



# 2016

EXPECTED RETURNS: HIGHLIGHTS

# 2020

2016

**BEHIND THE CURVE: THE PRICE OF NORMALIZATION**

2020

# Highlights

For the fourth year running, Robeco Investment Solutions is proud to present its Expected Returns publication. What should we expect for the world economy during the next five years, and how will that impact investor returns? While we believe that economic normalization is becoming more likely – including the return of inflation and rising interest rates – investors should still be braced for surprises. In this executive summary, we highlight some things to watch out for, along with the usual metrics of stock and bond valuations which will shape our world during the next five years.

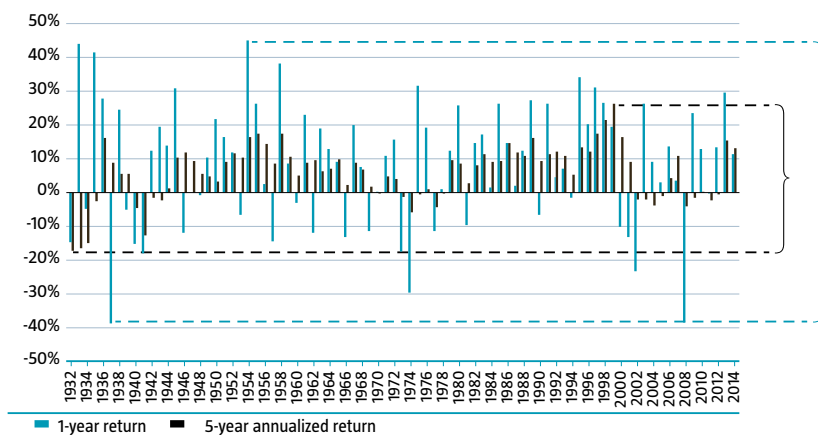
To read the full publication and to watch our movie, please visit [www.robeco.com/expectedreturns](http://www.robeco.com/expectedreturns)

Another year gone and a new outlook for the next five years is finished. Did the intervening year bring us what we had expected? Certainly not. We did not forecast oil to drop by USD 60 to below the USD 50 mark on account of the ongoing shale revolution. Neither did we forecast the subsequent return of deflation, which was the trigger for the ECB to launch an aggressive quantitative easing program. And indeed, we also failed to predict that Syriza would take political control in Greece, leading to the endless negotiations on debt reform and raising the prospect of a Grexit.

We could go on like this, because it is clear that we certainly missed many developments that have taken place since the publication of our last five-year outlook. The question however is: should we have tried to forecast these events in that publication? Certainly not. For one, the aim of this publication is to give a broad idea of the underlying developments in the world economy and financial markets on a five-year basis, not what happens over a shorter time horizon. We need another four years to see whether we made the right calls last year. More importantly however, it is incorrect to think that you can forecast to any degree of accuracy, let alone estimate the impact of certain events. Few could have predicted 9-11, nor what the longer-term impact would have been for the world economy.

This may raise the question of whether it is at all useful to try to say what the world will look like five years from now: we don't even know what will happen in three months from now. The answer may surprise you, as it sounds counterintuitive: for financial

**Figure 1.1: Longer timeframe leads to lower realized annualized volatility in stocks**



Source: Bloomberg, Robeco

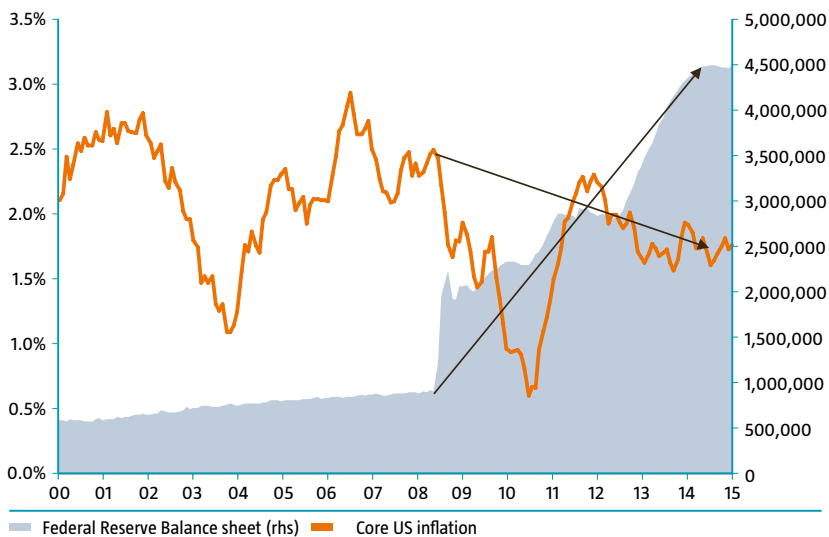
market returns, the longer term on average seems to be less uncertain than the short run. Partly this is related to the averaging out of the short-term fluctuations. This is clarified in one of the specials we present in this five-year outlook, which looks at the impact of recessions on returns. Added to this is the observation that valuation does not play much of a role in the short run, but does start to come into play on a longer-term horizon. Bonds that are currently expensive can become even more expensive in three months from now, but are unlikely to stay so for five years. The rally in European bonds, despite the fact that we already thought they were expensive last year, is a case in point.

