GENERALI INVESTMENTS

Core Matters

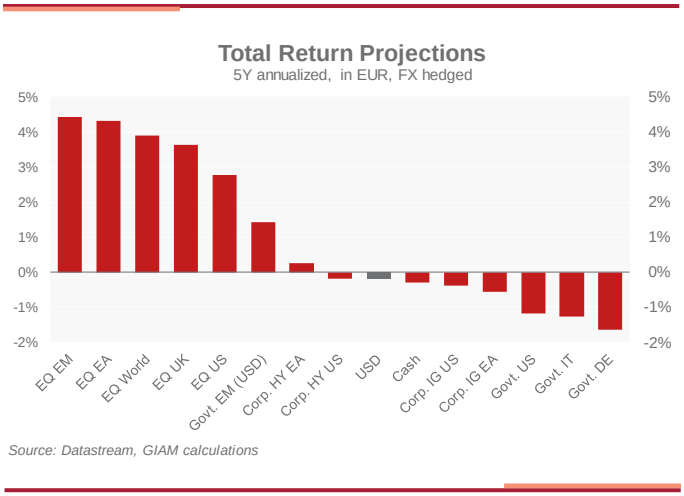
Sliding towards the new normal – 5-year return forecasts

GIAM Macro & Market Research Team

22 October 2021

Our Core Matters series provides thematic research on macro, investment and insurance topics

- **Now comes the hard part.** Global markets have staged a spectacular rebound from last year's pandemic trough. The economic rebound is flattening out, while governments and central banks are starting to pare back exceptional policy support.
- **The post-emergency world leaves investors in a bind:** high valuations cap expected returns, while inflation threatens to erode the real value of assets.
- **TINA is not dead**: There Is No Alternative to equities in the universe of liquid assets. Cash will render moderately negative real returns for longer. And government bonds will suffer from duration exposure as yields "normalise" (a bit) higher.



Source: Datastream, GIAM calculations

- **Credit will offer resilience**, but has lost much of its shine, following the sharp compression of risk premia over the past year. The modest carry is unlikely to offset the headwinds from rising rates and modestly widening spreads. In fixed income, only EM bonds may yield nominal returns that almost compensate for inflation.
- **The case for equities remains intact** in this bleak set of alternatives. Equity risk premia are still decent, especially in Europe, and earnings still have upside as the recovery proceeds.
- **Yet delivering performance through beta will get ever harder**; alpha becomes more important.
- **So does hedging**, given the lofty valuation and deteriorating diversification benefits.
- **Inflation and the pandemic (aggressive mutations) are the largest downside risks**. Much of the recent price overshoots seems transitory, but structural factors may well prevent a quick pullback. Inflation is toxic in a least three ways: it eats into both corporate margins and the consumer purchasing power and may require a faster monetary policy tightening.

CONTENT

1. Introduction 2

2. Macro backdrop: coping with fading policy support ..4

3. Financial return expectations 6

3.1 Fixed income assets: uphill battle 6

3.1.1 Government bonds: meagre times ahead 8

3.1.2 Credit: Carry is the key to positive returns 9

3.1.3 EM sovereign bonds: still positive return despite spread widening 9

3.2 Equities: mid-single digit returns ahead 10

3.2.1 Factors behind lower-than-norm returns 10

3.2.2 Long-term equity returns: the framework 11

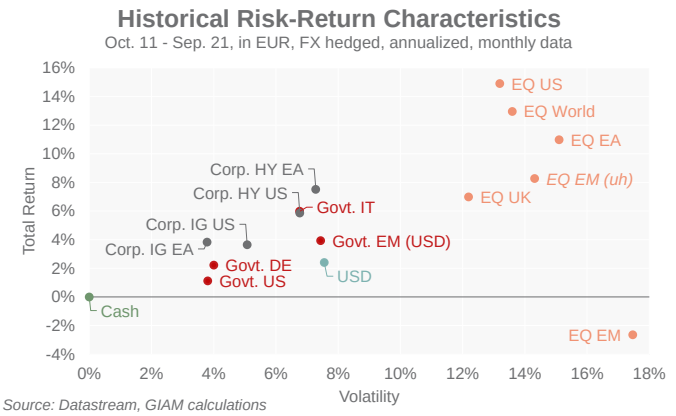
3.2.3 Equities beating subdued fixed-income returns 12

3.3 FX: Fundamentals point to higher EUR/USD 12

4. Conclusions: mounting inflation challenges 13

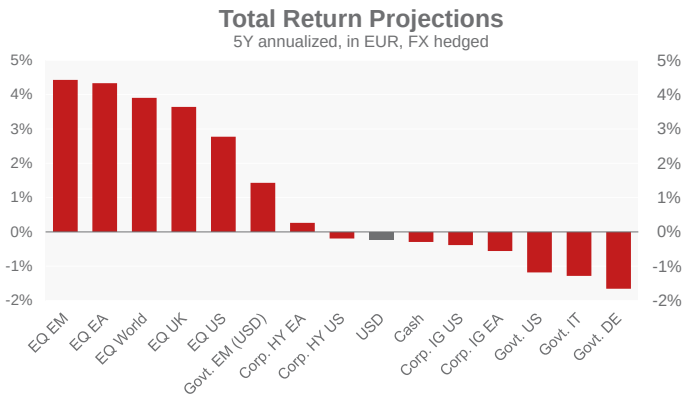
1. Introduction

Past performance is no guarantee of future returns – so they say. Anyone expecting asset price performance to repeat that of the past ten years (see first chart below) is set for serious disappointment. The rally that has followed the March 2020 crash has helped US equities return nearly 15% p.a. over the past decade (in EUR hedged... and even more in USD). Euro Area (EA) High Yield bonds have returned nearly 8% p.a., with volatility about half that of equities (but twice that of the German government bond index). Cash and EM equities have been the laggards of the universe under our consideration.



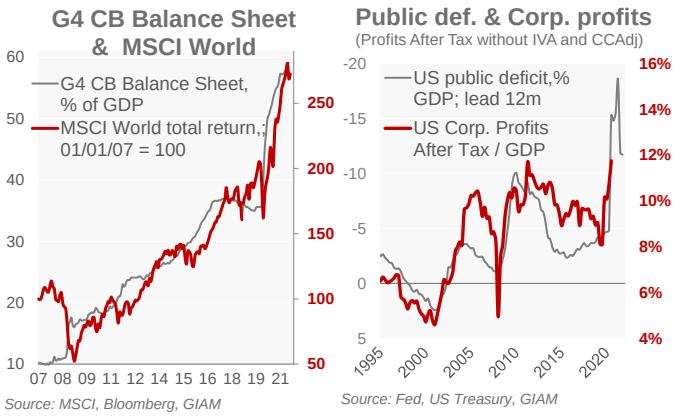
Source: Datastream, GIAM calculations

This annual report does not cover commodities, but for reasons that we will soon make obvious, it is worth reminding that even after the past 18 months' rally, the CRB index has delivered a cumulated return of -25% in USD over the past 10 years (or nearly -3% p.a.), and -36% in EUR hedged (-4.4% p.a.). In other words, commodity prices have started the recent bullish cycle from a very depressed level. It is too early to affirm that a super cycle has started, but we see disorderly commodity price action through the inextricable process of energy transition as the single largest threat to economic and financial stability out of the pandemic.



Source: Datastream, GIAM calculations

Our projections for the next 5 years (chart above) show a mixed bag of mid-single (at best) returns for equities and negative returns for High Grade bonds, particularly those with a long duration profile. The small downgrade of our 5-year total return forecasts for equities – relative to last year's – reflects both the more challenging valuation and the fading policy tailwinds. The balance sheets of the G4 central banks (Fed, ECB, BoE, and BoJ) have grown from 10% of GDP before the Great Financial Crisis to near 60%, and the brilliant asset price performance over this period is no coincidence. But the growth of CB balance sheets is now set to flatten out as tapering is around the corner. Likewise, the fiscal impulse has started to reverse – not least in the US – and this will inevitably put downward pressure on the share of profits in the GDP – from the currently high level.



