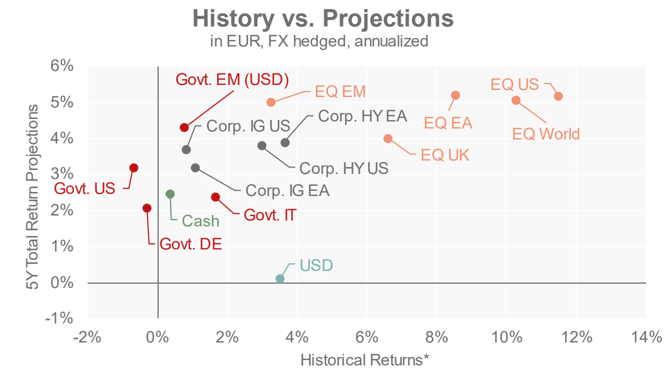
CORE MATTERS

Shaving expectations – our new 5-year return forecasts

GenAM Macro & Market Research
October 25, 2024

Our Core Matters series provides thematic research on macro, investment, and insurance topics

- Global economic resilience, solid earnings growth, cooling inflation and monetary easing have boosted risk assets since the release of our Capital Market Assumptions a year ago. Bonds have benefitted from a mild pullback in yields.
- **The return outlook looks decent, if now less exciting**. A more challenging starting point has led us to shave 5-year expected returns – notably for Euro Fixed Income (FI). Yields may retrace further in the coming year, but we see limited scope for capital gains to add to income over 5 years.
- **International diversification pays off**. Even adjusting for FX hedging costs, **US FI offers higher carry** and greater capital gain potential, longer term. **EM external debt looks attractive**, if less than last year, thanks to a resilient EM outlook amid the Fed's easing and muted EM vulnerabilities.

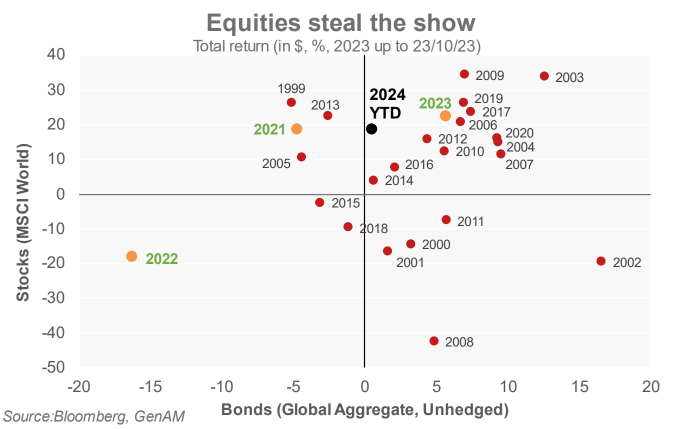


*based on monthly returns from 11/14 to 10/24
Source: Datastream, GenAM

- Public debt is no longer as "risk free" as it used to be, after public deficits and debt soared. Yet we expect the headwinds from mildly wider EGB spreads still to be moderately overcompensated by extra income from risk premia.
- **Credit is still attractive**, also within the euro area. Admittedly, **spreads are already very tight**. But contained **default rates and solid corporate balance sheets**, at least for large companies, should keep them tight: credit carry still looks appealing. US HY spreads look more vulnerable, but the expected pullback in Treasury yields and the higher income offer protection.
- **Equities should render mid-digit returns**, leading the ranking. But the expected margin vs. EM and Credit FI is small while entailing much higher risk exposure. Despite the rally and high valuations, US equities are buffeted by strong US earnings prospects. Mind, however, FX hedging costs and concentration risks linked to S&P500 exposure.
- **Risks abound**. Equity volatility may enter a higher regime (valuation, concentration, geopolitics). Rates volatility will restart its descent, but elevated inflation uncertainty (both sides now) means it will not return to the pre-Covid lows. Among the many risks, we highlight three. First, **yields may stay high for longer on stagflationary shocks** (e.g. escalation in Middle East, global trade war). Second, **political uncertainties and polarisation may fuel debt sustainability** worries and a rise in fiscal risk premia. Third, in a **Goldilocks scenario**, inflation may come down much more swiftly while AI adoption boosts productivity and supply side growth faster and more strongly.

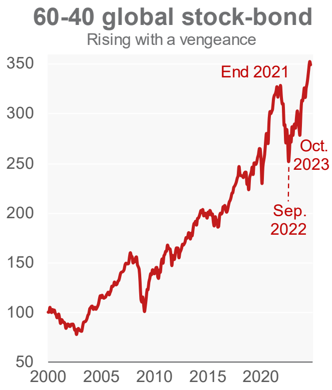
1. Introduction

What a difference a year makes. A year ago when this annual report was released ("The power of yield") it looked like 2023 would be mediocre for liquid assets, following an awful 2022. 4Q23 then rescued the year, as stocks and bonds rallied in sync. After nearly 10 months, 2024 looks good overall, if more contrasted – mediocre for bonds and excellent for equities.

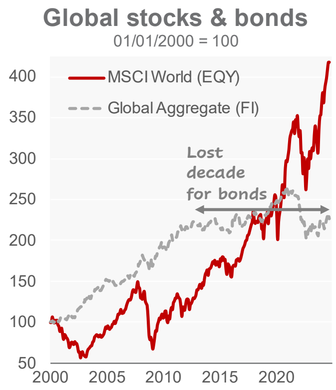


Source:Bloomberg, GenAM

The two upper-right charts summarise how the phenomenal equity rally over the past year has propelled a typical 60-40 stock-bond portfolio. Last year we talked about a lost decade for bonds, and 2024 has not marked the end of this era: 10-year Treasury and Bund yields have lost some 50-75bp over the past 12 months, supporting small capital gains there, but those were heavily concentrated in 4Q23.

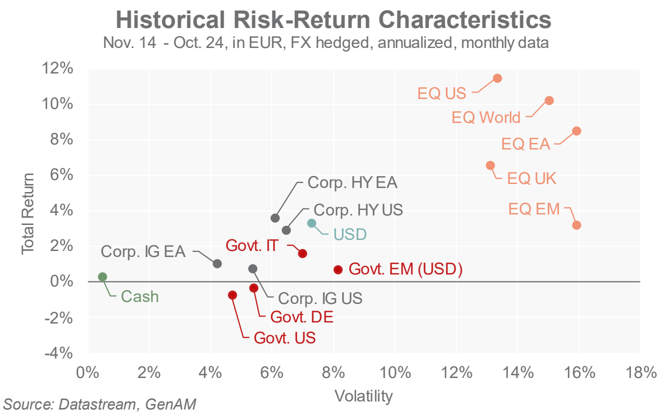


Source: MSCI, Bloomberg, GenAM calculations



Source: MSCI, Bloomberg, GenAM

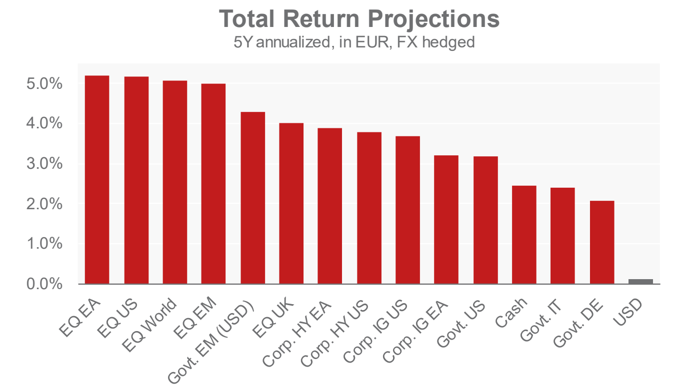
A lost decade in bonds. The chart below shows that both the Treasury and Bund indices have delivered negative nominal returns over the past 10 years, as the rise in yields has generated capital losses, particularly since the trough reached in 2020 (pandemic). In contrast the last decade has been strong for equities, with the MSCI World (developed markets) delivering more than 10% annual nominal returns. At that pace, portfolio value doubles in just over 7 years. The equity performance has been driven by the US, at nearly 12% p.a. This is strong, yet very much in line with US standards. Over the past century, the S&P500 10-year average nominal return (p.a.) stands at 11%, with the distribution going from -3% to +22%.



Source: Datastream, GenAM

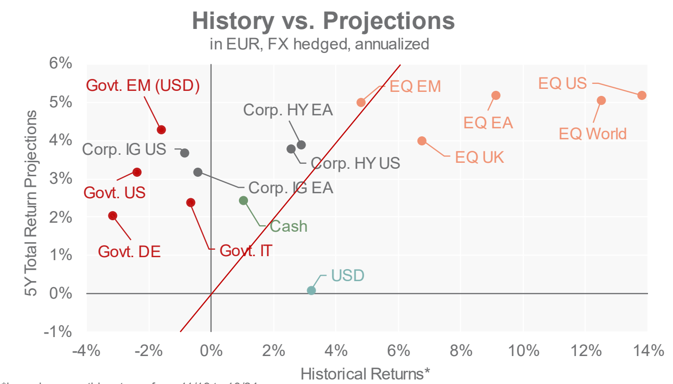
> *Our 5-year return expectations across asset classes are just around 5% and below*

Shaving expectations. Our return expectations for the next 5 years are mostly lower than a year ago. Marginally so in Fixed Income, as yields have pulled back a bit, which will eat into the income streams and/or pull to par. In equities, valuation have increased significantly; in other words, earnings yields have eroded, which will depress future returns. Arguably, the equity rally has also reflected strong earnings growth, especially in the US, and we have revised our index targets to the upside – mark to marking profits at a structurally higher level (see below discussion on profitability) – hence the limited changes in expected returns.