So much for the contemplative words. In our latest Expected Returns publication, we have updated the outlook for the next five years, as well as the alternative scenarios. Compared to last year's outlook we have raised the odds of our central scenario taking place (from 60% to 70%) at the cost of a reduced likelihood of the adverse scenario (from 30% to 20%). If we look at the characteristics of this central scenario, it is a logical update from the central scenario presented last year. At that time we expected to see a 'gradual normalization' of the world economy, with growth and inflation slowly returning to normal. We still believe this to be the most likely scenario. But as the leading economies in the world have moved closer to the point at which constraints will start to resurface, we have also moved into a more mature economic scenario. This scenario is called 'behind the curve'. Higher growth, and yes, the return of inflation are the key elements.

## Inflation, really?

Now we know that this 'behind the curve' scenario will lead to some raised eyebrows. Inflation, really? Ever since the Fed implemented the first quantitative easing program back in 2008, economists have been sounding the alarm bells with respect to inflation. Incorrectly, as it has turned out. The growth of money supply linked to the expansion of the Fed's balance sheet has not led to the disastrous 'rampant inflation' that has been forewarned by some very respectable names. The accepted wisdom of leading monetarist and Nobel laureate Milton Friedman that 'inflation is always and everywhere a monetary phenomenon' has turned out to be not as simple as stated. Inflation has remained well-behaved, and is currently even below the longer-term target of 2% at the core level, well below the level at the time the first QE program was implemented. If a fivefold expansion of the balance sheet did not do the trick, why would inflation pose any threats now that the Fed has officially stopped expanding its balance sheet? Isn't inflation officially a thing of the past?

**Figure 1.2: Inflation is not a monetary phenomenon after all...**



Source: Bloomberg, Robeco

To think that inflation is something that would just simply fall out of the sky once a central bank expands its balance sheet has always struck us as peculiar. Inflation is a process of firms raising prices, or labor demanding higher wages; processes which have no direct link with the money supply itself. No union will demand a wage increase because of the announcement of new QE program, and no company is deciding to raise prices on the basis of the latest money supply growth number: you need demand and shortages of supply for that. To stick to Friedman: inflation is the result of 'too much money chasing too few goods'. So far we have seen a lot of money, but very limited chasing: most of the increase in the money supply has ended up as dead money on the balance sheets of the banking sector. All the chasing that has taken place has been in the financial markets. This is what we expect to be different in the five years to come: strengthening demand will result in economies running into capacity constraints again, which will trigger the re-emergence of inflation.

Shortages and capacity constraints: this may all sound like an unlikely scenario given the current 11% European unemployment rate. Although this may indeed be the mindset of many Europe-based institutional investors, there are a number of developments to keep in mind. First, although European unemployment is high, the unemployment rates of the

leading economies in the world are at a much lower level. Looking at the unemployment rates of Germany (6.4%), the UK (5.6%), the US (5.3%), Japan (3.3%) and China (4.0%), it is clear that these are currently already below their longer-term averages. It goes without saying that these economies have a much bigger impact on the underlying trend of worldwide inflation than laggards like, for example, France or Spain. This is especially the case in the financial markets, with the US historically always acting as the leading market for bonds and equities. Bonds will react to higher inflation in the US, not to deflation in – say – Italy. Shortages in the labor market may not only arise from a demand perspective, but can also be supply driven. One of our specials specifically looks at the link between inflation and aging. Based on research conducted by the OECD and the BIS, we find that aging is likely to be inflationary. This runs against the popular belief, as a result of the experience in Japan, that this will be a deflationary process. With Japan, Germany and even China being confronted with a decline in participation rates, it is clear that shortages in the labor markets will start to play a role in the wage growth.

