



**GENERALI
INVESTMENTS**

Core Matters

Life after Covid:

5-year total return forecasts

12 October 2020

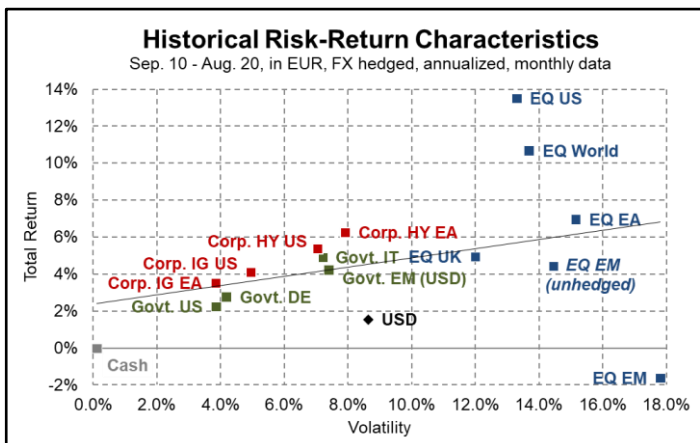


GIAM Macro & Market Research

- The Global Covid Crisis (GCC) has profoundly rattled our lives, economies and markets. The impact on our medium-term financial return forecasts is less dramatic: they are broadly in line with those produced a year ago, i.e. unexciting.
- Future returns will fall short of historical ones. Cash, US and EA Government Bonds as well IG Credit may well deliver negative returns. In liquid Fixed Income, only EM and European High Yield will provide returns that exceed our muted 5-year inflation projections. Equity valuations seem rich on several dimensions. Yet highly accommodative policies and tailwinds from recovering earnings still point to mid-single digit annual returns over the coming years.
- Positive risk include a quick end to the GCC and a wave of innovation. Yet risks are tilted to the downside. Vaccine disappointment, a spike in inflation and debt sustainability shocks amid high global leverage are the biggest downside risks.
- Changing central bank strategies will transform the investment paradigm, by leading to lower rates volatility, stretched valuation, reduced diversification benefits and more frequent corrections. More than ever, hedging matters.

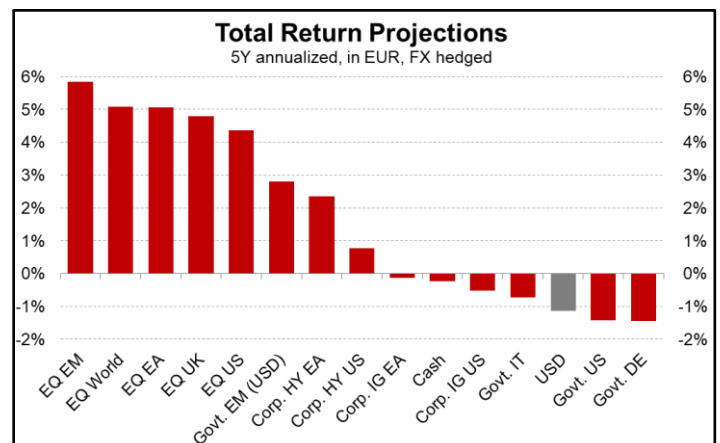
1. Introduction: richer and riskier

We update our 5-year total return report annually, and it is hard to imagine how the past year could have been more shattering. The Global Covid Crisis (GCC) has had a profound impact not just on our lives but also the economy and financial markets. Our White paper, "[Life after Covid: the LDI angle](#)", discusses the potential long-lasting implications of the GCC.

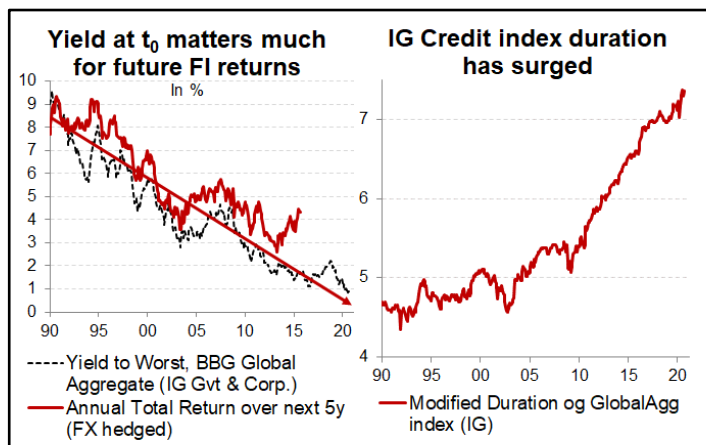


And yet, even after those life-changing developments and sharp market movements, **our 5-year total return forecasts have not changed dramatically**. Alas, we reiterate the view that future returns will fall very short of historical ones, particularly those of the past ten years (chart above). US equities, hedged in EUR, have generated almost 14% p.a. over the past decade, by far the best liquid asset to

own over the period. Never say never, but we cannot quite see how that feast could be repeated; we see them deliver low single digit returns over the next five years. Our rankings have moved a bit, with EM equities (instead of EA equities) now topping expected returns – partly because the cost of hedging dollar-denominated indices has diminished.

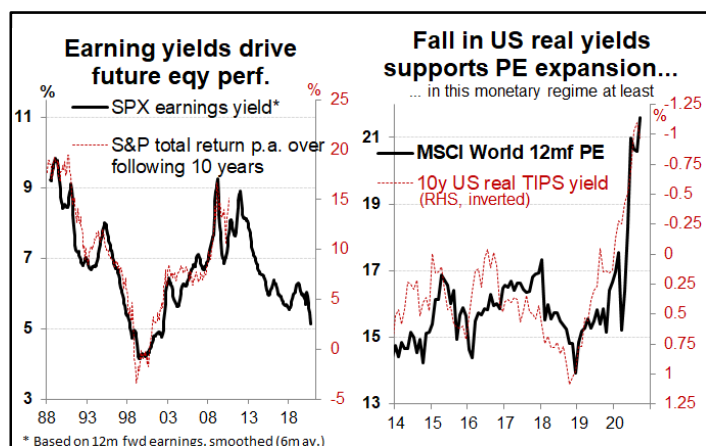


We marginally raised our Fixed Income return projections. That may sound foolish given that 1/ in the Investment Grade space, where defaults are virtually inexistent, future returns are closely linked to the yield-to-maturity (yield to worst) at entry level and 2/ risk-free and IG yields are trading at new lows. True, but we scaled back our (already low) yield forecasts, and the associated capital losses.



Mind that in the IG space, the modified duration of the Global Aggregate has increased by about 50% over the past fifteen years, from about 5 to now near 7.5 (chart). In other words, IG Credit has become more sensitive to changes in bond yields, whatever the driving force (risk-free yield or credit spread). **By the duration measure, IG credit is turning more risky as an asset class, not less.** However, this is somewhat offset by two factors. 1/ **Financial repression** will aim at keeping risk-free and corporate bond yields low (as sovereign and corporate leverage soared in the ten years to the GCC, and continued to do so through the GCC). 2/ IG credit has now become a **policy tool**: central banks are active buyers (in the US case with the back-up of government finances), and will likely remain so in the foreseeable future.

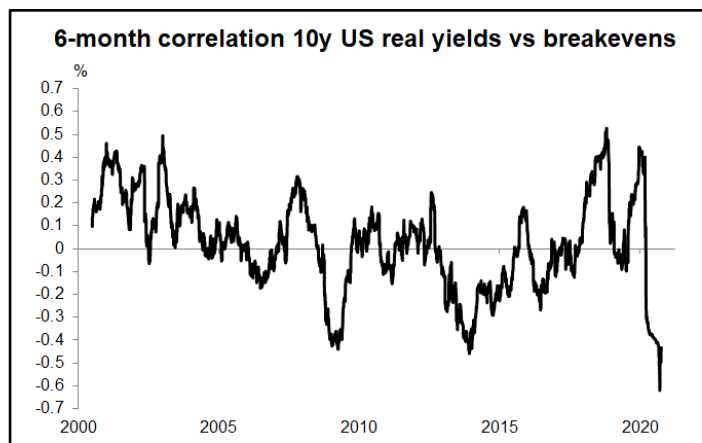
We slightly upgraded our forecasts for total return in High Yields, particularly so in Europe. Spreads, as we go to press, are about 75bp wider than they were a year ago, which will beef carry up. The lesser upward drift in risk-free yields will help there too. The limited pick-up in defaults will only be a partial offset.