Source: Datastream, GenAM

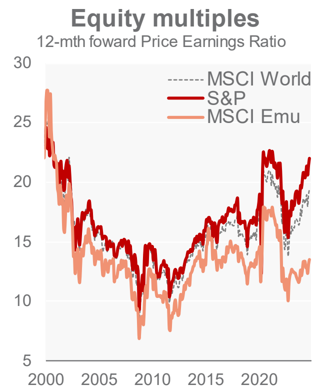
The chart below compares our expected returns for the next 5 years (ex-ante, y axis) to those of the past five years (ex-post, x axis). Any asset class on the right size of the 45° line is expected to lag the performance of the past 5 years. This is the case for all equity indices, except for Emerging Markets. US equities have delivered nearly 14% p.a. over the past 5 years, and we deem a repeat nearly impossible at the current record valuation levels – the MSCI US index is trading at 22 times the profits of the next 12 months. We expect Fixed Income to exit the ‘lost decade’ era, with the current level of yield offering decent carry, and the bias towards slightly lower yields potentially implying additional capital gains. Still, in developed markets, our forecasts imply FI returns of 4% or less in EUR (hedged).



*based on monthly returns from 11/19 to 10/24
Source: Datastream, GenAM

Equity valuation selectively elevated. Future equity returns tend to depend significantly on the valuation level at inception. The left one of the upper-right charts focuses on the king of equity markets, the US. The S&P500 earnings yields has dropped below 5% (inverse of the 12mf PER, now at 22), which suggests low single digits returns for the next 5-10 years. Arguably, returns over the past decade have exceeded what earnings yields suggested 10 years ago. This reflects both a strong *valuation expansion* (rising PER) and remarkable *profit growth*.

Source: S&P, Bloomberg, GenAM

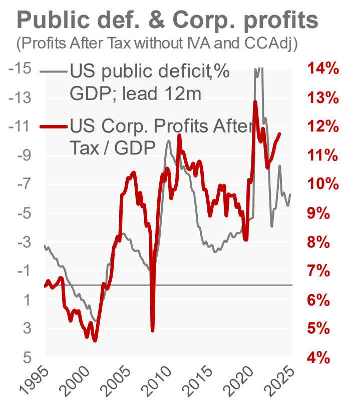


Source: Datastream, GenAM

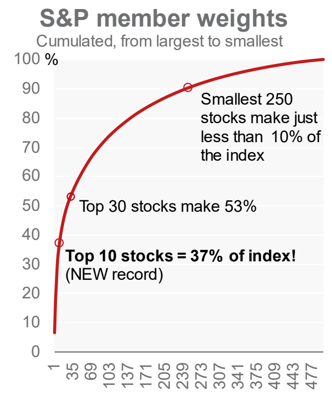
US equity valuation somewhat elevated, but ongoing fiscal profligacy supports profit growth

- On *valuation*, US 12m forward multiples are at levels unseen since the dotcom bubble at the turn of the century. We do not think a bubble has formed, yet historical evidence suggests that such valuation tends to be followed by periods of weaker returns.

- *Profit growth* has also been stellar. US corporate profits slumped to less than 5% of GDP through the dotcom crash; they also eased off through the decade that followed the Great Financial Crisis, as fiscal consolidation and consumer deleveraging hampered demand, to reach a local low of 8% of GDP at the start of the pandemic. They have now rebounded to near 12% of GDP, a historically high level. Profits are capturing an increasingly large share of GDP, as US real



Source: US BEA, Treasury Dpt, BBG, GenAM



Source: SPX, Bloomberg, GenAM calc.

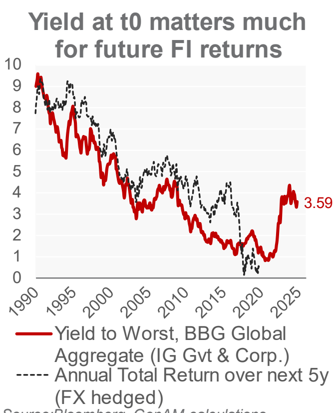
wage growth has lagged the rebound of labour productivity over the past couple of years. The left one of the bottom-right charts on the previous page also shows that corporations also tend to much benefit from fiscal profligacy. A Trump victory, via further corporate tax cuts and fiscal expansion (especially in a sweep), would likely continue to support profit growth.

One note of caution lies in the extreme concentration of US equity indices. The right one of the bottom-right charts on the previous page shows that the ten biggest US stocks now make 37% of the S&P500 market capitalisation, a new record. Historically, it has been hard for leading companies to continue to improve market shares and margins sustainably, as new competition emerges. Such concentration will also increase index volatility, as selected single stock moves will have a greater overall impact. In other words, the return/volatility mix of US equities is set to deteriorate relatively to historical standards.

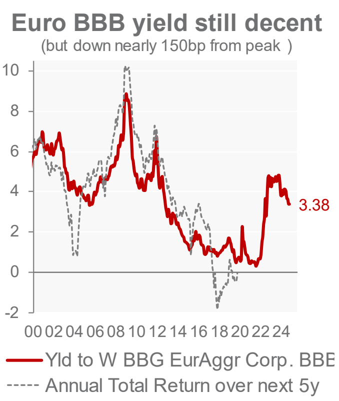
> *Return/volatility mix of US equities is set to deteriorate relatively to historical standards*

Fixed income: the end of suffering? It may appear paradoxical to talk about suffering for Corporate Credit where spreads are at historical lows. Yet Investment Grade indices have delivered pathetic nominal returns over the past decade, and deeply negative real ones. Let us remind that the US CPI has increased by 21.1% in the 5 years to Sep. 2024, and the EA one 20.6%, equivalent to respectively 3.9% and 3.8% p.a.

> *IG bonds have delivered deeply negative real returns over the past 5 years; the future is brighter but not stellar*



Source:Bloomberg, GenAM calculations



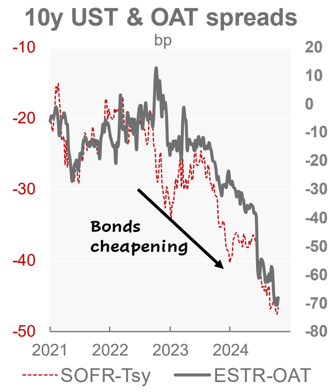
Source: Bloomberg, GenAM calculations

The charts above show that 5-year nominal IG returns track yields to worst (YtW) at inception. In the past 5 years, actual returns have even undershot the very low yields at inception, as the back-up in yields has produced capital losses. Looking forward, our bias towards lower US yields imply that returns may beat the current YtW (3.60% for Global Aggregate).

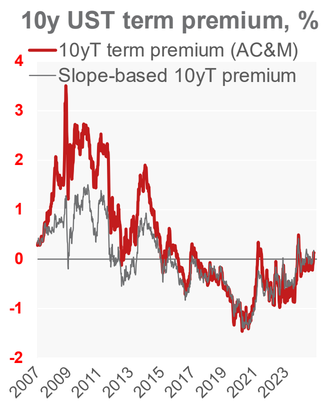
Credit spreads are now sitting at near record lows, hence the extra return from credit risk promises to be limited. That said, we expect spreads to stay tight. As discussed last year, the “risk-free” nature of government bonds appears increasingly wobbly: they are exposed to the risk of rating downgrades, as well as to default or monetisation. Arguably all *Fixed Income* assets are exposed to monetisation, but as we saw through the recent inflation crisis, greedflation made corporate profits and solvability resilient, contributing to spread narrowing.

A key fact remains that government balance sheets have uniquely deteriorated since the GFC. In contrast, the US consumer has deleveraged, with household debt falling from 130% of disposable income to nearly 90%. Savings rates are very elevated in Europe and China. Corporate balance sheets are also relatively healthy, though this applies more to large companies than SMEs, with some cracks also appearing at the private credit level (companies backed by private equity capital showing greater default rates).

We thus expect the **relatively poor government balance sheet position to keep risk premia over sovereign bonds structurally low, including credit spreads**. The left chart below shows the large cheapening of government bonds on a swap spread basis, on both sides of the Atlantic. At the current level of yields we start seeing value in duration extension, but term premia are still too low to ensure large extra returns (especially in EUR).