**Table 1.1: Return expectations asset classes**

	Returns	Returns	Returns
	This year (behind the curve)	Last year (gradual normalization)	Steady state
High-quality government bonds*	-3%	½%	4½%
Cash or money markets**	1½%	¾%	3½%
Investment grade credit bonds***	-1¾%	¾%	5¼%
High-yield bonds***	½%	2%	6¼%
Equities developed markets***	5½%	5½%	8%

\* Based on the German yield curve \*\* European rates \*\*\* worldwide. Source: Robeco

A final reason why we expect the risks of inflation to reappear is related to the action of central banks. With the experience of the past five years firmly on their minds, we do not expect the central banks to be in a hurry to raise rates aggressively, giving free rein to the ongoing recovery. The ECB will not repeat the mistake it made back in 2011, when it raised rates too early, only having to correct the rate hikes within the year. Although they will not state so openly, we get the feeling that central banks will not object to seeing the inflation rate somewhat overshoot the longer-term targets. It is because of this that we are calling this the ‘behind the curve’ scenario.

Does that mean we are heading for that rampant inflation outcome? Certainly not: we expect US inflation rates to peak at around 3%, while European inflation will not exceed 2.5%. As such, this ‘behind the curve’ scenario is a logical follow-up to our ‘gradual normalization’ base scenario of last year: we have moved a year further into the recovery phase.

## The price of normalization

Continued growth and rising inflation: what will the impact on the various asset classes be in our central scenario? Table 1.1 shows the expectations of the more important asset classes, compared to the forecasts we made in last year’s Expected Returns 2015-2019 publication. As we stressed last year, most of the asset classes are expensive, which means that we should not get our hopes up that we are heading for strong returns during the next five years.

The most striking element in this year forecast is the -3% average annual return we expect for European sovereign bonds. If we take into account that German government bonds are supposed to be the ‘risk-free’ asset, with lower volatility and more predictable returns, it probably raises the question whether this is correct. Looking at US data going back to 1871, there has only been one case in which US bonds yielded a negative return over a five-year period. In the 1964-1969 period, US 10-year Treasury yields rose from 4.1% to 7.6%, pushing the annual average returns to -0.1%. This example shows that it is possible to get a negative return over a five-year period, but that it is a rare event, and that the losses are normally minimal. So why should that be different this time?

Returns on high-quality government bonds typically depend on two elements. The first is the change in price. Rising bond yields represent falling bond prices, which will erode returns. Much in line with the US situation, in our central scenario we forecast bond yields to go up by 350 basis points, with German 10-year yields rising from the current low of 0.5% to a peak of 4.0% in 2020. The second return element is the coupon, or starting yield. In essence, it is this yield that offers a steady and predictable return and which acts as a buffer against possible price movements. Whereas the US in the 1960s had a starting yield of 4%, the current German 10-year yield stands at 0.5%. You can hardly call it a buffer.



**Table 1.2: Returns in three scenarios**

	Returns	Returns	Returns
	Central	Stagnation	High growth
Average growth*	3%	1½%	3¾%
Average inflation**	1¾%	¼%	2¼%
High-quality government bonds***	-3%	+2¼%	-4%
Cash or money markets**	1½0%	-¼%	+2¼%
Equities developed markets***	5½%	-1%	4%

\* Worldwide \*\* European \*\*\* Based on the German yield curve. Source: Robeco

The -3% sounds gruesome for sure. However, it is simply the mathematical result of combining low starting yields with a gradual return of inflation scenario. You can question the scenario itself, but not the return that follows from it. So how realistic are the assumptions of our baseline scenario? Looking specifically at Europe, neither the 2% real GDP growth rate, nor the 2.5% inflation rate can be seen as unlikely: these are comparable to the growth and inflation levels we have seen in 2006-2008, just prior to the start of the Great Recession. Combining a real growth forecast of 2% and inflation of around 2.5%, the expectation that bond yields will peak at 4.0% is by no means outlandish. It underscores that the -3% for German government bonds is not based on unrealistic or unlikely forecasts: it is the price of normalization, the pain we need to go through to get back to longer-term historic bond returns of 4½%.

