI on job opportunities for younger workers, and the investment opportunities that could be created.

Tim Drayson, our Head of Economics, zooms in on the other elephant in the room: the market reaction to the political drama surrounding the Fed. As Tim explains, a loss of Fed independence could have some counterintuitive ramifications, at least in the short term.

As longstanding assumptions about the Fed come into question, investors may do well to reconsider the rationale behind their core exposures. Chris Jeffery, our Head of Macro Strategy, tackles one such question in his piece, answering the question of why hold duration?

Finally, we offer an update on our long-term expected returns framework, which is now able to incorporate valuation mean reversion. This further builds out our valuations toolkit.

I hope you enjoy the articles my team has put together for Q4, and they provide you with useful insights for your client conversations.

A spotlight on our multi-asset capabilities

This outlook coincides with multi-asset month at L&G – the latest in a series of campaigns shining a light on our various capabilities at L&G.

I hope the depth and breadth of insights on offer in this quarterly provide an indication of the level of expertise we have within the Asset Allocation team. This expertise is a core component of our approach, which ultimately aims to deliver a range of benefits to our clients:

- **Client-centred partnership:** We are a trusted partner in portfolio management, implementation, strategic advice, and knowledge sharing
- **Expertise, track record, and scale:** With a strong heritage, growing AUM, and a proven track record, we offer wide-ranging capabilities backed by specialised teams and collaborative insight
- **Full access to the L&G Platform:** We leverage the full breadth of L&G's investment strengths – across Index, Active and Private Markets – supported by a world-class Responsible Investment team and Global Trading infrastructure

An update on our dynamic positioning

As you can see in the table overleaf summarising our key dynamic asset class views, we are overall neutral risk on equities and duration. The largest risk on an broad asset class level is our significant underweight in corporate credit. Credit spreads are very narrow, and we believe investors aren't well compensated for taking risk in these markets.

The overall neutral position on equities and duration does not mean we have low convictions in our portfolios. On the contrary, within the asset classes we see plenty of interesting opportunities.

For instance, we expect the AI theme to broaden; within fixed income we see interesting idiosyncratic value opportunities, like Romanian bonds; we like infrastructure trusts for their potentially attractive yields; and we see lots of opportunities in currencies.

Equities

- **Artificial intelligence:** expecting the theme's beneficiaries to broaden
- **UK mid-caps versus large caps:** depressed valuations don't reflect a stabilised earnings outlook

Bonds

- **Japan:** relative value preference within government bonds
- **IG credit:** expensive vs. government bonds with more downside
- **EM local debt:** yield premium vs. developed bonds doesn't justify risk
- **India and Romania:** provide idiosyncratic opportunities

Alternatives

- **insurance-linked bonds:** a potentially attractive source of uncorrelated return
- **Infrastructure trusts:** given high stable yields and low correlations

Currencies

- **Mexican peso:** sentiment is believed to be excessively negative
- **Swiss franc vs. Japanese yen:** big valuation difference provides opportunity
- **Norwegian krone vs. Swedish krona:** appealing carry and valuation
- **New Zealand dollar vs. Australian dollar:** valuations are approaching the limit of their historic range

Q4 2025 | Asset Allocation outlook

Our key asset class views

Overview	Strategic allocation
Equities	●
Duration	●
Credit	●
Inflation	●
Real estate	●

Equities (inter-region views)	Strategic allocation
US	●
UK	●
Europe	●
Japan	●
Emerging markets	●

Fixed income	Strategic allocation
Government bonds	●
Investment grade	●
High yield	●
EM USD debt	●
EM local debt	●

Currencies	Strategic allocation
US dollar	●
Euro	●
Pound sterling	●
Japanese yen	●
EMFX	●

This schematic summarises the combined medium-term and tactical views of L&G's Asset Allocation team as of 31 August 2025. Asset allocation is subject to change. The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. Regional equity views should be read in conjunction with the overall equity view. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point.

The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.

Trumpification of the Fed

How serious is the threat facing the independence of the bank? And if independence erodes, what might happen next?