We look for World equities to generate some 5% p.a. in EUR over the next five years, little changed from a year ago (lower returns actually, offset by lower hedging costs). This may appear generous, given that valuation appears more stretched. As the left chart above shows, the (12-month forward) earnings yield is a good predictor of future returns – and in selective areas, especially the US, has dropped. That said the apparent richness, mirrored in the high level of 12-month forward price-earnings-ratios (PERs), is exaggerated at two levels: 1/ 12mf earnings are still partly depressed by the short-term hit to production

and profitability; GDP in the developed world will not return to pre-crisis level before 2021-2022. 2/ Central banks are distorting valuations in Fixed Income like never before, and this trickles down to other assets. In the ‘secular stagnation’ era, the fall in real yields has been associated with an extension of equity multiples (right-hand chart). The aftermath of the GCC has seen the Fed push the monetary policy experience to a whole new level: its new strategic framework includes a more symmetrical inflation target (average inflation targeting) and a less symmetrical and more inclusive employment target. Should the Fed have embraced this strategy earlier, it would have delivered no rate hike in the past cycle (+225bp in the three years to end 2018), as inflation was undershooting.

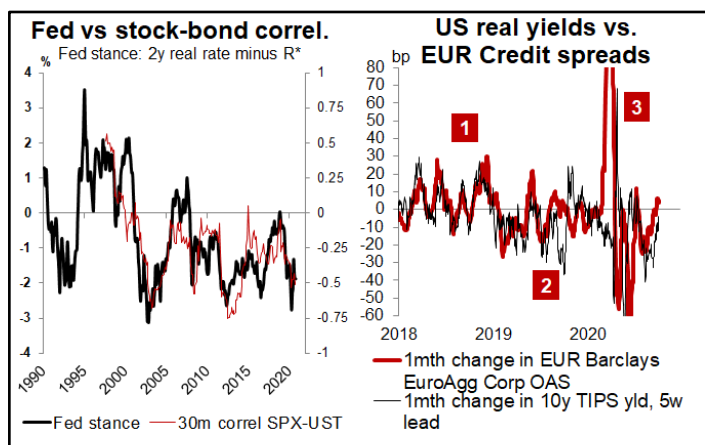
Expect valuations to get very stretched indeed. We cannot emphasise enough how important the change in Fed’s strategy is. The ECB is likely to take the same path, as the [strategic review](#) is completed over the coming year (September 2021). The Fed’s new framework will contribute to keeping real rates very low, or even lower, as inflation picks up. When inflation-linked bonds were launched in the US, in the late nineties, it was assumed that real (TIPS) yields and inflation breakevens would be positively correlated – and they were (growth and inflation cycles tend to move in sync, if with a lag). But the progressive shift in the monetary policy regime, initiated after the GFC, has undermined that correlation, and even led to some decoupling between real rates and inflation breakevens. Now the Fed’s new approach, which anchors nominal yields, has sent the correlation sharply into negative territories (chart below), which has crucial implications. First, real yields and breakevens moving in opposite direction **tend to reduce nominal rate volatility** (which depends on real rate volatility, breakeven volatility and the correlation between the two). Second, the new policy framework should be seen as a **positive for assets that benefit from higher inflation and/or lower real yields** – typically positive for companies that have some pricing power and/or are pro-cyclical, and for credit (lower real yields reduce the effective debt burden).



Richness, asymmetry and correlation. Before we go deeper into the macro foundations of our total return forecasts and the details of the main liquid asset classes, let us outline the **changing investment paradigm**. While the switch of the correlation between real rates and inflation breakevens is good news; other new features are much less exciting.

- First, the **diversification benefit of mixing bonds and stocks in a portfolio has diminished**. Arguably, super easy monetary policy, if we look at the historical books, should support a negative correlation between stocks and bonds (left chart below). But this may no longer be true at this extremely low level of bond yields. In a risk-off or recessionary scenario, where equity prices fall, there would be much less room for bond yields to fall and rescue portfolios. In a more bullish economic scenario, any pick-up in bond yields would shock the whole cross-asset valuation framework, and actually hurt equities (positive correlations between stocks and bonds).

- Second, **credit spreads have, for the past few years, most often moved in sync with real rates** – bad news for diversification. Arguably this is not true in periods of sharp risk aversion (phase 2 is right-hand chart below), but those tend to be very short-lived. In any case, even in such period, the offsetting protection (falling risk-free rates) that corporate bonds used to enjoy in period of stress has essentially vanished, for two reasons. 1/ At such extremely low levels, there is very little room for risk-free yields to fall – which makes Credit more dangerous in risk-off episodes. 2/ In extreme risk-off aversion, as in March 2020, real yields may temporarily surge (phase 3 of the chart), which of course can prove extremely detrimental to short-term portfolio performance of diversified portfolios. The evaporation of liquidity in periods of stress, as well as redemption flows and changes in the market structure driven by passive and rule-based investment funds, can explain such bizarre price action. Lower rates volatility in particular tends to lead to higher leverage within risk-parity funds, and extreme if not irrational market moves. In any case, the new (positive) correlation between rates and credit spreads crates an **asymmetry in credit**, whereby the potential for capital gains has shrunk but the downside (capital losses) has increased.



In all, the still-evolving monetary policy setting is the most evident expression of this “**New Age of Financial Repression**”. That puts investors in a new and difficult paradigm of lower returns (an incentive to increase leverage) and extreme valuations, whereby the risk of corrections become more acute (fatter tails). They will thus need to **spend more time on the hedging component of portfolio management**. Real assets, often less exposed to mark-to-market rules, are not covered in this study but will likely benefit from both the increased risk of Black Swan events and the rising long-term uncertainty about inflation.

2. Macroeconomic setting even more challenging

Even before the Covid-19 pandemic sent the world economy into its worst post-war recession, **potential growth was set to fall** over the coming years across all major economies. Ageing populations and slowing productivity gains were major drags on investment and potential GDP growth. The Covid-19 pandemic will amplify these trends.

Prolonged Covid-19 disruptions: Amid global lockdowns and supply chain disruptions, the Covid-19 pandemic has sent global activity into deep contraction, by 10.2% in the US and -15.2% in the euro area in the first half of 2020. Economic activity has started to rebound during the summer, but the way back to pre-crisis levels will be lengthy and cumbersome – at least in the developed world. The closing of the huge output gaps is unlikely to occur smoothly. Resurging waves of Covid-19 – as observed in Europe in fall 2020 – are dampening the recovery especially in face-to-face services. The key ingredient for going back to normal is an effective vaccine (or drug) that can be rolled out globally. This is still surrounded by high uncertainties, but we assume that it will happen in 2021, hopefully by spring. This view is backed by super forecasters and the fact already at the time of writing five vaccines are approved for early or limited use and eleven vaccines are in the critical large-scale efficacy phase 3.

Brexit – a headwind in any case: A happy end to the Brexit drama remains highly uncertain. We had a post-Brexit trade agreement as our base case in last year’s projections in our books. Now, even a fudge-deal by year-end, which would considerably fall behind the single market status quo, looks uncertain. Hence, there will be Brexit-induced headwinds to activity, with the UK impacted most severely.

Harmed growth potential: Near term the snapback from the Covid-induced recession will temporarily push growth rates above potential. Governments will play a crucial role, especially in Europe, by means of guarantees and furlough schemes in order to weather the crisis. But once the crisis is over and these schemes are unwound, expect a drag on growth. For instance there will be more digital communication at the expense of air traffic. As we have laid out **elsewhere** in greater detail, we expect deglobalisation, tighter regulation and state intervention to weigh on potential growth longer term. Therefore, potential growth will over the coming years be lower than envisaged one year ago. The shock on the economy will progressively fade out, but by 2025 we still see potential growth in the US and euro area 0.1 pp lower than we predicted one year ago.

Low inflation even more challenging: Central banks in the developed world (and the ECB in particular) have over the last decade failed to lift inflation back towards target. While deflation has been avoided, the return to ‘normal’ price dynamics is still far away. The reasons for the subdued inflation development are not fully understood but are likely related to the impact of globalization, changes in the structure of goods and labour markets (see **here** for a deeper discussion) and entrenched low expectations. The sharp rise in the output gaps amid this year’s recession has made the situation even more challenging. Structurally, deglobalisation, rising bargaining power of workers and increased industrial concentration may favour higher prices.

es over the medium term. But depressed inflation expectations keep dragging on price pressures, while fiscal consolidation cannot be ignored forever. Accelerated digitalization and automation are disinflationary, too. As we discussed [elsewhere](#), a marked acceleration of consumer price inflation thus remains a rather remote threat in our view. Even with ample monetary policy support over the coming five years, we see inflation by 2025 trending higher but still below target in the euro area (1.7%) and just in line with target (2.2%) in the US. In the 2021 to 2025 period inflation will likely average only 1.3% in the euro area and 1.9% in the US.

