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Shaping long-term expectations

A look at the longer-term investment implications of the pandemic

Executive Summary | June 2020

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Uncertainty remains high across markets and economies but what are the longer-term investment implications of the pandemic, how will it accelerate trends, and what will the impact be on investing in the next five years?

Our Investment Solutions team provides estimates of capital market returns across a wide array of asset classes and from multiple currency perspectives. This excerpt from our first-quarter Capital Market Assumptions update focuses on our five-year baseline expected returns. Since our June 2019 estimates, equities ended the decade with an admirable 10-year record and that momentum continued into February.

Then, the COVID-19 pandemic hit, and equity markets plunged more than 30% before rallying sharply in April and May. Government bond yields across all maturities declined in the US – which lowered expected returns in local terms. Credit markets have had surprising ups and downs, but are still at relatively wide levels at time of writing.

Market expectations over the longer-term

As the pandemic crisis resolves, some industries may quickly bounce back to something very recognizable. Other industries – such as airlines, cruise lines, hotels, restaurants, sporting events, theater, concerts, and public transportation – may be impaired for a lot longer as we struggle to find a new balance.

Balancing disruption is innovation. We already see the creation of new businesses and models from low tech to high tech: personal protection equipment (masks and plexiglass panels), video conferencing, and telemedicine.

The growth story going forward is also uncertain. A permanent rise in private sector savings could weigh materially on growth over the medium term, driving sovereign yields even lower.

In turn, if policymakers over-stimulate amid supply-side constraints, stagflationary pressures could erupt.

Although we have developed a number of scenarios for economic and capital market projections for the next five years, our base case is for slow, bumpy return growth that gradually trends back toward normal growth. This includes the

likelihood that some deglobalization, lingering outbreaks of COVID-19 and precautionary behaviors by consumers and businesses hamper growth initially. Inflation starts low and rises back toward trend in our base case.

The main changes in our five-year capital market assumptions compared to our mid-2019 report

– Expected global equity returns in nominal terms are higher, as valuation is improved.

– Government bond yields are even lower, so expected returns are lower. European yields did not drop as much as US yields, but were lower to start with.

– In general, we lowered expected 10-year yields in developed countries in 2025 by 0.4% to 1.1%. This has offset some of the drop in yields in projected returns.

– Credit spreads are higher due to higher default risks, but returns are still more attractive relative to governments. They bottomed out in early January 2020 and then ballooned late in the first quarter of 2020 before tightening significantly in April and into May.

– The dollar appreciated against most, but not all currencies. Some emerging markets currencies had extremely large depreciations. In general, we view the dollar as overvalued against both developed market and emerging market currencies.

Global asset class returns

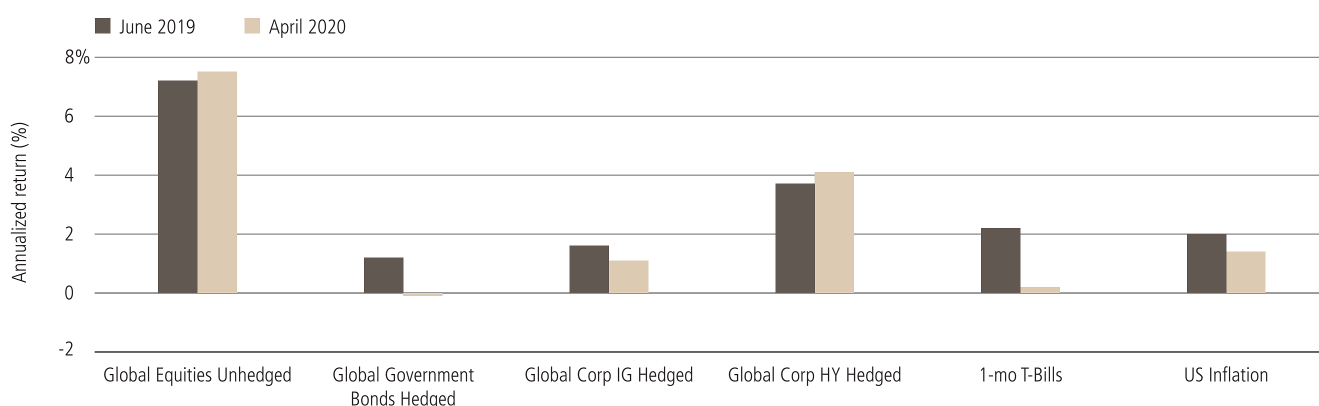
In nominal terms, the expected five-year return of equities rises to 7.5% in unhedged USD terms, an increase of 0.3% from the June 2019 version. A portfolio of global government bonds is expected to return -0.1% in hedged USD terms, a large drop from the 1.2% in June 2019. Global investment grade credit drops from 1.6% to 1.3% and high yield bonds grows from 3.7% to about 4%. Cash declines the most, dropping from 2.2% to 0.2%.

The resetting of valuations provides a more favorable back-drop for riskier assets over the medium term. Expected returns in global equities and high yield debt improved, whereas safe assets saw expected returns decline. For most risk assets, this valuation improvement was quite large, but it was somewhat offset by declines in expected growth and inflation.

US large cap equity was one significant outlier to this, as this expected return declined due to the large bounce back in valuations. US large cap returns fell to 4.9%; the valuation improvement since last June (0.5% increase) was offset by lower expected inflation (0.6% decline) and decline in aggregate earnings growth (a 0.1% decline).

In inflation-adjusted terms, prospective returns on global government bonds in April 2020 looked a bit better than the pure nominal rates indicate. With lower inflation, the real returns are boosted. In the short run, it is possible that with negative inflation and unchanged bond rates, real returns for bonds could be 2% to 3%, well within their historic performance.

Exhibit 6: Five-year expected returns in USD



Source: UBS Asset Management, data as of 30 April 2020.

Our estimate of expected inflation dropped sharply in the last 10 months. The 10-year breakeven inflation rate for the US, for example, declined from 1.7% in June 2019 to 1.1% at the end of April and reached a low of 0.9% in March. We have pegged cumulative inflation to be around 1.4% (annualized) for the next five years.

The pandemic of 2020 has dramatically shifted the starting point and path of the economy, leaving investors a wider array of potential economic outcomes. Along with bouts of volatility and normal rotations of performance, we need to prepare for regime shifts that alter some fundamental relationships in the markets.

The stock-bond correlation – time for a change?
One such potential regime change over the next five years is the stock-bond correlation. Over the last 22 years, stock returns have been negatively correlated with Treasury bond returns in most developed markets.

We believe that there is an increased likelihood that this negative correlation will break down sometime in the next five years. The historic data indicate that the stock-bond relationship is regime dependent. The critical threshold is sustained 2.5% inflation; below this, we expect the relationship to be negative; above this, there has been a positive stock-bond correlation. For now, inflation has been negated by the pandemic, with the US price index dropping 1.3% for the three months ending in May.

One tool to help evaluate portfolio rewards and risks is scenario analysis, as it allows investors to understand the economic drivers of performance. Complementing this with standard tools and modern risk control analytics should prepare investors to build, better, more resilient portfolios.

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