Source: MSCI, Bloomberg, GIAM

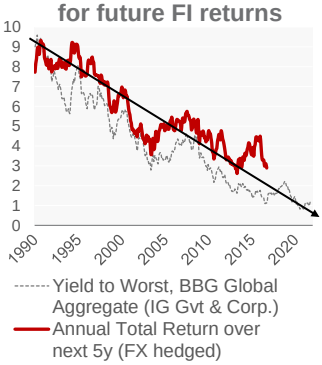
Source: Fed, US Treasury, GIAM

Not only the policy tailwinds are fading, but valuations are not cheap. As the two charts below remind, entry point valuation offers credible guidance about future returns. Equity earnings yields (in this case based on 12-month forward earnings) are just below 5% in the US, and this will make it harder to deliver more than mid-single digit returns in the next 5-10 years. Meanwhile, the Bloomberg Global-Aggregate (flagship measure of global investment grade debt) Yield to Worst is trading at 1.25%, as we go to press; this is about 30bp higher than a year ago, but still means that carry in the safe Fixed Income space is meagre, and likely to be offset by capital losses as yields continue to "normalise" higher.

Equity returns set to fall

Source: S&P, Bloomberg, GIAM

Yield at t0 matters much for future FI returns



Source:Bloomberg, GIAM calculations

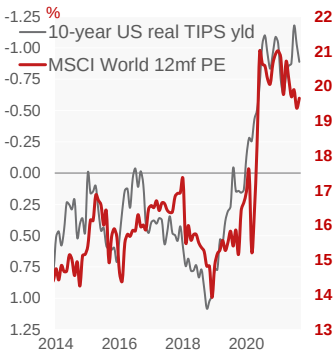
Correlation: life gets tougher for diversified bond-stock portfolios. The challenge for investors is not just that returns will be lower, but diversification gains will be harder to monetise. Already last year we concluded that "changing central bank strategies will transform the investment paradigm, by leading to lower rates volatility, stretched valuation, reduced diversification benefits and more frequent corrections. More than ever, hedging matters." A year later, we are less sure about lower rates volatility, given the looming supply side shock – which makes policy normalisation more challenging for central banks. They aim at delivering a smooth tapering and slow rate hike process, but persistent inflation pressure would make this more difficult. Yet faster policy normalisation is not without risk.

> *Supply-side shocks are another threat to the (already fading) diversification benefits*

First, global leverage has soared since the GFC, and the pandemic sharply accelerated this phenomenon as public debt soared through the pandemic. Such heightened leverage makes debt sustainability and economic stability dependent on low real rates – and accommodative monetary policy.

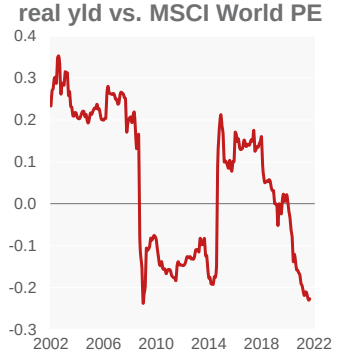
Second, low real rates are also the global anchor to elevated valuation across asset classes, liquid and private. The subsequent two charts show the coincident fall in long-term real yields and surge in equity multiples. The 5-year rolling correlation between 10-year TIPS yields and the MSCI World Price-Earnings-Ratio (PE) had dropped to near record negative levels. This, like excess leverage, creates a self-correcting mechanism whereby economic and financial instability would cap any increase in long-term real yields. This also highlights the lower diversification benefit for investors. Of course, the positive correlation between stock and bond prices proved very rewarding on the way up (stock and bond prices) – with central banks playing a key role in this financial "bonanza". But it appears far more threatening now that central banks appear to be turning the corner.

Real yld vs equity mutiple



Source: MSCI, Bloomberg, GIAM

5y (60m) correl. US 10y real yld vs. MSCI World PE

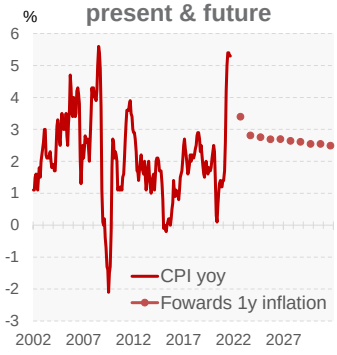


Source: MSCI, Bloomberg, GIAM calculations

Two macro forces will dominate future returns. They respectively represent a risk, and an opportunity.

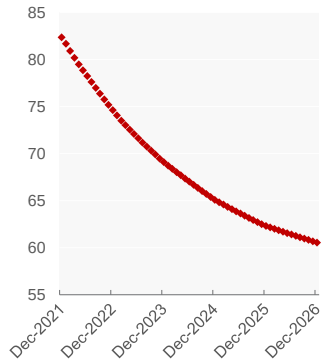
First, inflation. Of course, the 2021 inflation shock is partly transitory, reflecting a surge in demand and one-off factors impairing supply (such as weather events). Yet the size and speed of the policy stimulus, a rising focus on inequality and the level-playing field, de-globalisation, ageing (lower global force), and climate change are structural forces that may support inflation going forward (see Section 2).

US inflation, past, present & future



Source: Bloomberg, GIAM

Brent futures



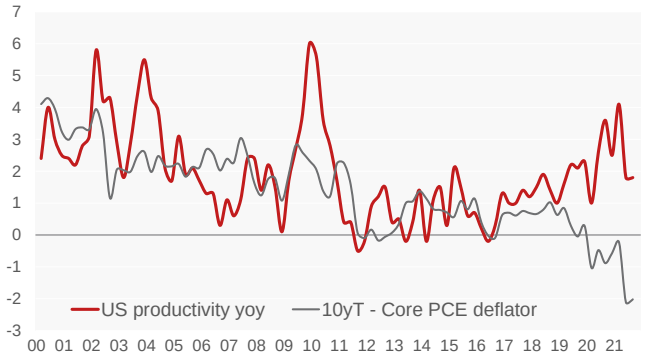
Source: Bloomberg, GIAM

So far, **markets have revised their inflation views, but not yet embraced the idea of permanent pressures**. 5y5y inflation swaps, at 2.60% (US) and 1.90% (EA) are

approaching levels not seen in more than 7 years; but they remain more than 100bp below the peaks seen since the turn of the century. Likewise, the oil price curve remains in deep backwardation, with 5-year futures trading more than 20$ below spot level. What if investors are failing to price the more permanent effects of climate change and other inflation-friendly policies?

Second, productivity. Productivity surged through the pandemic, as corporations successively coped with labour shortages and booming demand. Strong productivity is great for asset performance: it is good for margins and keeps unit labour costs muted (and central banks quiet). A durable or structural productivity boom – thanks to automation, digital transformation, work from home etc. – would be good news for potential GDP growth, and earnings (unless wages grow disproportionately). We **assume the productivity boom will prove largely transitory** (see Section 2). Any downward normalisation, at a time of rising US wages, may add to inflation pressures – and central bank concerns.

US productivity vs. 10y real yield



Source: BLS, Bloomberg, GIAM

We are in good company on our bias towards a largely cyclical productivity boost, e.g. the San Francisco Fed. But any upward productivity surprises would imply an upside for our equity return forecasts. Mind what you wish for: it would also likely contribute to higher real yields. The decoupling between productivity trend and long-term real yields has greatly contributed to the Goldilocks environment. Partly this reflects successful policy and guidance from central banks, but also doubts, among investors, about the permanence of the productivity shock.

> *Alpha becomes more important. So does hedging. Address the inflation risk through a broad asset allocation approach*

To conclude this introduction, and look deeper into each asset class outlook, let us reiterate our preference for equities over Fixed Income: equity risk premia, especially in Europe, still appear relatively generous. Still, delivering performance through beta will be harder; alpha becomes more important. So does hedging, at these lofty levels of valuation. The risks to our forecasts appear to be skewed to the downside, at least in real terms, since a major threat to our base scenario lies in more persistent inflation and a more forceful monetary policy adjustment. It makes sense to address the inflation risk through a broad asset allocation approach, and not just via inflation-linked bonds: real assets, Value stocks, commodities, or even High Yield bonds from issuers with decent pricing power are typically asset classes better equipped to deal with upside inflation surprises.

2. Macro backdrop: coping with fading policy support

Almost two years after the spreading of Covid-19, the pandemic may gradually loosen its tight grip on the global economy. With almost 60% of the population in advanced economies fully immunized and booster shots being rolled out, future lockdowns will hopefully be avoided. Lower hospitalisations and deaths will help the health systems to cope with future Covid waves. At some point we expect the pandemic to morph into an endemic. For emerging markets (EM), the outlook is less rosy amid lagging vaccination (only 36% of people vaccinated by late September, and less than 5% in low-income developing countries). But we expect the EM vaccination to campaign to gain traction, also thanks to help from advanced economies.