Rising public debt: Bold discretionary fiscal measures through the Covid-19 crisis (worth about 12% of GDP in the US, 4% in the euro area in 2020 alone) may herald public debt concerns further down the road amid low growth and inflation. While clearly concentrating on 2020, we deem pandemic-related support measures also likely in the years to come. The public debt pile will increase strongly. The debt-to-GDP ratio will be around 100% in the euro area by 2021, while in the US the debt held by the public is expected to rise to 107% of GDP in 2023, the highest level in history. We expect both economies to be able to cope with the higher pile of debt, not least due to the supportive monetary policy keeping interest expenditure low. In the euro area the Recovery Fund will help to mitigate the debt burden, especially for Southern European economies as it gives grants to the highly indebted economies in exchange of growth-enhancing reforms. However, true fiscal integration remains a vision rather than a realistic target for the next few years.

Central banks to maintain ultra-accommodative stance for longer: Amid the much more challenging economic outlook an even more accommodative policy stance will be needed. Following a persistent inflation undershoot for more than a decade, the key central banks are currently overhauling their strategies. The Federal Reserve unveiled a radical update of its monetary policy strategy for secular slow growth and a much weaker relationship between unemployment and inflation. From now on, the Fed will target full employment and will not react to a “hot” labour market; it will increase rates only if there is solid evidence of inflation persistently overshooting (moderately) the 2% target. Moreover, the inflation target will be measured as an average during the business cycle, with temporary overshooting making up for past shortfalls. Given the expectation of a slow job market recovery and sluggish inflation, this means that the Fed funds rate will remain within the current 0% to 0.25% range for years. As negative policy rates have been firmly ruled out, this implies that any sizeable further stimulus would need to come from direct action on the bond market. More pervasive measures, like yield-curve control, are in theory possible, but for the time being the commitment to keeping the policy rates low is deemed credible and anchors long-term rates at low level.

Likewise, the ECB has announced the completion of its strategy review by mid-2021. In its communication it strongly emphasized the **symmetry** of the inflation target and latest comments by President Lagarde suggest that it will also be reflected in the re-formulation of the inflation target. Moreover, we see a good chance that the **sustainability** of underlying inflation, already put forward over the past years, will also be reflected in the formulation of the

new goal. House prices might become part of the price index, which would raise measured inflation. Finally, the ECB might follow the Fed in anchoring inflation expectations by focusing on **average inflation** over the business cycle. Chief Economist Lane’s Jackson Hole speech emphasized that bringing inflation back to the pre-pandemic path is the mission of the ECB. Engineering this implies a much more accommodative policy stance than before the pandemic.

Economic theory states that the neutral real short-term rate (so called “r-star”, consistent with the economy on a balanced growth path) is positively related to population growth and technological progress but dampened by a higher savings rate. Looking ahead, productivity growth has slowed post-GFC already and will be further dampened by Covid-19 while the working population continues to fall. Heightened demand for safe assets as well as higher life expectancy will also contribute to a lower equilibrium rate.

Given the slower trend growth outlook, our expectation is for a further decrease in r-star. In the euro area it should drop to around -0.3% over the coming years. This is in line with an [ECB analysis](#) which concludes that r-star will be “*staying at levels around zero, or slightly below, in the coming years*”. For the US, we assume that a less pronounced deceleration in potential output will bring r-star to around 0.1% by 2025. R-star serves as a guide to central banks in order to set rates: a structurally lower value implies less scope for rate hikes. That said, the Fed suggested that it will in the future rely less on such model-related metrics and in doubt would rather maintain a more accommodative policy than suggested by models. We expect the ECB to adopt a similar stance. Both central banks will only embark on first rate normalization steps towards the end of our outlook horizon. We see the key rate in the US at 0.25% and in euro area still in negative territory at -0.2% by 2025.

2025 macro and central bank scenario				
	Euro area		US	
	current	2025 proj	current	2025 proj
Equilibrium real short term rate (r*)	-0.1	-0.3	0.3	0.1
Inflation	0.5	1.7	1.6	2.1
Potential growth	1.3	0.9	1.8	1.6
Neutral Central Bank policy rate	0.4	1.4	2.3	2.2
Current real short term rate	-1.0	-1.9	-1.5	-1.85
Current nominal short term rate	-0.44	0.0	0.1	0.35
Effective Central Bank policy rate	-0.5	-0.2	0.1	0.25

Downside risks prevailing: Our scenario remains surrounded by downside risks. The pandemic has increased the severity of these alternative developments. The major risk is that a vaccine becomes available only much later (beyond 2021) or not at all. This would trigger persistent stringency needs implying a much lower growth path. Globally, the US-Chinese trade tensions could intensify, thereby dampening global trade and confidence. Likewise, downside risks to growth stem from a much more harmful impact of the Covid-19 shock on the growth potential than currently foreseen.

We also see debt sustainability as a source of potential instability. One reason might be a surprising rebound in inflation, for instance triggered by the combination of ultra-accommodative monetary policy, persistent fiscal stimuli and a more benign global environment. Central banks might then come in a situation where inevitable rate hikes and unwinding of some unorthodox policy measures triggers a sharp rise in yields. A populist wave, especially in the economies hit very hard by the pandemic, could also put stress on sovereign debt. In both cases markets would question the sustainability of public finances.

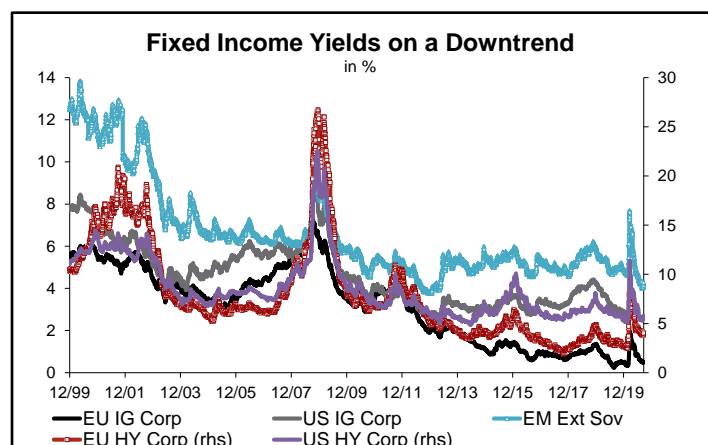
3. Financial return expectations

From this macroeconomic assessment we derive predictions for liquid financial assets (fixed income and equities). Moreover, we analyse whether investing in higher yielding currencies outside the euro area is a way to mitigate the scarcity of investment opportunities. Like in our original [Core Matters of 2019](#), non-listed assets and/or alternative assets are not covered.

3.1 Methodology used for fixed income assets

Notwithstanding mark-to-market risks fixed income assets generally provide a high level of security. Regular coupon payments are paid and investors receive their nominal value back, at the end of the term (as long as there is no default). Unfortunately, international yields are stuck at a historical low level; US yields, in particular, have decreased further in 2020. Hence, this predictability of fixed income assets currently goes hand in hand with meagre return prospects.

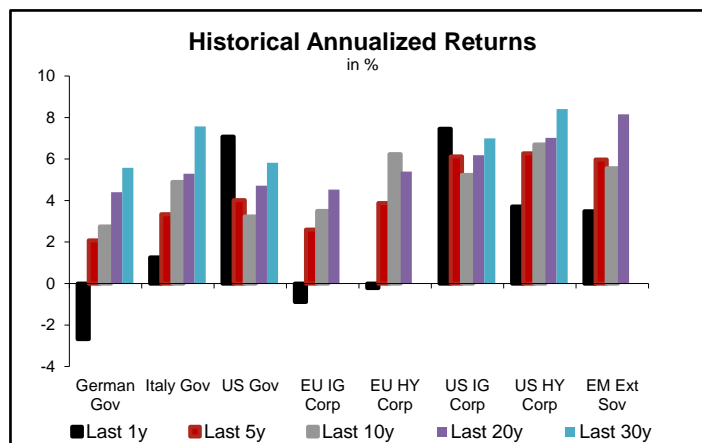
Accordingly, the high and stable returns of the past cannot be extrapolated into the future. Already, returns have fallen continuously in recent years. Over the last 12 months some bonds have actually delivered a low or even negative total return.



Thereby, fixed income investors face a dilemma as there is a trade-off which cannot be avoided. Decreasing yields create short-term profits (via capital gains as recently in the US), but at the same time reduce re-investment yields and, hence, future income from coupons.

The framework which we apply to calculate the medium-term return outlook for fixed income assets is basically unchanged from last time (methodology is described in more depth [here](#)). We assume that market participants invest in bond indices. Hence, we do not consider a buy-and-hold

strategy, but a dynamic rebalancing so that a stable maturity can be presumed. Analytically, the total return of fixed income assets is broken down into three different components: income, growth and valuation. This approach allows a transparent breakdown of the return prospects.



