MULTI ASSET

Forecasting The Next Decade: An Analysis Of Asset Returns

BARINGS INSIGHTS

Highlights From Our Multi Asset 10-Year Forecasts

- For many asset classes, valuations have improved over the past 12 months but they are still not cheap versus a long-term history. Indeed it is valuations, not economics, which present the more meaningful headwind to long-term returns from today's starting point. Most asset class valuations have only a limited buffer against losses from an economic recession taking place over the next ten years.
- Consensus estimates of trend economic growth are too low. Although demographics will be a headwind, our core belief is that real economic growth will remain decent—though far from stellar. Inflation looks to be structurally lower than in previous cycles, though.
- We have further developed our ESG framework this year, to explicitly include—together with governance—environmental and social factors into our analysis. We continue to believe ESG considerations are important for long-term asset allocators.
- Some of the asset classes with higher return forecasts are to be found within credit. In equities, the U.K. appears to be the world's most unloved market, allowing for the highest return potential from here from a combination of low valuation and high dividend payout. Instead, U.S. equities are the lowlight—valuations remain at lofty levels, such that long-term investors may be left disappointed.
- Each year, we revisit, debate and refine our forecasts. On occasion, we also create additional asset class forecasts—this year we added forecasts for European High Yield to our ten-year framework for the first time.
- Investors will need to be more dynamic and selective about asset classes. Over the past 30 years, a traditional balanced strategy delivered an annual return of around 8% per annum. For the next ten years, a static balanced portfolio will most likely deliver less than 3% per annum.
- The history of strategic forecasting at Barings: we dust down our ten-year forecasts made in 2003–2008. On balance, they have been an extremely useful guide to the future.

Revisiting Our Long-Term Forecasting

In today's world, with rapidly increasing access to data, newsflow and opinion, it is more important than ever to pause and reflect upon the underlying factors that will drive markets over the long term. Each year, the Barings Multi Asset Group does just that; we step back from the day-to-day market movements on our screens to consider these secular issues.

Factors such as demographics, productivity trends and the sustainability of a country's investment environment[1] sit outside the normal one year forecasting period used by many analysts. Yet, these are tectonic plates which are likely to move economies and markets over the long term.

A significant research effort goes into analysing, reviewing, and debating our ten-year forecasts. The exercise makes us more focused and disciplined as investors. In particular, when moments of extreme crisis or exuberance hit the market, these forecasts serve as an extremely useful anchor point on reality.

Our Methodology

We combine these long-term drivers of markets with today's valuations and produce total return forecasts for major asset classes over the next ten years. This is a three-stage process:

Step one: Quantification of specific secular trends. This might include productivity and demographic trends as well as our assessment of the likely evolution of mechanisms such as quantitative easing. We are aided in part by looking back at prior episodes, to determine how long the current state of affairs could last, as well as our own analysis.

Step two: We convert economic views into market views. This will reflect our judgement of how well certain relationships will hold. This year, we have built upon our ESG framework and broadened the scope of our analysis to explicitly include environmental and social analysis. This ESG analysis aids the conversion of a given economic view into a view on country by applying specific country risk premia.

Step three: These market views are combined with current market valuations, to see how each asset class may fare over the next decade, allowing for a 'normal' recession to take place.

In a sense, economic questions become simpler when viewed over a decade. Over such a long period, the economic cycle could be considered to smooth itself out. We may not be able to predict the exact year a recession will occur, but we can be reasonably confident that a recession will strike at some stage. Making allowances for the inevitable hit to our main assumptions (such as profit margins and default rates) is a sensible approach.

The benefit of this approach is that it allows the total returns of each asset class to be compared across markets using a consistent set of assumptions. In a sense, each asset class is being asked to respond to the same set of macroeconomic challenges, including a recession. By looking at how each asset is priced today, we can judge which of the markets will do best as the economic cycle normalises.

"In today's world, with rapidly increasing access to data, newsflow and opinion, it is more important than ever to step back from the computer screens and to reflect upon the underlying factors that will drive markets over the long term."

1. Analysis includes environmental, social and governance factors.

Does It Work?

The forecast methodology evolves over time but the key principles have always been the same. To test the success of any individual forecast we have to wait ten years to see if a given 'vintage' was successful. Since Barings began these forecasts in 2003, six sets of forecasts have run their course: those produced in years between 2003 and 2008. Below, we compare the average forecast to the average subsequent ten year outcome **(FIGURE 1)**.