After the boom, the new normal. The recovery from the deep pandemic recession has been extraordinarily fast. The US reached pre-pandemic output levels already in Q2/21, and the euro area is likely to follow suit by year-end. US growth will be back to trend by 2022 while the output gap is unlikely to close before 2023 in the euro area. But strong growth rates will progressively abate and the focus switches to the post-pandemic new normal.

No miracle on potential growth. The jury is still out whether Covid induced a permanent productivity shock thanks to digitalization. It has fostered investment in intangibles whose full benefits may show up with a lag. New consumption habits may help shift labour and capital from less productive services sectors to more productive ones. Yet, impaired corporate balance sheets will hamper investment in intangibles. If concentrated in few big firms, digitalization may increase market power, curbing innovation, and productivity. Prolonged policy support risks to keep unproductive ("zombie") firms alive, preventing an efficient reallocation of resources. School closures and skill gaps for new tasks will also weigh on productivity. For the broader economy, the net effects are not clear. But deglobalisation, tighter regulation and state intervention will likely weigh on potential growth longer term. All in all, we remain reluctant to pencil in a large productivity-induced boost to growth. Instead, the demographic transition will continue with a shrinking working population dragging on growth.

Fiscal policy focus will shift from emergency support to climate change funding

Fiscal impulse turning, but not as fast as before. With the pandemic being overcome, fiscal support measures will be scaled back. The euro area fiscal impulse will become (mildly) negative in 2022. In the US, the bold 2021 stimulus package will have run its course, resulting in a deeper drag. But consumers will normalize still high savings rate and partially draw on the huge stock of excess savings accumulated over the pandemic, supported by rising income on recovering labour markets.

The focus of fiscal policy will shift to measures tackling climate change. This concerns first the disbursement of the Next Generation EU (NGEU) funds through 2026. In the US, President Biden's ambitious plans to overhaul the welfare system and foster massive investments in the green transition still faces hurdles. With the administration based on only a thin majority in Congress and moderate Democrats wary of bold spending plans, the proposed $3.5tn package will likely be scaled down. The Republicans look well positioned to regain control of the whole Congress in the 2022 mid-term election and this would likely limit fiscal support for environmental policies.

Yet with climate change becoming more pressing, fiscal policy will contribute to the transition towards a greener economy. The EA Stability and Growth Pact (SGP) is still exempted for 2022; we look for a more flexible overhaul from 2023 onwards, which may benefit green and digital investment.

Low-inflation environment to be overcome

No return to pre-Covid subdued path. Following the Great Financial Crisis (GFC) stubbornly low inflation was the main headache for central bankers. Now risks are shifting.

First, supply-disruptions and commodity shortages could prove more protracted than initially thought. Temporary factors are at play there, e.g. flooding in Germany and China, draught in Brazil, soft wind in Europe etc. But supply chain disruptions are proving more persistent than central bankers were hoping for and commodity prices are still pointing North, with inventories unusually low at this period of the year. Even as base effects switch into 2022, this could prevent a marked retrenchment of inflation in 2022.

Second, on the road to a greener economy commodity prices (energy, base metals etc.) may increase. Climate change implies an inextricable transition from old fossil energies to renewables energy. The old economy, typical fossil fuels, has been under-invested for years, and renewable energies require large investments that will only be made progressively. This may create supply-demand imbalances that are unlikely to be resolved quickly.

Third, a key risk is that a transitory, but more prolonged phase of inflation overshoots triggers a rise in inflation expectations and second-round effects via higher wage demands. This risk is particularly tangible in the US where the labour market is fast tightening. In the euro area, there is more slack in the economy and key measures of underlying inflation are still well below the 2% threshold. While we acknowledge the upside risks to inflation, we base our projections on very limited second-round effects. But in contrast to previous 5-year total return reports we now expect inflation to come close to (EA) or even somewhat above target (US) within five years.

High post-pandemic debt remains a concern

Heavier for longer. An economic legacy of the pandemic is a strong increase in the pile of public debt, amounting to around 100% of GDP in the euro area and above 130% in the US. Lower deficits and an ongoing recovery will help to lower these ratios. But within EMU there are strong divergencies, with seven countries projected to have debt ratios above 100% in 2022 and five countries below 60%. As a result, the more indebted countries may face higher yields amid diminishing ECB bond purchases. In case of adverse shocks this could giving rise to bouts of EMU stress.

US debt is projected by the IMF to remain just above 132% of GDP by 2026. Low real rates contain the rise in effective borrowing costs, but a high and rising debt ratio bears risks for financial stability. Politics will not help in this context. Squabbles over the debt ceiling will lead to periodical bouts of market volatility. The risk of an accident is small, but the damage for global financial markets would be huge.

Monetary policy to become less expansionary

Off crutches. The post-GFC decade saw unprecedented monetary policy easing. Currently shadow rates (which account for the impact of unconventional policy measures) are in negative territory for the major central banks. With the pandemic being overcome and price pressures rising, central banks will progressively withdraw their exceptional support. The Fed will likely begin to taper its asset purchases in November and stop its purchases by summer 2022. We look for a first rate hike in late 2022, reaching 1.75% in five years.

ECB will significantly lag the Fed in normalizing policies

In contrast to the Fed, the ECB's policy normalisation process is still in an infant stage, with the recovery less advanced than in the US and the ECB's overhauled strategy cementing a dovish bias. The 2% inflation target is now symmetric and the threshold for hiking policy rates was increased. Inflation now

needs to reach the target well ahead of the end of the forecast horizon and this needs to be durable. Moreover, underlying inflation needs to be consistent with the medium-term inflation target. We think the ECB's new framework will allow for a first hike only in 2025. That said, The ECB has already started to cautiously scale back pandemic-related asset purchases. It will likely cushion the expiry of the PEPP purchases in March 2022 by means of higher ordinary QE purchases. And even after the end of QE (in our books 2024) the ECB will continue to reinvest the existing stock of asset purchases until just before it starts raising rates.

2026 macro and central bank scenario

	Euro area		US	
	current	2026 proj	current	2026 proj
Equilibrium real short term rate (r*)	0.00	-0.30	0.20	0.10
Inflation	1.10	1.80	2.50	2.20
Potential growth	1.50	1.00	1.90	1.75
Neutral Central Bank policy rate	1.10	1.50	2.70	2.30
Current real short term rate	-1.64	-1.50	-2.45	-0.33
Current nominal 3M short term rate	-0.54	0.30	0.05	1.88
Central Bank policy rate*	-0.50	0.20	0.00	1.75

* in case of the ECB the deposit rate if negative, otherwise the repo rate

Source: Refinitiv, GIAM

Assessing "r-star". 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. There is some upside potential for r-star due to higher productivity and reduced post-Covid savings rate near term.

However, we expect the fall in the working population to dominate. Heightened demand for safe assets as well as higher life expectancy will also contribute to a lower equilibrium rate. 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 2026. R-star serves as a guide to central banks: a structurally lower value implies less scope for rate hikes. While both central banks will embark policy normalization, we still assume that the real short-term will stay below the respective r-star levels at the end of our outlook horizon. Hence, monetary policy will remain supportive. We see the key rate in the US at 1.75% and in the euro area only at 0.2% by 2026.

Higher inflation major risk to benign scenario

We see higher than projected inflation as the major risk to our benign scenario. The current supply shock could become more permanent, with the green transition potentially adding stress. Second-round effects would force central banks to withdraw policy support faster. The ECB announced in its strategy review that it will consider house prices in its inflation measure at a later stage. But a quarterly index is scheduled for 2026 only and the regular inclusion into the monthly HICP will only take place beyond our forecast horizon. However, the Governing Council is until then also taking house price developments into account. Surging house price inflation could trigger an earlier hike. Downside risks remain primarily related to the pandemic. Resistant variants could force a return of lockdowns. Likewise, political woes have the potential to again dampen activity and inflation.

3. Financial return expectations

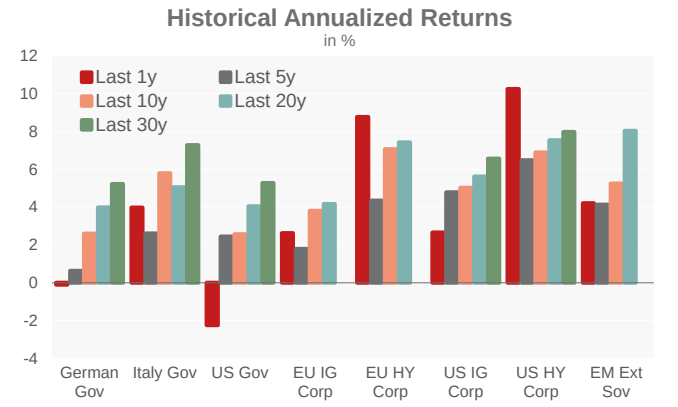
In our top-down approach we deduce financial market forecasts from the macroeconomic analysis, with growth, inflation, and central bank forecasts as key reference points. We focus on key liquid asset classes for euro-based investors, including government bonds (EA, US, EM), credit (US and EA), equities (various markets) and FX. Unlisted assets and/or alternative assets are not covered.

