Expected Returns

2020
2024

Escaping the Hall of Mirrors

Executive summary
It is said that Henry the Navigator (1394-1460), a Portuguese prince and noted patron of voyages of discovery, encouraged his sailors to dare to go beyond what was then feared as ‘the edge of the world’. Poring over charts and using all available information, he was a maritime visionary who managed to convince his sailors of the limits of their perception. Their discoveries brought great riches. In today’s financial markets we have experienced our own ‘edge of world’ phenomenon of what was once unthinkable: negative long-term nominal bond yields. Irony has it that the archetypical safe haven asset, the sovereign bond market, has set sail for the unknown. To stay with maritime terminology for another moment: a fleet of USD 15 trillion in outstanding bonds has already sailed beyond zero.
Clearly, the sands of the global economy and the financial system are shifting: globalization as we know it is under threat. In our view, a recession in the next five years is inevitable and will result in many assets generating returns below-average historical returns. Tariffs are just a symptom, not the disease. Stanley Baldwin, UK prime minister in the 1930s, described the root problem: “Business can flourish with tariffs, business can flourish without tariffs, but business cannot flourish where there is uncertainty”. The rot is in pervasive policy uncertainty that now is at the highest level in decades. The typical Davos (wo)man, looking “to improve the state of the world” is struggling to reach consensus with peers as we have moved from a unipolar to a multipolar world. Bond prices partly reflect the expectation that an age of transition may end up as an age of disruption.

Which state of world are we transitioning to in the next five years?

In this publication, we challenge the deflationary worldview embedded in bond prices as the new normal. In our view, there will be no secular stagnation, but no secular expansion either. On the contrary, we hold that the market is underestimating inflation risk on a five-year horizon. We expect the massive fleet of negative-yielding bonds to turn around but at the same time, a return to the ‘old normal’ (if there has ever been one) will remain out of sight in the next five years, as we acknowledge that the gravitational pull towards low interest rates will be present for longer.

The global economy is running a marathon, with the US economy now enjoying the longest expansion in post-WWII history. However, global growth has since last year become more uneven and continued to decelerate at a faster pace than we expected. China and the US have slowed to around-trend growth, but Germany, the manufacturing powerhouse of the Eurozone, is struggling. Unemployment rates in advanced economies are generally at decade lows, but there are no signs of an overheating economy exhibiting inflationary pressures. Inflation is the dog that hasn’t barked.

Our theme stems from former Fed President Ben Bernanke. Back in a 2004 lecture, he said: “What do markets expect about the future course of monetary policy? The question is important to policymakers, not because we are concerned necessarily that we should meet the market’s expectations – such a strategy quickly degenerates into a hall of mirrors – but as a check on the efficacy of our communication.” Fifteen years later, the monetary policy pursued by the Fed seems to be degenerating into a ‘hall of mirrors’ strategy. Monetary policy ought to be data dependent and made on the basis of evidence. Instead, central bankers seem increasingly occupied with meeting market expectations for ever lower interest rates. The context for the emergence of this dynamic is understandable as inflation remains anemic while recession fears are growing; markets see dovish monetary policy as the only solution. A barrage of tweets from a US president trying to bully the Fed towards a monetary easing stance does not help either to stay the course.
By reacting to market expectations for further easing, monetary policy becomes a distorted image of its former self. This is harmful. Fed President Jerome Powell recently said that "An ounce of prevention is worth a pound of cure", but economic history shows time and again that it is hard to prevent a buildup of imbalances in the economy that ultimately usher in a recession. Not least because the pound of cure (i.e. a central bank staying accommodative for too long) proves to be an overdose.

**Escaping the hall of mirrors**

In our view, it is essential for central banks to escape the ‘hall of mirrors’ strategy. Escape is the right word here, because monetary space needs to be optimized in advance of a recession. As New York Fed President John Williams recently stated, “if we fail to prepare, we prepare to fail”. Central bankers need to adopt the visionary mindset of Henry the Navigator by leading markets rather than reacting to them, using all of the tools available. Very low real rates led to an escape from a liquidity trap in the 1930s and it is no surprise to see today’s central banks aiming for an inflation overshoot, signaling to markets that policy rates will remain low for longer. However, achieving an inflation overshoot this way is like engineering an escape from Alcatraz. We give central banks the benefit of the doubt, though we note cheap money has failed to bring inflation to target during this expansion. Furthermore, it remains doubtful why moving the goalposts on inflation would result in success as long as the mindset of market participants remains tilted towards deflation.