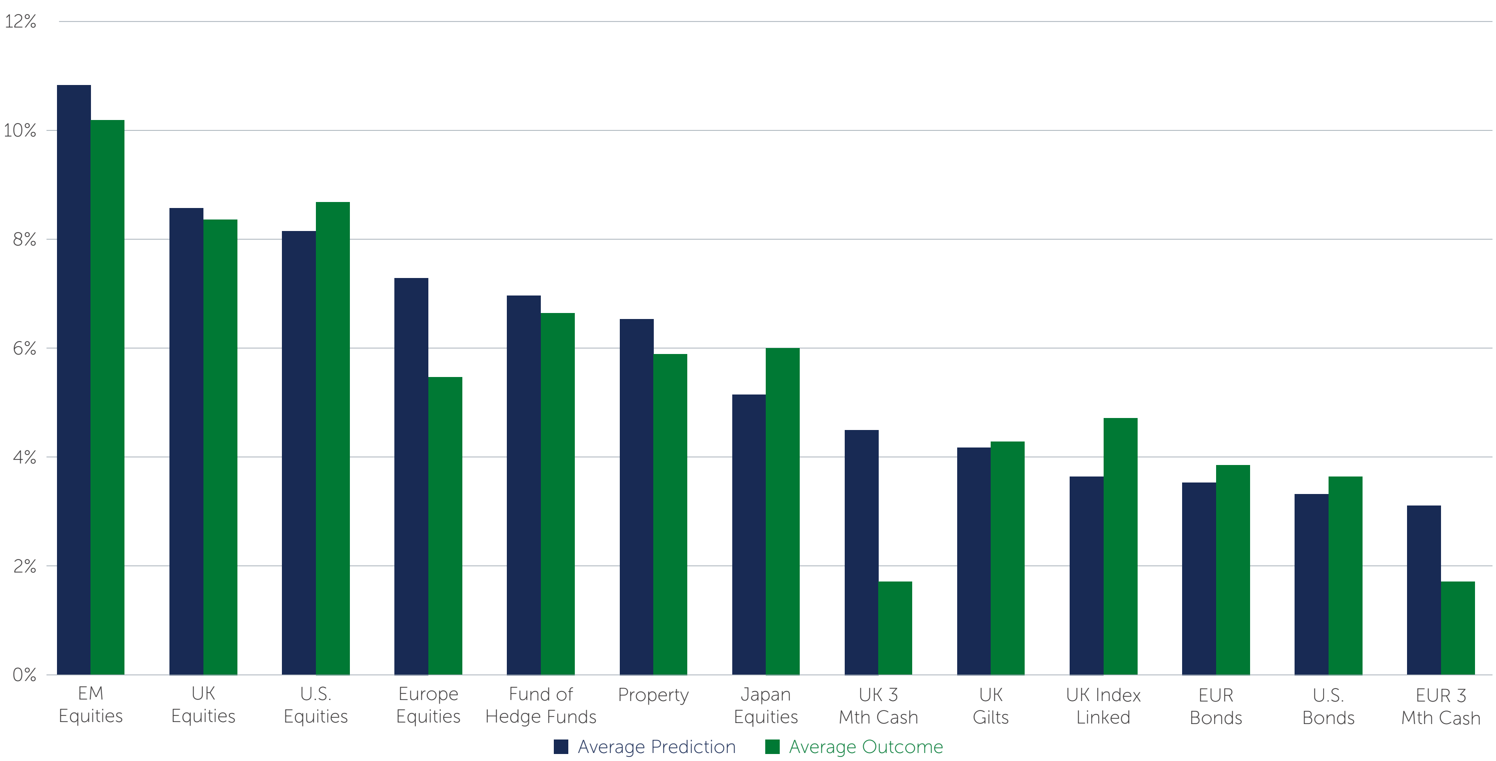
As ever, the purpose of long term forecasting is to indicate the broad direction of markets, rather than to estimate the precise return of any given asset class. As the chart shows, we can be proud of the fact that, by and large, we were correct in our high level asset class calls. Clearly, these forecasts say nothing about how smooth or rocky the journey will be, but the track record suggests that what the forecasts say about the end destination is useful.

Of course, not everything went our way. Cash rates going to zero was not part of our framework before the 2008 crisis—this has created discrepancies between the forecasts and outturn for cash and related assets such as bonds.

In equities, the one main surprise was the sizable gap between our European equity forecasts and reality. The primary driver of this gap is that our forecast methodology assumes one recession per decade whereas in Europe there have been two recessions (and in some Eurozone countries three) in that period of time.

Nevertheless, we believe taking a long-term view is a valuable discipline, and a key pillar to the Barings multi-asset approach.

FIGURE 1: Fifteen Years of Ten Year Forecasting: How Previous Forecasts Have Fared



SOURCE: Barings, based on the average of the ten year forecasts from 2003, 2004, 2005, 2006, 2007 and 2008. As of February 2019.

"Our ten-year forecasts have been an extremely useful guide to the future."

Special Topic: Developing Our ESG Framework

Our forecast methodology has always rested on our view of where sustainable growth lay for each country. As we wrote last year, our framework includes an Environment Social and Governance ("ESG") component to help convert economic views into market implications. Previously, this ESG component was focussed on the governance angle (G), but this year we have broadened our framework and introduced environmental (E) and social (S) factors too.

Social factor. Whilst the ESG concept is rapidly gaining traction in investment circles, the ideas are not new; the principles date back beyond the times of Keynes. Keynesian theory of marginal propensity to consume suggests that as an individual's income rises, the portion of income spent falls and the portion saved rises. In other words, the greater the extent of inequality in an economy the more the wealth is concentrated with individuals with low marginal propensity to consume (i.e. rich savers). As it is spending and not saving that generates economic growth and corporate profits, unequal societies have less potential for sustainable economic growth. Ultimately, high levels of inequality—which we define as the social factor (S)—lead to less sustainable outcomes.

Environment factor. This is equally important over a 10-year horizon. The consequences of environmental mismanagement are clear. Too much growth in the short term at the expense of any environmental concern will, in extremis, destroy the habitat in which the growth could be generated in the first place. There are numerous examples of this, from cities over industrialising to waters being over fished to beautiful landscapes being destroyed by rapid growth in tourism. Again, the sustainability of growth for countries with poor environmental records is called into question.

Governance factor. This element was introduced in our last ten-year forecast process and we wrote about it extensively at the time. The data we use comes from the World Bank, which produces governance scores for over 200 countries, based on close to 40 data sources.