3.1 Fixed income assets: uphill battle

The most obvious characteristic that distinguishes FI securities from other assets is the high predictability of cash flows. Assuming there is no default, investors receive regular coupon payments and at the end of a bond's lifetime they are paid the notional amount.

FI assets have generated high total returns in recent decades. Even the worst performing FI asset under review, German government bonds, has yielded an average annual return of around 4% over the last 20 years, helped by the secular downtrend in yields. However, FI returns have been on a broad-based downtrend for several years (see chart below), with lower yield levels eroding the return prospects.

The development of the last 12 months has not yet led to a sustainable change in trend. Indeed, core government bond yields have backed up (moderate increase in German Bund yields, more pronounced in the case of US Treasuries), with capital losses triggering a negative total return. However, corporate and public spreads have tightened significantly amid the strong economic recovery and the very accommodative monetary policy. The resulting strong annual returns (e.g. US HY has yielded more than 10% over the past year) are of course not sustainable as spreads are already tight. Hence, the dilemma for investors has even worsened. Falling yields lead to short-term profits via capital gains, but unavoidably reduce future returns due to the resulting lower re-investment yields.



Source: Datastream, GIAM own calculations

The methodology used to infer medium-term future FI returns is basically unchanged from our previous work (see original report here). We do not consider a buy-and-hold strategy but dynamic investments in bond indices so that maturity is assumed to be constant over time. Our total return is divided analytically into three different components.

A. Income: This most important component for a bondholder is the string of coupons received over the lifetime of the investment period. As current yields are well below the outstanding average coupon it will shrink over time as maturing bonds are replaced by new ones. The current average lifetime of the respective index is applied to calculate the share of bonds replaced every year. New bonds are assumed to be issued at par.

Low coupon levels a drag for future returns

B. Growth: This second component accounts for the mark-to-market changes. There are two effects: the *roll effect and* the *pull-to-par*. Amid upward sloping yield curves rolling down the yield curve yields a positive return. Although yield curves have steepened over the last year (implying a stronger roll effect) this is outweighed by the (negative) pull to par effect. The latter reflects the capital loss as prices fall towards par into the end of a bond's term.

Overall, the growth component will be negative for all FI sectors under review. Following the very strong spread tightening even HYs will be burdened by a negative pull to par effect. In contrast, core government bonds will suffer less as prices have already fallen since October 2020. It is noteworthy that the mark-to-market impact will shrink over time as yield and coupon levels are forecast to converge.

C. Valuation: The final component refers to the return impact of yield changes *at a certain time* (in contrast to the *change over time*, reflected in the growth component). For riskier FI segments credit migration and defaults must be considered as well.

Asset Class		FV Approaches				5-yr Projections	
	Currency	Current*	Regression	Forward	LT average	FV **	Applied
German Government 3-year	EUR	-0.70%	0.75%	-0.17%	-0.32%	0.28%	0.30%
German Government 10-year	EUR	-0.23%	0.89%	0.23%	0.55%	0.60%	0.60%
Italy Government 3-year	EUR	-0.30%	1.73%	1.18%	1.02%	1.44%	1.40%
Italy Government 10-year	EUR	0.78%	2.21%	1.72%	2.57%	2.05%	2.10%
US Treasury 3-year	USD	0.54%	1.90%	1.86%	1.07%	1.80%	1.80%
US Treasury 10-year	USD	1.45%	1.81%	2.11%	2.04%	1.95%	2.00%
EM Ext. Gov. (spread in bps)	USD	290	343		313	328	330
Euro IG Corp. (spread in bps)	EUR	83	86		130	95	90
Euro HY (spread in bps)	EUR	293	302		433	328	330
US IG Corp. (spread in bps)	USD	87	97		141	106	110
US HY (spread in bps)	USD	305	356		474	380	380

*as of 24/09/2021

**weighted average (Govies: 50% regression, 40% forward, 10% LT average, EMs: 50% regression, 50% LT average, Corps: 80% regression, 20% LT average)

a. Changes in the yield level. As we forecast yield levels of all covered FI assets to rise, this effect will affect all fixed income securities negatively in the years to come. This contrasts with last year's analysis, in which a positive effect for HY was expected amid the leeway for tighter spreads, which has been fully exploited already over the past 12 months. Remarkably, US government bonds and IG corporates will be burdened less as the yield adjustment has partially already taken place.

b. Credit migration. As we do not foresee a clear trend for government bonds on rating changes (neither developed nor EMs) the (moderately negative) impact only refers to corporate bonds. We cover this topic in section 3.1.2.

Asset Class	Coupon	Mark to Market*	Valuation adj.**	Credit migration	Credit default	Overall***
German Gov. Bonds	1.1	-1.2	-1.6			**-1.7**
Italy Gov. Bonds	2.2	-1.2	-2.3			**-1.3**
US Treasury Bonds	1.6	-0.4	-1.1			**0.2**
Euro IG Corp. Bonds	1.2	-0.5	-1.1	-0.1	-0.1	**-0.6**
Euro HY Corp. Bonds	3.2	-0.3	-1.1	-0.2	-1.4	**0.3**
US IG Corp. Bonds	3.1	-0.8	-1.1	-0.1	-0.1	**1.0**
US HY Corp. Bonds	5.1	-0.5	-1.8	-0.2	-1.4	**1.2**
US EM Ext. Sov. Bonds	5.0	-0.6	-1.1		-0.5	**2.8**

*roll and pull-to-par effect

**changing yield level at a certain time

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

c. Credit defaults. In case of a default bond holders suffer losses due to the (partial) loss of the bond notional and/or coupons. The extent is determined by the default probability and the recovery rate of the respective asset class. We regard sovereign default in the covered developed countries as very unlikely and describe the effects in sections 3.1.2 and 3.1.3.

The total returns are carried out in two steps. Initially, yield and spread levels for the respective asset classes on a 5-year horizon are forecast based on (up to) three different approaches. Based on this the total returns are calculated.

- The first (and most important) method for projecting yields and spreads is based on models, using various economic and monetary policy variables, corporate fundamentals and

financial market variables as inputs. The weight of this approach is at least 50%. Compared to last year, the expected fair value level has increased, particularly for developed market government yields due to higher expected inflation and upwards revisions in expected key rates.

Moderately raising our yield forecasts against last year

- The second constituent is market based, referring to 5-year forwards. The underlying idea is that financial markets use all available relevant information. Forwards are only available for developed government bonds, though, where the attached weight is capped at 40%. While forwards for Italian yields have moved only slightly compared to last year, rising US and euro area yields are reflected in higher forwards.

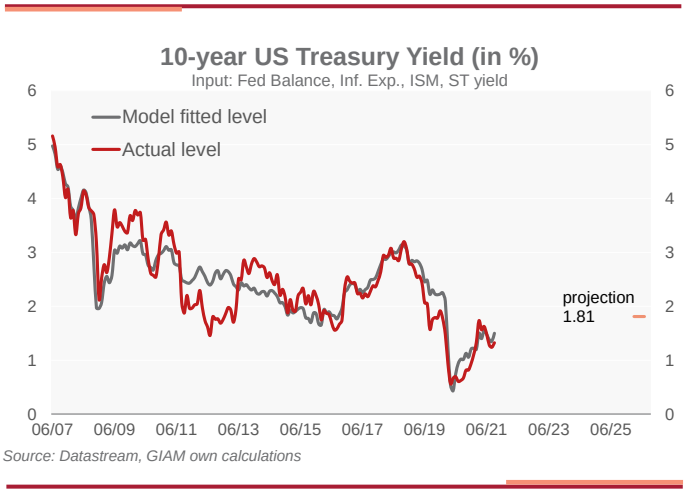
- The final input is the long-term average. The underlying idea is that financial markets eventually converge towards a long-term average (mean reversion). However, we do not see this as a key driver going forward and only attach weights of 10% (for government bonds) and 20% (for corporate bonds). As the current EM bond spreads do not deviate strongly from the long-term average, we attach a weight of 50% for this asset class. Compared to last year, the long-term average yields and spread levels have retraced further.

