

5-YEAR EXPECTED RETURNS

The Age of Confusion

EXECUTIVE SUMMARY

2023

2027

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The Age of Confusion

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Around 1720, Johann Sebastian Bach, arguably one of the greatest classical composers of all time, wrote a remarkably complex fugue in B minor that not only has four voices but also features a theme using all twelve pitches of the chromatic scale, unprecedented at the time. With the theme covering all notes in the octave, the fugue appears to completely lack harmony, which was why one of Bach's contemporary critics dismissed the fugue as "confused". Yet it turned out to be revolutionary. Bordering on atonality, it hinted at a major paradigm shift in music that would not occur until two centuries later, when Arnold Schönberg drew inspiration from this fugue to compose atonal music, abandoning the well-established realm of tonal music.

Bach's fugue resonates loudly in today's financial markets. Given the multiplicity and persistence of recent shocks, a feeling of disorientation resounds in skyrocketing bond market volatility on the back of the highest US inflation and the lowest Chinese GDP growth in 40 years. Like the four distinct voices of Bach's fugue, the orchestra of financial markets has been playing four different regimes in rapidly alternating fashion this year. Year to date, we have observed rising nominal Treasury yields and falling credit spreads (risk-on regime), declining Treasury yields and rising credit spreads (risk-off regime), rising Treasury yields and credit spreads (QT regime) and declining Treasury yields and credit spreads (QE regime).

Last year's 5-year outlook, entitled *The Roasting Twenties*, was subtitled "Things are heating up". Unfortunately, one year later we have to conclude that things have been heating up pressure-cooker style, not only because of global warming. A hot war in Europe triggering an energy crisis, a food crisis, and inflation in developed economies hovering around double digits were clearly not penciled in. While Covid appears to be on its way to becoming endemic, it is still hounding the largest contributor to global growth, China. A country that is also simultaneously battling a real estate crisis as well as drought.

The age of confusion is all about multiplicity, persistence and reflexivity

In our view, we have now entered the age of confusion. Confusion because of the many moving parts that market participants have to juggle, creating larger divergences in analyst views than usual around critical signposts such as the effectiveness of monetary and fiscal policy, climate change, the impact of energy and food prices, China's growth trajectory, debt overhang, zombification, and geopolitics. This heightened uncertainty is reflected in volatility almost doubling in analyst forecasts of 12-month forward global earnings estimates compared to pre-Covid levels. This age of confusion is being driven by the multiplicity of recent shocks, the persistence of the shocks, and reflexivity, the reaction to the shocks. We see the confusion or disorientation mainly in three key areas: the lack of understanding about inflation, the shift in monetary policy, and the ongoing debate about whether the Great Moderation has ended.

Understanding the lack of understanding about inflation

First, there is confusion about the origin of inflation and critically so in central bank circles. While Powell said in early 2021 that we should perhaps "unlearn" the monetarist textbook relation between monetary aggregates and output and inflation, other central bankers or former central bankers like Mervyn King disagreed, and held that Friedman's famous quip that "inflation is always and everywhere a monetary phenomenon" is still valid and that central banks should not have printed the extra money in the wake of the Covid recession. As we show in Chapter 4, unlearning Friedman seems unwise even if the velocity of money is low.

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Naturally, there is also confusion about the inflation trajectory ahead. Central bankers' judgment last year that inflation was going to be 'transitory' has clashed with reality. Powell had to concede that "I think we now understand better how little we understand about inflation". Major central banks have fallen prey to the same misconception in their forecasting, where just stating an inflation target you then allow your models to run on the assumption that inflation in the long run will always come down to 2%. In doing so, central bankers have been whacking at the ball and missing it in the post-pandemic recovery, ending up behind the curve. Ultimately, central bankers are not only taking the risk that the so-called 'expectations channel' for monetary transmission will collapse if inflation expectations were to become unanchored, but also their own credibility as inflation fighters. This year, central bankers have clearly acknowledged that risk by scrapping the word 'transitory' from their vocabulary and embarking on a fast-paced tightening cycle.

In last year's publication we warned that "inflation may prove less transitory than assumed", predicated on the view that the historical high macro uncertainty emanating from the Covid shock presented a prolonged, more persistent period of economic rebalancing. Reassuringly, rebalancing is already under way, with easing supply chain pressures visible in declining freight fees as well as declining core goods prices. On the demand side, the excessively strong goods consumption during 2020/2021 has normalized. Real oil prices have come down and with base effects from decelerating year-on-year oil prices in headline inflation becoming more pronounced, life should become a bit easier for central bankers.

Yet, there is an obstacle. At this stage, base effects from energy prices should have already led to declining overall CPI numbers but these effects have been subsumed by reflexivity¹: as the facts about the cost of living change, economic participants respond and start demanding compensation via wages and indexation of pensions. Reflexivity suggests that after peak inflation, the emerging process of disinflation could be erratic and does not automatically imply inflation will fall neatly towards central bank inflation targets. Even as the exogenous inflation shocks (food/energy) fade into 2023, the response from domestic producers and consumers creates endogenous effects with domestic inflation sources picking up (services, rents).