Tim Drayson
Head of Economics

There has been intense presidential pressure on the Fed to cut rates (Jerome "too late" Powell). This serves the purpose of deflecting blame should the economy turn down unexpectedly. So far, the Fed has ignored the political noise and conducted policy with its best intentions for the long-run health of the economy.

But is independence of the Fed under more serious threat? There has already been one early resignation from the Fed Board (Governor Kugler) with Stephen Miran now confirmed to temporarily fill the seat and voting for aggressive rate cuts.

There is also the prospect of another seat opening up, with Governor Cook accused of mortgage fraud and the president calling for her to resign immediately. She is resisting, citing a 'clerical error', and so far the courts have ruled the president does not have 'cause' to fire her, with the Supreme Court appeal set to hear oral arguments in January. It is also unclear if the Department of Justice will take the case to trial.

Could Powell stay on?

Then there is the question of Powell's seat. Typically, when the chair's term ends, they step down from the Board of Governors. This could open up a third nomination for the president. Other seats could also be in play. Will Governor Barr want to continue? He may have stayed on to support Chair Powell after resigning in February 2025 from his role as vice chair for supervision. It is common for governors to not serve their full terms. Vice Chair Bowman and Governor Waller preferred to cut rates earlier and more aggressively than the rest of the Federal Open Market Committee and were appointed by President Trump in his first term.

While clearly dovish, both are expected to uphold Fed independence. However, if the White House gains influence over four new governors, it would have the ability to a make more radical changes (a quorum of four is required for decision making).

For example, the 12 regional Fed presidents' five-year terms all expire at the end of February 2026. Normally, the reappointment by the Board of Governors is a formality, but this is now a critical moment for future Fed policy.

All Fed governor appointees have to go through the Senate confirmation process. This will not need any Democrats, as only a simple majority is required. Furthermore, the Senate has recently and controversially passed legislation which allows the bundling of nominations. This will make it even harder for Republican senators to vote against candidates, even if they have misgivings, as it would slow down appointments across a range of other agencies.

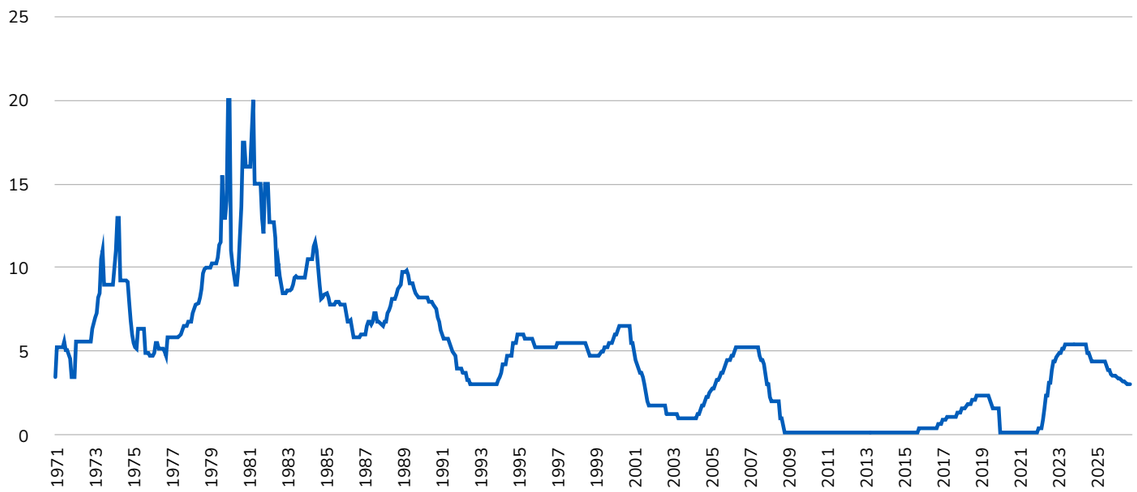
Market reaction:

Academic research and historical experience shows independent central banks are the best way to maintain long-run price stability as they can resist short-term political pressure. It takes years to build a reputation, and trust can be broken in an instant.