The ranking of total returns has hardly changed vs. 2020. In local currency EM bonds remain front-runners even though they have lost some of their shine, as spreads are seen to widen moderately. Second place come corporate bonds, which are still expected to yield a positive annual return (except for EUR IG corporate bonds). However, the expected spread widening and rising underlying yields will burden this asset class. Generally, US corporate bonds benefit from the higher yield level. Government bonds continue to rank last. Euro area government bonds will on average yield a negative return over the next five years. On the contrary, US Treasuries, which have lost ground recently, should achieve a slightly positive return in local currency, thanks to the higher starting yield. Money markets have little appeal as the total return will remain in negative territory for longer.

3.1.1 Government bonds: meagre times ahead

Bond yields rising, a bit. We expect developed government bond yields to continue their upward trend in the years to come. In particular short-dated bond yields have leeway to rise, driven by a less dovish monetary policy stance. Amid rising inflation rates the Fed will lift rates more aggressively than expected one year ago. Nevertheless, central banks will hike rates only moderately by historical standards. Still, yields for all fixed income classes considered here are seen to reach positive territory again.

Rising inflation and risk premia as well as the hardening of central bank stance are the main factors behind the expected rise in long-term yields. We project 10-year Bund yields to rise to 0.6% by 2026. Although this is still a rather low level it is up 50 bps from last year's expected end point.



Source: Datastream, GIAM own calculations

Long-dated BTP yields will rise even more as we forecast spreads to widen amid fading support from ECB bond purchases. However, the more stable political situation in Italy, some reforms, and the increased burden-sharing in Europe (e.g. EU Recovery Fund) may limit the widening to 50 bps from current levels. This implies that even on a 5-year horizon 10-year BTP yields are seen to remain below the long-term average – a key support for debt sustainability.

The extent of the rise in long-dated US yields is rather limited as the bulk of the increase projected in last year's analysis has already taken place. Nevertheless, the trend remains upwards. We assume that the 2% threshold will be reached sustainably by 2026.

US Treasuries to yield positive total return – in local currency

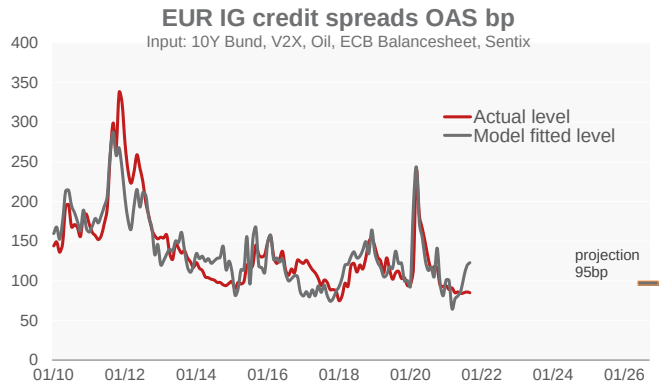
The overall return outlook for government bond investors is thus quite bleak. US Treasuries may manage to yield a slightly positive total return – in local currency and in nominal terms – assuming self-correcting mechanisms (debt overhang, crops-asset valuations) will cap the rise in yields. The comparatively favourable outlook results from the negative development of the last 12 months. In contrast, the outlook for BTPs has now turned noticeably less favourable – following sharp spread compression. As yields normalise higher, BTP investors are unlikely to preserve the invested capital. Bunds remain at the negative end of the spectrum: coupon payments will by no means be able to balance losses from the pull to par effect and the projected increase in yields.

3.1.2 Credit: Carry is the key to positive returns

Given depressed risk-free rates, the income is of course the most important return component for all credit indices considered here. Unsurprisingly HY offers the highest income (2.7% in EUR 4% in USD), which will also dominate the resulting total return forecasts.

The valuation component of our forecast is favouring IG compared to HY in both EU and US credit. Over the next 5 years, we expect credit spreads to widen moderately, but more so in HY than in IG. Following the sharp widening over the Covid crisis, 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.

Over the past year we had a positive contribution from rating migration as the post-Covid re-rating kicked off. This time we apply a **marginally negative adjustment for rating migration**. We expect the positive trend to extend further over the next two years but beyond that we return to a more standard approach, applying long-term transition numbers throughout the rest of the forecast horizon.



Source:Bloomberg, GIAM own calculations

Defaults have normalised rapidly from the highs reached end-2020. At slightly below 4% they are still more than a point above the long-term average, though. We expect the normalisation to continue and reduce the default adjustment compared to last year's forecasts for an annual rate of 2.5%.

Credit has acquired a more permanent role in monetary policy, as several central banks across the globe have launched credit purchase programs to ease financing conditions during the pandemic. In the past we employed equal weights for the long-term average and our model projection. But since last year we've applied a larger weight to our model projection as this new policy tool status has structurally improved the risk profile of credit.

> *HY EUR is the only part of credit to offer perspectives of positive returns.*

The very low income and the expected moderate widening of spreads render expected returns for IG Credit moderately negative. On a local currency basis, we expect EUR IG to post a negative performance of -0.56% p.a. while USD IG would do much better at +1%.

The same hierarchy is expected on the sub-investment grade space with EUR HY predicted to deliver +0.26% p.a. over the next five years thanks to the higher carry and generally shorter duration, while the expected widening of spreads leaves expected returns just marginally in positive territory. In the US, higher income is also mechanically leading to higher returns, with +1.19% p.a. expected over the period.

Now in hedged terms both US IG and US HY are seen under-performing their EUR peers with respectively -0.61% for US IG and -0.42% for US HY.

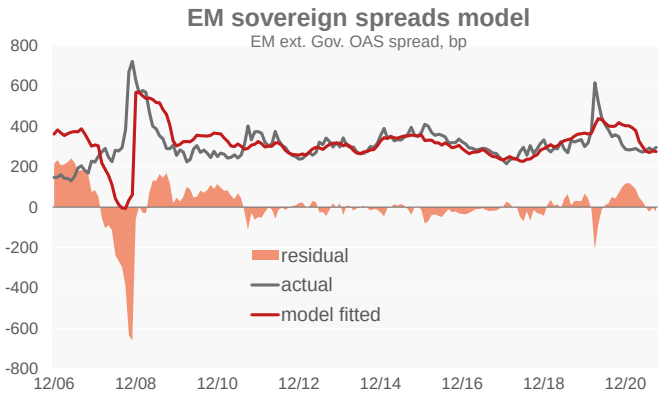
3.1.3 EM sovereign bonds: still positive return despite spread widening

EM external debt spreads have been on a tightening trend since the peak of the pandemic, currently back to their 2019 levels. The medium to long-term outlook is less supportive and upside pressure on core rates has led to more volatile EM spreads recently.

Over a 5-year horizon, we expect a modest widening of EM sovereign spreads, driven by higher US real yields and rising gross debt across EM countries. Despite the economic recovery, half of EM economies will see a wider fiscal deficit in 2022 and nominal GDP growth will not be high enough to suppress debt ratios. Despite their normalisation, core rates will remain below their long-term average and EM debt will still offering an attractive carry, attracting demand. Ultimately, the hunt for yield should cap the widening of EM spreads.

We assume that the spread on USD EM external debt will reach 327bp in 5 years from 299bp currently. This forecast is the result of the average between (1) the 10Y average of EM spreads, and (2) our fundamental long-term model. The latter is based on the 10Y US TIPS (real) yield, a weighted average of EM inflation (year-on-year change), EM gross debt and the level of Brent price. It leads to a 5Y forecast at 343bp. The fit of the model is good (R^2 at 0.80) with EM gross debt being the largest contributor.

However, the model has been overestimating the level of spreads post-Covid. In our view, this overestimation is likely related to the failure to capture short-term risk appetite. Indeed, despite the underlying deterioration of the EM macroeconomic fundamentals, abundant liquidity has triggered significant portfolio inflows that have capped the EM spreads widening.



Source:Bloomberg, BofA, GIAM calculations

This spread widening forecast still leave a sizeable positive expected return of a 2.8% p.a. in USD. EM sovereign debt remains the fixed income instrument that offers the largest return. Coupon is again the main contributor with a chunky 5%, which more than offsets headwinds coming from the pull to par and expected spread widening. Defaults subtract 0.5pp from the expected annual total return. The EM default cycle has likely passed its peak and should converge to its average. Despite higher debt and Covid scars, the debt restructuring framework and tools to support low-income countries have been upgraded with the DSSI and the G20 common framework, helping to ease systemic default risks.