In essence, our ESG framework penalises those countries with lower ESG scores. A poor ESG score would mean our framework will associate that country with a higher bond yield and a lower level of corporate sales growth over time. This is right and fair—countries with a worse track record on environmental, social and governance factors should see investors responding with a set of assumptions that are more conservative. Certainly, this is what is seen in practice, as evidenced by **FIGURE 2**. It is therefore sensible to incorporate ESG factors in a quantifiable and evidence-based fashion.

FIGURE 2: ESG Matters. The Market Typically Penalises Countries with Worse ESG Scores by Demanding Higher Real Yields

SOURCE: Barings. Each dot represents the average real yield and esg score for the last five years. Real yields for Poland are estimated based on historical nominal bond yields and inflation due to lack of data. As of February 2019.

What Does Our Approach Predict For The Next Decade?

Reasonable growth is likely, no thanks to demographics…

Our real growth forecasts for the U.S. and the UK see these two nations growing at a trend of 2.2% and 1.6%, respectively, for the next decade. Despite being relatively modest, these figures put us in the more bullish camp versus other commentators.

Despite our relatively upbeat view, there are a few headwinds that we must acknowledge and embed within our forecasts. The first is demographics: The slowing rate of population growth has weighed on economic growth rates over the past decade, and will continue to be a drag on growth throughout the developed world going forwards (see box). Productivity growth has also been slowing in a number of advanced economies. Tighter controls on credit growth will likely weigh on investment and global trade is much slower than it has been previously. This is why our forecasts are lower than the 3%–4% real GDP growth rate prevalent during the 2003–2007 period, even if our forecasts are more positive than many.

Consensus commentators such as the IMF believe low productivity trends in the U.S. and UK will be permanent. Instead, we suspect productivity growth is likely to be revised up as the economic cycle progresses[2]. Partly, our evidence for this is that not all countries have seen productivity declines over recent years. While economies like China have hit the headlines for such declines, we believe this is a natural part of China's economic development process. As any economy grows and "catches up" to western levels of GDP per capita, it becomes increasingly difficult to find the next leg of growth. However, other globally significant economies, such as the U.S., Germany and Japan have all seen recent productivity increases rather than falls.

As it is nominal GDP that drives markets, together with demographics and productivity (which sum to real GDP), we must also consider inflation. Economic textbooks would lead one to believe that, after a decade of economic expansion, and with unemployment rates around the world at record lows, inflation would be taking off. However, the Philips curve—the relationship between lower unemployment and higher inflation—has not asserted itself at all this cycle. Even with booming economic conditions in the U.S., fuelled by fiscal stimulus, loose monetary policy and high oil prices, inflation barely showed signs of life.

Technology has a big part to play here— advances have meant that assets can be used more productively (the Uber and AirBnB effect), workers can be found by employers more easily (the Linkedin effect), and tasks can be passed around the world where there is productive capacity (the globalisation effect). All of this means that the bottlenecks of yesteryear that used to cause squeezes in certain pockets, and hence inflationary pressures, are far less likely. Consequently inflation has been far more easily controlled. Whilst not wishing to underestimate the chances of inflation over the next decade, we have to take note of these developments and the impact they are having on realised inflation. Accordingly, we have trimmed our inflation scores, which have the knock on effect of trimming our forecasts for nominal GDP.

Overall, despite the headwinds we discuss, we remain believers in global economic growth. We are not in the secular stagnation phase that many predict—global growth will come through, just at unexciting levels.

"Whilst our real economic growth forecasts are more optimistic than consensus, we must acknowledge that future growth will be slower than we have enjoyed in the past."

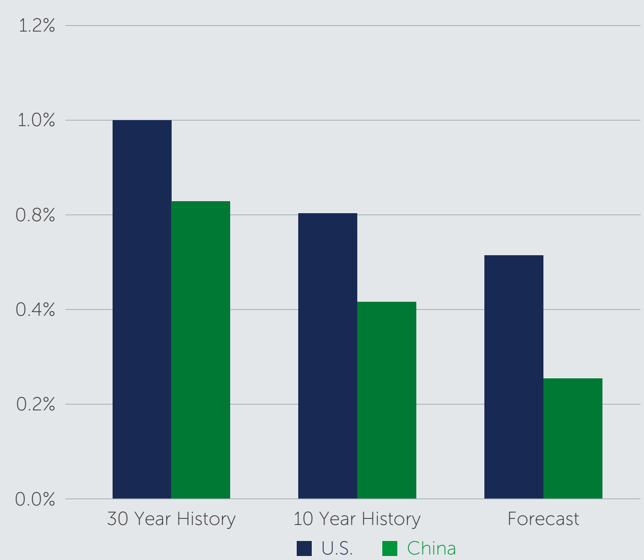
The Demographic Deceleration

It is commonplace in literature to find articles focussed on the very long-term effects of demographics. Frequently the issue of social security payments, and the increasing challenge a relatively smaller working age population will face to finance the needs of a relatively larger retired population comes up. This is an incredibly important issue and one that needs careful consideration, but often overlooked is the impact on economic growth over the next decade.

As we show in the chart below, the population growth rates in the world's largest two economies—China and the U.S.—have been slowing over the past 30 years, and we see no reason for those trends to turn around in the future. We forecast the population growth will continue to slow going forwards.

As regular followers of our 10-year forecasting process will recall, our approach builds up to nominal GDP growth from three component parts: population growth, productivity growth and inflation. Clearly, under this construct, a slower level of population growth feeds directly into a lower level of nominal GDP growth, which in turn implies a lower ability for corporates to grow their earnings. So, from a growth and ultimately from a market standpoint, these demographic forces will need to be offset by productivity growth if global growth is to be maintained.