Income: This most obvious constituent is the string of coupons a bondholder receives through the life of an asset and represents the main pillar of return for bondholders. In light of the long-term downtrend in yields, the average coupon is much higher than the current yield. Over time, however, bonds will mature and will be replaced by new ones (with a lower coupon). Hence, the income component will shrink over the forecast horizon. As we do not model a cyclical development of yields given our medium-term focus, we assume that yields follow a linear trend from current levels to the projected one in five years. New bonds are assumed to be issued at par so that the prevailing yield level at that time determines the new coupon. Finally, we use the average maturity of the respective index to specify the share of bonds which are replaced every year.

Growth: This component accounts for the mark-to-market changes over the course of time. One can distinguish the *roll* effect and the *pull-to-par* effect.

The roll effect is also known as 'rolling down the yield curve'. In case of an upward sloping yield curve shorter-dated bond yields are lower than longer-dated ones. The steeper the curve is, the greater the effect. As long as the curve is upward sloping, the impact is positive. However, as curves are currently rather flat, the benefit is rather small.

The pull-to-par effect will be negative over the period under review as most bonds are currently trading well above par. As they are repaid at par, they will suffer capital losses as the end of the term approaches.

Overall, the growth component will be negative for almost every fixed income asset class (except for Euro HY). Particularly euro area government bonds will be negatively affected.

Valuation: This is the final building block for the derivation of the total return of bonds. It represents the changing valuation of fixed income assets as yields move due to market movements *at a certain time* (in contrast to the growth component which reflects the valuation change due to yield change *over time*). Default is a less usual but more painful source of valuation change.

a. Changes in the yield level. This affects all fixed income assets. With the exception of HY, this effect will be negative for all fixed income assets as yields are seen to rise very modestly (and bond prices react inversely to yields). The longer the duration of the respective asset class is, the stronger this effect will be.

b. Credit migration. We do not expect a clear trend for sovereigns (neither developed markets nor emerging markets) in the years to come. We do not envisage downgrades of Southern European sovereigns amid continued very low rates, strong monetary policy support and temporary solidarity (recovery fund). Significant sovereign downgrades are mainly a risk scenario, as we assume the cost of debt to remain below nominal growth. Therefore, this effect refers to corporate bonds amid a changing average rating over time. The details are described in more details in section 3.1.2.

c. Credit defaults. It is essentially the expected negative impact due to a (partial) loss of bond notional, determined by the default probability and the expected recovery rate. As we do not assume any sovereign default in developed countries, and cover this effect in sections 3.1.2 and 3.1.3.

Based on this methodology, we calculate the total return for the several fixed income asset classes. For this, we first forecast the yield and spread levels in 5 years¹, applying (depending on the asset class) up to three different approaches (see table below).

- The first one consists in model-based fair values for each asset class, using several economic and monetary policy variables, corporate fundamentals and factors covering the financial market environment as inputs. This is the most important estimate and is included in the finally applied forecasts with a weight of 50%.

Asset Class	FV Approaches					5-yr Projections	
	Currency	Current*	Regression	Forward	LT average	FV **	Applied
German Government 3-year	EUR	-0.75%	-0.05%	-0.46%	-0.10%	-0.22%	-0.20%
German Government 10-year	EUR	-0.51%	0.14%	-0.08%	0.88%	0.12%	0.10%
Italy Government 3-year	EUR	-0.13%	0.93%	1.31%	1.38%	1.13%	1.10%
Italy Government 10-year	EUR	0.86%	1.66%	1.74%	2.98%	1.82%	1.80%
US Treasury 3-year	USD	0.15%	0.79%	1.03%	1.13%	0.92%	0.90%
US Treasury 10-year	USD	0.67%	1.32%	1.45%	2.22%	1.46%	1.50%
EM Ext. Gov. (spread in bps)	USD	365	249		312	280	280
Euro IG Corp. (spread in bps)	EUR	115	102		142	112	112
Euro HY (spread in bps)	EUR	462	321		471	373	375
US IG Corp. (spread in bps)	USD	137	110		151	142	145
US HY (spread in bps)	USD	545	385		505	410	441

*as of 22/10/2020
**weighted average (50% regression, 40% forward (if applicable), 10% long-term average (50% if no forward applicable))

- The second approach rests on the idea that financial markets may also give reasonable guidance on future developments, using all relevant information. Hence, the current forwards on a 5-year horizon enter the applied projection as well. However, as forwards are not directly available for corporate and EM bonds these forwards enter the final applied projection only in the case of developed government bonds (Germany, Italy, US) – with a weight of 40%.

¹ As in the preceding version we focus on the terminal value and do not incorporate cyclical movements. The intermediate annual data are interpolated linearly.

Internal

- Finally, the long-term average of the several variables is taken into account. While it is unlikely that bond yields will return to these long-term averages anytime soon, we include it amid the high degree of uncertainty about future developments. We weight this component at only 10% (in case of spread forecasts we give it a weight of 50% as no forwards are available and the current spread level is much more in line with the long-term average).

Asset Class	Coupon	Mark to Market*	Valuation adj.**	Credit migration	Credit default	Overall***
German Government Bonds	1.2	-1.5	-1.1			-1.4
Italy Government Bonds	2.4	-1.4	-1.8			-0.7
US Treasury Bonds	1.8	-0.9	-1.3			-0.5
Euro IG Corporate Bonds	1.3	-0.6	-0.6	-0.2	-0.1	-0.1
Euro HY Corporate Bonds	3.8	0.1	0.3	0.3	-2.1	2.4
US IG Corporate Bonds	3.3	-0.9	-1.8	-0.1	-0.1	0.4
US HY Corporate Bonds	5.9	-0.1	0.2	0.2	-4.4	1.7
US EM External Sov. Bonds	5.0	-0.7	-0.1		-0.5	3.7

*roll and pull-to-par effect
**changing yield level at a certain time
***annualized returns over 5 years in local currency and in %

Anticipating some key results detailed below, government bonds are rather unattractive with (even in local currency) negative annualised returns projected for the next 5 years. The meagre coupon is not sufficient to balance the pull-to-par effect and the capital losses amid moderately rising yields. The most attractive fixed income asset class (in local currency) will be EM sovereign bonds – cushioned by a still solid coupon. Corporate bonds are in between. Generally, HY is likely to outperform IG as the drag from higher default rates is more than offset by the other components. Investing funds in the money market does not help either; the negative key rate will depress the annualised total return and will keep it close to -0.3%.

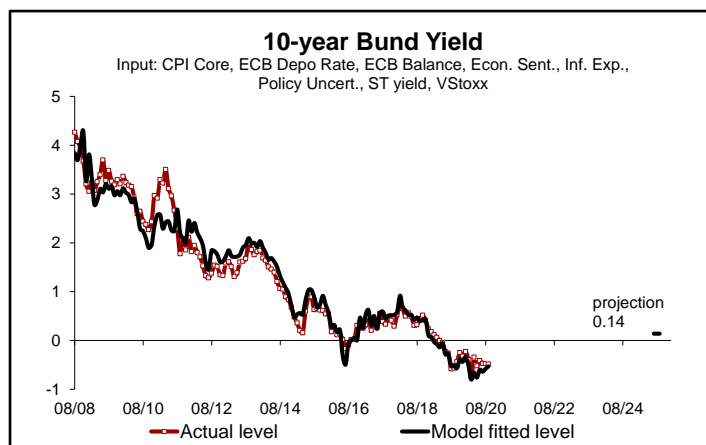
3.1.1 Government bonds: unfavourable outlook

Overall, government bond yields are seen to rise only moderately on a 5-year horizon from their current rock-bottom levels. Depending on the market and the tenor, the increase is between 50 bps and 100 bps. This is a more limited yield increase than assumed one year ago as we expect central banks to envisage rate hikes only towards the end of the forecast horizon amid the lasting disruptions by Covid-19. Hence, the low yield environment is seen to prevail.

In particular German bond yields will struggle to reach sustainably positive territory again. We see the ECB key rate below zero even on a 5-year horizon, which will keep the whole curve low. Note that over the past year the long-term average of 10-year Bund yields has come down by more than 30 bps.

Just like for Bunds, BTP yields have hardly changed compared to September 2019. We still assume that the BTP/Bund spread will widen modestly on a 5-year horizon as structural reforms in Italy may not suffice to compensate for the fading support from the ECB's asset purchase program. Hence we slashed BTP yield forecasts, along with lower Bund yields. Even on a 5-year horizon BTP yields are seen to remain below the 2% threshold. Given

the increased debt ratio of Italy this is an important prediction as low yields will contribute to keeping Italy's debt situation sustainable.



The largest downward adjustment, compared to one year ago, is in US Treasuries. In light of the new monetary policy strategy the Fed will keep key rates at an extremely low level over the next 5 years. The 5-year forward 10-year Treasury yield has dropped by about 70bp over the past year. This results in much lower applied projections on a 5-year horizon. Still, the planned increase is slightly more pronounced than for Bunds; the transatlantic yield spread is seen to widen towards its long-term average.

