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Investment Returns: A 5-year perspective

GIAM Macro & Market Research

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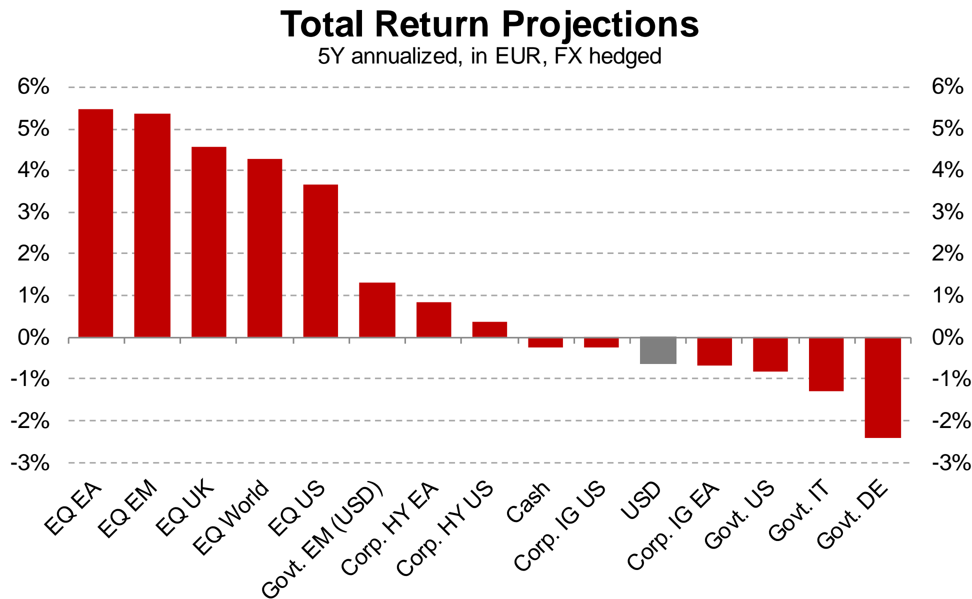
EXECUTIVE SUMMARY

Fixed income doomed, no alternative to equities



- 2019 has seen **huge inflows into Fixed Income (FI)** funds and outflows from Equities. **From a medium-term return perspective this makes no sense.** Strong demand for safe assets reflects cyclical and structural forces (e.g. ageing).
- No matter the economic scenario, **FI returns over the next five years are doomed**. Government bonds and IG credit will struggle to deliver positive returns. **Riskier credit should do better**, yet will hardly beat inflation. Worse still, FI assets, especially in EUR, will barely offer a cushion to portfolios in an alternative recession scenario.
- **Valuations in Equities are much less stretched than in FI**. They will not repeat the performance of the past ten years, but are still likely to deliver **mid-single digit returns** over the next five years.
- The **positive tail-risk** takes the form of an innovation and **productivity shock boosting both real rates and profits**. The **negative financial tail risk** includes a severe recession (unlikely) or a new form of **populism** tackling income inequality. The latter would likely support long-term stability but over five years would **imply higher inflation and taxes**.

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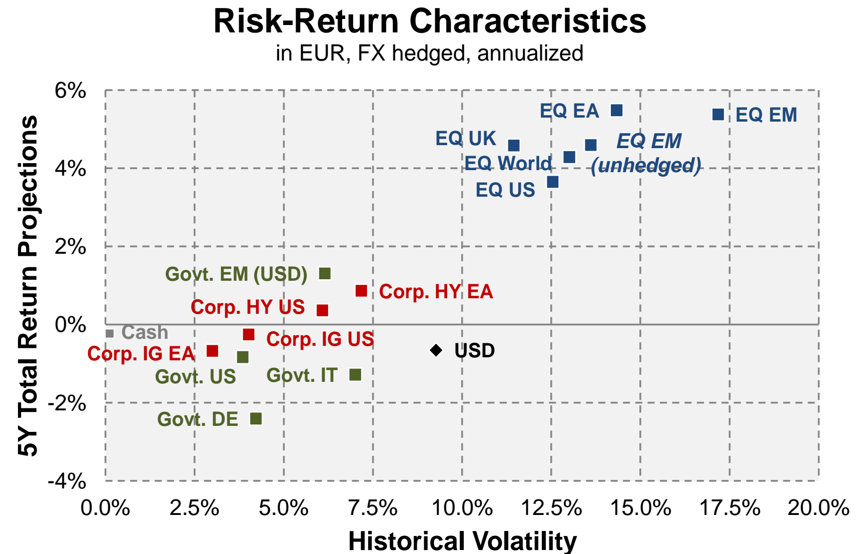
Key upshots from our analysis

- **Nowhere to hide**: to preserve capital, a large chunk of portfolios will need to be invested in riskier segments: **Credit** and, more importantly, **Equities**.
- Fixed income investors will struggle to achieve nominal capital preservation on a 5-year horizon.
  - annual returns on German Bunds to average -2.4%
  - Even IG Credit may fail to post positive total returns.
  - Decent expected UST performance (+1.3%), but high FX hedging costs turn exp. returns negative



- **Risk/reward: EM hard currency debt** (mostly USD) and **HY exposure** (both in EUR and USD) look superior to euro area IG corporates and govies (including BTPs).

