ROBECO
The Investment Engineers

5-YEAR EXPECTED RETURNS – EXECUTIVE SUMMARY

Triple Power Play

2024
2028

AUGMENTED
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our Expected Returns in this
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Executive summary

Triple Power Play

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Progress often precedes conflict. Take the birth of science during the age of enlightenment. One of the greatest controversies of the 17th century happened when Leibniz and Newton locked horns over who invented calculus first. Both men undoubtedly knew they were on to something and their intellectual legacy has proven just that, outliving them by centuries. Today calculus is used in computer science, engineering telecommunication and space exploration to name a few. While Newton was initially declared by the Royal Society as the winner, the tussle ended de facto in a posthumous stalemate when in the 1820s even the British mathematicians adopted the Leibnizian notation instead of the less effective Newtonian notation. The current consensus is that both geniuses invented calculus independently.

We live in a world of great progress as well as upheaval. We have made significant leaps in health care, as witnessed in May 2023 when the WHO declared the end of Covid-19 as a global health emergency. The March 2023 IPCC report on climate change outlined that global warming below 1.5 degrees Celsius is still feasible. The latest advancements in large language models like ChatGPT bode well for future productivity growth and have skyrocketed major technology stocks year to date. Inflation in G7 economies has peaked. Central banks have so far been successful in bringing down inflation without causing an increase in unemployment.

Goldilocks shines yet turbulence looms. It will prove difficult for central banks to take the sting out of (core) inflation without triggering a rise in unemployment that provides the required cooling of an overheated services sector. The hot war on the borders of Europe is unabating, partly sustained by the latest technology. The planned face-off between leading technology entrepreneurs Musk and Zuckerberg, after the latter launched an alternative social medium to X (formerly Twitter), is heavy with symbolism and echoes the infamous Newton-Leibniz priority dispute at the genesis of a new era. The surge in technological capabilities in today's economy has increased the stakes and upped the potential for dispute. In our view we are entering a power play economy. Specifically, we foresee a triple power play.

The rise of labor (capital vs labor)

The first power play we see developing is capital locking horns with labor. When it comes to the pursuit of profit, things have run smoothly for shareholders in recent decades. Companies have managed to grab an increasing share of the economic pie, judging by the corporate profit share of the total economy. In fact, corporate profit shares hit record highs in both the US and the Eurozone at the end of 2022. The flipside of this has been a steady fall in labor's share of the economy. We expect challenges for corporate profitability both from a secular (reshoring, climate change, taxation) as well as from a more cyclical origin.

Firstly, if the dawn of multipolarity spurs reshoring, it will likely increase domestic labor's bargaining power again, as long as reshoring relies on labor-intensive import substitution. There is a close-knit inverse relationship between the domestic labor share and global trade intensity. Secondly, the single-minded pursuit of maximizing profitability is increasingly being challenged by stakeholders pointing to the consequences. Increased internalization of companies' socio-ecological footprints through, for example, higher carbon taxes and spending on expensive green innovation to prevent or capture carbon emissions will also dent profitability. Firms that refrain from embracing SDG's will be faced with a higher cost of capital. Thirdly, a landmark deal in 2021 saw the imposition of a global minimum corporate tax rate of 15%, effectively ending a decades old race to the bottom. The focus on increasing revenues from corporate tax also suggests the tide may be shifting in favor of labor once again. From a cyclical point of view, the outcome of the tussle between capital and labor over the next five years will most likely be determined by wage dynamics in a sticky inflationary environment.

At the time of writing the overall unemployment rate for the OECD stood at 4.8% – a record low. The Phillips curve, which depicts the trade-off between unemployment and wages, is typically steeper when trend inflation is rising (see, for instance, Hajdini 2023).[1] The Phillips curve has steepened since the pandemic not only in the US, but also in the UK and Eurozone. Ari et al. (2023) find that the Phillips curve also tends to be steeper when trade intensity is lower and digitalization is higher. Central bankers have taken note. Andrew Bailey, the governor of the Bank of England, asked workers to 'think and reflect' before asking for a pay rise. Yet so far, we have seen more of a price-wage spiral than a wage-price spiral as wages have clearly lagged overall price rises since the pandemic.