Based on these assumptions, it turns out that the expected 5-year total returns for all developed market (DM) government bond indices are negative. The worst investment alternative remains German Bunds. However, due to the lower expected yield increase compared to 2019, the resulting losses are less painful. The same pattern applies to Italian BTPs. Despite a slightly lower income from coupons, the capital losses amid an only moderately increasing yield level will be lower than in 2019. US Treasuries, by contrast, lose much of their shine compared to 2019, following the sharp drop in UST yields. The projected increase in yields adds to the negative total return expectations of US Treasuries (even in local currency).

Overall, the dismal total return outlook has not changed much compared to 2019. Even without taking inflation into account (and hedging costs), government bond investors will not be able to preserve their capital. It should be stressed that this result is to a large extent independent of the assumed future yield development.

3.1.2 Credit: HY attractive despite rising defaults

Given depressed risk-free rates, the **income** is of course the most important return component for all credit indices considered in this publication. Unsurprisingly EUR HY offers the highest income (3.8%), which will also determine the resulting total return forecasts. For the **growth** component of our projections, only EUR HY displays a marginally positive effect (0.1%), while all other segments are negatively affected.

The **valuation** component our forecast is also favouring HY compared to IG on both EU and US credit. Over the next 5 years, we expect **credit spreads** to mostly tighten at the lower range of the rating scale (HY). Indeed, the Covid crisis caused credit spreads to widen sharply, but IG spreads both in the US and in Europe have returned close

to their pre-crisis levels while HY spreads have lagged on a beta-adjusted basis.

In relative terms, the Covid-related downgrades from rating agencies have been more frequent in HY than in IG. Moreover, rising default rates associated with the current global recession are also expected to affect only HY spreads as IG has proved to be almost immune to default risk, even during severe recessions. Consequently HY spreads have widened much more than IG even on a beta-adjusted basis and we see therefore greater scope for tightening over a 5-years horizon.

Despite the Global Covid Crisis, our spread expectations over the 5-year horizon differ only moderately from our September 2019 forecasts for HY spreads. Indeed we were already forecasting a rise in defaults last year; given the strong public support granted to the corporate world we only expect defaults to jump to nearly 5% for HY in 2021. However, our EUR IG spreads are somewhat tighter than our previous forecasts following the inclusion of central bank balance sheets into our fair value models: IG credit has become a major policy tool. Model inputs include growth, CPI, 10-year sovereign bonds (Bunds for EA, UST for US) as well as the size of the European central bank balance sheet in the EUR models. We do not consider the Fed's balance sheet since, in contrast to 'sticky' ECB buying, we expect the Fed to withdraw from the credit market early over our forecasting horizon. As IG spreads are already slightly below their long-term average, we expect them to be broadly stable over the next 5 years both in Europe and in the US.

The grown importance of ECB policy is also reflected in our weightings. We do not apply the usual average between the long-term (LT) average and fair-value (FV) model since we expect credit spreads to behave following a new pattern, below their long term average. Hence we apply FV only as we expect the ECB to keep spreads below their long term average for longer. For the US forecasts we continue to apply a 2/3 weighting of our FV model vs 1/3 for the LT average as we expect the Fed to be less supportive over time to the credit world.

Credit migration. Even before Covid, the average rating of IG corporate bonds deteriorated significantly. While less than 20 years ago, the average rating of euro area IG corporate bonds was slightly below AA, it is now between BBB and A (see chart below). All else being equal, a worse credit mix implies a higher default probability, wider spreads and, eventually, capital losses. Over our 5-year forecasting horizon, the Covid related rating actions will matter at the start of the period. Hence we have slightly increased the impact of downgrades on our total return forecasts.

In contrast, we expect credit migration to have a positive effect on HY bonds. We believe that a large part of the Covid downgrades have already taken place in the HY space and that corporate ratings should gradually recover from here. We assume a slight positive effect on USD and EUR HY corporate bonds.

Credit defaults. Historical data suggest that the default risk for IG corporate bonds is hardly noticeable. Accordingly, we subtract less than 0.1 pp from the annual return. By contrast, there is a marked negative default effect for HY.

For calculating the expected annual loss, we employ the expected default and recovery rates over the forecast horizon. Firstly, we consider the composition of the index. This is important as the rating determines the default risk. Secondly, we incorporate our default projection. Thirdly, we assume an index-specific recovery rate for each asset class.

To illustrate this approach, consider the example of US HY corporate bonds. The index contains around 50% of BB-rated bonds, 38% of B-rated bonds and 12% of CCC-rated bonds. Multiplying with our default rates assumptions, results in an estimated annual default probability of around 5.5%. Assuming a recovery rate of 45%, this implies an annual loss of around 3%.

In all, we forecast higher total return for European credit led by HY with 2.4% p.a. and -0.1% for IG, as we think that default will not rise enough to eat up all the carry that HY credit is offering. US credit is slightly less attractive on a hedged basis, with 0.8% on HY and -0.5% on IG: this reflects higher defaults and lower certain central bank purchases.

3.1.3 EM sovereign bonds: thanks Carry!

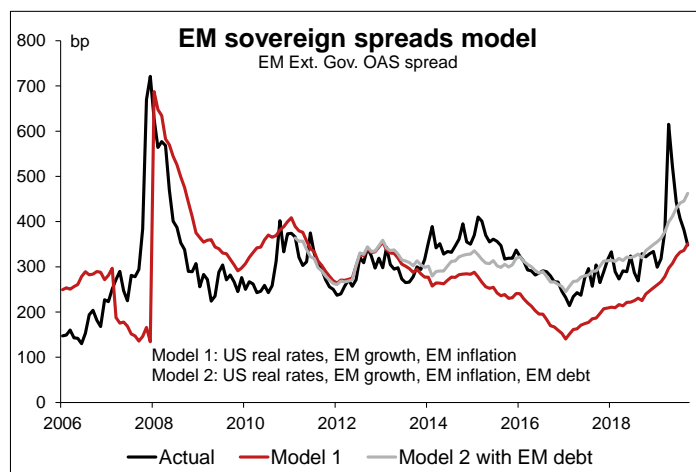
Over the past year EM sovereign bonds have continued to be supported by very low real rates in the developed markets. That said, the spreading of Covid-19 led to a temporary surge in spreads, which to date has not been fully reversed (EMBI Global Spread up from below 300bp to 650bp and now through 375bp).

Risk premia. Over a 5-year horizon, we continue to expect a tightening of EM sovereign spreads. The more accommodative new Fed's Average Inflation Target may support a more distinct spread compression; amid a persistent global search for yield in a low US real yield environment, high carry will also continue to attract inflows into the EM sovereign space.

We expect EM sovereign spread to reach 280 bps in 5 years from 365 bps currently. This forecast is largely based on external EM spreads models using two approaches (1) two quantitative models to estimate a long-term fair value and (2) a 10-year mean reversion approach. We average the quantitative results with the long-term average.

Our first model is based on 10-year US real rate, global EM growth and global yearly EM inflation for 21 countries. The model explains 89% of spread variation (R-square) but tends to underestimate spreads since 2014. Looking at individual variables, a 1% rise in real rates widens spreads by 40 bps while a 1% EM growth acceleration tightens spreads by 37 bps. This model leads to a 5-year spread forecast at 179 bps.

In the second model, we keep the variables of the first model and to add the global EM debt in % of GDP to capture the variation of the credit risk. The model explains 98%. It leads to a higher 5-year forecast at 318 bps but we suspect an overfitting of the model. That said, as EM debt remains by construction one of the main drivers of the EM credit risk, we decide to keep this model and to average the forecasts of the two quantitative models to obtain a more accurate view.



These models do not capture short-term volatility related to the change in the risk environment. We also include the 10-year long-term average at 312 bps.

Defaults. Alongside these spread forecasts, default rates across EM countries have a significant impact on the total return over the long term. Credit default subtracts 0.5% from the expected annual total return.

Indeed, 45% of the BofA sovereign index is HY and unlike in the corporate sector, the EM sovereign universe is smaller: sovereign default occurrences are not frequent but one single country default can adversely impact the total return. The EM sovereign default rate could deteriorate in the next two years due to the fiscal consequences of the Covid-19 pandemic. Default occurrences have already risen with Lebanon, Ecuador this year while Zambia and Sri Lanka are currently under pressure. However, the deterioration of the EM fiscal metrics would be offset by easier external refinancing conditions than last year and abundant USD liquidity. Over a 5-year period, default rates should finally be in line with the historical average, in our view. To this extent, we apply the one-year default rate computed by S&P, based on a sample of 69 countries since 1979. It leads to a 1.0% index default rate and we assume a 50% recovery rate.