FIGURE 3: Population Growth in the Largest and Most Important Economies is Slowing

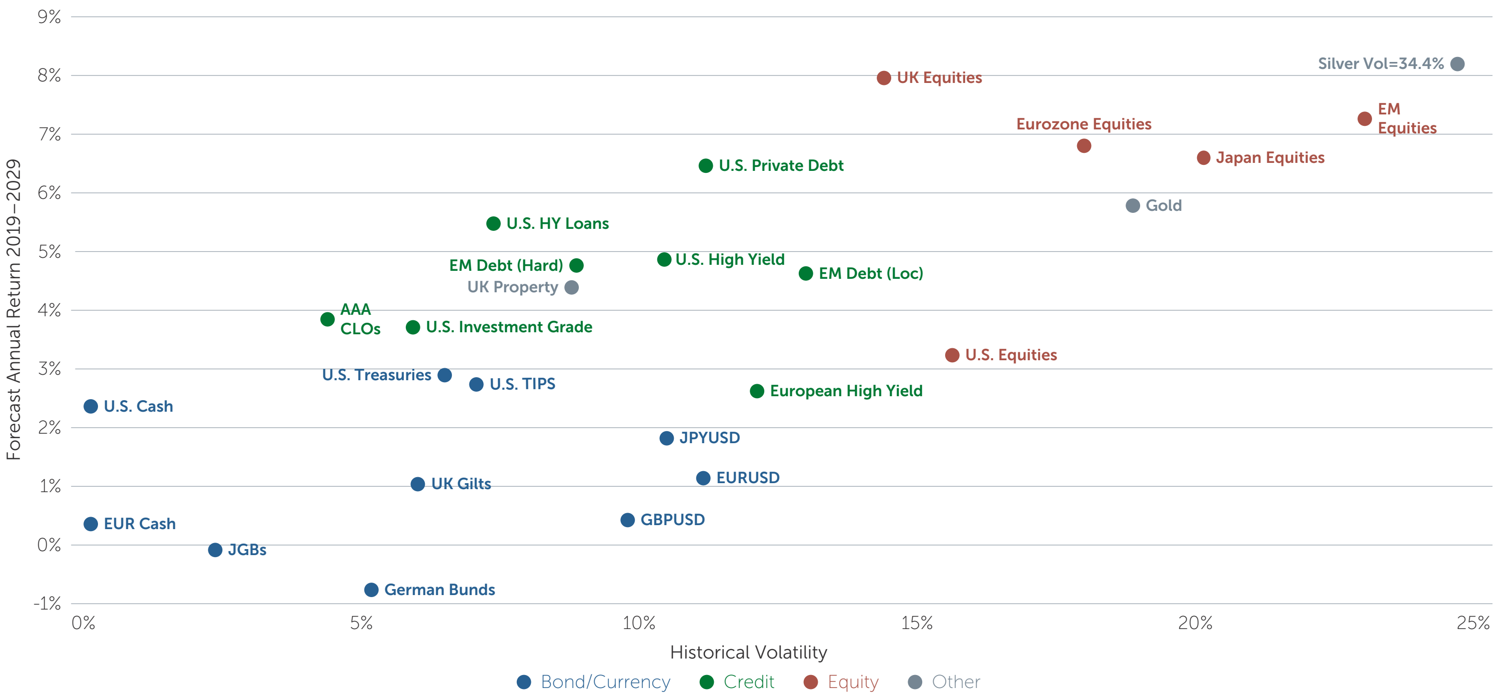


SOURCE: IMF. Barings estimates as of February 2019.

From Economics To Markets: What Our Views Say About Markets

Our forecasts are shown in **FIGURE 4**.

FIGURE 4: Multi Asset Long Term Forecasts (10 Years Starting February 28, 2019)



SOURCE: Barings. Local currency returns, except for EM and FX (USD). EM indicies use standard index weights. Risk is calculated as the 10 year realised volatility, except for property and private debt, where adjustments are made to account for their illiquidity. As of February 28, 2019.

1) G4 government bonds offer disappointing returns, but U.S. bond yields are not too far from fair value.

We have what is considered today to be a bullish view on economics versus consensus. Naturally, this translates into our view that—on a global basis—government bond yields will rise. However, our forecast that the U.S. 10-year bond will yield 3% in ten years' time is roughly in line with current market forward expectations at the time of writing (April 2019). So, whilst it is true that U.S. bond yields should grind higher from here, it should not cause too much pain from a total return standpoint, as that move higher is already baked into market pricing. However, returns for markets such as German Bunds and Japanese Government Bonds will disappoint from today's low starting yield levels.

Why are we confident that the equilibrium rate for bonds is not far off where bonds are trading today? We have felt for some time that the level of global debt means we are likely to be living with low interest rates for many years. History suggests policies designed to bail out debtors (especially the government) tend to last a very long time. For instance, low interest rates and financial repression were used after World War II to allow governments to repay the huge war debt. The implications lasted until the early 1970s: 25 years of low real rates. Such experiences show how long low interest rates could remain even as central bank balance sheets gradually return to normal levels.

We combine our view on bond yields with the typical shape of the yield curve to derive an equilibrium policy (Fed Funds) rate for the U.S. of 1.8% across the next decade. Of course, rates will be above this level for a period of time but equally there will no doubt be periods when growth concerns require policy rate cuts (when the next recession strikes).