  This is also due to a benign volatility profile (comparable to Bunds/UST while juicier in returns).
  - US bond returns are not materially above European bonds, but UST yields have more cushion to fall: **US bonds offer better risk protection** against adverse macro scenarios than European bonds.
- Holding **cash remains unattractive,** as it will render negative returns for sure. But it will quite likely still **outperform government bonds** by a sizeable margin.
- **TINA (there is no alternative):** Devoting a **substantial share of the funds to equities** is essential. MSCI World expected at 6.5% p.a. in USD, still above 4% when hedged in EUR. Euro area stocks rank highest (5.5%).

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What could make us completely wrong?

1. A severe downturn

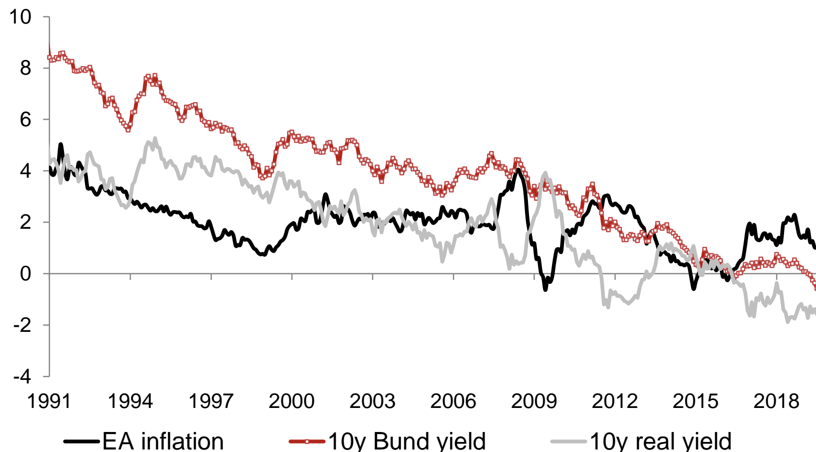
- Equities, EM and credit would suffer.
- Fixed Income, especially the safer 'risk-free' government sector, would not offer the same cushion as it did in the past.
- That said, we see two silver linings:
  - **Overall no large macro imbalances in the system**. However watch pockets of fragilities from gap risks (crowded preferences in style, algo trading, rise of passive investing, banks retreat as market makers). At the macro level non-financial leverage has increased but longer debt maturities and lower debt servicing costs have reduced the risk of a severe balance sheet crisis.
  - The negative yield disease has increased the **economic pain threshold** that would force investors to rush out of risky assets.

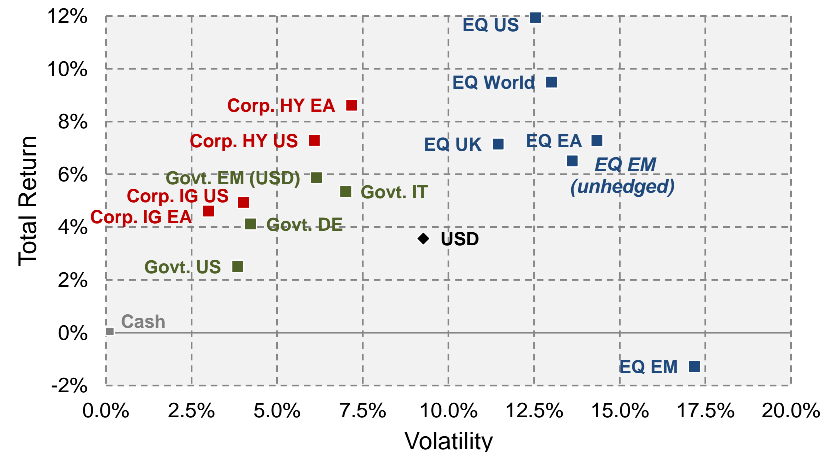
		Total Return Projections *(5Y, annualized)*		
Asset Class	**Currency**	**Local**	**EUR, FX hedged**	**EUR unhedged**
Cash	EUR	-0.2%	-0.2%	-0.2%
Govt. DE	EUR	-2.4%	-2.4%	-2.4%
Govt. IT	EUR	-1.3%	-1.3%	-1.3%
Govt. US	USD	1.3%	-0.8%	-1.5%
Govt. EM (USD)	USD	3.5%	1.3%	0.6%
Corp. IG EA	EUR	-0.7%	-0.7%	-0.7%
Corp. HY EA	EUR	0.9%	0.9%	0.9%
Corp. IG US	USD	1.9%	-0.3%	-0.9%
Corp. HY US	USD	2.5%	0.4%	-0.3%
EQ World	USD	6.5%	4.3%	3.5%
EQ US	USD	5.9%	3.7%	2.9%
EQ EA	EUR	5.5%	5.5%	5.5%
EQ UK	GBP	6.0%	4.6%	6.8%
EQ EM	USD	7.6%	5.4%	4.6%
		Spot	**Carry**	**Total**
USD		-2.8%	2.1%	-0.7%

2. Reflation and a normalisation in bond yields

- Many structural reasons to assume that low *real* yield environment will persist. But blurring of frontier fiscal/monetary policy may trigger rise in inflation and yields.
- Mounting pressure to tackle inequality, triggering rising wages & taxes, reversal of tax cuts and breaking monopolies (watch US presidential elections next year).
- Scenario may be **initially bearish for both stocks and bonds**, but ultimately benefit cash and *real* assets.
- The impact on bond returns would also depend on the **speed** of the correction: the earlier the shock the better, as at least re-investment through the holding period is quickly done at a higher level.