1. Trend Inflation and Implications for the Phillips Curve (clevelandfed.org)

The end of monetary lenience (fiscal vs monetary)

The second power play we have on our radar is fiscal authorities challenging their central banks. During the pandemic, the view that governments should provide strong countercyclical policy, with central banks acting as a fiscal financier (with unconventional monetary policy like the pandemic emergency purchase programme circumventing the binding zero lower bound), quickly became mainstream policy. However, as the inflationary aftermath of the pandemic stimulus shows, too much of a good policy mix can be a bad thing. BIS (2022) provides evidence that the pandemic has resulted in a shift from a monetary-led to a fiscally-led regime. Whether this shift towards more profligate governments will leave inflation structurally higher depends on the fiscal-monetary policy mix. BIS finds that the combination of a profligate government and a weak central bank with limited independence creates the highest inflationary impulse. By contrast, a strong independent central bank is able to act as a counterbalance to even a profligate fiscal authority, with the result that there should only be marginal upward pressure on prices.[2]

2. Fiscal deficits and inflation risks: the role of fiscal and monetary policy regimes (bis.org)

As such, the power play between fiscal and monetary authorities in an above-target inflation environment is important for asset allocators to consider. If a government were to prioritize security and climate change over a return to fiscal prudence it would be signaling to consumers that Ricardian equivalence (consumers postponing spending now in anticipation of tax hikes in the future) does not hold, and sticky inflation would be the natural outcome. A government that runs deficits for a prolonged period will not be able to avoid inflation and run into the crosshairs with central banks mandated to target 2% inflation. As long as inflation is significantly above target it is unlikely an independent central bank will facilitate sovereign profligacy by adopting an easy money stance. The potential for central banks and fiscal authorities locking horns looms even larger in a quantitative tightening regime. This is particularly the case where incurred losses from the central bank's selling of its stockpile of government bonds lower revenue for the Treasury while simultaneously raising government funding costs.

The dawn of multipolarity (US-China)

The third power play is of a geopolitical nature. In June 2023, during an interview to mark his recent 100th birthday, former US diplomat Henry Kissinger urged the US and China to step back from "the top of a precipice". The dawn of multipolarity is real. China and the US are both pushing the frontier of technological possibilities in their strategic competition for hegemony. The promise of generative AI has only raised the stakes. According to the Centre for New American Security[3], the US added 519 entities to the entity list in 2022, prohibiting them from receiving US origin technology. A further erosion of trust between major economies will inhibit technology spillovers and lower trend growth in global GDP

3. https://www.cnas.org/

per capita. A European Central Bank study (2023) finds that if trade intensity were to fall to its mid-1990s level, the initial hit to the global economy would amount to about 5% of global GDP. Whatever one's view on the future balance of power, the peace dividend seems to be gone. Western governments' overriding concern with maintaining the status quo could have profound consequences in terms of more regulation, increased military spending and less laissez-faire economics.

Our scenarios

How does the triple power play shape our scenario thinking? Our previous outlook, titled 'The Age of Confusion' introduced a three-pronged approach to assess the macro landscape, explaining that investors needed to weigh up the wide variety of macro shocks, their persistence and their tendency to be self-reinforcing. This year we enrich this framework by introducing three major 'power plays' we believe will play a significant role in the global economy and can therefore be useful in developing various scenarios for strategic multi-asset allocation. The dynamic of these power plays is subject to the aforementioned elements of multiplicity, persistence and reflexivity.

Stalemate (base case)

Monetary policy works with long, but variable, lags. In the end, the recession signal that the deep inversion of the US yield curve has been flashing since spring 2022 is unlikely to prove false. After a mild recession in 2024, which sees headline inflation dip below 2%, we expect developed economies to transition towards trend growth and above-target inflation again, with consumer price inflation remaining on average around 2.5% towards 2029. In the US, we expect real GDP growth to average 2.3%, 20 bps below what the current S&P 500 stock market valuation entails. While the growth outlook is rather benign, it is unlikely to be a smooth ride, with macroeconomic volatility remaining well above pre-pandemic levels as the dislocations in labor markets resulting from the pandemic are yet to be fully resolved. A study by Bernanke and Blanchard (2023) shows that even if the 'job openings per unemployed' ratio reverts back to its equilibrium rate of 1.2, US inflation will probably converge towards 2.5% by 2027, which is above the Fed's inflation target. A cooling vacancy rate per unemployed towards its natural rate of 1.2 in the coming years would probably still mean annual growth in pay of 3.0-4.5% for US workers. Stronger demand for labor from domestic manufacturing because of subsidized reshoring, nominal wage rigidity, and a further decline in non-cyclical unemployment result in an increase in the labor share of GDP in developed economies at the cost of corporate profitability.