Source: Bloomberg, GenAM

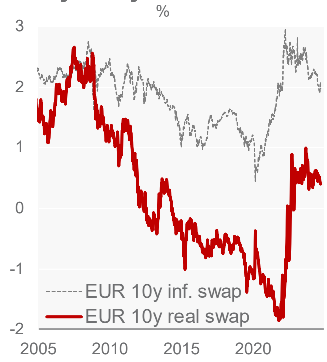


Source: Adrian Crump & Moench, BBG, GenAM

In all, Fixed Income assets will perform much better in the coming 5 years than they have in the past 5 and 10 years. But real yields remain subdued, at 0.30% in 10-year Bund and 1.90% in 10-year TIPS (barely more than Bund linkers, after FX hedging in EUR). Of course, this is much better than the deeply negative levels seen just 30 months ago (Spring 2022). Rates volatility is expected to resume its decline from the peaks reached in 2022-23, during the inflation crisis.

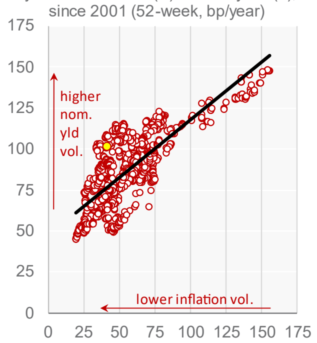
However, it is unlikely to return to the very subdued pre-Covid levels. Arguably realised nominal yield volatility appears elevated relative to inflation breakeven volatility (right-hand chart below). But we fear the latter may rise. Structural factors suggest inflation will not return to the pre-Covid lows, but deflationary pressures from China and weak demand in the EA could still create downside surprises in this cycle – this makes **inflation particularly hard to predict**.

€ 10y real yield & inflation



Source: Bloomberg, GenAM

Realised rates volatility



Source: Bloomberg, GenAM calc.

2. Macro backdrop

The global economy keeps recovering from the deep adverse shock from the pandemic. Yet the speed across regions has significantly diverged. Europe – while likely resuming its recovery in 2025 – will remain burdened by lost competitiveness and high energy costs. The US, by contrast, keeps benefitting from a solid labour market and striking productivity gains. We expect inflation to gradually ease further, allowing central banks to cut rates to around neutral rates, which would still exceed pre-pandemic levels. China will see its growth potential slowing, with woes around its oversized property sector adding to structural headwinds from unfavourable demographics.

Signs of a turn in the global manufacturing cycle in spring turned out to be a fata morgana. Persistent weakness of the Chinese economy and unfinished normalization in the post-pandemic consumption pattern away from goods towards services are key factors. Looking ahead, we expect these headwinds to diminish over the coming years, helped also by further rate cuts. Moreover, the announcement of a bold monetary and fiscal policy stimulus by the Chinese authorities will provide tailwinds for global growth near-term.

Ongoing disinflation backed by energy prices … Inflation has been receding over the past twelve months on both sides of the Atlantic. Helped by a volatile decline in energy price inflation euro area inflation even temporarily even fell below the 2% threshold in September. While the favourable base effects are set to peter out, stable energy supply lets us to assume energy price inflation in line with the historical average over the coming years.

… and underlying inflation to slowly come down too. Underlying price pressure is normalising more sluggishly than energy price inflation as high wage growth is abating only slowly, with the latest Euro Indeed wage tracker still pointing to 4%yoy. In the US, the employment cost index is down from a peak of 5.1% yoy in Q2 2022 to 4.1% two years later. This reflects a lagged adjustment of wages to the inflation spike that will gradually fade as the labour market gets back into balance. Longer term, a demography-driven labour force slowdown will likely support workers' bargaining power, keeping wage growth at around 3% yoy, slightly higher than before the pandemic. However, this will be offset by the continuation of the productivity gains seen over the last couple of years. All in all, we expect inflation to lastingly recede towards target by 2025.

Markets have largely priced out the risk of a lasting inflation overshoot. Inflation expectations over the medium and long term have stabilised at elevated levels (15 to 30y EUR break-evens, which include an inflation risk premium are in the 2.00% to 2.40% range). The ECB Survey of Professional Forecasters anticipates average inflation at 2.0% over five years– down from the peak of 2.2% – and sees the risks only slightly tilted on the upside now.

> *Upside inflation risks from Middle East war and tariffs vs. downside from China deflation*

We see two major upside risks to our benign inflation outlook. The war in the Middle East might escalate, reducing oil supply thereby triggering a stagflation shock. A Trump victory in the US election may result in higher tariff-driven import prices, in the case his program were to be fully implemented. Likewise, the announcement of the European Commission to levy tariffs of up to 45% on the import of Chinese EVs may escalate into tit-for-tat action. Extreme weather events and the transition to a green economy will also exert upside pressure on prices.

Reversely, we see downside risks to inflation primarily related to the Chinese economy. Tariffs may aggravate overcapacity, leading China to export deflation to the rest of the world. AI-led productivity gains could also depress inflation, as well as poor demand in Europe, more so in a deeper fiscal consolidation. All in all, we see inflation risks on both sides now, if still slightly skewed to the upside over the coming years.

Growth to trend lower. Potential growth will suffer from a falling working population in the coming decades, especially in Europe. Accelerated digitalisation and AI may boost productivity, but the net effects tend to be delayed and hard to quantify. We expect population dynamics to gain the upper hand and drive potential growth down. Given strong structural headwinds for the euro area economies (e.g. car industry, fiscal consolidation) we revised EA growth potential down to 0.8% (from 0.9%) in five years. For the US we do not see these factors at work so that amid better demographics we see US trend growth within five years now at 1.9% (from 1.8%). That said, we expect the euro area economy to recover the current output loss from the manufacturing woes and grow slightly above potential in the years to come. We cut our estimated neutral policy rate within five years to 2.7% (from 3.0%) in the euro area but rose the US estimate to 3.1% (from 2.95).

Monetary policy easing to continue

Amid receding inflation pressure and stalling EA activity, the unwinding of the restrictive monetary policy stance started in 2024. The ECB's policy is already 75 bps below peak and the Fed's 50 bps.

Fiscal headwinds in the euro area. Unlike monetary policy we expect euro area fiscal policy to become more restrictive over the coming years. A still high post-pandemic debt-to-GDP ratios of 90% will need to be reduced to ensure debt sustainability amid lastingly higher interest rates. The euro area economies are already exhibiting on average a structurally negative primary balance, and the costs of ageing, the green transition and the rise in military spending towards the 2% NATO target all imply an augmented structural deficit of currently -2.2%. This concerns especially the highly indebted economies of France, Italy, and Belgium. With the Stability and Growth Pact (SGP) no longer suspended consolidation will need to intensify. The new SGP offers more flexibility and in our view is more credible than the old one, will hopefully spur consolidation. While this is very welcome from a debt sustainability perspective, it also implies persistent headwinds to growth over the projection horizon. In the US, federal debt is expected to reach 110% of GDP by 2029, from 95% currently. With little appetite for fiscal consolidation and given the huge political polarisation, structural measures to rein in the deficit appear unlikely.

2029 macro and central bank scenario

Item	Euro area		US	
	current	2029 proj	current	2029 proj
Equilibrium real short term rate (r*)	0.5	0.7	0.7	1.1
Inflation (HICP, core PCE for US)	1.8	2.0	2.4	2.0
Potential growth	1.2	0.8	2.1	1.9
Neutral Central Bank policy rate	2.3	2.7	3.1	3.1
Current real short term rate (r)	1.6	0.2	2.5	0.9
Current nominal short term rate (ESTR, SOFRE)	3.41	2.2	4.9	2.9

Source: Datastream, GenAM calculations

ECB balance sheet reduction continues, Fed will complete it soon

Central banks continue to normalize their balance sheets around the globe. While the Fed has started slowing down the pace of disposal of bonds and should complete quantitative tightening by the beginning of 2025, the ECB is still in the process of unwinding its asset purchases. Apart from the non-reinvestment of APP-related redemptions it started to unwind PEPP holdings by € 7.5 bn per month in July and will likely fully stop reinvesting PEPP-related redemptions from 2025 onwards. This will then reduce the balance sheet by about € 45 bn per month and further bring down excess liquidity of currently still €3 tr. The ECB communicated that balance sheet reduction will remain in the backseat as a structural policy issue which is to be distinguished from the actual policy stance.

EUR terminal rate below neutral? Due to headwinds from fiscal policy and ongoing balance sheet reduction in the euro area, we see policy rates to terminate at levels slightly below neutral. The derivation of the neutral policy rate, of course, remains subject to great uncertainty. According to a recent ECB study there is overall agreement that r-star, the equilibrium real interest rate, rose after the pandemic. But recent estimates on average suggest that the current level is positive but significantly lower than the 0.9% we assumed last year. As we deem the new SGP more effective than the old, net government bond supply will likely diminish. Moreover, key economies like Germany suffer from structural problems holding back investment activity and capital demand. This translates into a neutral policy rate of 2.7% by 2029 and we expect the ECB to bring the money market rate to 2.2%, thus below this reference (see table above).

Global politics remains the biggest source of risk

In the US the economic outlook is more favourable, with potential growth around 2% and some upside potential if the latest increase in productivity proves long-lasting. This means that our estimate of r-star is some 40 bps higher than in the euro area, which is also due to less appealing factors such as the wide fiscal and current account deficits.