A radically changed investment outlook





- "*It is difficult to predict, especially the future*." Predicting 5-year returns is ambitious, yet key for **Strategic Asset Allocation**.
- Reassuringly, medium-term returns depend on **valuation metrics** that we control better than drivers of short-term returns.
- **Beat inflation if you can**. People invest to see their money grow. In today's **'upside-down' world** – with about 25% of the global IG Fixed Income universe trading at negative yield – even **capital preservation will be far from trivial**.
- This is a **radical change from historical norms**. Real 10-year Bund yields have fallen from an avg. of +2.1% prevailing during the decade before the Great Financial Crisis to -1.7% as of late. Safety has become very costly for investors.
- Over the **past decades** the consistent downward trend in yields boosted financial returns:
  - German government bond index yielded almost 4% p.a. (since 2009); Italian bonds +5.4%.
  - Credit about 4.5% (Investment Grade) and High Yield 8.6%; EMU equities: +7.3%.

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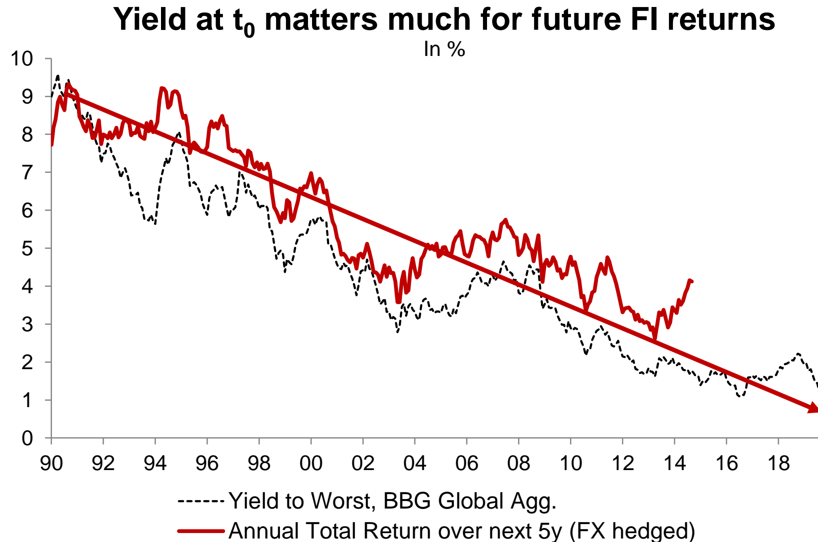
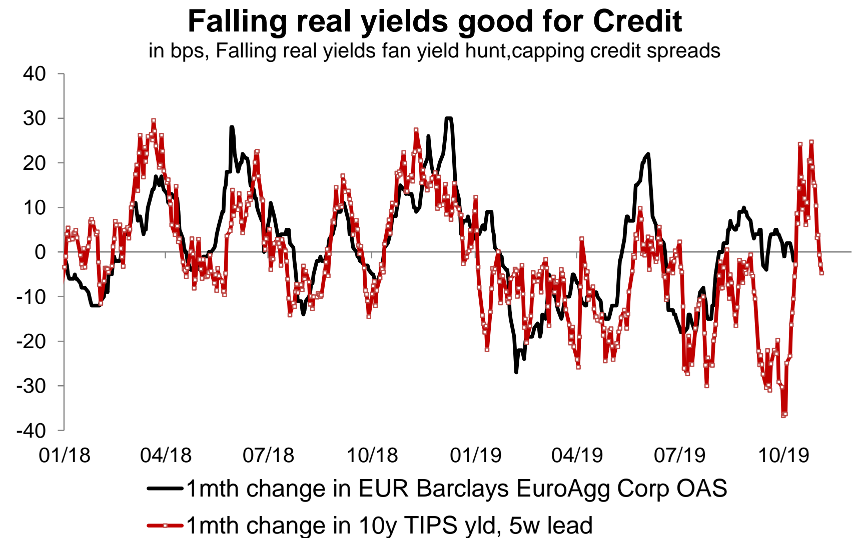
Fixed Income outlook burdened by low yields and asymmetric risks





- **Yesterday's boon is today's headache**. Future FI returns largely depend on today's yield levels. Total Return has consistently stood above current yield (left chart) as declining in yields generated capital gains. With yields stabilizing (or rising) the two lines will converge (cross) – FI total returns **are poised to prove much lower than they have been.**
- **Furthermore, FI now offers asymmetric risks**. The leeway for a further drop in yields is very limited, with the ECB rates already close to the lower bound. But there is much to lose in case inflation accelerates and bond yields rebound.
- Similarly, corporate risk premia are already fairly tight. Strong central bank support notwithstanding, **the potential for a widening will likely be larger** in case the global economy and risk sentiment deteriorate more materially.
- The **correlation between credit spreads and risk-free rates** is now less benign (right chart). In the past, setbacks in credit were cushioned by a fall in risk-free rates. This cushion is now largely reduced.