However, markets might even cheer at first. Consider the uncertainty around the neutral interest rate. If the market believes an independent Fed has kept policy too tight, a steady loss of Fed independence could lead to interest rates being brought down closer to their optimal level and growth might improve. Any negative consequences from higher inflation could take time to materialise.

The most severe reaction from financial markets might come if inflation starts to rise and a White House-controlled Fed denies there is a brewing inflation problem. This could lead to a sudden loss in the credibility of the Fed, rising inflation expectations and a weaker dollar. In theory, yield curves should steepen, but in extreme the Fed could introduce some type of yield curve control.

Fed funds target rate, mid point



Source: Macrobond and Bloomberg for market forecast. As at 30 September 2025.

Assumptions, opinions, and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

All bonds are equal, but some are more equal than others

Which duration assets should investors own? It depends on the underlying motivation for holding duration.

Chris Jeffery
Head of Macro Strategy

Duration risk, defined as the sensitivity of portfolio returns to changes in risk-free interest rates, is embedded in almost any portfolio.

For some assets, it is explicit. Fixed income securities (bills, bonds, loans, asset-backed securities) reprice directly when government bond yields change.

For some assets, it is implicit. Securities with variable cashflows (notably equities) are sensitive to changes in government bond yields because they impact the discount rates applied to those cashflows. For assets with no cashflows (notably commodities and digital assets), changes in government bond yields impact the price through their effect on the opportunity costs associated with investment.

Thinking about it from first principles helps us to consider why (and where) to hold that duration risk. When crafting a portfolio, we should aim to eliminate unrewarded risk and diversify rewarded risks.

It should be noted that diversification is no guarantee against a loss in a declining market.

Duration for risk reduction

If you think that duration risk is unrewarded, it only makes sense to hold if it reduces risk (putting aside arguments about liability-hedging or reinvestment risk). That is more likely to be the case when the markets fret about the growth outlook and is less likely to be true when fiscal or inflation concerns dominate.

In the current environment, we think these arguments point to taking duration risk in slightly unusual places. Australia has very little debt by international standards, with net debt at just 30% of GDP, and continues to enjoy AAA ratings. The British/French/US/Japanese concerns about unsustainable fiscal deficits simply don't apply, but nonetheless they pay some of the highest yields in the developed world.

If you want to hold duration for protection purposes, you can do a lot worse than looking down under.

Duration for returns

But, if you think that duration risk is rewarded, then you should be looking for the markets where government bonds are likely to deliver a return over cash when held to maturity. Academics refer to a "positive term premium" when that condition is met.

The historical data suggests that positive term premia are more likely when yield curves are steep or when government yields are meaningfully above equivalent maturity interest rate swaps. Those conditions are currently met in Japan and the long end of the gilt market. It's no coincidence that those are the markets where questions are being raised about fiscal sustainability.

All else equal, where investors worry most about fiscal risks the reward for bearing that risk is likely to be highest.