2. Other factors that impact the productivity debate include (1) Likely revisions to productivity data as typically occurs during economic expansions increase (2) evidence for the need for revisions in the data comes from GNI outpacing GDP since 2008. GDI and GDP are economically identical but simply measured differently. Such differences suggest that the productivity data may well be a poor measure of output—and worse than normal. (3) greater acknowledgement of the costs of the Iraq and Afghan conflicts which totaled around 11% of U.S. GDP. As this spending took place overseas it appeared as a drag to U.S. productivity in the historical data. As spending on overseas conflicts declines, so U.S. GDP should improve.

2) Credit markets should fare reasonably.
Sub-investment grade credit markets have the potential to do well, even allowing for the likely level of defaults and the probability that spreads will rise from their current levels. Whilst government bond yields could back up from here, we believe the magnitude of any such move is well contained, and so the impact on credit total returns somewhat limited. This year we also include European high yield bonds in our analysis for the first time. In local currency terms, Euro high yield will likely underperform their U.S. counterparts, but shorter-term considerations, such as currency hedge costs, will come into sharper relief to investors looking to allocate to the asset class in the interim periods.

3) Prospects for equities are looking better, at least outside the U.S.
Since we last ran our forecasts in 2018, equity market valuation multiples have fallen, and as such markets should fare slightly better than we predicted last year. Globally, equity returns of just about 5% per annum are realistic, but this headline figure masks the underlying trend. From today's valuations, U.S. equities are likely to struggle to match the returns investors have been used to. However, global ex-U.S. equities are likely to perform moderately well, but even there the returns are likely to be some way below the high single-digit annual return that so many investors require.

We set out in **FIGURE 5** the breakdown of our forecast equity returns. Firstly, we assess sales growth, which we expect will continue to be positive, as nominal GDP expands, even allowing for the likely level of dilution and share issuance over the decade. Then, we assess corporate profit margins, and the valuation which the market will award those profits. As the emerging markets index is multi-currency in nature, we show the returns in U.S. dollar terms, so we also provide the return component associated with its currency moves. All other returns are in local currency terms. Finally, we add in the dividends to make forecasts a total return estimate.

After a strong market for equities since the 2008 crisis, it comes as little surprise that almost all of the returns will come from earnings growth and dividends.

The stand out from **FIGURE 5** is the U.S. equity market, where investors are set to be disappointed.

U.S. margins are likely to see a slight decline, driven by a) a mild increases in labour costs, b) some drag from higher interest costs c) corporate taxes normalising as some one-offs dissipate.

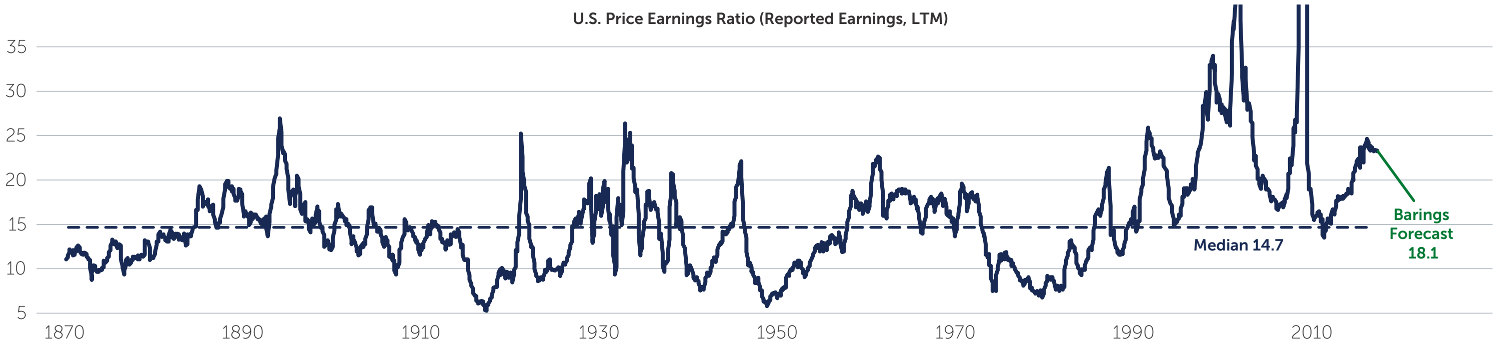
FIGURE 5: Breaking Down Our Equity Return Forecasts

Region	Sales Growth	Margin Change	Multiple Change	Dividend	FX Moves	Total Return Forecast
U.S.	3.8%	-1.6%	-1.1%	2.0%		3.2%
UK	3.5%	0.2%	0.4%	3.9%		8.0%
Europe	2.8%	0.1%	0.8%	3.1%		6.8%
Japan	1.1%	0.7%	2.4%	2.4%		6.6%
EM[3]	6.1%	-2.0%	1.6%	2.8%	-1.3%	7.2%

SOURCE: Bloomberg, Factset. Barings calculations as of February 28, 2019.
3. Note that all forecasts are in local currency terms, except for EM equities which are in USD terms. We forecast the impact of FX movements over the period will detract 1.3% pa from EM equity returns.

"From here, the majority of equity returns will come from earnings growth and dividends"

FIGURE 6: From The Current Levels U.S. Equity Valuations Can Only Lead To Disappointment



SOURCE: Bloomberg, Barings. As of February 2019.

Of more concern to us is that today's valuation **(FIGURE 6)** makes life very difficult for U.S. investors. Of course, some of today's valuation premium in the U.S. is due to the current sector mix, with high weights in some of the more expensive sectors such as Information Technology, but there remains a question of the degree to which these premiums will still exist in a decade's time. Other international markets are not suffering from this headwind to nearly the same degree and, therefore—on a ten-year time horizon—are more likely to outperform.