1. A term introduced into the economics discipline by Soros in his book "The alchemy of finance" (1987).

Thus, the emergence of disinflation still does not resolve the question of where inflation will land in the medium term. After financial markets were surprised by both the multiplicity and persistence of shocks in 2022, reflexivity might be a new element that could prolong an episode of confusion about inflation against a backdrop of increased bargaining power of labor versus capital. Although we find that the bar for inflation becoming entrenched is pretty high and recessions, which we expect one way or another in each scenario, are highly disinflationary, a right-hand skew to the expected inflation frequency distribution for developed economies is a key thread for 2023-2027.

A landmark shift in monetary policy

The second reason why we are entering the age of confusion is that a major regime shift for financial markets is getting traction with the transition from QE to QT by central banks. The reason for this shift is that inflation risk premiums tell us that the decade-old deflation scare has reversed into an inflation scare, removing the need for artificially low interest rates and unconventional easing measures. We are sailing largely uncharted waters here. Accustomed to the Fed put, markets have been interpreting bad macro news as good news as more easy money was on its way. A whole generation of traders, and algos for that matter, has now been conditioned on central bank balance sheets trending up as a percentage of GDP. This uptrend has caused massive asset price reflation. Note that, despite the significant multiple compression observed over the last year, the S&P 500 standard price-earnings ratio is still up 97% since former Fed president Bernanke first

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announced QE in November 2008. As the trend of central bank balance sheet expansion is about to reverse, it is simply too easy to assume that QT will be the mirror image of QE and therefore everything is already fully reflected in current pricing. The experience of the mild QT period 2017-2019 in the US has already shown that the impact on liquidity conditions is asymmetrical to the downside. In a world where inflation risks are tilted to the upside, bad macro news will be simply bad news after all.

Farewell to the Great Moderation?

Thirdly, the multiplicity, persistence and subsequent reflexivity emanating from recent shocks has triggered a major macro debate on whether the Great Moderation has ended. While confusion itself could be indicative of a nascent paradigm shift, it is not enough in and of itself. We find that the future has become less predictable and remain agnostic on regime change in the next five years, though it is clear that the Great Moderation is getting punctuated by bouts of a stagflation.

Major claims of paradigm shifts require a heavy burden of proof. We find insufficient evidence to conclude that we are close to a tipping point where reflexivity leaves inflation in developed economies spiraling out of control. If the ongoing demographic reversal in China, the largest contributor to global growth, ultimately proves to be net disinflationary as a prolonged deleveraging in its vast real estate sector results in subdued consumption growth, the Great Moderation could very well continue. If, on the other hand, overly growth-sensitive central banks pivot prematurely and abort the tightening cycle without taking the sting out of inflation as China recovers, we will likely inch closer to saying farewell to the era of the Great Moderation.

Our scenarios

Where does all this leave us with our scenario thinking? In our base case, **the hard landing that unstings inflation**, we envisage a global economy that undergoes a wobbly, drawn-out recovery after a US recession in 2023 cools demand enough to take the sting out of inflation. The Fed policy rate cuts during the next recession will have a hawkish signature nonetheless as inflation is expected to remain in the twilight zone (2.6% on average during 2023-2027). Investment activity towards restoring supply chains builds resilience but also compromises efficiency. Three engines, which historically are low real interest rates, level of excess savings, and housing affordability, that would be able to sustain above-trend consumption growth in the next five years for developed market economies have started sputtering. We therefore downgrade the US growth trajectory from 2.3% to a below trend 1.75% annualized real GDP growth in the next five years. Worsening demographics will decelerate China's real activity growth below 5%.

In our bull case, **The Silver Twenties**, we see a silver lining emerge from the recent multiplicity of shocks. We expect US real GDP to rebound to 3.75% in 2024 and see its 5-year geometric annualized GDP grow at a healthy above-trend growth rate of 2.75% in the 2023-2027 period. This is predicated on our view that innovations stemming from green capex and the post-Covid capex boom will finally start to appear in productivity data. The recently enacted Inflation Reduction Act in the US will create a cyclical upswing in green capex. Europe accelerates its move away from Russia as a major energy supplier via LNG import terminals and accompanying long-term LNG contracts and becomes strategically independent from Russia. At the same time, the REPowerEU initiative contributes to Europe's Fit for 55 goal. China manages to establish Covid herd immunity in 2023 as well as a controlled deleveraging of its real estate sector, enabling it to achieve the CCP's 5.5% annual growth target.