Overall, we pencil in annual total returns of 3.7% p.a. for USD denominated EM sovereign debt, making it rank highest among the fixed income classes considered. The favourable outlook is largely driven by the high carry of 5.0% and an expected spread compression.

3.2 Equities: mid-single digit returns ahead

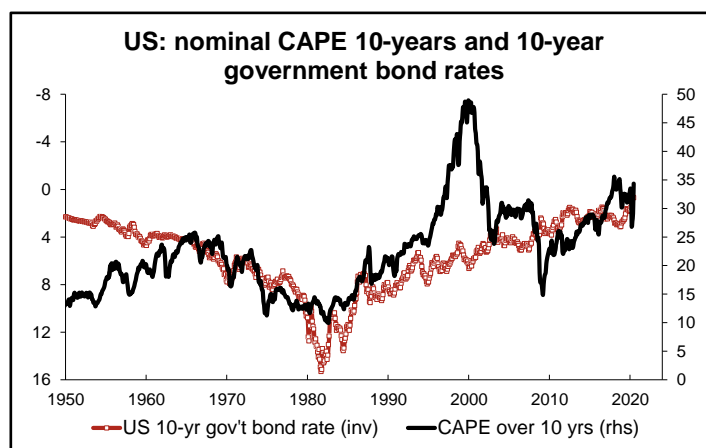
Very strong liquidity injections and rate cuts by central banks have supported **high equity returns** by historical standards (TR, MSCI World +11.3% p.a., US +15%, US IT 22.6% and euro area +6.9% in the 10 years to August 2020). This was particularly true for the US and China, where monetary stimulus was complemented by a strong pro-cyclical fiscal push, including substantial US corporate tax cuts. The monetary and fiscal impulses are alive and well after the Covid-induced crisis, so much that the market recovery since March bottom has been remarkable. For the mid-term, such policies will continue yet we expect materially lower annual returns for the next five years.

3.2.1 Factors behind lower-than-norm returns

To begin with, the slump in global capacity utilization caused by the Covid crisis will be a drag on corporate profitability. Furthermore, we expect lower GDP growth ahead, and EM countries to take a bigger chunk of the global profit cake ([McKinsey](#)), especially at the expense of the euro area. Besides, future economic policies may tackle inequality: the gap between labour and capital share of income are likely **to pressure corporate margins in the develop world**. Margins in the US (proxied as a share of NIPA profits in GDP) have already declined since 2015, and have stagnated in the EA at a lower level since 2012.

Additionally, the internationalization of the value chain, which largely contributed to the margins' expansion of sectors like Tech, Auto, Industrial or Luxury (the last three being key leading export sectors in Europe with big weight in the MSCI Europe), is now harmed by the new wave of populism and protectionism. Secondly, US technology firms (29% of the index) are more likely to be pressured by antitrust measures, thus representing a cap for the biggest driver of US profitability and market performance so far.

However, a partial mitigating factor for IT is the Covid-induced importance of adopting digital technology: countries characterized by low Covid-19 per-capita mortality rates seem to share strategies that include massive use of technology, especially in the communication field.



Finally, in contrast to the EA and EMs, the **US** market continues to show a **high CAPE multiple** (32X vs an average of 23.4X since 1955), so that mid-to-long term returns are set to diminish. The CAPE is the cyclically-adjusted price earnings ratio which uses a 10-year average of past profits at the denominator to smooth out the fluctuations that occur over the business cycle - both numerator and denominator being adjusted for inflation.

In all, we assume lower earnings growth in developed markets (Europe still lagging US growth): our forecast is lower than the historical average over the last two decades. It has been slightly revised down compared to our original report, due to the cited Covid-19 effects, which have caused severe pressure on corporate balance sheets (already stretched pre-crisis). This will have some long-lasting negative effects on capex, productivity, and return on capital. While EMs will also be affected by the crisis, superior nominal GDP growth will maintain higher earnings growth over the next years.

Notwithstanding lower earnings growth forecasts, lingering low yields and credit spreads (thanks to supporting policies) will keep the discount rate of future earnings low and the cost of equity will stay contained, thus supporting higher equity valuations vs norm. Indeed, the implied equity risk premia (earnings yield minus 10-year government bond yield) linger at high levels vs the average since 1988 (for the MSCI EMU index 6% vs an average of 2.9% and 3.9% vs 2% for the S&P). This should support positive returns ahead, even after having accounted for structurally higher global political uncertainty.

3.2.2 Long-term equity returns: the framework

While long-term returns (beyond 10 years) are dependent on fundamentals and stock market valuations, they are uncertain and, as our analysis of historical data shows, more volatile for shorter time horizons.

To provide a quantitative framework in assessing prospective equity returns, we combine different approaches:

1. a regression-based approach employing forecasts for macro variables and other asset classes as an input,
2. a CAPE-based model, deriving return expectations from adjusted target price earnings ratios (PE) and future earnings growth,
3. a historical assessment of future returns at CAPE levels similar to current ones.

We then adjust the average of those three models with an estimated factor of **under/overvaluation**, which we assume to correct over the 5-year time horizon. Since our October 2019 paper, markets have shown some dichotomy, with the S&P 500 and the EM index showing positive total returns (+14% and +8% respectively) vs. negative ones for EMU (-8%) and UK (-16%). This, of course, modifies the index starting point from which the 5-year exercise is performed, penalizing the US and the EM from this point of view. Additional factors contribute changes in the estimated average 5-year return. In what follows we briefly describe the three building blocks of the framework. For more details, please refer to [our original publication](#).

Our **first regression-based approach** employs our projections on macro and financial variables provided in this study to come up with consistent equity total returns. Variables used are GDP growth, 10-year government yields, the EUR/USD exchange rate and HY spreads. This approach is applied only to the US and the euro area (EA) - at the core of our universe. The aim is to derive equity returns consistent with other projections (reality check). This approach produces higher return projections than in October 2019, especially due to lower High Yield spreads.

The **second approach** employs our **CAPE-based model**, which uses in-house expectations of earnings growth, payout ratio (PR), dividend yields (DY), buyback yields and target CAPEs for the end of the 5-year horizon. Thus, long-run returns are broken down into three components: **income** (dividend and buyback yields), **growth** (earnings growth), and **valuation** (target CAPE).

In the end an equity investor gets the stream of cash yields plus the annual price appreciation. We derive the target CAPEs for the different markets from the projected one for the US, by applying historical valuation gap relative to the US. The target for US CAPE is derived from the historical

average (last 30 years excluding bubble years), which is then adjusted slightly upward, having also taken into account two positive factors: low CPI (and 10-year interest rate) plus money printing. In this year's study we adopt a slightly higher level of CAPE (up from 23 to 24, from 15 to 16, and from 14.5 to 15 for the US, the EA and EMs, respectively), as a result of increased probability of lingering lower yields and dovish monetary policy.

For the EA and EMs we apply the valuation gap based on the analysis of the data since 2007. The final targets are: 24x, 16x, and 15x for the US, the EA, and EMs.

We lowered the earnings assumptions due to the COVID crisis, in particular for Europe, and to a lesser extent for the US (higher resiliency). The net result is that for the CAPE model approach annual projections are on average lower by 1 pp vs our release in October 2019. For years 2021 and 2022 we forecast an appreciable recovery from 2020 lows, which is typical of after-recession periods. In particular in 2021, earnings growth rates are expected to be high: 43%, 27% and 32%, for the EA, the US and EMs. Growth then normalizes and from 2023 on, our earnings growth expectations are respectively 4%, 5% and 7%, which is nearly 2pp below the historical average. Compared to October 2019, they have been further reduced by 50 bps to take into account long-lasting negative effects from COVID (lower capacity utilization, service stress, etc.). In our projections, US recovers to the pre-crisis levels in 2021, while the EA only in 2022.

In the **third approach** returns are derived from **historical patterns, for periods of similar CAPE levels**. We analyse the distribution of subsequent 5 to 10 year returns. Across all markets under consideration: the dispersion of 5-year returns is rather high, and it decreases as the time window extends (from 5 to 7 or 10 years). For this reason, we take the average of returns over 5 and over 10 years which show projected returns in the range of 5-6% for current US CAPE levels - 1pp lower than in October 2019 and below the average returns conditional on CAPE. Mind that the 12-month forward earnings yield (EY) in the US is indeed rather low, pointing to returns below 5% over the next 10 years; two caveats are due in this regard: first, as said 5-year returns are subject to high volatility and, second, the structurally low yield environment could back up somewhat higher equity returns compared to the past periods with similar low EY but higher yields and inflation.