We expect the price of normalization for equities to be less painful, which is reflected by the fact that we have kept our return estimate unchanged at 5.5%. There are a number of forces tugging in opposite directions. On the negative side, we see high valuation (especially in the US) and margin pressures related to rising labor and interest rate costs, pulling potential returns lower. The downside however is capped by the dividend yield of 2.5%, which represents a buffer comparable (although with a lower guarantee) to that of bond yields. Additionally, equities will be supported by steady earnings growth, linked to our positive growth outlook. Much like last year, the forecasted average annual return of 5.5% means that we expect stocks to become less expensive during the five-year period: earnings growth will outpace the absolute price return of stocks.

## Alternatives?

Are the returns presented in Table 1.1 set in stone? Certainly not: they present our best estimates of the returns we expect if our baseline scenario comes true. Take another scenario and you get different results, for sure. Compared to last year, we have raised the odds of the central scenario taking place (from 60% to 70%), while we have lowered the chances of the negative scenario prevailing (from 30% to 20%), reflecting our increased underlying optimism.

In our adverse scenario (20%), the world is not a happy place. The slow productivity growth that we have seen over the past five years has not been a symptom of the healing process of the Great Recession, but rather a reflection of fundamental changes that are here to stay. Population growth has peaked, the easy wins on education have been reached, and inequality has eroded consumer spending, while public debt is set to hamper growth for the foreseeable future. The US and Eurozone economies slow down once again, with deflation a constant threat. Monetary policy will continue to be aimed at reviving the economy through new quantitative easing programs, as rates have lost their ability to influence growth at the zero bound level. Generally speaking, this scenario is positive for bonds and negative for equities, although defaults will pose a serious threat for corporate bonds with a lower credit rating. It should be stressed that this is not a recession scenario, but much more a Japan-like ongoing low growth outcome.

In our strong growth scenario (10%), the world is a lot happier. Rather than being caught up in a secular stagnation framework, we rather are on the eve of a technologically driven boom. Robotics, driverless cars, new ways of organization (for example Uber or Airbnb): the world economy is anything but stagnant. Disruptive, for sure, but the underlying trend is one of higher, not lower growth. In this scenario, the world economy enters a virtuous circle with debt ratios and unemployment rates declining, thereby supporting additional growth.

The main risk in this scenario is that the economy overheats, with inflation picking up more strongly. Although we do forecast inflation to rise above the rates seen in the central scenario, the risk of rampant inflation is still limited: productivity growth will be high, while central banks can allow themselves to act more aggressively. This would represent the perfect storm for bond investors, especially those bonds with a low starting yield. It will certainly not be plain sailing for equity investors either, as margins will come under pressure from rising costs (wages, commodities and interest costs), and

the disruptive nature of the new technological changes will eat into the returns of the current equity holders, while bond yields at some stage will start to become a serious competitor again, with yields rising to 5%+ levels.

Again, this scenario raises a question, which we have addressed in a special topic: what to think of the longer-term impact of the technological changes currently taking place. We have tried to identify the main underlying trends, ranging from robotics, near zero marginal costs and big data to Moore's law to try to assess what their impact could be for inflation growth and returns. Given the disruptive nature of a number of these developments, the net effect is not per se positive. Much will depend on the technological breakthroughs that are bound to take place, but which are difficult to identify in advance. In that sense, predicting technological breakthroughs is even more difficult than forecasting what returns we are going to get in the next five years.

## Conclusion

And that's where we stand: we are more bullish than bearish, though the nature of risk and returns will change as the world economy continues to recover. Compared to last year's outlook we have raised the odds of our central scenario of a gradual normalization taking place, at the cost of a reduced likelihood of the adverse scenarios of either strong growth, or stagnation. And we think investors who think globally with a strong focus on the right asset allocation at the right time will reap the rewards. But there are challenges, some of which will be just as disruptive as the unprecedented economic and monetary conditions we have witnessed in the past five years. In giving our insights, we have drawn on Robeco's long tradition of research, and in trying to be pioneering but also cautious at the same time. Happy investing!

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