Politics constitutes the biggest source of risk to the outlook. The potential return of Trump, backed by a loyal Congress, could trigger an accelerated fragmentation of world trade, with steep tariffs imposed on China and restrictions on European imports. A broader confrontation with China would strain supply chains. Furthermore, military escalation keeps looming in several hotspots. An attempt of invasion of Taiwan by China would sharply disrupt trade in one of the busiest areas of the world and impair the functioning of strategic industries like semiconductors. In the Middle East, greater tensions between Israel and Iran could undermine oil and gas supply. Policy inaction, specifically on climate, creates risks. Disruptive climate events like hurricanes or protracted droughts are more probable. In all these scenarios global inflation would rise and become more volatile, while growth would take a hit, creating fresh headaches for central bankers.

3. Financial return expectations

To derive our updated 5-year total return expectations for the various asset classes, we resort to a top-down approach: We use our growth, inflation, and central bank forecasts as inputs to asset class models that derive point forecasts for yield levels, spreads, exchange rates and equity performance. We focus on key liquid asset classes for euro-based investors, including Government Bonds (EA, US, EM), Credit (US and EA), Equities (various markets) and FX (focus: USD). We do not hereby cover unlisted assets and/or alternative assets. A more detailed description of the underlying methodologies is provided in our original 5-year return report.

3.1 Fixed income assets: still attractive returns

Attractive returns. Following a decent 2023 and a mediocre 2024, the environment looks slightly supportive for fixed income assets. The 12 months to end 3Q24 have actually been strong, as that period encapsulates the sharp rally of 4Q23. We expect decent positive returns over the next 5 years, but the performance drivers will vary from the discussion a year ago. Expected returns will be more modest than we forecast last year, but well above their mediocre 10-year average.

Asset Class	Coupon	Mark to Market*	Valuation adj.**	Credit migration	Credit default	Overall***
German Government Bonds	1.9	0.4	-0.2			**2.1**
Italy Government Bonds	3.3	0.2	-1.1			**2.4**
US Treasury Bonds	3.3	0.5	0.8			**4.7**
Euro IG Corporate Bonds	3.0	0.4	0.0	-0.1	-0.1	**3.2**
Euro HY Corporate Bonds	5.3	0.6	0.1	-0.2	-1.8	**3.9**
US IG Corporate Bonds	4.6	0.3	0.5	-0.1	-0.1	**5.2**
US HY Corporate Bonds	6.9	0.4	0.0	-0.2	-1.9	**5.3**
US EM External Sov. Bonds	5.8	0.5	0.3		-0.8	**5.8**

*roll and pull-to-par effect
**changing yield level at a certain time
***annualized returns over 5 years in local currency and in %

Long-term valuations change. The macroeconomic assumptions have changed slightly, as have the long-term fair values of most fixed income assets. An upward revision to the equilibrium real short-term interest rate (r*) pushes up our fair values for US yields, while in Europe instead we have slightly lowered our German long-term forecasts. In the credit space, considering the recent spread rally, long-term valuations have been tightened.

Asset Class		FV Approaches				5Y Forecast
	Currency	*Current**	*Regression*	*Forward*	*LT average*	*FV ** *	*Applied*
German Government 3-year	EUR	2.05%	2.20%	2.20%	0.13%	1.99%	2.10%
German Government 10-year	EUR	2.26%	2.45%	2.72%	0.62%	2.38%	2.40%
Italy Government 3-year	EUR	2.64%	3.01%	3.76%	1.00%	3.11%	3.00%
Italy Government 10-year	EUR	3.53%	4.21%	4.51%	2.24%	4.13%	4.20%
US Treasury 3-year	USD	3.87%	2.88%	4.24%	1.99%	3.34%	3.20%
US Treasury 10-year	USD	4.06%	3.10%	4.59%	2.43%	3.63%	3.50%
EM Ext. Gov. (spread in bps)	USD	232	361		323	342	340
Euro IG Corp. (spread in bps)	EUR	112	97		119	101	100
Euro HY (spread in bps)	EUR	342	325		401	340	340
US IG Corp. (spread in bps)	USD	93	103		133	109	110
US HY (spread in bps)	USD	315	335		450	358	370

*as of 10/10/2024
**weighted average (Govies: 50% regression, 40% forward, 10% LT average, EM: 50% regression, 50% LT av., Corps: 80% regression, 20% LT average)

Carry in the driver seat. Carry should be the most important driver of FI returns, as the expected yield decline is now more limited. Globally, carry is lower than a year ago, but still provides a very decent buffer in case yields rise. This is a welcome factor as valuations have become less attractive since the rally in core rates in Q4 23 and the compression of credit spreads in 2024.

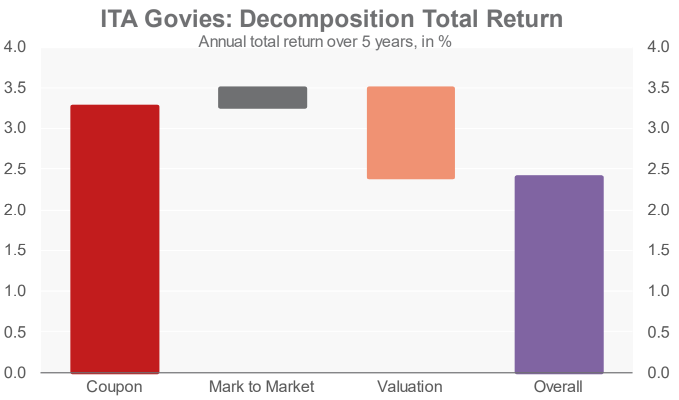
Higher defaults than historical average. We expect defaults to be slightly more of a drag on returns, as the previous period of higher yields still weighs. Defaults in both EM and HY credit will remain above their long-term historical averages. In EM, market access has improved but remains challenging. Fragile countries have borrowed at double-digit yield levels (Kenya) and interest-to-revenue ratios are higher than historically, sowing the seeds for more defaults in the future.

3.1.1 Government bonds

A year ago, we forecast very solid total returns for government bonds. At over 11%, Italian BTPs have performed exceptionally well over the last 12 months. Even German Bunds have achieved a strong total return of almost 6% (US Treasuries just under 8% in local currency, achieved essentially in 4Q23).

We had expected yields to fall, but the actual decline in Bund yields in late 2023 was much sharper than forecast. BTPs also benefited from a sharp tightening of spreads. The flip side of the coin is that this trend cannot continue indefinitely, so that investors should prepare for lower total returns in the future.

Given a muted EA growth outlook and the slightly lower key rate forecasts, **we lower our yield 5-year forecast for 10-year Bunds marginally** by 10 bps to 2.40%. By contrast, we raise our forecast for US yields by 20 bps (3.5% for 10y tenor). This reflects a more solid growth outlook and a slightly higher key rate forecast, but also the upward pressure emanating from persistently high budget deficits. As a result, we forecast the transatlantic yield spread to remain on a moderately higher level than assumed a year ago. Despite the higher forecasts, **US yields still have downside potential over the next 5 years,** in contrast to European peers.



Source: Bloomberg, Datastream, GenAM

We assume that the BTP/Bund spread will slightly widen from its current low level. Although Italy is not expected to be downgraded to non-investment grade in the base scenario, concerns about debt sustainability will keep lingering. Considering the reduced Bund yield forecast and the realised spread narrowing, this nevertheless leads to a noticeable reduction in BTP yield forecasts vs. last year's forecast.

> *Rising yields weigh on return outlook of EA government bonds*

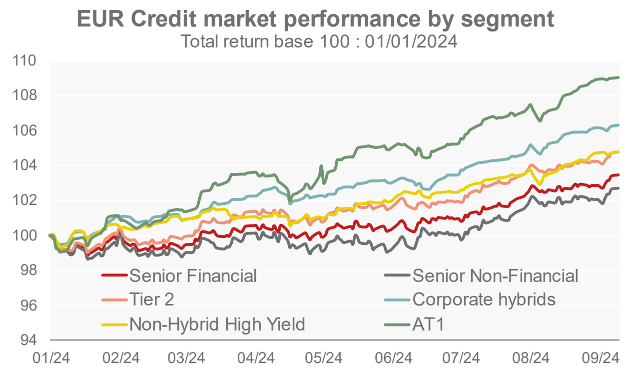
Overall, government bonds must pay tribute to their past performance, with the **return outlook more muted compared with the last 12 months**. The income component (coupons) remains the most important factor in the return outlook for government bonds.

US Treasuries remain the undisputed frontrunner (both in local currency and hedged), mainly due to the expected further decline in yields. The high coupon keeps BTPs in second DM sovereign place despite the forecast spread widening (2.4% annualised return over 5 years, see chart above). It should be noted that the volatility of Italian government bonds has recently fallen below that of German bonds, as spread movements have tended to offset yield changes. This makes BTPs more attractive from an investors' point of view. At 2.1% p.a., German Bunds remain at the bottom of the league, implying that the real total return over the next 5 years will be close to zero. With ECB key rates high, cash offers an attractive alternative (particularly at the beginning of the forecast horizon). Overall, we expect cash to generate on average 2.5% p.a. over 5 years.