3.2 Equities: mid-single digit returns ahead

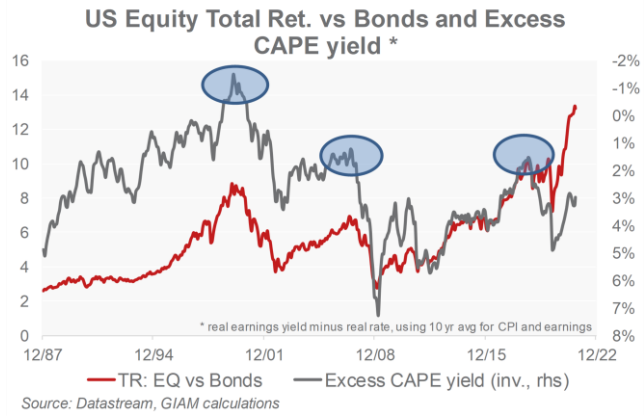
After the boom. Very strong liquidity injections, rate cuts and fiscal support have all supported high equity returns by historical standards over the 10 years to September 2021 (total returns: MSCI World +13.5% p.a., US +16.9%, US IT 23.2% and euro area +11.1%). This was particularly true for the US 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 set to reverse as the pandemic ends. China is also adding regulatory pressure, which burdens earnings prospects and valuations. The MSCI China is now fairly valued, coming from significantly overvalued level in early 2021. We expect materially lower annual equity returns for the next five years. Our new 5-year return forecasts are slightly lower than in our Autumn 2020 release: following the stellar performance achieved since then, we see greater macro risks, such as declining policy support and lingering inflation. The latter has historically made fair values more volatile.

3.2.1 Factors behind lower-than-norm returns

Margins have surged, but supply chains disruptions, spikes in input costs and the withdrawal of policy support are all headwinds. We also expect lower GDP growth and higher inflation for the next 5 years.

> *Valuation, declining policy support and higher inflation to contribute to lower returns*

Unlike EA and EM markets, US equities continue to show a high real CAPE multiple (38X vs an average of 20.6X since 1955). hence mid-to-long term US returns are set to diminish – but not massively so, as yields will stay contained, relative to history, over the forecast period. The CAPE (cyclically adjusted price earnings ratio) uses a 10-year average of past profits at the denominator to smooth out the fluctuations that occur over the business cycle; both the numerator and denominator are adjusted for inflation.



Source: Datastream, GIAM calculations

Earnings rising but flattening out. Following the outstanding earnings recovery over the past quarters, we assume that earnings growth in developed markets (for Europe 4%, US 5%) will fall below the average of the last two decades (around 7%). This reflects some pay-back following a remarkable margin, sales and profit boom through the policy-driven V-shape recovery. While EMs remain affected by the crisis, superior nominal GDP growth vs. DMs should eventually help. That said, persistent Chinese regulation pressure and Covid scars (which IMF forecasts to last longer vs DM ones) may tame relative earnings growth in the coming years. Overall, we lowered the expected EM earnings growth forecast from 7% to 5% for the next 5 years.

Our forecasts need to be seen in the context of the past bonanza: earnings increased by nearly 40% over the past year, surprising consensus and our own forecasts by some 20%. Such feast reflects the huge positive effect from operating leverage during the V-shaped recovery, itself sustained by a timely and unprecedented policy support. Even in Europe, the anticyclical fiscal policy was unusually positive for corporate results, not least for southern European countries. Then, as vaccination spread, the economic reopening saw a surge in demand while costs (including credit) remained contained (only recently bottlenecks and

commodity have started to hurt). Hence the large margins expansion over the past quarters. Government subsidies and guarantees also reduced the banks' exposure to credit risk and the cost of risk. In Europe, banks, energy, material, auto, semis and consumer goods registered the highest positive revisions. Defensive sectors have lagged in the process.

Notwithstanding a more muted earnings growth outlook, persistently low yields and credit spreads will keep the discount rate of future earnings low and the cost of equity contained, thus supporting higher equity valuations relative to historical norm. Indeed, the implied equity risk premia (earnings yield minus 10-year government bond yield) remain elevated (6% vs an average since 1988 at 3% for the MSCI EMU index, and 3.4% vs 2% for the S&P). Furthermore, the **spread between the CAPE yield and real yield remains distant from the low levels that characterised market tops** in 2000, 2007 and 2018. This should support positive returns ahead, even after having accounted for structurally higher global political uncertainty and the 30% TR already achieved over the last year (well above our own solid forecasts).

Finally, our short-term models currently suggest that the overvaluation is very similar to that of October 2020 (3% to 5%), which means the past market move was driven by fundamentals rather than exuberance. Our long-term forecast for HY spreads (an important input variable for equity returns in our models) is 75 bps lower than it was a year ago.

3.2.2 Long-term equity returns: the framework

While long-term returns (beyond 10 years) are largely dependent on fundamentals and stock market valuations, this is less for shorter time horizons. We provide a quantitative framework to assess prospective equity returns, and 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, for 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 will be corrected over the 5-year time horizon. In what follows we briefly describe the three building blocks of the framework. For more details, please refer to our original publication.

1. In our first regression-based approach the model's input variables are expected 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). The aim is to derive equity returns consistent with other projections (reality check).

> *CAPE yield gap vs real yield remains distant from recent tops in 2000, 2007 and 2018*

2. Our CAPE-based model is based on in-house expectations of earnings growth, projected payout ratios (PR), dividend yields (DY), buyback yields and target CAPEs for the end of the 5-year horizon. 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 various markets from the projected US one, by applying historical valuation gaps. The target for US CAPE is derived from the historical average (last 30 years excluding bubble years), which is then adjusted slightly upward (around 1 point to 24X), given two positive factors: low CPI versus historical long-term average (and real interest rates), plus only slowly reverting supportive 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, 17x, and 15x for the US, the EA, and EMs. We increased the EA one from 16X to 17X due to the anti-cyclical use of fiscal policy becoming more structural (upcoming revision of the SGP), together with the changing of EU governance (discussion around simple majority adoption, some risk-sharing post-Covid, and more strict vigilance on structural reforms agenda following the NGEU recovery plan agreement).

For years 2022 and 2023 we expect EA and US earnings to normalise but stay higher than on average over the 5-year period (nearly 7% in the first two years vs 5% average). The net result is that for the CAPE model approach annual projections are mostly unchanged on average (lower by 0.6% for EMs due a lower earnings growth).

3. Applying historical patterns 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. For this reason, we take the average of returns over 10 years adjusted downward by one fourth of the historical average standard deviation of returns. The result is a projected return of 3.7% for EA, 3.5% US and 6.1% EM. EA is mostly unchanged compared to our previous study while EM is lower by 1.2% and the US higher by 1%.

Mind that the 12-month forward earnings yield (EY) in the US is indeed rather low (4.2% vs. historical average of 6%), 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 real yield environment could back up somewhat higher equity

returns compared to the past periods with similar low EY but higher bond yields and inflation.

Market	Hist. avg 5-year total return since 1998 (p.a.)	5-year total return projection (p.a.)
World (in $)*	7.1	5.3
US	8.8	4.2
EA	6.8	4.3
UK**	6.0	4.8
EM (in $)	6.9	5.3

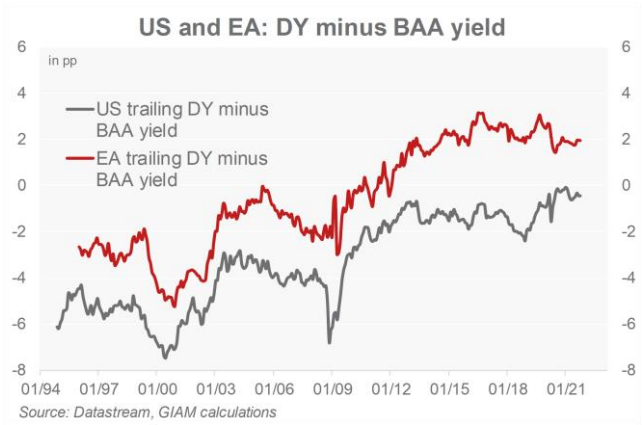
*derived from the single returns in local currency, taking into consideration the expected depreciation of TW USD

** On valuation grounds, we decided to put the UK projection 0.5% (p.a.) above that of the EA

In the final step we assess the degree of current under-/overvaluation of each market under consideration adding a small negative factor to adjust for structural risks of higher inflation (making fair values more volatile), reduction in policy support and higher input costs (wages included). Models based on future developments of macro and micro variables could underestimate the present valuation bias. 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.