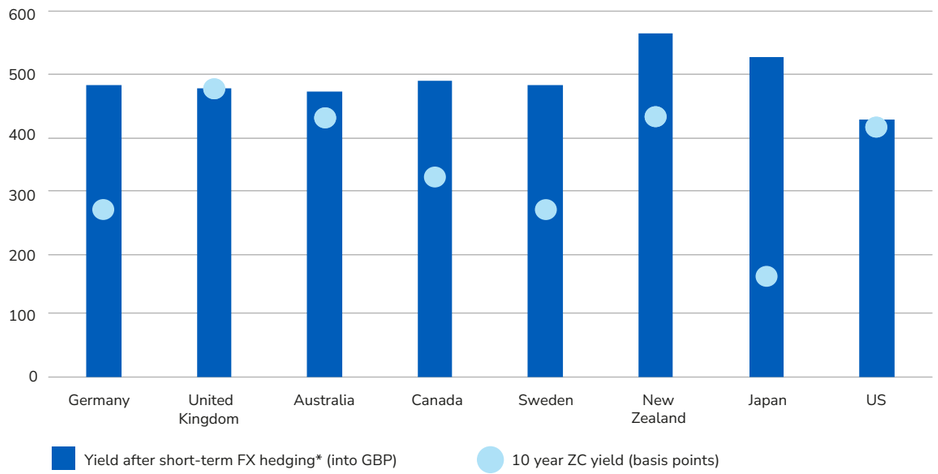
Horses for courses

So, we're left with a bit of a conundrum: either avoid the markets where fiscal risks are greatest or actively seek them out, depending on your motives. That might sound two-faced, but it raises the prospect of different strategies being appropriate for different investors.

For low-risk portfolios, there's a good case for allocating more to those government bonds which now compete with investment-grade rate credit.

But for portfolios where growth risks dominate, the incentive to allocate to the more fiscally prudent sovereigns is likely to dominate.

G10 yields (before and after FX hedging into GBP)



* Short-term FX hedged yields using 3M FX forwards
Source: Bloomberg, as at 24 September 2025.

AI adoption and jobs – positive for productivity?

While younger workers are finding careers in jobs where AI augments their skills, they are struggling to find jobs in sectors exposed to automation.

James Carrick
Senior Economist

It's been clear for at least the past 12 months that the outlook for artificial intelligence (AI) could make or break the equity market. Large-cap earnings growth has long been driven by the largest tech names.

But, in recent quarters, it has become increasingly clear that AI-related capex plans are directly keeping the economy afloat, partially offsetting a cyclical slowing in consumer spending, as shown in the chart that accompanies Emiel's introduction to this outlook.

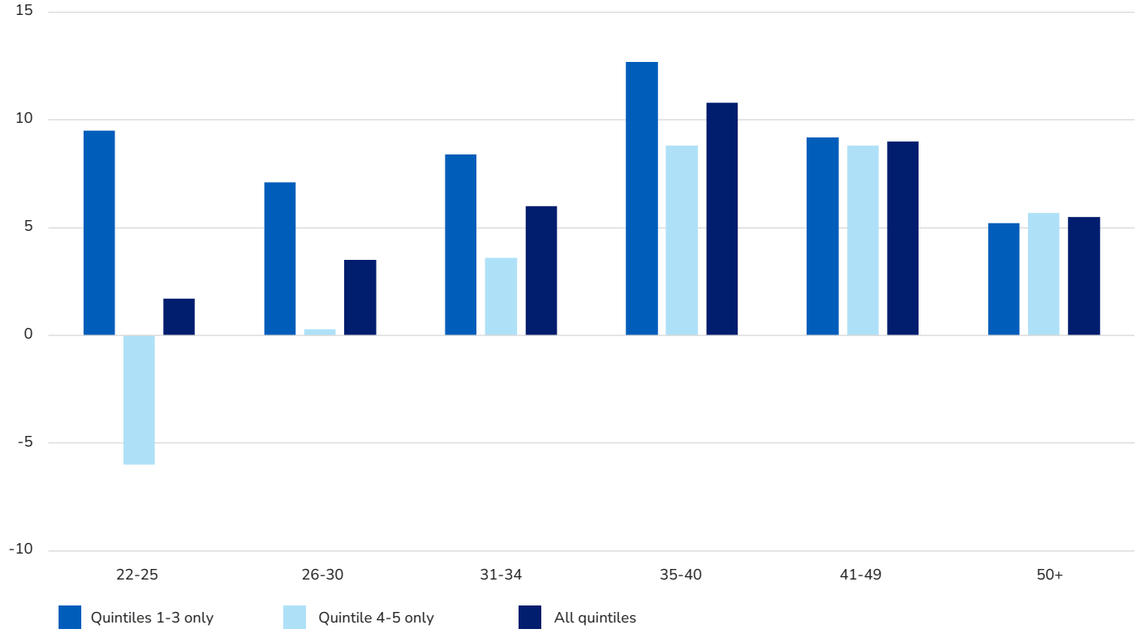
The proof of the pudding for AI will be whether the technology can deliver economy-wide productivity improvements. That will determine whether returns on investment are sufficient to validate the US$600bn spending splurge of the past decade. It is with that in mind that we are interested in new micro-level data that points to a notable impact developing at the younger end of the labour market.