3.1.2 Credit: still attractive given the high carry

Since our update last year, Credit spreads have tightened significantly, supported by the perspective of monetary easing of major central banks. Indeed, lower yields are improving both technicals and fundamentals, provided they take place in an orderly manner. Lower interest rates mean companies' profitability improves thanks to lower financing costs. But the most powerful effect has been the demand from investors appealed by the elevated all-in yield in a context where monetary products are expected to gradually offer lower returns.

Following the rally over the past twelve months, **we are modestly cutting our return assumptions for all segments of the credit market.** The contribution of return components are different compared to 2023:



Source: Bloomberg, BofAML indices, GenAM

1/ The underlying yield contribution is positive, as mentioned in the previous section, though at more muted levels. Spread forecasts are also lower compared to last year both because the long-term average decreased and because we generally forecast lower levels for the spread complex. Hence carry is much lower compared to 2022 and 2023 as both interest rates and credit spreads have declined.

2/ Valuation turns slightly negative for prospective performance, as both our fair value models and the 10Y moving average point to moderately wider spreads.

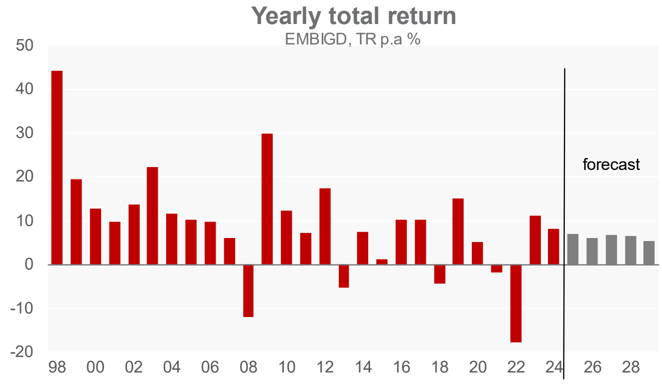
We slightly reduce the adjustments we make for defaults this year. Indeed, according to Moody's, we are currently just over 3% in Europe and over 4% in the US, which is close to the long-term average, and we are expecting them to fall further. However, we continue to expect a higher long-term average of default-related losses. Indeed, over the past decade, US defaults rates have exceeded European ones because of a different bankruptcy regime and support during the Covid was directed directly at individuals rather than companies. This time around in Europe, the unconditional support that European governments provided to their private sector during Covid to prevent economic destruction will not be as generous in the future as 1/ public debt has already increased in recent years; 2/ central banks cannot buy bonds on a sustainable basis when inflation is no longer undershooting; 3/ markets are very vigilant on fiscal developments and can abruptly restrict market access; 4/ there is an important wall of maturities over the next three years, which implies increased liquidity risk.

> *Defaults will be higher than the long-term average, but net risk-adjusted returns are still very attractive relative to equities.*

Hence our 5Y TR expectations for credit are lower compared to last year's forecasts with IG above 4% in Europe and in the US while we expect HY to deliver around 5% total return over the next 5Y in both regions.

3.1.3 EM sovereign bonds: enjoy carry

After an impressive return since our last update a year ago, we still see a positive medium-term outlook for EM USD bonds, with a 5-year return of close to 5.8% p.a. (in USD).



Source: JP Morgan, Bloomberg, GenAM

This is well below our previous exceptional forecast (8.8% p.a. expected in 2023), sourced in the higher spread and underlying yield levels at that time. Since then, EM spreads have rallied an impressive 160bp and the valuation proposition is now less attractive with EM spreads ex CCC names close to all-time lows. The 5-year expected return remains above the 10-year average and the risks are skewed to the upside, especially if the Fed easing cycle triggers a return of long-awaited inflows into the EM asset class, which have been scarce over the past two years.

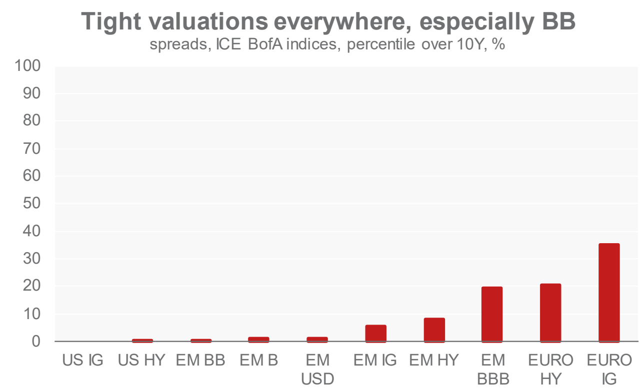
A carry trade, but not only. Carry will be the main contributor to performance with an all-in yield still attractive at 6.36%. Despite the recent decline, the yield is still 120bp above its 10-year average, providing a large cushion in the event of a sell-off in rates. We expect the carry to account for some 88% of total return. Much of this will come from CCC and distressed countries, but IG countries also currently offer above-average carry.

The other contributor to return is the positive duration effect from the decline in US core rates. However, given the expected limited decline in US Treasury rates, the duration effect will be more limited than the one assumed a year ago.

Returns dampened by unattractive valuations. The positive contribution from underlying US yields will be dampened by unattractive EM valuations. Spread in all rating buckets but CCC are very close to their 10-year lows. Our short-term model shows valuations a bit of rich in the HY segment and = fair in the EM IG segment. Thus, it is difficult to see further compression from external debt spreads in the medium term.

Source: Bloomberg, ICE, GenAM

Long-term credit risk slightly lower. We slightly cut or 5-year spread forecast from 350bp to 340bp. But from current levels close to 230pb, this still implies a significant widening and thus negatively impact returns. We maintain the same multiple approaches to forecasting our long-term spread fair value: (1) the 10-year average of EM spreads and (2) our long-term fundamental model based on the 10-year US real yield, oil price (Brent), EM inflation and global risk appetite. The fundamental value has barely widened (+3bp), but the long-term average has declined meaningfully, ultimately resulting in a tighter long-term fair value of 340bp.



Source: Bloomberg, GenAM calcuations

Defaults higher than history. We continue to expect higher defaults than in the past. While we do not expect any defaults in the next two years, the history of high yields has caused a rise in interest-to-revenue ratios for the lowest-rated EM countries. Primary market access has improved recently but remains difficult or at prohibitive yields. Recently issued bonds will need to be repaid and refinanced over the next 5 years. Fortunately, the situation is much less worrisome than in 2020-22, so the absolute level of defaults will be lower and will affect smaller EM countries. Systemic spillovers to the rest of the world are unlikely. Moreover, there has been intensive work to reform EM restructuring processes and recent debt workouts suggest upside potential in the recovery level**.**

3.2 Equities: expecting below norm returns

Since last year's report (25/10/23), the MSCI World index has risen by around 36% (Total Return), with the 12-month forward earnings (EPS) revised up by around 12% and US 10-year yields down by some 70 bps. In terms of our value Indicator (EPS divided by the 10-year rate adjusted for the equity risk premium), the US market (TR + 40%) is currently "only" 8% more expensive than a year ago; and the MSCI EMU (TR up 24%) 9% more expensive. The US index is very sensitive to long rates, and their decline is a boost for fair value.

Over the past year, EM equities (+28%) have shown an impressive performance as well, despite China's economic growth concerns and struggling real estate sector. They got support from a weaker dollar (-1.1%), lower EM yields and EMBI spreads (-195 bps and -65 bps respectively) and, more recently, hopes of a more substantial Chinese policy stimulus.

Behind equities' very strong performance, we see several key drivers. First, a solid rise in the ISM impulse, decent macro surprises, a bottoming of M2 money growth, improving US bank liquidity, falling inflation which induced higher real disposable income and the pullback in the long-term real rate. Furthermore, HY spreads have tightened by -150 bps, while decent EPS growth, high margins and increasing expectations of CB rate cuts have proven supportive too.

In our base scenario, we are constructive over the next 12 months, as rate cuts, better financial conditions, and sector rotation out of US Tech should help to offset the headwinds from slowdown fears, political uncertainty, and a lingering rise in volatility. We see total returns (TR) at 4% for S&P 500 with risks on the upside and 7% – 16% for EMU over 1 year. That said, compared to our Autumn 2023 5-year projections, we have increased US returns by 1.4pp while lowering the other markets by 0.7 – 1.0 pp (s. section 3.2.3).

3.2.1 Earnings outlook still superior in the US

We slightly increase our average earnings (EPS) growth over the next 5 years for the US (by 150 bps), in line with the improved GDP forecast. **We assume earnings growth of 7% p.a., near the historical average** of 7.1% since 1987 and below 9.5% since 2009. Indeed, our proprietary models based on the EPS long-term historical trend suggest a range of 7%-8%. We also consider a somewhat higher buyback yield potential, given currently very high free cash flows and some of the expected positive impact of AI on productivity. Despite moderate EA GDP growth, we maintain EA earnings growth at 3.5% p.a. This compares to averages of 4.7% since 1987 and 5.2% since 2009. Indeed, EPS growth of 3.5% looks rather conservative, especially when adding a buyback yield contribution of at least 1%. But we also consider higher macro uncertainties and structural weakness versus the US. For EMs, we factor in lower GDP growth (China's slowdown) and reduced expected earnings growth from 4.0% to 3.5%.

