

# EXPECTED RETURNS

2022  
2026

## THE ROASTING TWENTIES

### THINGS ARE HEATING UP

# Executive summary

## The Roasting Twenties

Things are heating up

It's easy to understand Elon Musk's fascination with Nikola Tesla, the inventor of the alternating current (AC) technology that serves as the backbone of the company's electric vehicles. Talking to *Collier's* magazine back in 1926, in the midst of what came to be known as the Roaring Twenties, Tesla essentially predicted the wireless age, stating: "When wireless is perfectly applied the whole earth will be converted into a huge brain, which in fact it is, all things being particles of a real and rhythmic whole. We shall be able to communicate with one another instantly, irrespective of distance."

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Thanks to technologies such as Zoom we are clearly now in the era that Tesla envisioned, in which we indeed “see and hear one another as perfectly as though we were face to face, despite intervening distances of thousands of miles”. Like many of his peers in the Roaring Twenties, Tesla was a techno optimist, inspired by the breathtaking pace of technological advances in the early part of the 20th century.

Looking ahead to 2026 – the end of our five-year horizon in this publication – it’s not difficult to envisage similarities between the Roaring Twenties and what we believe the 2020s may bring. Much like in the 1920s, we have just emerged from a major global crisis during (and thanks to) a period of rapid technological change. US labor productivity growth averaged 2.4% between 1919-29, 60 bps higher than during the war- and pandemic-plagued second decade of the 20th century. We think there could be a similar improvement this time around, and have grown more optimistic about a supply-side boost for the global economy compared with last year. We expect an investment-led pick-up in productivity growth that beats the subdued GDP per capita growth during the 2009-19 Great Expansion – not unlike the jump we saw in the Roaring Twenties.

And we’re also excited about the prospects for technological breakthroughs. If Elon Musk is interviewed by Forbes or a similar magazine in 2026, it’s likely that he’ll have even more reason to exude his optimism about technology than his source of inspiration had exactly a century previously.

### **Introducing the Roasting Twenties**

However, we see some crucial differences between what we now call the Roaring Twenties and the world we live in today. In our view, we are not now in the roaring 2020s, but the Roasting Twenties instead.

First, the reason for optimism linked to technological and economic growth in the coming decade (and so the coming five years as covered by our outlook) rests on a paradox: the optimism is intertwined with that sinking feeling that climate catastrophe is closing in. Back in the 1920s, people could object to the cheap, reliable cars made by Henry Ford by asking what’s wrong with the horse? Today it is obvious what’s wrong with fossil fuel-powered cars and why they need to be replaced. Therefore, the productivity boost that we expect will be the result of the urgency to extend the existing technological frontier to help us face the increasingly complex demands of an aging society, health and climate risks, and economic polarization.

The world is heating up: a recent Intergovernmental Panel on Climate Change report shows that the average global temperature will increase to 1.5°C above pre-industrial levels in the next two decades, even in the most optimistic emissions-reduction scenario. This

temperature increase will be accompanied by more extreme weather events, such as floods, heatwaves and hurricanes, while sea levels are forecast to rise by up to 50 cm by 2100. Developed economies are now facing increased physical climate risks, as we have seen with the recent wildfires in California, Greece and Italy and the flooding in Germany and Belgium. There is no longer any doubt among scientists whether climate change has been caused by human activity: the changes in recent decades are unprecedented in the last 2,000 years.<sup>1</sup> Although carbon futures prices have been surging lately and 86% of investors believe climate risk will be a key theme in their portfolios by 2023,<sup>2</sup> regional equity valuations do not yet reflect the different climate hazard risks that the various regions are exposed to.

We expect investors to increasingly incorporate a consideration of climate risk into their asset allocation decisions in the coming five years. To help them do so, this year we have enriched our existing Expected Returns framework by introducing an analysis of how climate factors could affect asset class valuations in addition to valuation and macroeconomic factors. We also discuss the prospective climate-related risks and opportunities for the various asset classes in our new 'Climate' chapter.