Youth employment stagnation

A new academic paper from Stanford uses a large administrative dataset (ADP) to examine employment trends by age and exposure to AI. The researchers find that employment is falling for 'early career' workers (defined as age 22-25) in AI-exposed jobs such as software development and customer service. However, while early-career jobs that AI can automate are declining, those where AI can 'augment' labour (e.g. maintenance and repair workers) are not.

Job losses in highly AI-exposed areas explain stagnation of young-people employment

Growth in employment between October 2022 and July 2025



For younger workers (higher quintile = more AI-exposed). Source: Stanford paper: Canaries in the Coal Mine? Six Facts about the Recent Employment Effects of Artificial Intelligence.

The researchers' theory is that young people are struggling because they have 'textbook' knowledge that AI can reproduce, while older workers have more 'on-the-job' knowledge (e.g. how each firm works) and so are less affected. However, they also find that less-educated occupations vulnerable to automation are seeing problems even up to age 40, as the benefits from experience are less relevant in such roles.

The authors also suggest firms could be in an evaluation phase. It's easier to pause hiring and test AI than to fire experienced workers (we note that half of job losses in recessions are typically due to less hiring) so firms could be experimenting with AI. This seems likely to lead to broader job losses down the line.

Overall, the paper concludes that job losses in highly AI-exposed roles explain the stagnation of young-people employment, as shown in the chart.

How does this compare with previous research?

In a recent blog, we evaluated some earlier research and suggested that the impact of AI on the graduate market may be more gradual than feared. So how does this new paper differ?

For starters, the latest research uses *employment* data rather than vacancies. We were previously unsure how to interpret unfilled vacancies falling from 'war-like' highs following COVID.

Moreover, it has a much bigger dataset. It uses administrative data from ADP on around 3.5 million workers. This is 58x bigger than the 60,000 people sampled in the monthly labour-force survey. This allows for better-quality granular analysis: the labour force survey becomes erratic even just looking at recent graduate unemployment, let alone by occupation.

We suggested a general hiring freeze due to tougher macro conditions would also explain an underperformance of recent-graduate employment. However, the authors control for macro shocks using 'firm' and 'time' fixed effects (e.g. how an individual construction or nursing-home company behaved as monetary policy tightened from 2022). The authors still find a *relative* decline of 12% of most-to-least AI exposed youngest workers *within* each individual firm.

We found similar struggles for both recent college graduates and school leavers. This paper ducks that issue by only focusing on workers aged at least 22. However, it does find less-educated workers are struggling up to age 40 in careers exposed to AI automation.

Watch this space

Overall, this fascinating paper uses a larger dataset to find 'canaries in the coalmine' (early-career workers) struggling to find work in areas most exposed to AI automation. This should, over time, lead to a notable productivity boost – which is much needed given demographic pressures from ageing.

It is only three years since large language models burst into the popular consciousness. The fact that we can already see their footprint in the labour market points to an extremely encouraging rate of adoption and impact.

More of our thinking on AI
This article is an expanded version of a blog we published in September.

If you're interested in our research on the impact of AI on jobs, the global economy and geopolitics, check out these links:

- **Degrees of doubt:** AI, anecdotes and the graduate labour market: why the threat may be more gradual than feared
- **Black cabs and bookstores: Does youth employment track technological change?** Historical analysis suggests early-career workers may indeed be canary chicks in the coalmine. So, their current career challenges could be the first flutters of AI adoption
- **Can China's engineering state break US AI dominance?** For now, the US has a significant advantage in cutting-edge AI chips, but China promises more surprises to come

Adding a new lens to our CAMERA: mean-reverting valuations and expected returns

We've evolved our expected returns framework to incorporate valuation mean reversion, providing new insights into a range of asset classes.