Emerging markets see both a gain and a loss from their faster level of nominal GDP growth. On one hand, faster nominal growth leads to faster sales growth in these regions, but on the other hand, the gain in faster nominal GDP growth is partially offset by inflation. This is likely to erode the value of their currencies (albeit modestly) over the period.

4) Precious metals are still a good way to diversify portfolios. Probably better than government bonds

With equities struggling to deliver the strong returns investors might have become used to, other asset classes may fare better, particularly on a risk/reward basis. As the table in **FIGURE 7** shows, gold and silver, while very volatile on their own, can be useful return-boosting assets, which have the added benefit of diversifying portfolio risk. Property and certain illiquid assets should fare well on a risk/reward basis, even allowing for credit events such as voids, vacancies and defaults.

While developed government bonds such as bunds and JGBs may once have been decent portfolio diversifiers, they now rank at the bottom of our list on a risk/return basis.

FIGURE 7: Forecasts Ranked By Return/Risk

Asset Class	Return/Risk
AAA CLO	0.83
Loans (HY)	0.75
Priv Debt	0.56
U.S. IG	0.54
UK eq	0.54
EMD (hard)	0.51
Prop (UK)	0.48
U.S. HY	0.45
EZ eq	0.37
UST	0.36
EMD (loc)	0.35
Jap eq	0.33
TIPS	0.32
EM eq	0.31
Gold	0.30
Silver	0.24
EZ HY	0.20
U.S. eq	0.20
JPYUSD	0.16
EURUSD	0.10
Gilt	0.09
GBPUSD	0.05
JGB	-0.07
Bund	-0.21

SOURCE: Bloomberg. Barings calculations as of February 28, 2019.

Trade Wars & The Impact Of Brexit

Our investors have been asking if we have made many changes to our forecasts as a consequence of Brexit and the current U.S./China trade dispute. We have been tempted to reply that the key purpose of strategic forecasting is to avoid getting caught up in headline drama, but of course there is more to it than that.

Certainly today there is less unquestioning support for free trade policies. Market-wise there are implications stemming from this rise in protectionism. Embedded in our equity valuations is a premium that we believe results from open borders and free trade. This premium is connected in part to the stellar rise in markets since the end of the Cold War—more than can be explained by other variables alone. Prior to this year, we had cut this premium in each of our last three yearly forecasts, to reflect the headwinds impacting capital markets as a result of slowing growth in global trade, and regulatory fragmentation. This year we have declined the opportunity to cut further, but equally are not reversing our prior cuts.

For the world, Brexit is likely to be a non-event. The UK economy is simply too small to matter, dominated as it is by what happens in the U.S., China and even continental Europe. But for the UK itself, Brexit is most likely to reduce its trend growth rate. Small adjustments to the growth in GDP per capita stem from likely future higher barriers to trade with the EU. This is combined with a slowing of population growth as more controls are likely to be placed around immigration. These losses are unlikely to be offset by easier trading conditions with the rest of the world, as the UK does considerably less business with any individual country outside of the EU. Hence, the trend rate of growth for the UK has come down in our forecasts, albeit modestly.

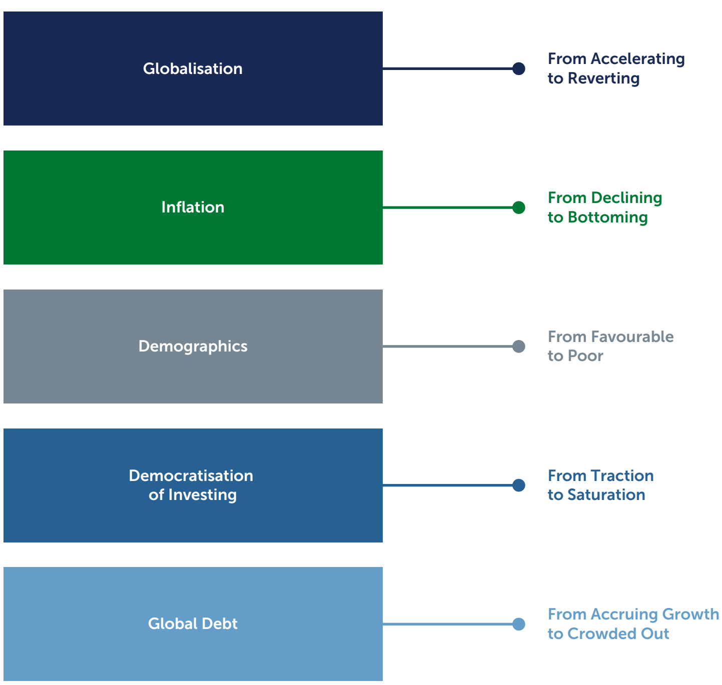
Going Beyond A Traditional Balanced Portfolio: Implications For Investors

For the past 30 years, investors have had it relatively easy. They could simply have owned a traditional portfolio of equities and bonds and watched it deliver handsome returns of around 8% per annum. Even over the past ten years, such a stance would have delivered a decent 5%.

Times are changing. As **FIGURE 8** highlights, equity markets have benefitted from a number of tailwinds over the past 30 years that are now abating. Globalisation has allowed corporates to allocate resources in the most suitable location, improve their efficiency, and boost their margins. Low inflation has a provided support. Productivity enhancements have been fantastic, and whilst we remain more optimistic about the future here than most, the trend is likely to be slower into the future. PE multiples have been boosted by the market access that new products have provided—buying an Exchange Traded Fund (ETF) has never been so easy. Investment has been democratised. Finally, the expansion in global debt has left levels so elevated that the multiplier of future fiscal expansion is likely to be significantly lower than it has been in the past. All of this points to lower future returns than investors have enjoyed in the past.