Expected returns (p.a.)	EA	US	EM (in $)
Regression models (macro- and financial variables)	7.6	7.6	
CAPE-based model	4.8	5.9	5.6
Historical returns coherent to current CAPE levels	3.7	3.5	6.1
Average	*5.3*	*5.7*	*5.8*
Adjustment due to risks & current over-/undervaluation	-1.0	-1.5	-0.5
Final projection	**4.3**	**4.2**	**5.3**

Accordingly, our projections are adjusted down by 1 pp p.a. for the EA, 1.5 pp for the US and 0.5 pp for EMs, not too far from October 2020. US overvaluation on some measures (fair value approach, DDM and 3-stage earnings growth model) is near 7% which translates into a -1.5% per year. EA is almost fairly valued but when adjusted for expected earnings growth, ROE and risk (beta) the valuation is comparable to the US one. The latter still deserves higher policy flexibility, higher R&D and education spending on GDP, energy independency and population growth. For these reasons we decided to prudently cut also EA returns by 1 pp per year. For EM, valuations are more appealing, and we decided for a more limited yearly 0.5 pp cut to factor in Chinese risks and a very weak relative trend in earnings vs DMs.



3.2.3 Equities beating subdued Fixed Income returns

The final return expectations are presented in the tables above. The rankings between different stock markets are little changed vs. Oct. 2020, with overall annual return projections being adjusted downward by around 100 bps on average (150 bps for EMs). While we have adjusted the 5-year target for EMs the most, they are still expected to outperform developed markets. The drivers of future mid-term outperformance of EM equities remain a weaker US dollar, lower CAPE multiples and structurally superior GDP growth.

> *Our below-norm expected returns still imply an equity risk premium close to historical average*

In all, **our expectations are below the historical averages since 1998**. Equity remains attractive vs fixed-income, with the implied risk-premium close to historical average.

3.3 FX: Fundamentals point to higher EUR/USD

USD-denominated investments offer diversification benefits, while higher yields make US FI assets more attractive in local returns. Yet this advantage comes at the cost of exposure to FX risk.[1] The FX risk can either be hedged (at hedging costs of currently 1.4% p.a. over five years, vs. just 1% a year ago) or left open, i.e. unhedged, with gains and losses determined by the EUR/USD outlook. As illustrated in last year's edition,

[1] We also provide forecast EUR/GBP for UK equity exposure. The PPP model points to EUR/GBP at slightly above 0.96, with the tendency consistent with IMF models. That said, we pencil in a somewhat lower target of 0.94 due to a sharper monetary policy divergence and widening rates gap over the next years

FX risk tends to dominate fixed income risk, even for Credit. In our summary tables, we show the results for all three categories (local, hedged in EUR, unhedged in EUR).

5y projections EUR/USD

	Forecast	Weight
Fair value projection (regression)	1.243	50%
PPP model	1.347	50%
Weighted avg	**1.295**	
Projection after qual. adj.	**1.270**	
Current (24/9/2021)	1.172	
Spot return USD p.a.	-1.6%	
Forwards	1.255	
Implied carry p.a.	1.4%	
Total return p.a.*	**-0.2%**	

*Source: Datastream, GIAM calculations; * spot return + carry*

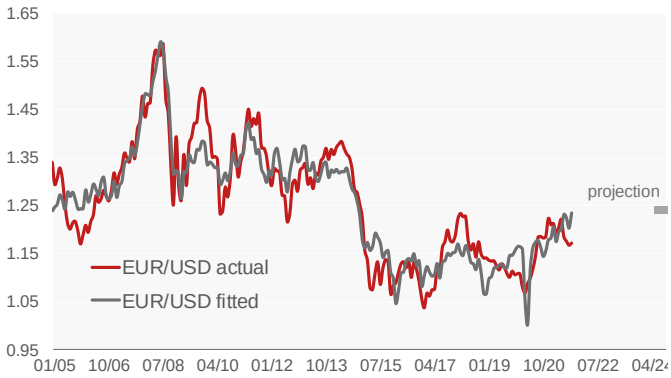
For assessing whether it pays off to leave USD exposure open, we apply our long-term EUR/USD forecast. This is based on a quantitative approach involving (a) a mean-reversion framework based on purchasing power parity (PPP) and (b) projections based on a financial market fair-value model. We then add the forward-implied carry (which equal the hedging costs) to arrive at the expected total return on open USD exposure (see table).

For (a), we employ PPP values for the EUR/USD in 2020 provided by the OECD and project its evolution by 2026 with the expected average inflation rates for the US (2.75%) and EA (1.8%) over 2021-2026. This projects PPP at 1.45 in 2026 (from 1.37 in 2020). Assuming a mean reversion to PPP with a half-live of four years, this implies a rate of 1.347 in 2026.

Our fair value projection is based on a regression model including US and Bund yields, EMU risk (spreads on Southern Europe government bonds), overall risk sentiment (proxied by the S&P500) and the oil price, which explains 87% of historical EUR/USD variation. The model projections imply an only very mild uptick in the EUR/USD, with upside from an anticipated closing 10y yield gap largely offset by somewhat higher EMU risk premium and easing oil prices.

EUR/USD model

fitted based on 10y yield gap, periph. spread, S&P500, oil



Source: Datastream, GIAM calculations

Yet given the sizeable current undervaluation implied by the model, the fair value forecasts still see EUR/USD higher at slightly above 1.243 over the 5-year horizon. The simple average of the two approaches points to levels above 1.29, indeed not too different from our 2020 model forecast.

> *Divergent monetary policies will curb the long-term upside for the EUR/USD*

Cross-checking the model outcomes, the tendency seems right, despite our expectations of USD strength near term. The USD seem dear on other metrics, with the real-effective value some 7% above long-term norm, while the EUR is 4% below. The trend is also consistent with the IMF assessment, with the mid-point of their models showing an 8% overvaluation for USD vs. a mild EUR undervaluation. A continued diversification of global reserves out of the USD should also underpin this direction.

Yet, when finetuning the forecast, we set a somewhat lower forecast at 1.27. The next few years will be characterized by a divergence in monetary policies between the Fed and the ECB. And while the long-term sensitivities to changes in short-term yield gaps are not high, phases of changes tend to see a greater statistical impact. Indeed, our forecast for 2022 is for a lower EUR/USD and it is not clear how fast the exchange rate will subsequently converge towards fair value.

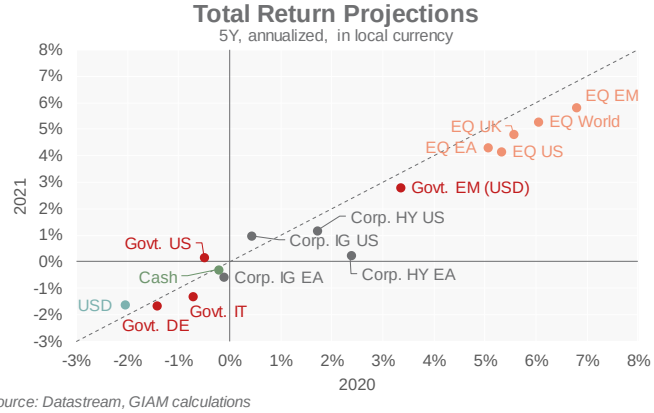
Our 1.27 EUR/USD forecasts is only mildly above forwards (see table). This implies that after accounting for the higher carry of USD exposure reflected in forwards, the expected total return (spot return plus carry) is marginally negative at -0.2%. The forecasts also imply that hedging USD is slightly preferable to leaving the exposure unhedged.

4. Conclusions: mounting inflation challenges

Following the strong market rebound from the pandemic, the longer-term investment outlook has become challenging, with our expected returns a bit lower than the already meagre expectations presented last year. This bleaker outlook is

Total Return Projections

5Y, annualized, in local currency



Source: Datastream, GIAM calculations

compounded by higher expected euro area inflation, which we assume to average 1.6% (vs. 1.3% last year) over the next five years. Preserving the real value of capital will be hard. Simply holding cash over the five years (-0.3% nominal return) would erode the real capital by 10%.