Patrick Greene
Strategist

John Southall
Head of Strategic Research

We're introducing a new enhancement to CAMERA (our expected returns framework): the ability to incorporate historical sensitivities[1] into our valuation signal. The new approach introduces a statistically robust way to incorporate valuation mean reversion, guided by history.

What's different?

The existing model assumes ratios like the earnings yield (or price to earnings) do not revert to any historical average or equilibrium value. That is a prudent but cautious approach. When equity market valuations are very high (low) we will forecast lower (higher) returns because you have paid more for the future earnings that determine your returns. But we don't expect any additional losses (gains) from valuations changing. The new model allows for valuation changes.

Why didn't we do that from the start?

When it comes to forecasting returns, valuation signals are a powerful tool, but they're not without their problems. We've written extensively about the pitfalls of traditional scatterplot or regression-based analysis of valuations and returns: start the 5-part series here. For the purposes of this article, it's sufficient to note that a lot of charts and regressions you see are overestimating the influence of valuations, and we wanted to avoid making that mistake.

But our new approach corrects for the statistical issues that commonly plague this type of analysis. After correcting for the bias, we find there is still a meaningful impact of valuations on returns. And that in many asset classes the beta is greater than 1. A beta greater than 1 means valuations did historically revert. For those who want to know all the detail, part two of our series goes into more detail on the bias and our correction.

We think having both versions is a great enhancement.

Implications for expected returns

Valuations now play a more prominent role in shaping expected returns. Our existing model already uses valuation signals to inform expected returns. What's new is that we now allow you to incorporate mean reversion by asset class, based on historical data. This means:

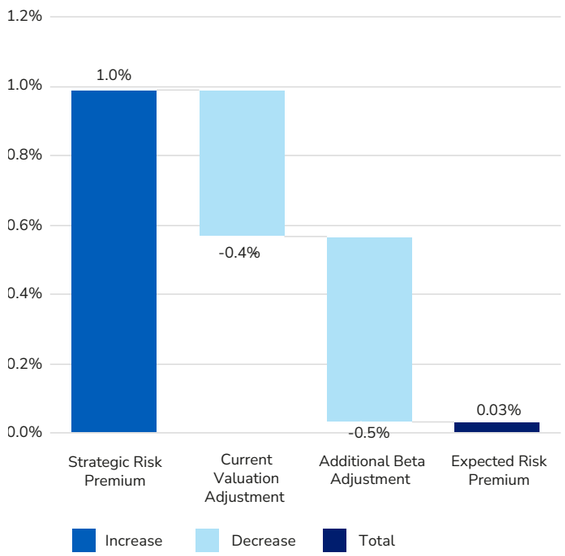
- If valuation has historically been a strong predictor of returns in an asset, the model will reflect that
- If the relationship has been weak or inconsistent, the model will downplay the signal accordingly
- If there's evidence of mean reversion – where valuations tend to return to long-term averages – we'll capture that too, even though our core model doesn't assume it explicitly

1. This refers to thesensitivity of annualised expected returns over the forecast horizon to the starting yield level. If this number is 0.8, for example, then annualised expected returns change by 0.8% (on average) for every 1.0% change in yield.

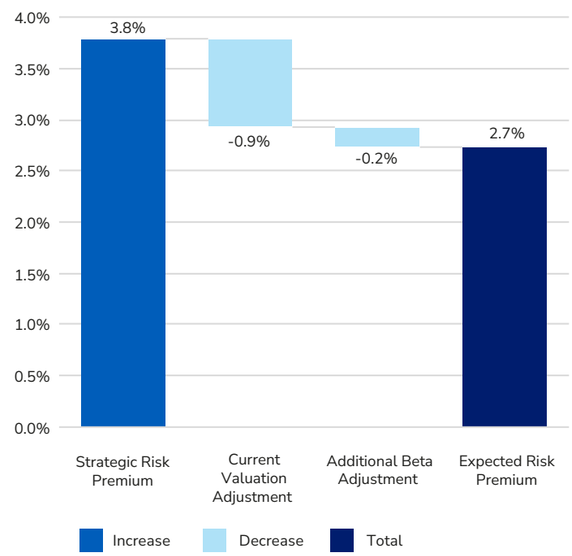
Examples: credit vs equity

To bring it to life, we have two examples. The first is US investment grade credit. The historical evidence for mean reversion is particularly strong in investment grade spreads, so the impact here is large. The new methodology reduces the risk premium by an additional 0.5%: more than the entire adjustment applied under our previous approach.