In the **final step** we assess the degree of current under-/overvaluation of each market under consideration. Models based on future developments of macro and micro variables could underestimate the present disequilibrium in valuation of market indices. We adjust the average of the three quantitative results for future returns for this over-/undervaluation gap, assuming the latter will close over the full forecast horizon.

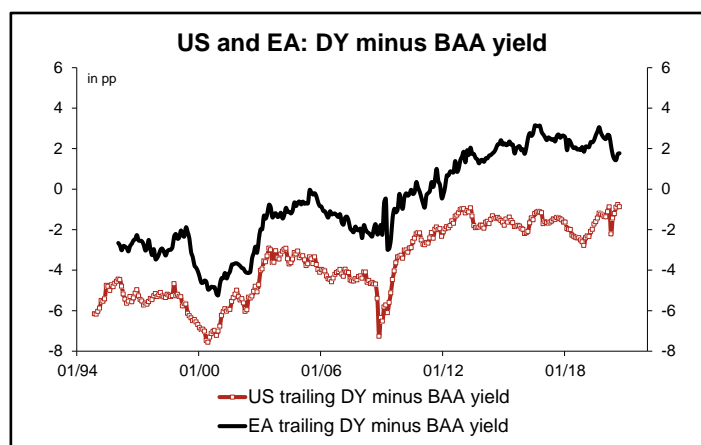
Market	Hist. avg 5-year total return since 1998 (p.a.)	5-year total return projection (p.a.)
World (in \$)*	6.8	6.0
US	8.5	5.3
EA	6.7	5.1
UK**	6.1	5.6
EM (in \$)	6.7	6.8

*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

Expected returns (p.a.)	EA	US	EM
Regression models (macro- and financial variables)	9.8	13.6	
CAPE-based model	5.1	5.8	6.2
Historical returns coherent to current CAPE levels	3.2	2.5	7.4
<i>Average</i>	6.1	7.3	6.8
Adjustment due to current over-/undervaluation (p.a.)	-1.0	-2.0	0.0
Final projection	5.1	5.3	6.8

Accordingly, our US and EA projections are adjusted down by 2pp and 1%pp p.a. compared to 1% and 0% in October 2019, respectively. The EM index does not need such an adjustment. Compared to our assessment in October 2019, stocks have become more expensive according to our short-term quantitative models, which see the US and the EA overvalued by 10% and 5%.



3.2.3 Equities beating subdued fixed-income returns

The final return expectations are presented in the tables above.² The rankings between different stock markets are little changed vs. Oct. 2019, with overall annual return projections being adjusted downward by around 50 bps on average. While we have adjusted the 5-year target for EMs the most (by 80 bps down due to higher EM earnings volatility and higher inflation), they are still expected to have the highest performance across the markets covered here. The drivers of future mid-term outperformance of EM equities remain a weaker US dollar, lower CAPE multiples and structurally superior GDP growth, resulting in higher earnings growth.

In all, **our expectations are below the historical averages since 1998**. They remain attractive vs fixed-income instruments, with the implied risk-premium of around historical average.

3.3 FX: Hedges warranted for a weaker USD

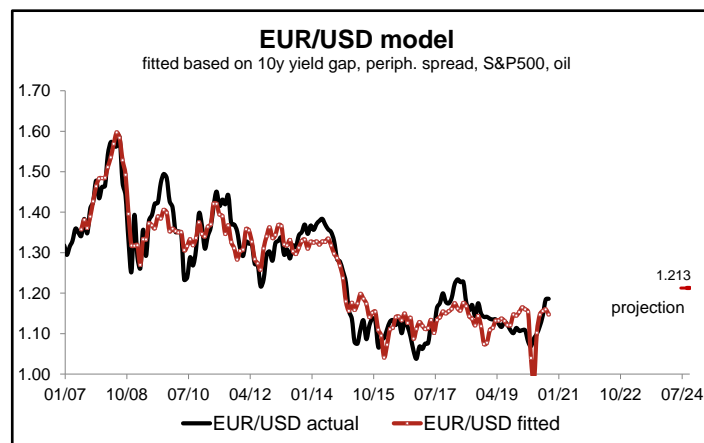
Portfolio diversification and (moderately) higher yields still render assets denominated in other currencies attractive for European investors. In our asset class universe, we focus on USD denominated classes.³ **Return projections in local currency** need to be converted into EUR to make them comparable euro area investments. The FX risk can either be hedged (at **hedging costs** of currently ~1% p.a. over five years) or left open, i.e. **unhedged**, with gains and losses determined by the EUR/USD outlook. In our summary tables, we show return figures for all three categories.

The decision to hedge USD exposure or not thus primarily hinges on the EUR/USD outlook. Furthermore, open FX exposure can add a substantial amount of investment risk, with the average EUR/USD volatility over the past 10 years (8.6%) well above that of USTs (3.8%) and US IG Credit (5.0%).

We assess EUR/USD point forecasts in a quantitative approach involving (a) a mean-reversion approach based on purchasing power parity (PPP) and (b) projections based on a financial market fair-value model. We then add the forward-implied carry to arrive at the expected total return on open USD exposure (see table).

For (a), we resort to OECD calculations of PPP values for the EUR/USD and project its evolution employing the averages of our inflation estimates for the US (1.9%) and EA (1.3%) over the coming years. PPP is projected at 1.439 in 2025 (from 1.39 in 2019, latest available point) on this ba-

sis. Assuming a mean reversion to PPP with a half-life of three years, this implies a conversion to 1.355 in 2025.



Regarding (b), we use a fair value model based on financial market variables with close links to our overall forecast exercise and a good overall fit (R^2 at 0.89 based on monthly data since 2007). These include yields on 10-year USTs and Bunds (yield gap), 5-year peripheral spreads (EMU risk), S&P500 (risk backdrop) and the Brent oil price (assumed at US\$ 65 in 2025). Inserting our projections, the model renders a EUR/USD projection at 1.213 for 2025. This is a near 6% projected rise in the estimated fair value, partially offset by an assumed unwinding of a current 3.5% overvaluation in this framework (see chart above). Combining approaches (a) and (b) as a simple average renders a quantitative projection at 1.284.

EUR/USD 5y projections		
	Forecast	Weight
Fair value projection	1.213	50%
PPP	1.355	50%
Weighted avg.	1.284	
Projection after qual. adjustments	1.300	
Current (22/9/2020)	1.171	
Return USD p.a.	-2.1%	
Forwards	1.233	
Implied carry p.a.	1.0%	
Total return p.a.	-1.1%	

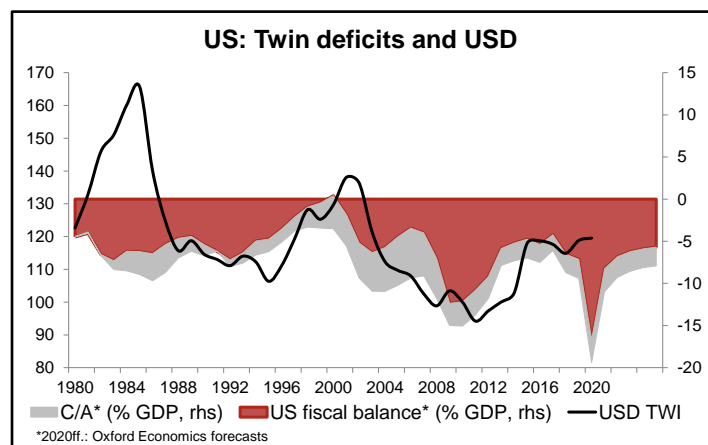
Crosschecking this quantitative approach with qualitative considerations confirms the case for a rising EUR/USD. The USD real effective exchange rate is 6.5% dear vs. long term average (EUR: 1.6% cheap). **IMF models** even imply a mid-point overvaluation by 11%. The prospective persistence of a high US twin deficit (fiscal and current account) amid persistently accommodative monetary accommodation will also require a deeper discount on the USD. Finally, reserves diversification out of the US dollar (albeit at a gradual pace) will weigh on the Greenback.

Blending the model-implied projections with these qualitative considerations, we thus deem a EUR/USD target at 1.30 as reasonable. This is well above forwards (1.233), implying that **unhedged USD exposure will render negative returns of 1.1% p.a. relative to a hedged exposure**. This is slightly more negative than in last year's projections

² The expected return of the MSCI World in dollar terms is higher than the weighted average of covered developed markets in local currency (representing 80% of the MSCI World). It was derived by regressing the returns of the MSCI World in USD on the returns of the single markets under consideration and the TW USD.

³ The only exception is the MSCI UK denominated in GBP. The outlook for sterling is still dominated by Brexit uncertainties. A bare-bone deal by year-end would help to unwind a part of the estimated ~11% premium in EUR/GBP. **IMF models** also point to a 7.5% GBP REER undervaluation. This may imply a EUR/GBP 5y target at 0.85 in a (bare-bone) deal scenario. A hard Brexit, however, would severely undermine sterling, likely pushing it close to parity with the euro. Considering the at best 50/50 chance of a deal, we thus employ a much more careful EUR/GBP estimate of 0.90 for the unhedged return calculations, implying an annualized 0.44% appreciation effect from GBP exposure.