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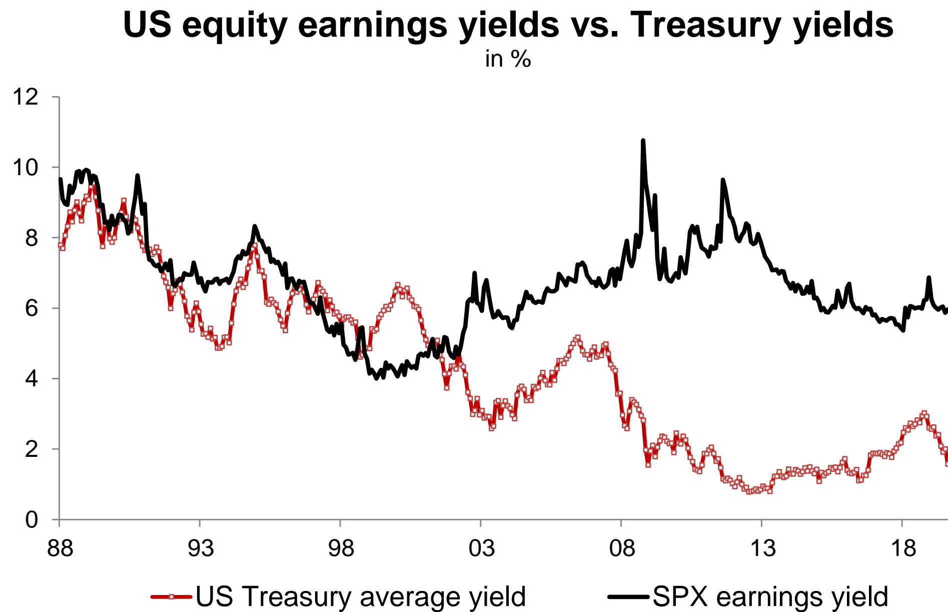
Investors inevitably need to assume risk in equities to escape the negative yield trap



- In order to escape the negative yield trap, **investors inevitably need to assume some risk in their portfolios.**
- Luckily **equities still offer better returns perspectives**. The earnings yield, which offers solid guidance to future equity returns, exceeds bond yields by far.
- **Equities** offer a **decent risk premium**, though they **will not reproduce the double-digit returns** that have been the norm over the past decade (+12% p.a. for S&P500).
- Our 5-year annual return expectations of around 3.5-5.5% for equities are averages that of course may include severe drawdowns.

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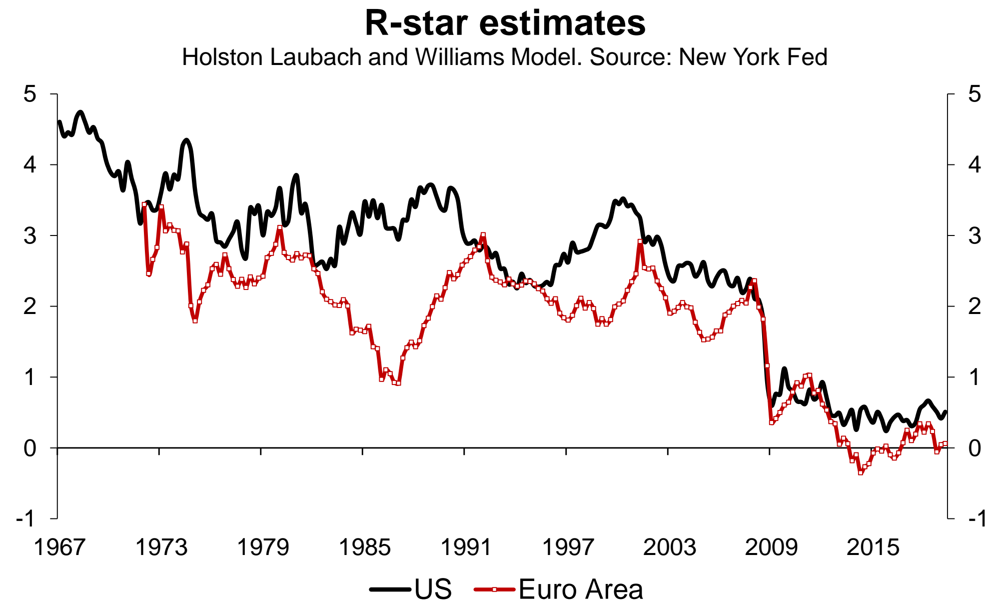
A persistenly lower growth and rates environment

- We expect **secular stagnation** (= increase in overall propensity to save, whereas that to invest falls) over the coming years due to:
  - Slower population and (possibly) technological growth
  - Cheaper capital goods
  - Rising income and wealth inequality increasing the income share of people with a lower propensity to consume
  - Ageing (higher risk aversion) and tighter financial regulation will result in higher demand for safe assets.
- Moreover, **productivity growth has dropped sharply**. Adverse demographics and de-globalization will continue to drag on productivity growth.



➔ As a result, we see euro area (US) **potential growth falling** from ~1.5% (1.9%) to 1% (1.7%) within five years.

We also expect **low inflation to persist**. We deem it unlikely that the ECB's inflation target of 2% will be reached in the foreseeable future whereas the Fed's inflation objective appears attainable.

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Monetary policy to stay accommodative for much longer

- The real central bank rate at which monetary policy is neither expansionary nor restrictive (r-star) is estimated to be currently around 0% in the euro area and 0.5% in the US.
- Looking ahead, we **expect r-star to recede on a 5-year horizon** in the US as well as in the euro area.
- Central banks:
  - **ECB**: only **slowly unwinding its ultra-lose monetary policy** over the coming years, keeping the *real* short-term policy rate deeply negative.
  - **Fed**: Following the current easing cycle we expect only a **cautious upward adjustment** from 2022 onwards.