US IG credit 10-year risk premium estimate



US equity 10-year risk premium estimate



Source: L&G as at 30 September 2025.

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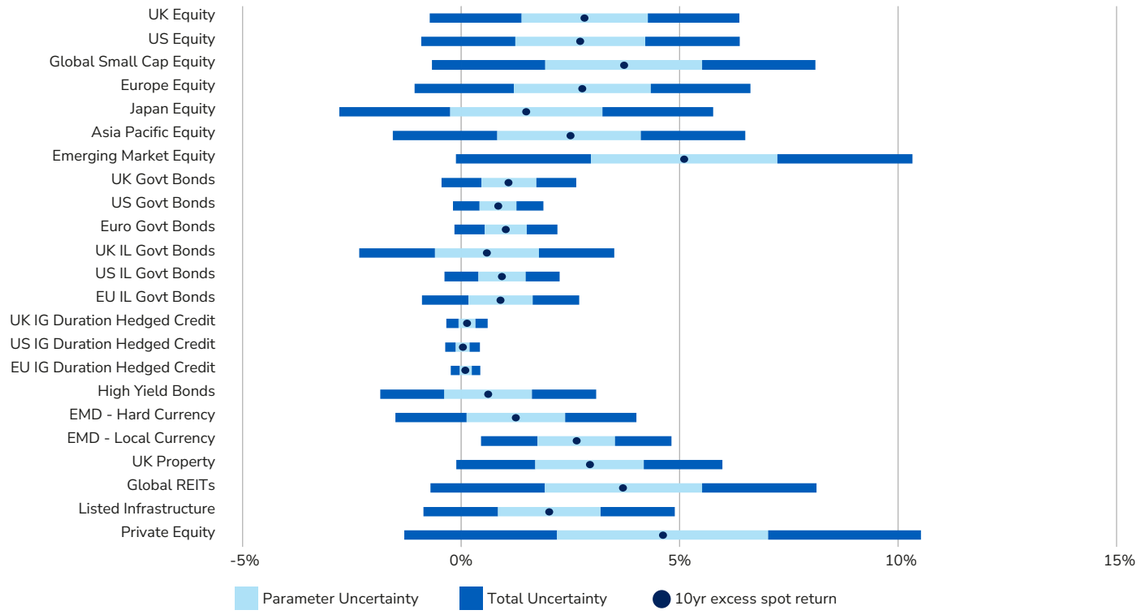
Ten-year excess return distributions



Source: L&G as at 30 September 2025.

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Past performance is not a guide to the future.

The second is US equity. There is evidence of mean reversion for equity valuations, but it is comparatively weak. So, the effect is smaller. Starting with our structural risk premium of 3.8%, we adjust it for valuations using our current methodology, reducing it by 0.7%. The second adjustment reflects the influence of our new methodology, over and above the current methodology. That is an additional decrease of 0.2%.

What's next?

CAMERA is an important part of our valuation toolkit. It is one of a variety of valuation signals our strategists use. This enhancement means better valuation signals, particularly in asset classes where historical mean reversion is strong. Being able to estimate both versions of our model should allow us to make more informed decisions and push us to think carefully about which state of the world seems more likely going forward.

That is not the end of our CAMERA innovations. We will continue to develop our model. Expected returns estimates are highly uncertain. Assumptions we make about the world can determine the answer and there are not always obvious right assumptions. To that end, we will continue to stress test alternative assumptions, refine the model and evolve the way we use it.

Contact us:

For further information about the Asset Management business of L&G, please visit **am.landg.com** or contact your usual L&G representative.

Key risk

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested.

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