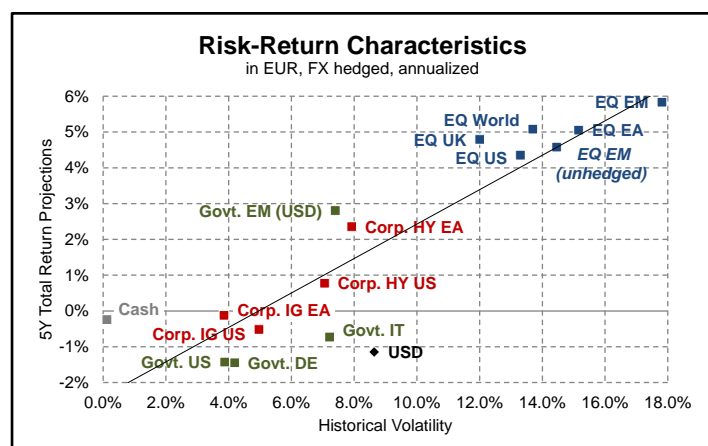
(-0.7% p.a.), with the 1pp lower carry partially offset by a milder depreciation assumption.



The risk/return profile remains clearly inferior to hedged exposure once we also take into account the risk involved in open FX exposure. We thus dismiss open FX exposure and focus on hedged FX exposure when comparing total return perspectives for the different asset classes. Unhedged return numbers are presented only for the sake of completeness of the respective overviews.

4. Conclusions: Nowhere to hide

Capital preservation will prove extremely challenging for long-term investors over the foreseeable future – and even more so if it is about the *real* value of money, which will require returns north of average EA inflation assumed at around 1.3% over the next 5 years. Yields are at rock bottom and about a quarter of global IG yields is yielding negatively. This unavoidably requires risk taking. While valuations of risk assets are definitely not cheap, they fortunately still offer opportunities to beef up longer-term portfolio returns.



Cash will render **negative** returns throughout the forecast horizon. But apart from its negligible volatility, it should **still prove superior to longer-dated government bonds**, whose total returns will additionally suffer from (modest) increases in yield levels. **High quality buckets of EUR Credit offer only limited consolation.** The modest carry will be more than eaten up by mark-to-market losses from rising underlying yields, resulting in mildly negative 5-year returns for IG Credit, too.

USD denominated fixed income generally offers higher local returns than Euro area ones. And the cost of FX hedging USD exposure has halved to 1% p.a. compared to last year. Still, with coupons compressed, too, and yield curves in the US set to steepen somewhat more strongly than in the EA, **US fixed income no longer offers a better return perspective than European bonds.** Given our moderately bearish USD forecasts, **hedged exposure is clearly superior to engaging in open FX risk.**

To find positive nominal returns **investors have no alternative but need to buy riskier assets.** In the fixed income space, **EM sovereign bonds** and **EA High Yield Corporates stand out:** we expect annual total returns of more than 2% over the coming five years at moderate market risk (see chart, which shows EM bonds above the risk/return line).

At the higher end of the risk spectrum, **equities will remain an integral part of revenue generation in a balanced portfolio.** We acknowledge stretched valuations, especially after the bounce from the March 2020 troughs. And following a technical snap-back from the spring slump, earnings may recover much more gradually over the coming years in a macro environment marked by persistent scars from the Covid-19 crisis. Yet valuations look much less stretched amid the outlook of persistently very low rates. **Equity risk premia are still elevated.** Real yields may even fall further if inflation expectations slightly recover while nominal rates remain nailed at or below zero by central banks for years. This is why **for European equities, we have annual returns of around 5% in our books (even more so for EMs),** which adequately compensate for higher risks.

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	-1.4%	-1.4%	-1.4%
Govt. IT	EUR	-0.7%	-0.7%	-0.7%
Govt. US	USD	-0.5%	-1.4%	-2.6%
Govt. EM (USD)	USD	3.7%	2.8%	1.6%
Corp. IG EA	EUR	-0.1%	-0.1%	-0.1%
Corp. HY EA	EUR	2.4%	2.4%	2.4%
Corp. IG US	USD	0.4%	-0.5%	-1.7%
Corp. HY US	USD	1.7%	0.8%	-0.4%
EQ World	USD	6.0%	5.1%	3.8%
EQ US	USD	5.3%	4.4%	3.1%
EQ EA	EUR	5.1%	5.1%	5.1%
EQ UK	GBP	5.6%	4.8%	6.0%
EQ EM	USD	6.8%	5.8%	4.6%
		Spot	Carry	Total
USD		-2.1%	0.9%	-1.1%

What are key differences vs. last year's projections? Owing to the milder predicted increase in core yields, expected annual total returns for EA government bonds are higher (10y Bunds: +1pp, BTPs: +0.6pp), if still negative. Favourable returns for EM sovereign bonds have been further enhanced (+1.1pp) thanks to lower USD hedging costs. We raised expected returns for Euro Area HY (+1.5pp), which largely owes to the potential of a risk pre-

mium compression from higher current spreads levels than in 2019.

By contrast, owing to a lower carry and reduced roll-down benefits, USTs look less attractive than last year (-0.6pp) – lower hedging costs notwithstanding. The appeal of US Treasuries as a hedge against market turmoil is still notable, but much less exciting: with 10-year UST yields down by more than 100 bps since last September to levels around 0.65-0.70%, yields have much less room to fall (and UST prices to rally) in any new bout of safe haven bids. The Fed still seems reluctant to bring rates below zero, even in an adverse scenario. Finally, we have prospective local annual returns in global equities (MSCI World) 0.5% lower than last year. This is more than compensated by a return upgrade of equities in other regions on fallen USD hedging costs – rendering **international equity diversification more attractive**.

What are the main things that could go wrong? The Covid-19 pandemic has been a reminder on how economies and markets can turn upside down, and all the more so over a 5-year horizon. We see three main factors potentially derailing our forecasts for the coming years - as flagged in the macro section 2.

- **A renewed severe downturn/recession.** The Covid-19 crisis and its detrimental impact on growth may prove much more protracted, causing a double-dip recession. Similarly, the UK and euro area economies may be impacted severely by a hard Brexit over year-end. Consequently, equities and Credit (HY in particular) would suffer renewed setbacks. Core government bonds yields (even in the US) will offer only limited protection, as central bank rates are close to their lower bounds ('reversal rates') and yields have much less to fall than in previous risk-off episodes. At the same time, with the purchases of IG Credit turned into a more common central bank tool, higher quality buckets of Credit may prove more resilient in such a risk-off environment than in previous episodes.

- **Rebounding inflation.** Conversely, reckless monetary accommodation and a faster economic recovery may be the ingredients for a rebound in inflation. Amid very wide output gaps, this is no near-term threat at all. But if governments pursue highly expansionary policies for long and central banks react only sluggishly with new 'average inflation' policy frameworks in place, rising inflation risk concerns may trigger a faster increase in yields than in our assumptions. This would primarily hit fixed income exposure. Equities may initially be less affected (with upgraded earnings revisions compensating for rising discount rates), but would start to suffer once investors suspect that central banks have lost control of price stability.

- **Debt sustainability concerns.** Governments and firms have amassed huge amounts of new debt over the pandemic, with global non-financial debt already at 245% of GDP in 2019 according to the Bank for International Settlements (BIS). For many governments and firms the burden still seems sustainable amid much lower interest rates and large-scale central bank support. Yet at some point of the recovery, central banks will trim their asset purchases, while yields may still trend higher. Governments with high debt burdens will be watched with more scrutiny, both by investors and – in the euro area – by their euro peers and the EU Commission. Denial on fiscal consolidation and/or

rising market interest rates bear the greatest risks to debt sustainability. In a worst case, this may result in a renewed sovereign debt crisis in the euro area. Equities and HY Credit would suffer, while safe haven bonds (lower yields) and the USD would benefit.

Conversely, we acknowledge the scope for positive surprises, especially in equity returns. The Covid-19 pandemic may be overcome more quickly with effective vaccines. Similarly, higher innovation may boost capex, structural growth and profits. Equity multiple expansion may have further to run, too, with discount rates held close to zero. Faster growth amid low interest rates would also reduce effective debt burden, favouring lower Credit spreads.

On balance, however, we think that the downside risks around our base forecasts still dominate. Amid generally high valuation levels, this means that the tail risks to our 5-year portfolio returns are tilted to the downside. The challenge to grow investment portfolios has become an even tougher enterprise.

Imprint

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