2024 macro and central bank scenario	Euro area		US	
	current	*2024 proj*	*current*	*2024 proj*
Equilibrium real short term rate (r*)	0.06	-0.18	0.40	0.12
Inflation	1.30	1.70	1.70	1.95
Potential growth	1.50	1.00	1.90	1.65
Neutral Central Bank policy rate	1.36	1.52	2.40	2.07
Current real short term rate (r)	-1.74	-1.50	0.25	-0.10
Current nominal short term rate	-0.31	0.25	1.95	1.85
Effective Central Bank policy rate	-0.50	0.20	2.10	1.80

➔ **Central banks to remain accommodative**, especially in the euro area. Neutral policy rates will not be reached.

We see the risks tilted to the downside, unless we see a radical change in (non-monetary) policies (strong push towards reducing *inequality* could prove inflationary).

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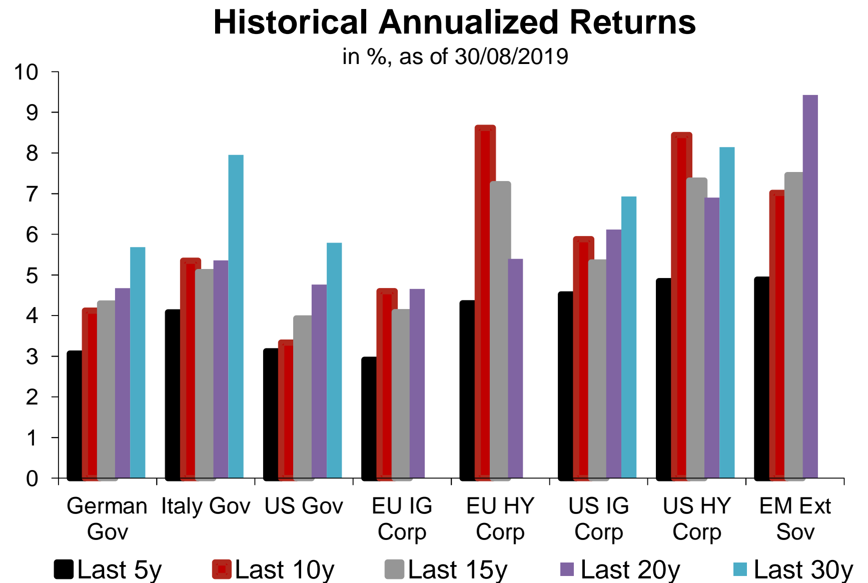
Very low yields today imply meagre total returns going forward

- A **common approach** for fixed income assets and equities is applied to ensure consistency. This way transparency and comparability is achieved.
- Three common components which add up to the overall total return for all assets:
  - **Income**
  - **Growth**
  - **Valuation**
- For fixed income assets, the **current yield is a major component of future returns**.
- Very low starting point. Many bonds are even trading in negative yield territory.



- The fall in yields has already taken its toll. Returns have been trending lower. The **impressive total returns of the past will remain out of reach**.
- In contrast to other assets, bonds deliver a pre-determined pay-out over their lifetime.
- Other factors partly cancel out, e.g. an increase in yields causes a capital loss but increases the re-investment yield.
- The **risks are asymmetric**. A further significant yield decrease is hardly possible. Hence, in addition to the low current yield investors will eventually suffer capital losses.

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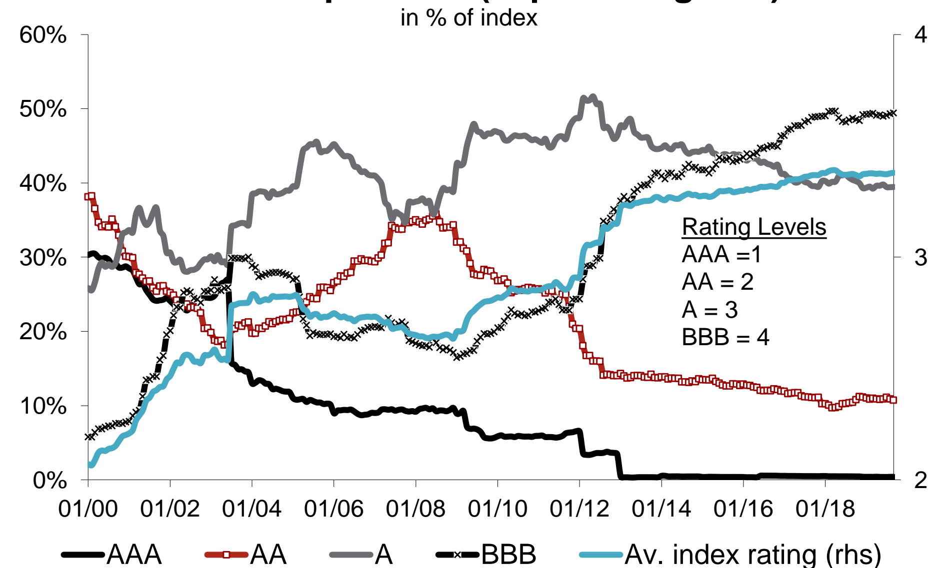
The framework to derive return forecasts rests on income, growth and valuation as key pillars

- We assume that **investments are made in indices** (not in a specific portfolio). Dynamic rebalancing justifies the assumption of stable maturity.
- **1. Income**: The sum of coupons (main pillar for FI):
  - To abstract from cyclical developments, a linear development from the current yield level to the forecast yield at the end of the horizon is presumed.
  - New bonds are assumed to be issued at par.
- **2. Growth**: mark-to-market changes due to the passing of time (roll and the pull-to-par effect).
  - The **roll effect** is positive (positive slope) as the remaining maturity decreases over time.
  - The **pull-to-par effect** will be negative as most bonds are currently trading above par.



