ROBECO
The Investment Engineers

EXPECTED RETURNS 5

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Sustainable Investing Expertise by ROBECOSAM

BRAVE REAL WORLD

5-year outlook

Executive summary

Brave real world

It's as if nothing happened. At the time of writing, the MSCI AC World index in EUR is up 8% since a year ago, which is very close to our long-term equilibrium equity return estimate of 7%. Yet, in the interim period, when the global economy was first confronted with Covid-19, we experienced the most significant US GDP contraction since the third quarter of 1932 and the deepest global recession since the 1930s. To overcome the crisis, we believe investors need to understand, now more than ever, that ultra-low interest rates are a key feature of the current investment landscape. We foresee a protracted period of negative real interest rates, meaning their impact on the relationship between economic fundamentals and asset price performance, and the consequences for multi-asset allocation, will be critical. We are living in a time of radical transition, and volatility in markets will remain elevated.

FOR PROFESSIONAL INVESTORS

Yet, there are signals to be found amid the static. Financial markets have been confronted by pandemics and prolonged episodes of negative real interest rates before. We believe risk taking will be rewarded in the next five years, especially as some traditional safe havens will eventually be deemed risky as well.

During the Great Depression, Aldous Huxley published his famous 1932 novel *Brave New World*. It has become somewhat passé to praise Huxley's foresight in accurately describing our current world.[1] Nevertheless, Huxley's vision has some relevance when describing an unequal, technologically advanced, consumerist society, in which governments interfere in the private sector – even infringing on individual freedoms. For instance, would it have been possible a year ago to imagine being forced into 'lockdown' or 'quarantine'? And therefore to be consuming more digital media than ever before?

1. A sentiment displayed for instance in a July 2020 New York Times play review: "Brave New world arrives in the future it predicted", https://www.nytimes.com/2020/07/13/arts/television/brave-new-world-peacock.html.

And yet, it's not a brave new world as it is unlikely that the post Covid-19 era will mark the beginnings of a completely new world. There is much talk about a 'new normal'. This is no wonder, considering the great divide emerging in the global economy, which can be seen most clearly in the discrepancy in performance between the technology sector and the non-tech sector since the 23 March trough. What this suggests is that the global economy's sudden standstill in 2020 has created a structural break. In fact, this is an acceleration of a tectonic shift that was already in the making. It's not a new normal, but the old normal amplified. What was bubbling under the surface in the old normal has gradually become more real and more urgent. The larger trends are still present: high non-financial corporate leverage, declining trend growth, ever widening wealth and inequality gaps and shrinking monetary and fiscal policy space – all themes discussed in detail in previous Expected Returns editions.

So, that being said, we don't believe the dark, deeply ironic undertones of *Brave New World* reflect the future. Without resorting to irony, it's not a brave new world that will emerge in the next five years; it is a brave *real* world.

It's a brave real world because medical workers and researchers are caught in a frantic race to solve the largest global health crisis in decades. The acronym of the proposed Democratic fiscal package this summer, the HEROES act, reflects this sentiment. Without a solution for the health crisis, a sustained economic recovery seems implausible.

It's a brave real world in the making, because a post Covid-19 recovery will remain incomplete and lopsided if only sustained by the virtual world. Covid-19 has highlighted the fact that digitalization was falling short of its potential in many sectors before the pandemic began. The outbreak has ensured that the productivity benefits of working from home, online learning and telemedicine have come to the fore. Nevertheless, a saturation point will

be reached, requiring us to get real instead of virtual. Growth needs trust and trust needs proximity and real-life interaction. Returning to normal life means ensuring conditions are safe enough for vulnerable groups to visit shopping malls and participate in offline services.