3.2.2 Long-term equity returns: the framework

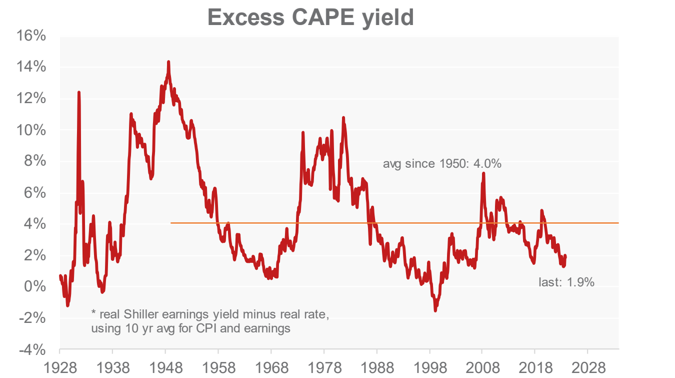
While long-term returns depend on fundamentals and stock market valuations, they are uncertain and particularly volatile over shorter time horizons.

To provide a quantitative framework in assessing prospective equity returns, we combine different approaches:

1. a regression-based approach employing forecasts for macro variables and other asset classes as an input,

2. a CAPE-based model, deriving return expectations from adjusted target price earnings ratios (PE) and future earnings growth,

3. a historical assessment of future returns consistent with current CAPE levels.



Source: Shiller, Datastream, GenAM calculations

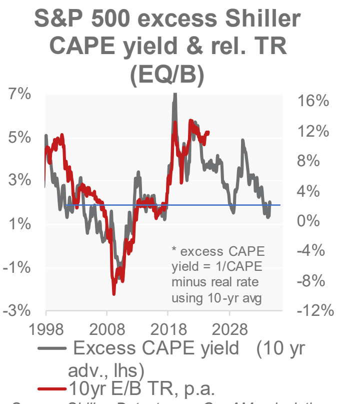
We then adjust the average of these three models by an estimated factor based on risks and under/overvaluation metrics, which we assume to correct over the 5-year time horizon. Below we briefly describe the three building blocks of the framework. For more details, please refer to our original publication.

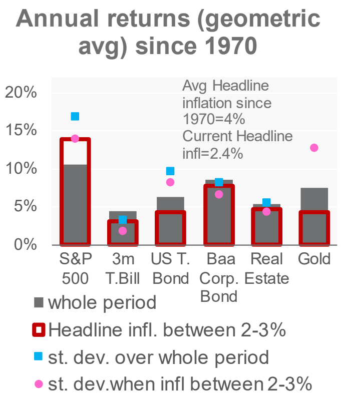
1. **The regression-based approach** employs our projections of the macro and fixed income variables to derive estimates of prospective equity returns. Variables used include GDP growth, 10-year government bond yields, EUR/USD and HY spreads. This macro-based approach is applied to US and the euro area markets. The models' forecasts for the MSCI EMU have fallen slightly from 4.7% to 4% p.a., with muted growth expectations partially compensated by slightly lower forecast in EA yields (an average of -25bps over the next 5 years vs. last year). The S&P500 results have risen to 5.5% from 4.4% p.a. because of our higher US GDP growth expectations, lower US yields and US HY spreads. This time we have also developed a regression model for MSCI EM based on S&P 500, USDEUR, US 10-year Treasury yield and US HY spread. The model has a high goodness of fit (R^2 of ca. 85%) and delivers a forecast of 7.1% p.a..

2. **Our proprietary CAPE-based model** uses our expectations for earnings growth, payout ratio (PR), dividend yields (DY), buyback yields, and target CAPEs at the end of the 5-year horizon. In addition, we derive total return forecasts based on modelled fair PEs over the estimation period (proprietary macro quant models). In the end, long-term returns are decomposed into three components: income (dividend and buyback yields), growth (earnings growth), and valuation (target CAPE).

Indeed, an equity investor gets the stream of cash yields plus the annual price appreciation. We use the US target CAPE expected at the end of 2029 as an anchor and then apply historical valuation gaps relative to the US for other markets. The target for the US CAPE is derived using mean reversion properties and qualitative judgement.

For the EA and EMs, we retain the valuation gap vs. the US based on the analysis of the data since 2007. The final CAPE targets are: 26x (US, +1 vs 1 year ago, coherent with lower CPI inflation and similar to the average since 1995), 15.2x (EA), and 14.6x (EMs). The latter are derived from the US CAPE targets, taking into account the gaps of around 40% since 2011. As our analysis of CAPE data for different CPI levels shows, a 26x level for the US would be commensurate with what we had historically when inflation stands between 2% and 3% (our forecast range). For the EA, we applied a more severe historical gap (since 2011) vs the US, at 40% (from 30%). Higher energy dependence vis-à-vis the US and the associated loss of competitiveness may prove to be a persistent drag (lack of political unity on strongly needed EU reforms), barely offset by limited progress towards greater fiscal integration and vigilance on structural reforms.





Source: Shiller, Datastream, GenAM calculations Source:NYU, GenAM calculations

Applying the CAPE targets and the earnings growth expectations described above, the positive price performance over the past year implies that 5-year projections for all indices covered have decreased on average by 0.5-1 pp vs. last year, to 8.2% and 7%, respectively for the EA and the US.

3. **Historical assessment**. We derive future return perspectives from the historical returns observed during periods when CAPE levels were in line with current levels. For all the markets under consideration, the dispersion of 5-year returns is large, and it decreases as the time window extends (e.g. from 5 to 10 years). For this reason, we start with a 10-year window, and, as a precaution, only for EMU (lower correlation of CAPE level and subsequent returns), we further adjust TR downwards by a quarter of the historical standard deviation (SD) of the same returns. The result is a projected TR of 5.6% for the MSCI EMU (-0.8% vs. last year), 4.1% for the S&P500 (-1.8%), and 3.9% for the MSCI EM (-3.6%).

Reduced equity outperformance vs. FI, looking forward. Diversify within US (to small cap & equally weighted SPX) and outside US to exploit better valuations vs. norm

In the final step, we assess the degree of current under-/overvaluation plus specific risks for each market under consideration. The resulting positive or negative adjustment is then attributed equally over the forecast horizon. We apply a negative factor to EA (-0.5pp p.a.) to account for expensive energy, lagging innovation and geopolitical risks. For the US, we make a positive adjustment (+1% vs prior -0.5%). This is justified by the AI supremacy, productivity growth, higher policy flexibility, higher R&D and education spending, energy independence, and higher population growth. Furthermore, after the last US GDP revision, we discovered the US economy grew substantially more rapidly than previously believed (including profits) and far faster than other wealthy countries, and the US saving rate has been corrected higher. The adjustment factor for EMs is modest (+0.5), balancing the significant undervaluation vs China's structural economic challenges. Still for the US, as a check, we have this time also run our Shiller approach based on the average risk premium achieved in the past (since 1871) for similar range of expected inflation. This gives an average expected US TR of 6.5%. Having said that, we recognise that the current US valuation (i.e. CAPE) is high relative to history. This suggests that investors should diversify their portfolios outside the US (EU, EM, Japan) and take exposure within the US to smaller caps – the Russell 2000 index – and to the equally weighted S&P 500 index. This is to smooth out the possible headwinds from a currently very concentrated S&P 500 index, which has an abnormal weight on Tech (the Magnificent 7 alone account for 32%).

Market	Hist. avg 5-year total return since 1998 (p.a.)	5-year total return projection (p.a.)
World (in $)*	7.5	6.6
US	9.3	6.7
EA	6.8	5.2
UK**	5.8	5.7
EM (in $)	6.4	6.5

*derived from the single returns in local currency, taking into consideration the expected FX moves

** On valuation grounds, we decided to put the UK projection 0.5% (p.a.) above that of the EA

For EMs, TR forecasts are supported by relative appealing valuations as well as higher GDP growth and expectations of a weaker US dollar (-1.4% vs. EUR p.a.).

3.2.3 Equities: better outlook vs. FI

Except for the US, expected 5-year expected equity returns are slightly lower than last year. The earnings outlook has brightened a bit, but this is largely offset by the more demanding valuation. This makes the outlook for equities subdued from a historical perspective. We predict a meagre 2% additional TR in US equity vs Treasuries which is very contained relative to history. This is explained by a current CAPE yield gap vs real 10-year yields, almost 1.5pp below the historical norm: i.e. US equities are less attractive vs. 10-year bonds and should render a lower excess TR in the next years. Indeed, the 2pp differential return compares with an average of at least 4% since 1970 or 1928, and even more during periods when headline inflation was between 2% and 3%. The EMU (and ex-US countries) CAPE yield gap, on the other hand, is aligned with history, although risks and volatility may still weigh on future TR.