- **3. Valuation:** changing valuation as yields move.
  - A **change in the risk-free yield level** will affect all bonds negatively as moderately higher yields are predicted.
  - A deteriorating credit mix implies higher spreads and capital losses. The **credit migration** is expected to remain negative for IG corporate bonds. For HY corporate bonds, a slightly positive effect is predicted (as in the past).
  - Finally, **credit defaults** cause losses. While less relevant for IG corporate bonds, HY corporate bonds and EM debt will experience a negative effect in the forecast period.

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Methodology to deduce yield and spread levels for a 5-year horizon

- To derive total returns, we need to project yield and spread levels on a 5-year horizon.
- We assume a linear path towards the terminal value (no crystal ball).
- Three different approaches are applied:
  - Regression models (most important)
  - Forward pricing (if available)
  - Long-term average (lowest weight)
- **1.** To deduce a fundamental level for each sub-asset class several models are used. Input factors into the **regression models** include economic and monetary variables, corporate fundamentals and financial market values.
- **2.** Where available, **current forward pricing** is used to reflect market view on a 5y horizon.

Asset Class			Diff. FV Approaches			5-yr Projections	
	Currency	*Current**	*Regression*	*Forward*	*LT average*	*FV ** *	*Applied*
German Government 3-year	EUR	-0.79%	0.46%	-0.37%	0.08%	0.09%	0.20%
German Government 10-year	EUR	-0.58%	0.53%	0.01%	1.20%	0.39%	0.70%
Italy Government 3-year	EUR	-0.06%	1.37%	1.31%	1.55%	1.36%	1.40%
Italy Government 10-year	EUR	0.84%	1.72%	2.10%	3.24%	2.03%	2.40%
US Treasury 3-year	USD	1.60%	1.87%	2.05%	1.17%	1.88%	1.80%
US Treasury 10-year	USD	1.70%	2.26%	2.37%	2.43%	2.32%	2.10%
EM Ext. Gov. (spread in bps)	USD	308	291		298	295	310
Euro IG Corp. (spread in bps)	EUR	110	102		142	122	125
Euro HY (spread in bps)	EUR	343	321		471	396	375
US IG Corp. (spread in bps)	USD	119	110		151	131	145
US HY (spread in bps)	USD	381	385		505	445	450

*as of 20/09/2019
**weighted average (50% regression, 40% forward (if applicable), 10% long-term average (50% if no forward applicable))

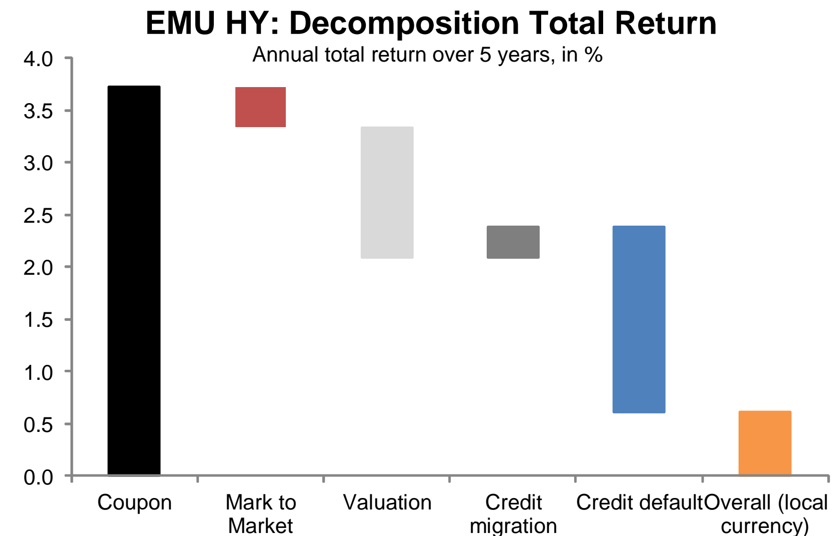
- **3. Long-term averages**. Although the gap between the long-term average and the current levels is unlikely to be closed, some mean reversion is assumed over the years to come – but only a small weight is attached to this input.
- The combination of these three approaches delivers **a fair value is calculated**. We then make a final (small) adjustment to reflect the research's qualitative assessment (projections are not purely mechanical).

➔ Overall, government bond yields are expected to **rise moderately** but remain well below long-term averages. Public and private spreads are likely to widen modestly (see table).