In our bear case scenario, **The Stag Twenties**, we foresee that the current global tightening cycle and the ensuing recession in 2023 are not enough to knock stubborn inflation off its

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pedestal. In this scenario, myriad actual risks materialize as reflexivity abounds, both in financial markets as well as the real economy. Echoing the Volcker-led Fed back in the 1980s, two recessions are required to tame inflation. The Fed shows a heightened sensitivity to growth as it progresses in the ongoing tightening cycle and cuts policy rates for the US deeper in the 2023-2024 recessionary episode compared to our base case. The recession is nonetheless longer as consumer confidence does not recover as quickly as in the other scenarios because of high experienced inflation.

With supply side issues lingering against a backdrop of heightened geopolitical tensions, core inflation accelerates again to 4.75% by 2025. This now starts to greatly worry the Fed and it embarks on an aggressive tightening cycle. Yield curves invert again and another, deeper, recession unfolds around 2026/2027. The 5-year geometric annualized GDP growth is at the lower end of its historic range, with the US GDP growth rate only 0.95% in the 2023-2027 period.

From the current juncture, it is entirely plausible to see more extreme and divergent scenarios transpire in the next five years, ranging from outright deflation after a hard landing to an economic situation where inflationary psychology settles in, thereby reaching a tipping point where inflation spirals out of control. Yet, though plausible, such states of the world have a low likelihood in our view and present highly unstable equilibria.

Low to negative real returns, subdued risk premiums

How does an investor prevent deflection in the age of confusion? By looking at developments through the lens of multiplicity, persistence and reflexivity. Confusion in financial markets is nothing new, it has actually been a fact of life for investors since the very beginning, as evidenced by La Vega's 1688 book entitled *Confusion of Confusions* about the world's first stock exchange, in Amsterdam in the seventeenth century. Confusion creates opportunities for active investors. From a financial market perspective, the age of confusion could very well end up as the age of alpha opportunities for skilled active investors as the tide of excess liquidity that allowed for easy money trades recedes.

We expect asset returns in euro to remain below their long-term historical averages over the coming five years, mainly due to the below steady state risk-free rate and, in some cases, subdued risk premiums, except for commodities. For US dollar-based investors with an international portfolio, perspectives are more rosy as we expect other currencies to appreciate against the US dollar with the US dollar bull market coming to an end in the next five years.

We have reduced the expected return on equities slightly by 0.25%, leading to a 4% geometric total nominal return on a developed equity market portfolio in euro. The surge in nominal risk-free interest rates since September 2021 has resulted in an upgrade of returns for many fixed income asset classes with a notable upgrade of 1.5% for developed market sovereign bonds (hedged to euro).

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Expected returns 2023-2027

	5-year annualized return	
	EUR	USD
Fixed income		
Domestic cash	1.00%	2.50%
Domestic AAA government bonds	-0.50%	3.25%
Developed global government bonds (hedged)	1.00%	2.50%
Emerging government debt (local)	2.75%	5.75%
Global investment grade credits (hedged)	1.75%	3.25%
Global corporate high yield (hedged)	2.75%	4.25%
Equity		
Developed market equities	4.00%	7.25%
Emerging market equities	5.25%	8.25%
Listed real estate	3.75%	6.75%
Commodities	4.00%	7.00%
Consumer prices		
Inflation	2.25%	2.75%

Source: Robeco. September 2022. The value of your investments may fluctuate and estimated performance is no guarantee of future results.

Compared to last year, taking developed market equity market risk is somewhat less rewarded compared to fixed income risks. This is the first time since we first published the Expected Returns twelve years ago that we project that the developed equity risk premium for a euro investor will be below its steady-state excess return. This is partly because we envisage a level shift in consumption volatility that warrants a higher medium-term equity risk premium than is currently reflected by the market. Yet, from a nominal absolute return perspective, there is still hardly an alternative in the traditional multi-asset universe to equities, with only commodities on a par with equity returns for a euro investor.

Maintaining real purchasing power for a globally diversified portfolio will be daunting as we find that a globally diversified portfolio of stocks and bonds has a real, i.e. inflation-adjusted, return of -2.9% per annum when annual inflation is above 4%. In other words, inflationary periods are by far the worst when it comes to investors' purchasing power. With the exception of our bull case scenario, we see inflation in the 2.5% to 5% bracket for developed economies and this clearly also challenges portfolio diversification as the stock-bond correlation tends to be positive in this inflation range for developed markets. The quest for alternative assets to hedge equity risk will therefore continue. In this respect we note that we did not lower our real estate forecast while commodities are still expected to generate steady state-like returns despite the supercycle commodity returns posted over the last two years.

Bach's last B minor fugue from *Das Wohltemperierte Klavier* rocked the ruling paradigm of the eighteenth century musical world, inspiring Beethoven, Mendelssohn and many others in later centuries. Yet, Bach did not topple things as ultimately his compositions remained tonal in nature. Likewise, the age of confusion will challenge and transform the underpinnings of the Great Moderation we enjoyed in the past 40 years, but might not topple them yet. ●

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