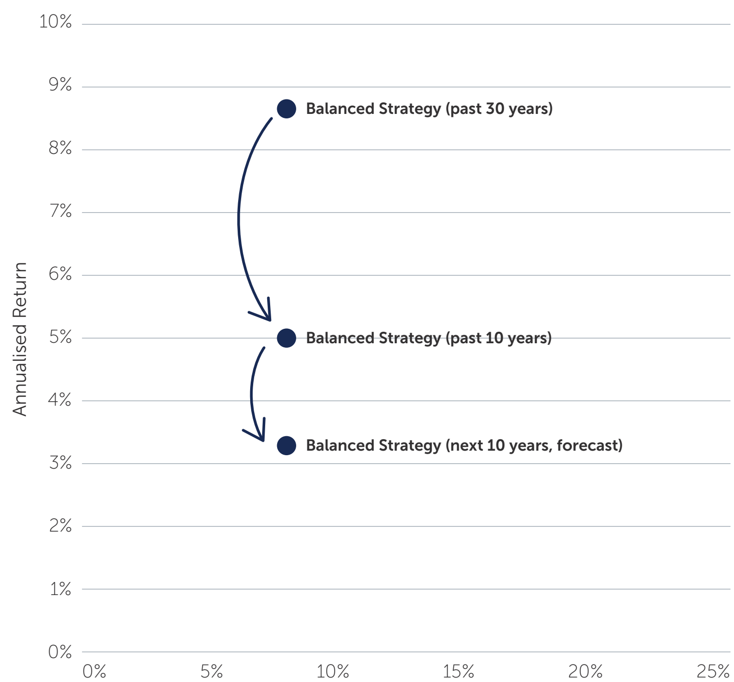
Both equity and bonds started the ten-year period at elevated valuations. Our strategic forecasting analysis suggests meagre returns to a traditional strategy, with just 3% likely, as we can see from **FIGURE 9**.

FIGURE 8: Times are Changing



SOURCE: Barings.

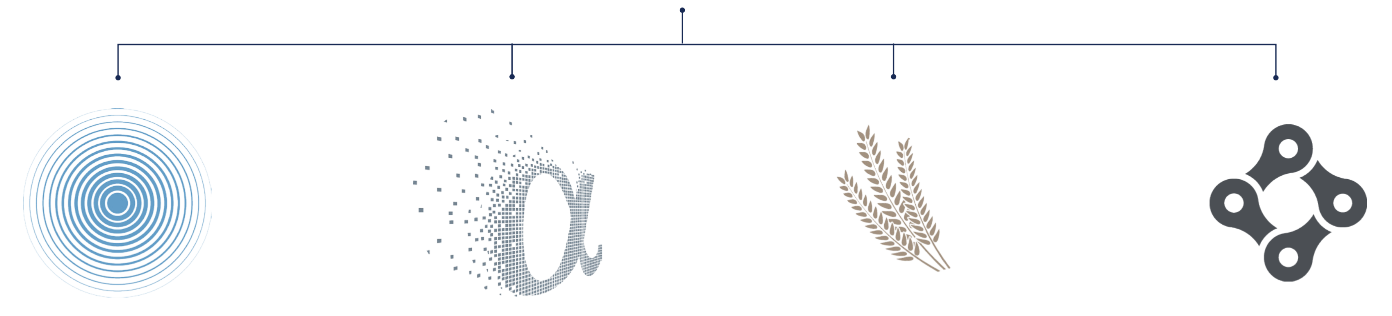
FIGURE 9: Balanced Mandates Face Particular Headwinds



SOURCE: Barings. Based on a 60:40 equity bond strategy. As of February 28, 2019.

IMPROVING ON THE TRADITIONAL STATIC BALANCED STRATEGY

THE FUTURE OF MULTI ASSET INVESTING



In Our View There Are Four Ways Investors Could Tackle The Problem:

1) Adopt a dynamic approach to asset allocation. Investors need to construct a portfolio that looks beyond the simple equity/bond universe. Some of the best returning assets today are both in the credit and commodity complexes. Of course, over time the most attractive asset classes will change. Investors need to be able to take advantage of these shifts and be ready to act. Our ten-year framework is a key anchor point that helps us avoid getting caught up in short-term drama or exuberance.

2) Within equities, investors will need to extract greater alpha from country, sector, style and security selection.

3) Harvest illiquidity premiums. It is no surprise that some of the better performing assets on a risk/return basis are those which might be considered less liquid. Investors will need to decide if they can stomach a degree of illiquidity risk in their portfolios.

4) Active FX management. Much of the turbulence over the past few years has originated in the FX world. With alarming regularity, certain currencies have been very volatile. This has presented strong opportunities for active managers who are able to take advantage of these moves, something which is likely to continue into the future.

Conclusion

Our ten-year view is based around certain core beliefs;

- Moderate economic growth is likely.
- The burden of global debt means interest rates will remain low, with yields rising only modestly.
- Valuations are generally cheaper than at our last forecast date, but remain elevated such all asset classes face subdued returns.

Over a ten-year timeframe, our return projections also include an allowance for the likelihood of a recession occurring at some point. In this context, we believe the U.S. equity market at today's valuations is the market to avoid. Global ex-U.S. equities, however, fare reasonably well. Credit probably scores best from a risk/reward point of view.