Sobering total returns in fixed income, but risk-taking still pays off

Asset Class	Coupon	Mark to Market	Valuation adj.	Credit migration	Credit default	Overall*
German Government Bonds	1.4	-1.5	-2.3			-2.4
Italy Government Bonds	2.6	-1.3	-2.6			-1.3
US Treasury Bonds	2.3	-0.4	-0.6			1.3
Euro IG Corporate Bonds	1.5	-0.6	-1.3	-0.2	-0.1	-0.7
Euro HY Corporate Bonds	3.7	-0.3	-1.0	0.3	-1.8	0.9
US IG Corporate Bonds	3.8	-0.5	-1.2	-0.1	-0.1	1.9
US HY Corporate Bonds	6.2	-0.1	-0.7	0.2	-3.1	2.5
US EM External Sov. Bonds	5.6	-0.5	-0.7		-0.9	3.5

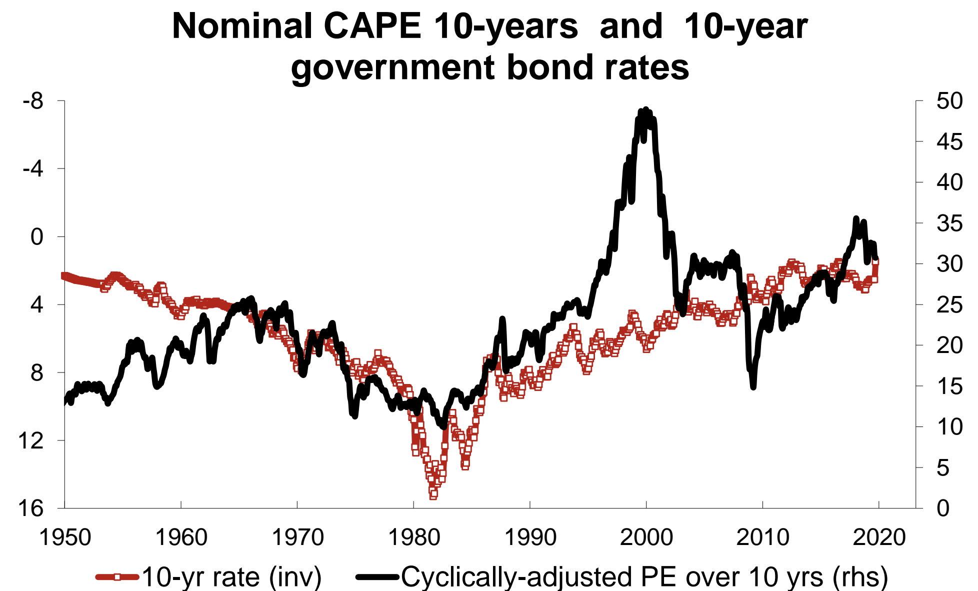
*annualized returns over 5 years in local currency and in %



- **Returns over the next five years will be rather low** - for sure, much lower than in the past. Despite the low yield environment coupon payments will remain the most important component for all asset classes.
- **US-dollar denominated EM sovereign bonds** are forecast to achieve the highest total return (in local currency), followed by US corporate and government bonds. But hedging costs (~2%) will reduce returns for euro-based investors.
- **Euro-denominated fixed income assets will deliver poor returns**. With the exception of HY corporate bonds, all analyzed assets will deliver negative returns. The worst performing asset will be German government bonds.
- Results depend only partially on the applied projections. It is **payback time following years of falling yields**.

Factors affecting prospective equity returns

- Over the past decade, the performance of equities has been supported by very strong liquidity injections and rate cuts by central banks, which added to a relevant fiscal expansion in the US and China.
- For the next five years we **expect lower yet positive** annual returns:
  - Given **high current US CAPE* multiples** (31X vs an average of 23X since 1955), US mid-to-long term returns are set to diminish.
  - US technology firms are exposed to **antitrust measures** in the future = a cap to a major driver of US profitability in the last ten years.



🡻 **Slower GDP growth** also a drag. EM countries likely to take a bigger chunk of the global profitability cake (at the cost of developed countries, especially Europe).

🡻 Increasing wage costs and a higher sensitivity to inequality are expected to **pressure corporate margins**. The sharp fall in corporate taxes over the past 25 years (from ~40% globally to ~25%) will not be repeated.

🡻 Lastly, the internationalization of the value chain, which largely contributed to the margins' expansion of relevant growth sector like Tech, Auto, Industrial or Luxury in the last years, is now impaired by **protectionism**, especially from the US.

🡹 Yet the environment will continue to be characterized by **supportive central banks** (and possibly more fiscal expansion), low yields and inflation rates along with contained credit spreads.

* CAPE = Cyclically adjusted price/earnings ratio

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Long-term equity returns: the framework

- Prospective future equity returns are assessed by combining different approaches and a subsequent qualitative adjustment where appropriate:
  - a **regression-based approach**, using expectations for macro variables and other asset classes as an input (consistency check);
  - a **CAPE-based model**, deriving return expectations from adjusted target price earnings ratios and future earnings growth;
  - a **historical assessment** of returns at CAPE levels similar to current ones.
- We then adjust the average of these three models by a factor of current under/overvaluation, which we assume to correct over the 5-year time horizon.

Approach	5yr projections (p.a.)		
	EA	US	EM
Regression models (macro- and financial variables)	6.0	9.0	
CAPE-based model	5.8	6.9	7.3
Historical returns coherent to current CAPE levels	4.7	4.7	8.0
Average	*5.5*	*6.9*	*7.6*
Adjustment due to current over- /undervaluation (p.a.)	0.0	-1.0	0.0
Final projection	**5.5**	**5.9**	**7.6**

- Our CAPE-based model uses in-house expectations of earnings growth, payout ratio, dividend yields, buyback yields and target CAPEs an a 5-year horizon. Long-run returns are broken down into three components: **income** (dividend and buyback yields), **growth** (earnings growth), and **valuation** (target CAPE).
- From the stream of expected future earnings, we extract a 10-year average that we multiplied by the target CAPE at the end of the 5-year period to get the index forecast. Investors get the stream of cash yields plus the annual price appreciation. In the US we also add to the dividends an estimate for the net buyback yield (+0.8%); the latter is not relevant for the EA and Japan.