Central bankers, mindful of the post-pandemic surge in inflation, are reluctant to act as fiscal financiers once again. Yet governments are still running deficits and are in need of low policy rates. The tug of war between fiscal and monetary authorities means there is not enough monetary policy tightening to remove demand-pull inflation.

The Chinese economy manages to escape prolonged outright deflation because its move towards a more self-sufficient growth model results in expensive import substitution, which pushes up input costs. What's more, Chinese companies ultimately do not shift from the goal of profit maximization towards debt minimization, which characterizes a balance-sheet recession. However, key elements of Japanification – low growth, low inflation and low interest rates – surface on the back of partially forced deleveraging, falling trend growth and an aging population.

AI gets wings (bull case)

What if the current hype about artificial intelligence does not prove to be misplaced? In our bull case we see above-trend growth and at-target inflation emerging on the back of early adoption of AI and its rapid diffusion across sectors and industries. An AI-led productivity growth boost probably only appears in the official statistics after 2024 due to underreporting and measurement problems. In this scenario, AI technologies become cheaper in light of increased competition and accessibility thanks to government regulation and targeted technology education efforts. As such, small and medium-sized companies also adopt them. Facing the existential threat of AI, high-income workers tone down their wage demands in exchange for job security and non-wage compensation, like tech education. Companies, especially those at the technological frontier, enjoy an increase in profitability as unit labor cost growth remains in check. The power play between capital and labor is convincingly won by capital in this scenario.

The result is an almost Goldilocks scenario in which things are running neither too hot nor too cold. Consumption volatility drops and returns to its pre-pandemic level of 1%. Central banks can take a break from tightening policy as benign disinflation emerges around 2025 due to the supply-side boost that the rapid diffusion of technology results in. This balances the increasing demand-pull inflation stemming from consumers remaining in strong shape thanks to a positive wealth effect (from rising house and stock prices), higher disposable income and solid real wage growth. The power play between fiscal and monetary authorities is at its least intense in this scenario. On the geopolitical plane, we expect a resurgence in mutual trust, leading to lower export controls, allowing positive technology spillovers to emerging economies.

De-risking (bear case)

Our bear case sees a vigorous display of the triple power play (US-China, capital vs labor, fiscal vs monetary). Governments are in the crosshairs of their central banks as they fuel goods inflation with massive military spending. Mutual trust between superpowers hits rock bottom, accelerating friendshoring and reshoring, thereby driving demand for domestic labor. Expensive import substitution of formerly outsourced inputs and AI-linked cyberwar threats compel companies to increase investments, denting profitability. Labor gains bargaining power in the goods sector but loses ground in the services sector. Ultimately, a turbulent environment results in growth of just 0.5% per year for developed economies, while inflation remains stubbornly high at 3.5% on average. A stagflationary environment emerges, intensifying the policy dilemma for central bankers.

Fatter tails, improved diversification

How should a multi-asset investor navigate the triple power play? A closing gap between the main contestants in the global economies' great power plays more likely creates fat tails in a return distribution. Extreme outcomes are more frequent compared to a steady state-like world, especially as we leave an era of ultra-low interest rates behind. Therefore, the compensation for exposure to systemic risk factors that a strategic portfolio seeks will vary notably depending on which scenario will materialize. In the bear case, developed equities will only see 2.5% geometric annualized return in euro, whereas the bull case eyes an 11% return. For a dollar-based investor, the swings are even more outspoken. The good news is that with the exception of our bear case, we expect inflation to average below 3% in the US which has historically coincided with a negative bond-equity correlation regime. Thus, especially for US-based investors, portfolio diversification opportunities over the next five years could increase after a tough spell for a traditional 60/40 portfolio during the heydays of the post-pandemic inflation surge.