Second, we expect the 2020s to see lots of literal roasting in the metallurgic sense: meeting the Paris climate goals requires an acceleration of the green energy transition, which in turn will mean a lot of ore smelting needs to be carried out. That's because, according to the International Energy Agency, constructing an offshore wind plant requires nine times more mineral resources (in weight terms) than a gas-fired plant, while a typical electric car requires six times more mineral inputs than a conventional vehicle. Electrification of transport will require huge amounts of copper and aluminum in particular.

Third, we envisage that there will be a degree of roasting taking place in the post-Covid corporate landscape due to creative destruction and economic scarring. New forms of hybrid working and labor-saving technological innovations resulting from the pandemic could act as a powerful catalyst for productivity gains, while the heat of new competition (there has been a notable rise in the number of start-ups post-Covid) will eliminate industry laggards. Certain sectors will probably experience a structural fall in demand in the post-Covid expansion, while zombie companies are likely to start feeling the heat of structural economic change.

This brings us to our macroeconomic projections. The global economy has been experiencing an atypical stop-start dynamic in 2020-21. The result is that macroeconomic uncertainty has hit its highest level in recent history, exceeding the levels it reached in the Volcker disinflation period in the early 1980s and the 2008 global financial crisis. This means investors should keep an open mind as to how the economic landscape could unfurl over the coming five years.

Today, the market narrative is dominated by the question of whether inflation will be transitory or longer-term in nature. For now, it's too early to tell. However, we believe that four key factors will play an important role in shaping the macroeconomic landscape in the medium term, and they should also shed some light on the inflation debate.

First is the debt legacy of the Covid shock, as there has been no cleansing of corporate balance sheets of the kind we see in a normal recession. Second, the evolution of the policy trilemma between ending the pandemic, keeping the economy functioning and maintaining personal freedoms. Third comes the interplay between central banks and governments. Finally, geopolitics will be important as tensions between the world's superpowers are on the rise.

1. For example, between 1800-2006, sea levels rose by around 1.7 mm per year. Since 2006, they have risen by around 3.7 mm per year.

2. Source: 2021 Robeco Global Climate Survey.

### Let's now consider our three main scenarios

In our base case scenario, the **Roasting Twenties**, the world transitions towards a more durable economic expansion after a very early-cycle peak in growth momentum in 2021. There is still no clear exit from the Covid-19 pandemic, although governments, consumers and producers have adopted an effective way of dealing with what has become a known enemy.

Negative real interest rates drive above-trend consumption and investment growth in developed economies, while the link between corporate and public capex and the productivity growth that ensues remains intact, with positive real returns on capex benefitting real wages and consumption growth. Workers' bargaining power increases due to more early retirements by members of the baby boomer generation after the pandemic – not only in developed economies, but also in China. Central banks want their economies to grow, but not too much, and in this scenario they have luck on their side.

What about the debate about whether inflation is transitory or on a secular uptrend? It remains largely unresolved, reflecting a stalemate between rising cyclical and falling non-cyclical inflation forces. This creates leeway for the Fed and other developed market central banks to gradually tighten monetary conditions, with a first Fed rate hike of 25 bps in 2023 followed by another 175 bps of tightening over the following three years.

We call our bull case the **Silver Twenties** because in it we see a silver lining for the global economy emerging from the pandemic. Shocks like pandemics have the power to change the fabric of society for the better. In this bullish scenario, effective vaccines lead to herd immunity across the globe and Covid-19 gradually falls by the wayside without the need for an active approach to battle it. There is enormous relief and as such 'animal spirits' are released: "the spontaneous urge to action rather than inaction", as Keynes described this emotional mindset in 1936. The USD 2.5 trillion of excess household savings that have been built up during the pandemic flow into the real economy, while elsewhere, stretched savings rates fall below historical averages.

The global economy is able to maintain above-trend productivity growth for longer as the dislocations in goods and labor markets that have forced companies to adapt are resolved more quickly than in our base case. This means non-cyclical inflation pressures fall in 2022, while cyclical inflation remains in check due to more sizable labor productivity gains on the back of greater technology dispersion across sectors. And with the pandemic out of the way, there is a more constructive dialogue between the US and China on a broad range of topics.

But it's not all good news, so we can't refer to this scenario as the **Golden Twenties**: outcome-oriented central banks start tightening sooner than in our base case due to the earlier-than-expected progress towards their full employment and inflation targets.