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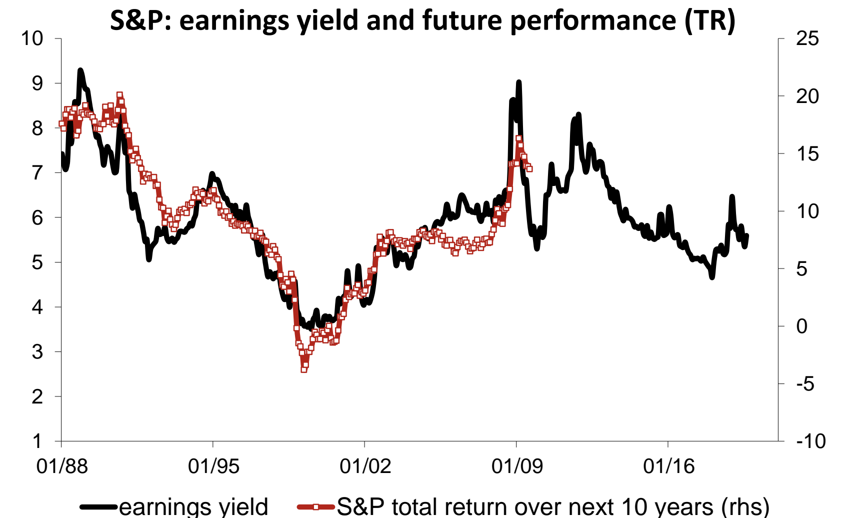
Equities outperforming but below historical norm

Market	Hist. avg 5-year total return since 1998 (p.a.)	5-year total return projection (p.a.)
World (in $)*	6.8	6.5
US	8.4	5.9
EA	6.9	5.5
UK**	6.2	6.0
EM (in $)	7.8	7.6

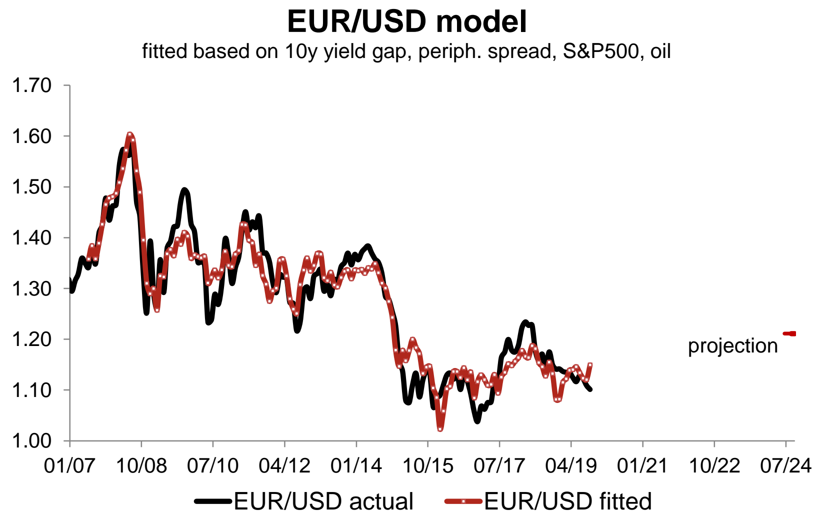
* derived from the single returns in local currency, taking into consideration the expected depreciation of TW USD

** Brexit is a risk (along with lower projected earnings growth) but due to high UK firms's international exposure, flexibility (organizational) and nearly 10% valuation gap to the EA, we decided to put the UK projection 0.5% (p.a.) above that of the EA



- EM equities are expected to deliver the highest return. The drivers of future mid-term outperformance of EM equities would be a weaker US dollar, current lower CAPE multiples and superior GDP growth.
- Our total return projections for the US (+6.9%) are in line with the **total returns derived from the current earnings yield**, making use of the historical relationship since 1987 between earnings yields and subsequent 10-year compound annual returns (6.7%, see chart; for the EA and EMs the relationship is less reliable).
- In all, **our expectations are below the historical averages since 1998.**

USD exposure not suited to escape depressed European yields



EUR/USD 5y projections	Forecast	Weight
Fair value projection	1.211	50%
PPP	1.292	50%
Weighted avg	1.251	
Projection after qual. adj.	**1.270**	
Current (as of 20/9/2019)	*1.102*	
Forwards	*1.232*	

- Investing in FX may be **tempting for escaping depressed euro area yields**.
- That said, **FX exposure greatly raises overall risk** (e.g. hist. 10y vol. of EUR/USD at 8.8% vs. 2.4% for global govies).
- **Hedging USD exposure comes at substantial cost** of currently ~2% p.a. on 5-year term.
- **Open USD is neither appealing**: USD is dear, EUR cheap:
  - **Purchasing power** considerations point to EUR/USD approaching 1.30 over 5 years;
  - **Fair value projections** (incl. projections for yields, spreads, equities and oil) are more sanguine (EUR/USD at 1.21).

  Including additional considerations (USD burdened by reserve diversification, fading economic outperformance and less favorable capital flows) we project EUR/USD at 1.27 on five years. **Hedging USD exposure is superior**.

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