From a portfolio perspective, diversification is more difficult to achieve, as bond markets start from low yields. Nevertheless, our views do not see bond yields rising precipitously, thus it would not take much of a sell-off for us to build significant positions in G4 fixed-income securities. In the meantime, our preferred diversifiers are gold, property and currencies.

Over time the most attractive asset classes will change. Investors need to be able to take advantage of these shifts and be ready to act. Dynamic asset allocation is key.

Christopher Mahon
Director of Asset Allocation Research,
Barings Multi Asset Group

Michael Jervis
Investment Manager,
Barings Multi Asset Group

Appendix: Frequently Asked Questions

Why do you do it?

- Long-term secular factors, such as demographics, sit outside our normal 12–18 month forecasting period
- Like the slow movement of tectonic plates, secular factors like demographics, productivity and the quality of governance can be crucial in driving markets over the longer term
- Each year the Barings Multi Asset Group performs a 'deep dive' on the likely impact of these trends on markets
- Our ten-year framework is a key anchor point that helps us avoid getting caught up in short term drama or exuberance

Do you have proof that your approach works?

- Ten years is required to see if a previous ten-year forecast had validity
- Barings has been running this process since 2003—so we now have six "vintages" where accuracy from those early forecasts can be seen
- These vintages show high levels of predictive power in picking up long-term trends. For instance:
    - The ranking of the equity markets (emerging markets highest, Japan lowest and UK/U.S. preferred over Europe) has been correct
    - Similarly we expected property to outperform bonds, which has also been correct
- However cash rates going to zero was not part of our framework pre-crisis—this has created errors in the cash returns and related issues with our bond forecasts which were a bit low versus the outturn, especially for UK linkers where inflation has been a feature of the post 2008 backdrop
- European equities were the area where our equity forecasts have been quite out of line with the outcome. The primary driver of this gap is that our forecasts methodology only allows for one recession a decade whereas in European there have been two recessions (and in some Eurozone countries three) in that period of time.

What factors do you look at?

- We consider secular trends such as productivity trends, demographics, availability of credit, financial repression, globalization and political factors
- We combine these drivers with ESG factors to give market-based assumptions. In turn these normalized assumptions are combined with current market valuations
- This allows total returns of each asset class to be compared across markets using a consistent set of assumptions

Why ten years?

- Ten years is chosen as a decade is longer than the typical economic cycle. Conclusions are therefore secular rather than just cyclical.
- Ten years is also short enough to be useful to investors

Can you tell me more about the ESG process and how that feeds into the 10-year forecasts?

- ESG scores feature in the process of converting economic views into market views
- ESG scores are applied to both equity and bond forecasts
- Data from Yale University and the World Bank is used to assess the environmental and governance aspects. We make use of Gini coefficients to assess the social performance of an economy.

Is there any evidence that incorporating ESG is useful to investors?

- Yes. Given we are projecting over the next decade, it makes sense to incorporate the degree to which growth is sustainable into these longer-term projections. To give an example there is clear evidence that in the bond world countries with worse ESG scores tend to see higher real yields.

What are the key conclusions from your predictions this time around?

ECONOMIC

- Growth will come in better than consensus expects
- Nevertheless productivity, credit regulation and especially demographics will all present headwinds versus the past 30 years
- Despite our longstanding caution on economics, consensus trend growth expectations have for some time been too bearish, particularly for the U.S.
- Inflation will remain under control—it has not presented itself this cycle despite boom conditions and we do not expect it to assert itself in any meaningful way
- Low interest rates will be with us for a long period of time due to the burden of debt

FIXED INCOME

- Bond yields will rise from today's levels with the ten-year bond yielding 3.0% in ten years' time, roughly in line with today's market expectations
- The equilibrium U.S. policy rate in 2029 will be just 1.8%, derived by applying a normalized shape of the yield curve to our bond yield
- For the UK, the expected equilibrium GBP policy rate in 2029 is just 1.0%, with the ten-year bond yielding only 2.2%
- Credit will fare respectably in a world where outsized returns are difficult to find
- The lower competition from banks will mean decent returns for credit investors as spreads can afford to be sustainably higher than the last cycle
- Emerging markets debt is also worth considering, especially when denominated in hard currency

EQUITIES

- In general, equities should perform moderately from today's starting levels
    - Decent and growing dividend yields will prove attractive
    - Valuations for most areas are less expensive than at last year's forecast date
- The exception is U.S. equities, which we view as expensive. This will mean the U.S. market likely underperforms the international alternatives
    - In addition, with profit margins already at cyclical highs, U.S. equities may see mild margin erosion as interest costs rise
- Outside of the U.S., the UK market is the standout—it is unloved by the market, and looks cheap on a long-term framework with profitability at a cyclical low and with dividend yields of about 4%.
- The emerging markets are predicted to deliver relatively good returns. Whilst we expect profit margins here to fall, the underlying economic growth, and the starting valuations, should be more than enough to offset this.

CURRENCY

- The yen is most likely to see some appreciation. In ten years' time, the structural forces supporting the yen will overpower the current ultra-loose money stance, and bring it closer to fair value
- Sterling has potential to appreciate versus the U.S. dollar, but is nearer to fair value than some might suggest

FOR PORTFOLIOS

- Thinking beyond historical portfolio strategies is vital. A traditional balanced approach is highly unlikely to deliver the best returns for investors
- Non-traditional areas from certain types of credit to commodities present some of the best opportunities, particularly on a risk/reward basis
- Over time, the most attractive asset classes will change. Investors need to be able to take advantage of these shifts and be ready to act. Dynamic asset allocation is key.

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