Expected returns (p.a.)	EA	US	EM (in $)
Regression models (macro- and financial variables)	4.0	5.5	7.1
CAPE-based model	7.5	5.4	7.1
Historical returns coherent to current CAPE levels	5.6	4.1	3.9
Average	*5.7*	*5.0*	*6.0*
Adjustment due to risks & current over-/undervaluation	-0.5	1.7	0.5
Final projection	**5.2**	**6.7**	**6.5**

Concerning final return expectations vs. last year, we have increased our projections for US equities (by 1.4pp), while lowering other markets' (by 0.7pp for EMU and by 1.0pp for EM). Thus, S&P500 is expected to provide the highest returns over mid-term, being closely followed by EM equities. However, the latter are characterized by higher volatility. Rising protectionism and trade tensions could impact supply chains and EM economies negatively.

Equity risk premia too low? Compared to historical rolling 5-year averages (since 1998), our 5-year equity return expectations are almost 25% below for developed markets and are in line for EMs. Equities are expected to beat most of Fixed Income, yet only by a relatively narrow margin compared to history for US equities, which raises some questions for investors, especially given the significantly higher volatility compared to bonds.

3.3 FX: moderate USD downside

Apart from euro-based assets, we also consider a few USD-denominated asset classes, which offer diversification benefits and access to markets with higher yields. Yet FX risk is not negligible. For investment in USD denominated bonds, FX moves may easily dwarf volatility caused by changes in interest rates. For example, volatility in the EUR/USD over the past 10-years (7.3%) exceeded that of US Treasuries (4.7%) by a factor of 1.6. A key decision is thus to either hedge USD exposure or engage in FX exposure.

Hedging USD FX risk remains costly though, currently amounting to around 1.5% p.a. (based on 5y forwards), almost unchanged from last year. Alternatively, if left open, expected returns in EUR hinge on the USD outlook. In our summary tables, we show the results for all three dimensions (local, hedged and unhedged in EUR).

5y projections EUR/USD

	Forecast	Weight
Fair value projection (regression)	1.118	30%
PPP model	1.202	70%
Weighted avg	**1.177**	
Projection after qual. adj.	**1.170**	
Current (10/10/2024)	1.092	
Spot return USD p.a.	-1.36%	
Forwards	1.175	
Implied carry p.a.	1.46%	
Total return p.a.*	**0.1%**	

*Source: Datastream, GenAM calculations; * spot return + carry*

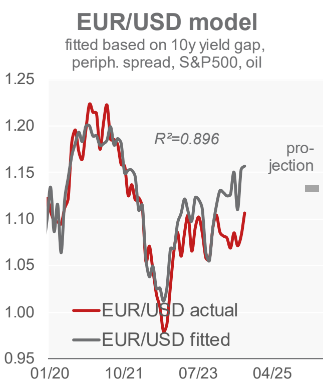
We favoured USD hedging in last year's outlook. The almost 2+% USD depreciation (vs. 1.5% hedging costs) proved this call slightly beneficial. Looking ahead, we continue to see the benefits of FX hedging tight prevailing, but the marginal benefit vs. open exposure has shrunk further. This is because our 5y EUR/USD target is unchanged (1.17), but the starting level is now higher (1.09 vs. 1.06 a year ago). This implies an annual USD depreciation of 1.4% (see table). The costs of are only marginally higher (0.1% p.a.), while eschewing large valuation risks from FX volatility. Given the not negligible risk from FX exposure, hedging may still be the preferred option.

We employ various steps to achieve at our 5-year EUR/USD target. As in our previous long-term reports, we start with two quantitative approaches: (a) a mean-reversion framework based on **purchasing power parity** (PPP) and (b) projections based on a financial market **fair-value model**. We then add a qualitative adjustment to the weighted average of these approaches. Finally, we add the forward-implied carry (the reverse of the hedging costs) to arrive at the expected benefit (+) or disadvantage (-) of leaving USD open vs. a hedged exposure.

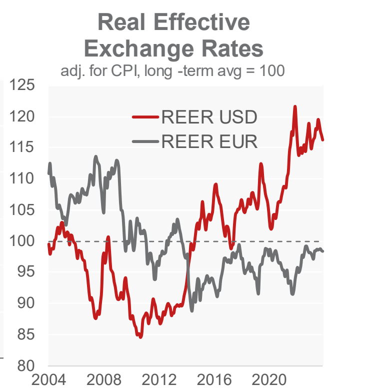
For (a), we employ OECD PPP values for the EUR/USD in 2023, infer current values from CPI data and project the further evolution by 2029 based on our US and euro area inflation forecasts. This projects PPP at 1.40 in 2029. Assuming a mean reversion towards PPP with a half-live of four years, this implies a spot rate slightly above 1.20 by 2029, somewhat lower than last year's estimate of 1.227.

For (b), we use a EUR/USD regression model based on 10y US and Bund yields, EMU risk (spreads on Southern Europe government bonds), overall risk sentiment (proxied by the S&P500), and the oil price. It explains 90% of EUR/USD variation since 2020 (left chart below). The model suggests an undervaluation of the EUR/USD of ~5%. We assume three quarters of this gap to close over the next 5 years. There is also some downside to the projected fair value, to a large extent driven by widening EGB spreads. Combined, these factors imply a projected fair value of close to 1.12, materially lower than in last year's update (1.18).

The weighted average of the two approaches (attaching 30% to the fair value model and 70% to the PPP approach) renders a target of 1.177, about 4 cents lower than last year's gauge.[1]



Source: Datastream, GenAM calculations



Source: Datastream, GenAM calculations

Other metrics point to USD richness. Alternative approaches support the tendency of a further EUR/USD accent on valuation grounds over the longer term. The real-effective USD is still dear, exceeding its long-term norm by 17% (right

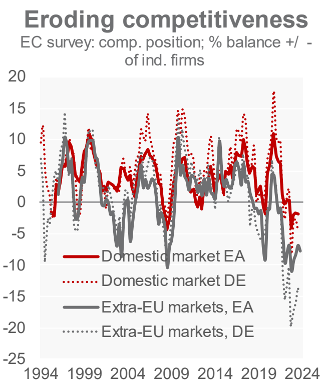
[1] We also provide forecast EUR/GBP for UK equity exposure. The PPP model (applying a 5-year half-life time to the gap vs current) renders 0.93 in 5 years, consistent with the ~9% overvaluation of GBP REER identified by the IMF for 2023 (likely to have grown after another 3% appreciation). Emplyoing this target renders a 2.0% annual GBP. This favours hedging GPB exposure (annual cost of 1.4%).

chart on the previous page) while the real effective EUR seems roughly aligned.

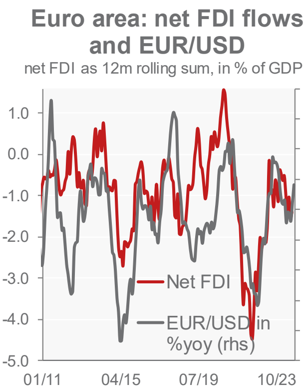
> *Hedging USD exposure helps to reduce risk, but is unlikely to materially change expected returns compared to open FX exposure*

These findings rhyme with this year's IMF External Sector Report, which suggests a milder overvaluation for 2023 of about 6% (with current USD REER up another 2% vs. last year's average). The Report deems the EUR slightly cheap (-1.7% mid point) for 2023, but the EUR has gained close to 2% in the meanwhile.

In our **qualitative overlay** to the model implied values **we see up- and down-side forces roughly in the balance** this year. The USD may suffer from further reserves diversification. As shown by a massive increase in official gold purchases, the incentives for several EMs to diversify out of the USD have risen over the past years following stiff sanctions imposed on



Source: EC, Datastream, GenAM



Source: Datastream, GenAM

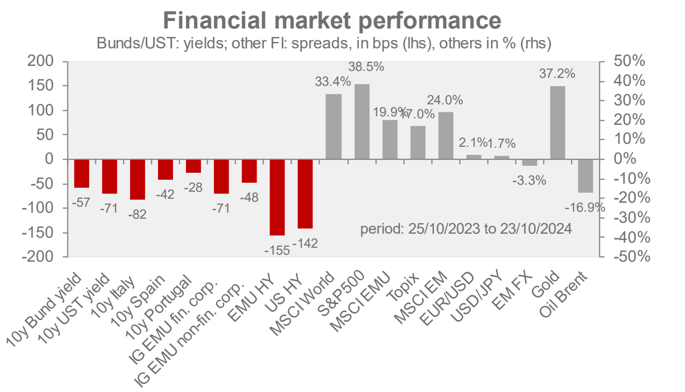
Russia and lingering trade frictions with China. The greenback may also face some further headwinds from an increasing public debt pile. Deep political divisions may continue to prevent the next administration from endorsing serious fiscal consolidation. The CRFB – an independent fiscal watchdog – sees US public debt rising from 100% of GDP now to 125% in 10-years, with both Harris and Trump fiscal agendas adding upside risks.