It's a brave real world looking to overcome the challenges of achieving a sustainable, greener future. The lockdown episodes have increased our awareness of the true impact our current economic structures have on climate change. We're now potentially on track to recording the largest drop in greenhouse gas emissions since the Second World War.[2] This stresses both the importance and the difficulties of meeting the Paris Agreement objectives that aim to limit global temperature rise to below 1.5-2 degrees Celsius above pre-industrial levels. To this end, EU leaders have initiated the European Green New Deal, which will encourage and inspire further ESG-related engagement.

2. https://www.nature.com/articles/d41586-020-01497-0

It's a brave real world for policymakers who, facing the deepest recession since the Great Depression, have pulled out all the stops to prevent an even worse outcome for the global economy than the one we're currently experiencing. The degree of monetary and fiscal stimulus greatly outweighs the response to the global financial crisis more than a decade ago. In fact, in the US it has been unprecedented. A key question to consider in scenario thinking is whether policymakers will succeed in getting real rates low enough for a substantial period of time to facilitate a self-sustaining economic recovery. We believe they will. But their success will depend, more than ever in post-war history, on close collaboration between the monetary and fiscal authorities.

Expanding the macro framework

In last year's five-year outlook, we stated that "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." In our current scenarios, our four building blocks are: solving the health crisis, crisis relief, aggregate demand management, and addressing the policy failures along the way. The coordination between fiscal and monetary policy will still largely determine the success of aggregate demand management, but this depends on solving the global health crisis and providing effective crisis relief first. How effectively these four building blocks are implemented in actual policy will also largely determine the type of economic recovery path for countries and regions, as well as the behavior of asset markets.

In our base case, 'Credible fiscal financiers', the post-pandemic recovery starts off lopsided as the existing divide opens further between tech-savvy sectors with a low degree of in-person services and those sectors that lack the leverage of further digitalization. Small corporates, especially those in the leisure and hospitality sector, recover incompletely with restructurings and defaults lingering for longer. However, in-service sectors catch up significantly after 2022 as Covid-19 vaccines deliver herd immunity and recovery becomes less fragmented and asynchronous. Growth increases to trend towards the end of our projection period, while inflation in developed markets increases to 3% in the US by 2025.

Compared to last year's base case, we see a higher degree of coordination between policy makers. Central banks adapt effectively to their new roles and delay the erosion of sovereign debt sustainability. After exhausting the conventional monetary tools (bringing policy rates to zero) and subsequently running into diminishing returns with unconventional ones (stimulating aggregate demand via central bank balance sheet expansion), central banks enter a phase where the primacy of aggregate demand management is shifted to governments.

Playing second fiddle, central banks focus on their new role as facilitators of the fiscal experiment: keeping nominal rates close to the effective lower bound and monetizing fiscal deficits in order to ensure government debt service costs are low enough to facilitate government payouts and the stimulation of aggregate demand. We have been here before. For instance, after the Second World War, the Fed had a tacit commitment to the US Treasury to stabilize the latter's cost of financing the war debt until 1951, when the Fed established its independence from the Treasury. At the end of our projection period, central banks reorient their strategy as they finally see a persistent satisfactory inflation level, and possibly even an overshoot of the target range.

In our bull case scenario, 'A reboot for growth with echoes of the 1970s', economic growth retains momentum after an initial rebound in 2021. The first phase, solving the health crisis, is more successful. A larger number of effective Covid-19 vaccines are brought into circulation in 2021 and the virus doesn't mutate its spike proteins, keeping those vaccines effective for longer. In terms of crisis relief, a fiscal cliff is avoided with no significant delay between the expiry of liquidity provisions by governments and the emergence of a self-sustaining recovery that generates cash flows. This phase is managed better than in our base case, as the European example of targeted preventive measures to keep workers employed for longer is more widely adopted.