Finally we come to our bear case: the **Stag Twenties**. Here, a slowdown in economic growth momentum in 2022 is reinforced by stubbornly high input costs resulting from persistent dislocations in the capital and labor markets. There is no resolution to the policy trilemma as the pandemic spins out of control as vaccines lose their effectiveness against new mutations. As a result, there are renewed strict lockdowns across the globe, followed by a repeat of the supply shock the world experienced in 2020. The subsequent output losses feed through into lower income growth. With inflation in developed economies in the 3-4% range by 2023, fiscal and monetary policy is constrained and stagflation rears its ugly head.

And now the issues that have been the focus of our Expected Returns publication in recent years come to the fore: excess corporate leverage, high income inequality, the sustainability of the euro experiment and zombification. A new, longer, but shallower recession than the first Covid-19 downturn ensues. After the burst of stagflation, disinflation emerges due to lower consumption growth, higher taxes, forced deleveraging, rising corporate and household defaults, and a depleted wealth effect as financial markets were dealt a severe blow in the preceding episode of stagflation.

### **Frigid bond markets, torrid equity markets**

What does this all mean for investors looking to put their money to work in markets that are already back to – and in some cases above – their pre-pandemic levels?

Current asset valuations, especially those of risky assets, appear out of sync with the business cycle, and are more akin to where they should be late in the cycle. The dominant role central banks have taken on in the fixed income markets has forced yields well below the levels warranted by the macroeconomic and inflation outlook. Torrid valuations are suggestive of below-average returns in the medium term across asset classes, and especially for US equities. This is reason enough to keep an eye on downside risk at a time that many investors have a fear-of-missing-out, buy-the-dip mentality.

And yet ex-ante valuations have historically typically only explained around 25% of subsequent variations in returns. The remaining 75% has been generated by other, mainly macro-related, factors. From a macro point of view, the lack of synchronicity between the business cycle and valuations should not be a problem given our expectations for above-trend medium-term growth, which bode well for margins and top-line growth. In our base case, we expect low-double-digit growth in earnings per share for the global equity markets to make up for sizable multiple compression. Previous regimes in which inflation has mildly overshot its target – something else we expect in our base case – have historically seen equities outperform bonds by 4.4 percentage points per year. A world in which inflation is below 3% should also see the bond-equity correlation remain negative.

Negative real interest rates are here to stay for longer, even though we expect real rates to become less negative towards 2026. That implies some parts of the multi-asset universe could heat up further. With 24% of the world's outstanding debt providing a negative yield in nominal terms, investing in the bond markets is a frigid proposition from a return perspective as it is hard to find ways of generating a positive return. Sources of carry within fixed income are becoming scarcer, and are only to be found in the riskier segments of the market, such as high yield credit and emerging market debt.

With excess liquidity still sloshing around and implied equity risk premiums still attractive, the TINA (There is No Alternative) phenomenon persists as alternatives for equities are hard to find. Overall, we expect risk-taking to be rewarded in the next five years, but judge the risk-return distribution to have a diminishing upside skew. The possibility of outsized gains for the equity markets is still there, but the window of opportunity is shrinking.

Nikola Tesla predicted that the world's temperate zones would become "frigid or torrid". We now know the two extremes co-exist.<sup>3</sup> Likewise, asset allocators should ponder how their portfolio could weather a frigid bond market and a torrid equity market at the same time over the next five years.

3. In Greece alone temperatures have ranged from -19°C to +48°C in 2021.

## Expected returns 2022-2026

	5-year annualized return	
	EUR	USD
<b>Bonds</b>		
Domestic AAA government bonds	-1.50%	1.00%
Developed global government bonds (hedged)	-0.50%	0.75%
Global investment grade credits (hedged)	0.25%	1.50%
Global corporate high yield (hedged)	1.50%	2.75%
Emerging government debt (local)	2.75%	3.75%
<b>Cash</b>	-0.25%	1.00%
<b>Equity</b>		
Developed market equities	4.25%	5.25%
Emerging market equities	4.00%	5.00%
Listed real estate	3.75%	4.75%
Commodities	5.00%	6.00%
<b>Consumer prices</b>		
Inflation	2.00%	2.25%

Source: Robeco. September 2021. The value of your investments may fluctuate and estimated performance is no guarantee of future results.

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