These headwinds for the USD, however, may be slightly more than offset by challenges faced by the EUR. The energy crisis in the wake of the Ukraine war and sticky regulation have deepened competitive disadvantages of European firms in global businesses (see chart above). Furthermore, due to its strong exposure to China, Europe looks more vulnerable to a further fragmentation of global trade links. These challenges are likely to keep capital inflows into Europe lukewarm for longer. Net FDI has recovered from the double blow of the pandemic and Russia's invasion of Ukraine but will struggle to gain traction (right chart, left column),

Overall, we apply a slight discount to the model-implied forecasts and employ a EUR/USD 5-year target of 1.17. This implies an annual spot depreciation of -1.4%, which almost exactly matches the costs of hedging USD exposure via forwards (-1.5%).

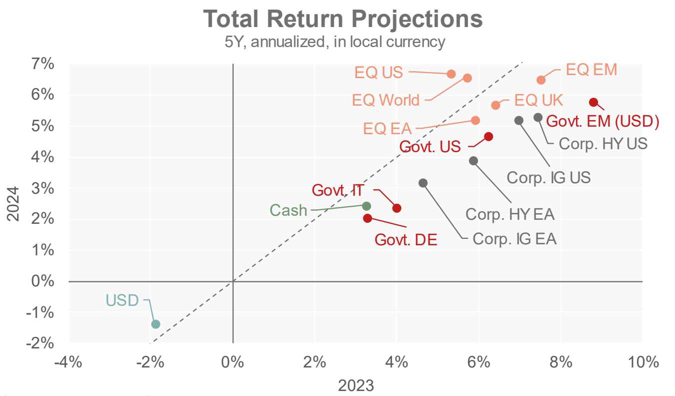
4. Conclusions

In last year's update of our long-term return expectations we flagged the striking appeal of fixed income (The power of yield) following a rise in yields that took 10-year US Treasury yield temporarily to around 5%, levels we deemed well above long-term equilibrium. Since then, core yields have retraced nicely (10y UST down about -70bp, 10y Bunds by about -60bp, see chart below) while yields on Southern European papers and Credit have rallied on sharply falling spreads. Global equities have advanced by 36% (TR) even if held back by more meagre returns on European stocks (up by around 20%).



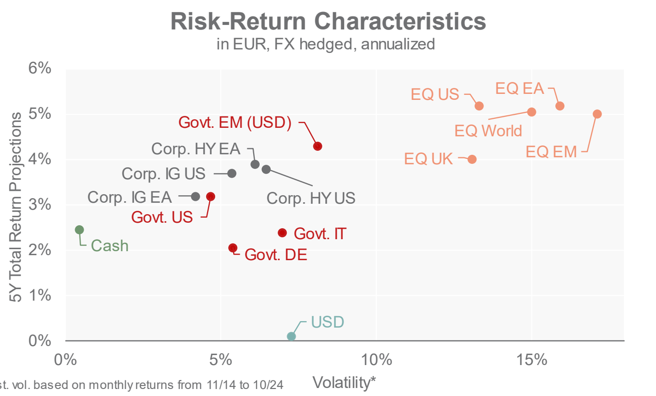
Source: Datastream, GenAM calcuations

Following this massive rally, it comes with little surprise that the **return expectations for the coming years are now generally lower**. This is reflected in the upper chart on the next page which shows almost all expected returns smaller than in the 2023 update (i.e. below the dotted 45° line). While we have cut 5-year target values for both Government and Corporate bonds slightly, this is not enough to compensate for the lost attractiveness as entry yield levels have come down. This not only reduced the coupon but also the scope for valuation gains. Expected annual returns for European fixed income are 1.2pp (Bunds), 1.4pp (IG Credit) and 1.6pp (BTPs) lower than a year ago, while the prospects for Cash have shrunk by 0.8pp.



Source: Datastream, GenAM

For fixed income investors it should still pay out to diversify into non-EMU papers. We expect US Treasuries to outpace returns Bunds by one third (3.2% vs. 2.1% p.a.) and render similar returns as riskier EUR IG Credit even after taking still elevated USD hedging costs of 1.5% into account. This is mostly because we see some more pronounced downside for US yields by the end of the horizon from current levels. HY exposure in both the EUR and USD (projected to render 3.9% and 3.8% p.a.) should perform well as contained default rates are unlikely to dent the risk premium on the asset class by much. This still pales against EM debt for which the high carry and lower underlying US yields facilitate an annual return of 5.0%.



*hist. vol. based on monthly returns from 11/14 to 10/24
Source: Datastream, GenAM

Expected **returns on European equities are slightly lower** vs. last year's exercise following the gains posted over the past 12 months. The still challenging environment for euro area companies (lost competitiveness, lagging recovery, strong exposure to global trade fragmentation) neither helps. Yet despite the sharp rally, we have **slightly raised the expected returns for US equities**, with earnings growth upgraded on raised GDP levels and expectations, higher margins and productivity gains (AI) while lower US yields and receding inflation keep the risks to valuation at bay.

It marginally paid off to hedge USD exposure over the past 12 months – as we had recommended –, as the greenback fell by 2%. With the EUR/USD target of 1.17 unchanged, this implies a smaller USD depreciation than pencilled in last year. While the drag on returns from open (-1.4% p.a.) and hedged USD (costs -1.5% p.a.) exposure are now very similar, most investors may want to opt for the latter for the benefit of reducing the volatility of the portfolio.

Total Return Projections

(5Y, annualized)

Asset Class	Currency	Local	EUR (FX hedged)	EUR (unhedged)
Cash	EUR	2.5%	2.5%	2.5%
Govt. DE	EUR	2.1%	2.1%	2.1%
Govt. IT	EUR	2.4%	2.4%	2.4%
Govt. US	USD	4.7%	3.2%	3.3%
Govt. EM (USD)	USD	5.8%	4.3%	4.4%
Corp. IG EA	EUR	3.2%	3.2%	3.2%
Corp. HY EA	EUR	3.9%	3.9%	3.9%
Corp. IG US	USD	5.2%	3.7%	3.8%
Corp. HY US	USD	5.3%	3.8%	3.9%
EQ World	USD	6.6%	5.1%	5.1%
EQ US	USD	6.7%	5.2%	5.2%
EQ EA	EUR	5.2%	5.2%	5.2%
EQ UK	GBP	5.7%	4.0%	3.5%
EQ EM	USD	6.5%	5.0%	5.1%
		Spot	**Carry**	**Total**
USD		-1.4%	1.5%	0.1%
GBP		-2.1%	1.6%	-0.5%

Stagflationary shocks and public debt worries are key risks to the outlook, but we would neither dismiss upside risks from a protracted Goldilocks scenario

Among multiple **risks to our base projections**, we see three key sources that may impact returns. First, yields may stay high for longer on **stagflationary shocks**, e.g. a full-blown war in Middle East or a global trade war under a new US administration. Second, political uncertainties and polarisation may undermine fiscal consolidation needs, fuelling **debt sustainability worries** and a rise in fiscal risk premia. Third, in a **Goldilocks scenario**, inflation may come down much more swiftly while AI adoption boosts productivity and supply side growth faster and more strongly.

1. Stagflationary shocks. The pandemic and the oil crisis of the 1970s have shown how strong supply side shocks may unsettle inflation while depressing activity. Central banks are on a good track in bringing inflation gradually back to target. But an escalation of Middle-East tensions into a full regional war could still increase oil prices sharply, sending inflation and inflation expectations higher. Furthermore, punitive US tariffs may escalate into a full-blown trade war, potentially involving not only US and China but also the European Union amid tit-for-tat actions. This would undermine trade and send prices higher. Both stagflationary shocks may require central banks to halt or even reverse their easing cycle. Bonds would suffer, while inflation linkers and to some degree exposure to oil/gas commodities would offer some protections.

2. Debt sustainability worries. Public debt levels and fiscal deficits soared over the pandemic. Governments need to embark on painful consolidation measures to reverse the trend of rising debt/GDP levels while expenditure needs for defence, climate transition and ageing populations increase. Rising populism and polarisation may thwart consolidation efforts, fuelling debt sustainability worries and raising risk premia on public debt. High quality Credit may benefit vs. vulnerable sovereigns notably in Europe. US public debt will keep benefiting from the strong backing of the USD reserve currency, a powerful Fed and a deep capital market. But given the sheer scale of the fiscal challenges, even the UST market no longer looks fully immune to such worries. Structurally higher yield levels on fiscal worries would also curb valuations for Equities.

3. Goldilocks. While adverse risks to bond and equity markets are still looming large, upside risks to our return expectations should not be ignored. Inflation may abate faster and without any significant economic pain, allowing central banks to cut rates faster and deeper. AI adoption may boost productivity more quickly and sustainably, boosting activity and earnings, notably in the more flexible US economy. US/China tensions are unlikely to abate quickly, but diplomacy may help to mitigate global trade fragmentation. This scenario would render higher returns especially for riskier assets like Equities and HY Credit.

Imprint

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