With nominal policy rates close to or at the effective lower bound, our view is that central banks in advanced economies are ill-equipped to counter a recession. We do not underestimate the ability of central banks to push the frontier of unconventional policies, but there will be an increasing recognition that monetary policy has its limits. Central banks have been too central in market discussions. Monetary authorities can’t eliminate the savings glut and they can’t change consumer risk aversion in an environment of skyrocketing political uncertainty. Central bankers can’t tweak factors like a lower degree of unionization, declining bargaining power for workers or the fact that global value chains have made domestic inflation more sensitive to global output gaps. If, for instance, global trade goes into reverse, like it did in the 1930s after the introduction of the Smoot-Hawley tariffs, durable goods might turn from a deflationary force into an inflationary force again.

Governments are better equipped to shift these crucial macro parameters. We expect fiscal policy to step in. This view is rapidly gaining ground and is strongly advocated by Olivier Blanchard, a former IMF chief economist, who points out that the low nominal interest rate environment offers an opportunity for fiscal policy.

The monetary policy space – and increasingly so the fiscal policy space, too – provides the building blocks for the states of world we deem likely and the interplay between these two policy tools is a common thread throughout our scenario thinking. The quest for policy space will remain a key focal point for the next five years.

In our base case scenario, ‘hall of mirrors’, the escape route from the failed ‘hall of mirrors’ strategy for central banks is an uncoordinated fiscal response. The fiscal stimulus is effective in increasing aggregate demand and inflation expectations, but comes at a price. Debt sustainability is eroded and, as the recession proves to be mild, the private sector anticipates a swift return to fiscal prudence and lower budget deficits. The recovery from downturn remains sluggish.

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In our bull case scenario, ‘a reboot for globalization’, central banks stay out of the ‘hall of mirrors’ quagmire as political uncertainties dissipate and trade issues are resolved, though the zero lower-bound problem remains prevalent when the recession hits. Increased international cooperation makes fiscal stimulus effective.

In our bear case, ‘echoes of the 1970s’, the world faces a negative supply shock. An age of transition morphs into an age of disruption and techno-nationalism. The global world order crumbles and the US leaves the WTO. In the US-China battle for global hegemony, other countries are caught in the crossfire and the decades-long process of globalization goes into reverse. The escalated trade war proves to be inflationary. Chinese authorities aim for full employment to stem social unrest by combining monetary stimulus with massive fiscal stimulus, becoming a global exporter of inflation instead of deflation. Stagflation, though more timid compared to the 1970s, ensues.

**General outlook for returns**

What does this all mean for investors? This expansion is not secular, and a recession in the next five years seems inevitable. We penciled in a recession in last year’s publication, which was entitled ‘Patience is a virtue’, but advised that, despite looming downside risk, the greater risk would be doing too much de-risking too soon. With the prices of risky assets up over the year, patience has proven to be a virtue so far. Risk taking in a late-cycle environment may be rewarded initially, but asset returns will remain below their long-term historical averages over a five-year horizon. We don’t think the next recession will be an edge-of-the-world event, like the GFC was. It will likely be more of a smörgåsbord recession – smaller pockets of excess in the global economy snowballing into something substantial enough to stifle global growth.