In contrast to the base case, the paradox of thrift (i.e. excessive saving inhibiting the aggregate demand recovery) largely vanishes. The recovery in the labor market is strong and very low real rates encourage household and corporate dissaving as the economy gets on a stronger footing. Fiscal stimulus proves to be very effective with higher multipliers caused by more technology spillovers to sectors in which digitalization has so far missed its potential. Aggregate demand overshoots trend as a wave of pent-up spending takes shape. Given a sluggish supply-side response in labor and commodity markets relative to demand-side improvements, inflation in developed markets overshoots the 2% inflation target in 2022, and accelerates to 3% as feverish catch-up spending takes hold.

Central banks start thinking about raising rates earlier than in our base case, with the Fed initiating a tightening cycle by 2023 as US core CPI edges up to 3.5%. In this bull case, the paradox emerges: policy coordination has worked so well in kickstarting the economy that central banks find reason to distance themselves from their role as fiscal financiers, wanting to signal independence.

Our bear case, 'The great Covid-19 stagnation', sees the cracks in the global economy get wider. The pandemic can barely be brought under control, with setbacks in vaccine research owing to unexpected mutations of the virus. Distribution of an effective vaccine is thus delayed until 2022. Economic actors remain in crisis mode as the seesaw between lockdowns and reopenings tips towards lockdowns. The crisis-relief toolkit is exhausted and a fiscal cliff develops before a self-sustaining recovery can set in.

With fiscal and monetary policy space in some parts of the global economy depleted, another recession takes hold. This W-shaped path is followed by stagnation. The issues this publication has focused on in recent years come to the fore: excess corporate leverage, rising income inequality, and the erosion of trust in institutions and geopolitics. All those risk factors that would typically have ushered in a classic recession even if the Covid-19 crisis hadn't occurred are still very much with us, only aggravated by the pandemic. The role of central banks as fiscal financiers fails, against a background of lower consumption growth due to strong disinflationary forces, forced deleveraging, and a lower wealth effect. A prolonged episode of disinflation and very low real growth follows.

What does this scenario analysis imply for investors in the next five years?

Investors are entering a brave real world. The defining feature of this investment environment is ultra-low nominal interest rates and significantly negative real interest rates for longer, as inflation in both our base case and bull case picks up. This echoes 1971-1977 when developed countries had a negative real cash return of on average -2.4%.[3] But the echo will be faint: note that we have not penciled in an outright stagflation scenario.

3. Another analogous event would be the streak from 1946-1952, which saw consistent negative real rates in developed markets.

In such an environment, investors must boldly reorient themselves regarding stores of wealth and hedging capabilities of traditional safe haven assets. The mild inflation overshoot caused by policy makers in our base case transforms the *risk-free returns* of cash and bonds increasingly into *return-free risks*. We expect a negative return on cash for Eurozone investors and negative returns for developed sovereign bonds.

So, the brave real world is a paradoxical one: there will be risky safe havens. We expect risk taking to be rewarded in the next five years, even as volatility levels remain elevated. The preoccupancy of financial markets will shift from central banks to governments. This will bring about higher levels of asset and foreign exchange volatility as politicians offer guidance and policy implementation that is less smooth compared to those from their central banking counterparts.

For most risky asset classes, the expected reward for the volatility risk is substantial, leading to attractive Sharpe ratios. Despite elevated risk premiums, absolute asset returns will remain below their equilibrium values.

Expected returns 2021-2025

	5-year annualized return	
	EUR	**USD**
Bonds		
Domestic AAA government bonds	-1.75%	-0.25%
Developed global government bonds (hedged)	-0.75%	0.00%
Global investment grade credits (hedged)	0.25%	1.00%
Global corporate high yield (hedged)	2.25%	3.00%
Emerging government debt (local)	2.00%	3.50%
Cash	-0.50%	0.25%
Equity		
Developed market equities	4.75%	6.25%
Emerging market equities	6.75%	8.25%
Listed real estate	3.00%	4.50%
Commodities	5.00%	6.50%
Consumer prices		
Inflation	1.75%	2.00%

Source: Robeco. September 2020. The value of your investments may fluctuate and past performance is no guarantee of future results.

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