Expected returns 2024-2028

	5-year annualized return	
	EUR	USD
Fixed income		
Domestic cash	2.50%	3.25%
Domestic government bonds	2.50%	5.25%
Developed global government bonds (hedged)	3.50%	4.25%
Emerging government debt (local)	4.75%	5.75%
Global investment grade credits (hedged)	4.50%	5.25%
Global corporate high yield (hedged)	5.50%	6.25%
Equity		
Developed market equities	5.75%	6.75%
Emerging market equities	7.25%	8.25%
Listed real estate	5.50%	6.50%
Commodities	4.75%	5.75%
Consumer prices		
Inflation	2.50%	2.75%

Source: Robeco. September 2023. The value of your investments may fluctuate and estimated performance is no guarantee of future results.

Navigating the changing landscape of risk premiums and risk-free returns

While we have upgraded most asset classes compared to last year's estimates, we expect asset returns in EUR to remain below their long-term historical averages over the coming five years, with the exception of commodities. We are gradually moving away from a low-risk-free rate, high-realized-risk-premium world to a higher-risk-free-rate, lower-risk-premium world. Yet, despite the recent surge of >400 bps in risk-free rates in G7 economies, our below long-term historical average returns are mainly the result of below steady state risk-free rates and to some extent subdued risk premiums. We believe that taking equity market risk is somewhat less rewarded compared to fixed income risks at this stage of the cycle.

After a peak in policy rates has materialized, equity outperformance against riskier fixed income is notably weaker. The end of open-ended quantitative easing, rising policy uncertainty, margin compression and a relatively subdued ex-ante embedded equity risk premium in developed equity markets pose further headwinds. For a US dollar-based investor with an international portfolio, perspectives are rosier as we continue to expect other currencies to appreciate against the US dollar, albeit that headwinds for the dollar have eased compared to last year's expectations.

Lastly, investors shouldn't rule out the perceived underdog in each power play. Gottfried Leibniz, who initially appeared to lose the calculus priority dispute, was no less a genius than Newton. In 1679 he foresaw that his invention of binary coding would pave the way for an age of digital computing: "the human race will have a new kind of instrument which will increase the power of the mind much more than optical lenses strengthen the eyes". At the dawn of generative AI, some 344 years later, one can only appreciate the genius foresight it took to accurately predict the future instead of just attempting to minimize surprises. ●

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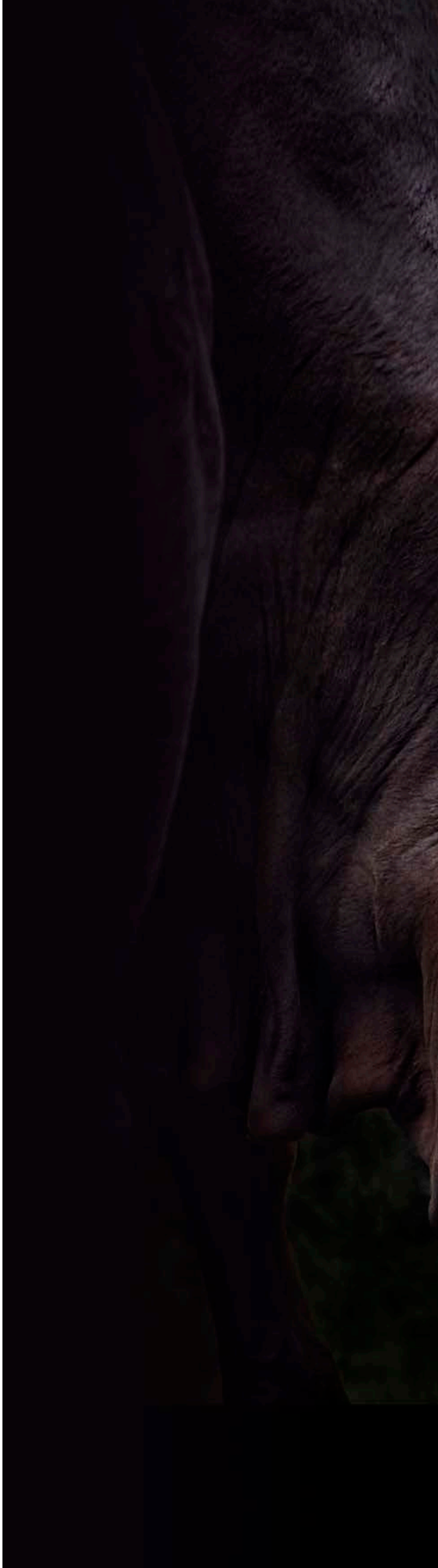
The Investment Engineers



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