<table>
<thead>
<tr>
<th>Expected annual returns 2020-2024</th>
<th>5-year annualized return</th>
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<tbody>
<tr>
<td></td>
<td>EUR</td>
</tr>
<tr>
<td><strong>Bonds</strong></td>
<td></td>
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<tr>
<td>Domestic AAA government bonds</td>
<td>-1.75%</td>
</tr>
<tr>
<td>Developed global government bonds (hedged)</td>
<td>-0.375%</td>
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<tr>
<td>Global investment grade credits (hedged)</td>
<td>0.25%</td>
</tr>
<tr>
<td>Global corporate high yield (hedged)</td>
<td>0.75%</td>
</tr>
<tr>
<td>Emerging government debt (local)</td>
<td>2.75%</td>
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<tr>
<td><strong>Cash</strong></td>
<td>-0.50%</td>
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<tr>
<td><strong>Equity-like</strong></td>
<td></td>
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<tr>
<td>Developed market equities</td>
<td>3.25%</td>
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<tr>
<td>Emerging market equities</td>
<td>3.75%</td>
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<tr>
<td>Listed real estate</td>
<td>3.25%</td>
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<tr>
<td>Commodities</td>
<td>4.00%</td>
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<tr>
<td><strong>Consumer prices</strong></td>
<td></td>
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<tr>
<td>Inflation</td>
<td>1.60%</td>
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The value of your investments may fluctuate and past performance is no guarantee of future results.
Source: Robeco
On a five-year horizon, we have revised downwards our return forecast for most asset classes. For government bonds, the outlook for the next five years is divided. German Bunds are significantly overvalued and as inflation picks up, returns are predicted to remain well below cash. In contrast, US Treasuries will benefit the most when the recession sets in, comfortably beating cash.

Valuation is also a negative factor for developed market equities. Still, returns can remain relatively strong in the first half of our forecasting period. However, as we expect a recession around 2022, returns end at relatively low levels towards the end of our projection period. Emerging equities are generally quite cheap, but we kept our return outlook relative to developed markets intact: due to lingering protectionism we expect only a 50-basis-point premium.

There is one bright spot in terms of relative return, namely commodities. The macro environment is becoming less supportive for investment grade credit and high yield, and we expect excess returns to be below historical average levels, despite neutral valuations.
Special topics
This year we have included four special topics. Three of them are highly topical, while one is timeless. The first two topics fit our ‘Escaping the hall of mirrors’ theme, while the third looks at the investment consequences of China’s increasing weight in benchmarks.

This publication presents different scenarios and our return expectations under each scenario. These expectations can play an important role in portfolio construction. In our fourth special topic we introduce a method for integrating these views into the portfolio construction process.

1. Paving the way for unconventional policy
Our first special report describes one escape out of the hall of mirrors: monetary policy. Yet, with policy rates close to their effective lower bound, monetary policy space to fight the next recession has dwindled. Luckily, monetary policy space is not the only game in town. In this article, we show that the policy space available and the willingness to use it have important consequences for economic recoveries and asset returns following a recession or financial stress event.

2. Celebrating 30 years of inflation targeting?
Inflation targeting is celebrating its 30th anniversary. It is widely seen as a success, but has it been too successful? Stubbornly low inflation rates have led central banks to bring down policy interest rates to or close to their effective lower bound. In this special report, we focus on a debate that is taking place at the Fed and which will likely shape future monetary policy. The outcome of this debate has major consequences, especially for bond markets.

3. Giving China its rightful share in your portfolio
It’s a puzzle to most investors: why is China’s market weight in investment indices so low compared to its economic weight? Many will argue that China’s weight should and will be greater in the future. What should an investor do? Wait for this to happen, or act now? Investors can and need to take time to address all the consequences of a greater allocation to China, including ESG factors. With a rising allocation, the impact of China on the ESG profile of a portfolio becomes a factor which investors can no longer ignore.

4. Refining the inclusion of views in portfolio construction
Humankind has a tendency to be fooled by conviction. However, a base case scenario is only one of many scenarios that may unfold. As the investment consequences of other scenarios can be large (for instance, our ‘echoes of the 1970s’ scenario) investors would be advised to assess how the “tail can wag the dog”. So, investors face a difficult task: how can one effectively combine all views in a portfolio? In this special report, we describe a well-known approach that can be used to deal with this task, the Black-Litterman model. As the model can be quite challenging with respect to market views, we propose enhancements that enable market views to be more easily translated into portfolio construction.
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