Opportunities to break even in real terms are virtually absent in fixed income. At the worst end, EA core bonds not only suffer from their largely negative carry but also from a sizeable yield increase, with expected total returns for Bunds at -1.7% (upper chart and table below). Southern European debt offers a higher carry, but a spread widening on expiring ECB support should cap the expected returns (-1.3%) only slightly above that of safe-haven Bunds.

Opportunities across the Atlantic are hardly better. Higher yield levels and a shallower expected increase bring expected returns in US Treasuries slightly above zero (in local currency). Yet currency conversion will take its toll: open USD exposure may shave returns by some 1.6% in our book. Full FX hedges looks preferrable, but would also incur hedging costs of 1.4% p.a., rendering USTs only marginally preferable to Euro government bonds.

Credit fares better but is not stellar either. We predict a very small widening of spreads, but current low yields on safer IG buckets are not sufficient to keep expected returns in positive territory. And even speculative high-yield indices will struggle to deliver positive returns, with the strong yield compression seen over the past year leaving carry at levels that barely compensate for higher yields and (modest) losses from defaults. This leaves **EM hard currency debt** as the most appealing alternative in the fixed income space. A more muted spread widening may allow euro-based investors to reap 1.4% in annual returns, thus only slightly falling short of real capital preservation.

Total Return Projections

(5Y, annualized)

Asset Class	Currency	Local	EUR (FX hedged)	EUR (unhedged)
Cash	EUR	-0.29%	-0.29%	-0.29%
Govt. DE	EUR	-1.66%	-1.66%	-1.66%
Govt. IT	EUR	-1.28%	-1.28%	-1.28%
Govt. US	USD	0.20%	-1.18%	-1.40%
Govt. EM (USD)	USD	2.83%	1.43%	1.19%
Corp. IG EA	EUR	-0.56%	-0.56%	-0.56%
Corp. HY EA	EUR	0.26%	0.26%	0.26%
Corp. IG US	USD	1.00%	-0.38%	-0.61%
Corp. HY US	USD	1.19%	-0.19%	-0.42%
EQ World	USD	5.32%	3.90%	3.64%
EQ US	USD	4.18%	2.77%	2.52%
EQ EA	EUR	4.33%	4.33%	4.33%
EQ UK	GBP	4.83%	3.64%	3.80%
EQ EM	USD	5.85%	4.43%	4.16%
		Spot	Carry	Total
USD		-1.60%	1.38%	-0.22%

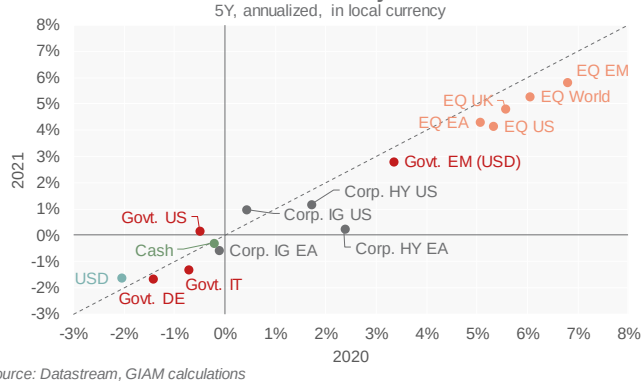
Source: Datastream, GIAM calculations

Mere real capital preservation will require a substantial amount of risk taking

Investors keen to grow their assets in real terms will still need to consider equities. We still see annual returns between 2.8% (US, EUR hedged) and 4.4% (EM, also hedged). Considering the more favourable volatility, EUR equities (+4.3%) look relatively attractive. Valuations are no longer cheap, but the improvement in the earnings outlook still leaves upside for stocks despite the significant rally see since the trough of the pandemic.

Total Return Projections

5Y, annualized, in local currency



Source: Datastream, GIAM calculations

How do projections differ vs. 2020? Neither the ranking of asset classes nor the magnitude of expected returns has changed dramatically (see chart above). Yet almost all return expectations are lower, as signalled by the positioning below the dotted line. There is less oxygen at such high altitude.

For risk assets, this is mostly due to the stellar performance of the past year. Key equity indices have rallied 35%, while HY spreads have tightened by 170bps in the EA and even 240bps in the US. Substantial upward revisions of – with hindsight – too prudent earnings assumptions keep the outlook positive, but less so. Dearer valuations do point to more prudent total return forecasts. For US stocks, higher FX hedging costs also matter.

The much tighter spread levels not only curb the carry from Credit exposure but also make risks asymmetrical. Given much less volatility in the IG space, however, the impact on safer Credit buckets should be much less pronounced.

Return expectations are lower than a year ago, but that follows a stellar performance

The outlook for European government bonds – bleak already last year – has become even less appealing. The almost 30 bps higher carry vs. last year in 10-year Bund does not offset the additional drag from the stronger expected yield increase amid rising inflation. The reverse is true for the US. Driven by a significantly upgraded rates forecast, we raised our forecast

for UST 10y yields to 2% (+50 bps). Yet thanks to the 80 bps higher current yields level, the carry is higher and the drag from the further yield increase more muted. This leaves USTs (and to a lesser extent also US IG Credit) the only asset classes with a return upgrade vs. 2020 forecasts.

Where do we see the key risks to our forecasts? Amid a plethora of risks, two stand out as most relevant: a protracted period of high inflation on the one hand and adverse Covid mutations on the other.

Persistently high inflation. This year's overshoot in inflation has thus far been much due to temporary factors including base effects from last year's price drops amid the pandemic and disruptions/bottlenecks amid the global reopening. In the base case underlying our forecasts, these factors will flatten out over 2022. Yet risks of much stickier pressures have increased further. This holds especially if underinvestment in fossil fuels keeps energy inflation high during the transition towards renewables. In this scenario with elevated probability, central banks will need to unwind support faster and bring forward their rate hikes to cap rebounding inflation expectations. This would weigh on growth expectations, underpinning stagflation concerns. Both bonds and equities will suffer amid this unfavourable growth/inflation mix, even though core bonds may benefit in the second half of the forecasts horizon as central banks manage to re-anchor expectations (at the cost of curbing growth). Hedges against such a scenario include exposure to energy commodities and inflation linkers.

Covid mutations undermining the effectiveness of vaccines. Vaccinations have clearly helped to bring Covid under control, by decoupling cases on the one hand, and hospitalisations and deaths on the other. Yet adverse mutations of the virus (a low probability, high impact risk) may bring about highly infectious and detrimental variants that prove more resistant against current vaccines, forcing governments to impose new lockdowns. New drugs reducing the risk of hospitalisation and death are expected in 2022, but maybe not early enough to annihilate this tail risk A new recession would severely harm earnings and risk sentiment, with equities falling and governments bonds rallying. Potential hedges include long-dated US Treasuries with unhedged USD exposure.

On the positive side, we do not rule out for the next few quarters positive surprises on easing bottlenecks in manufacturing, easing energy inflation amid a warmer winter in the Northern hemisphere and an accelerated return to a new normal that shifts consumers from crowded goods demand to reopening services. This would entail upside risks to our equity return forecasts which are below the historical norm. On balance, however, adverse risks are dominating, with high inflation the most important one to watch.

IMPRINT

Issued by: Generali Insurance Asset Management S.p.A.
Società di gestione del risparmio, Research Department

Head of Research: Vincent Chaigneau

Head of Macro & Market Research: Dr. Thomas Hempell, CFA

Team:
Elisabeth Assmuth | Research Operations
Elisa Belgacem | Senior Credit Strategist
Radomír Jáč | GI CEE Chief Economist
Jakub Krátký | GI CEE Financial Analyst
Michele Morganti | Head of Insurance & AM Research, Senior Equity Strategist
Vladimir Oleinikov, CFA | Senior Quantitative Analyst
Dr. Martin Pohl | GI CEE Economist
Dr. Thorsten Runde | Senior Quantitative Analyst
Dr. Christoph Siepmann | Senior Economist
Dr. Florian Späte, CIIA | Senior Bond Strategist
Guillaume Tresca | Senior Emerging Market Strategist
Dr. Martin Wolburg, CIIA | Senior Economist
Paolo Zanghieri, PhD | Senior Economist

Head of Insurance and AM Research: Michele Morganti

Team:
Raffaella Bagata | Research Operations
Alberto Cybo-Ottone, PhD | Senior Economist
Mattia Mammarella | Research Analyst
Roberto Menegato | Senior Insurance Research Analyst
Antonio Salera, PhD | Economist, Pension Expert
Federica Tartara, CFA | Senior Economist

Head of Credit Research: Vivek Tawadey