



Investment Horizons

Key themes shaping future returns



STRATEGIST VIEWS

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Too often, investors are preoccupied with the near term. That can lead to misjudgments, like recency bias, which assigns undue importance to current events. Obsessing over the near term may also obscure arising investment themes. And it can result in an underestimation of the fundamentals that anchor asset prices over time.

When it comes to wealth enhancement, the longer run is decisive. Many studies have shown that the strategic asset allocation decision, and adherence to it, determines the lion's share of a portfolio returns and risk over time.

It therefore makes sense to step back from current conditions and assess the medium-term outlook for growth, earnings, interest rates and valuations, and to consider secular forces likely to produce solid investment returns over time.

In what follows, we outline our thinking about the next 1–3 years. In ensuing notes, we will delve more deeply into various aspects, examining more closely where medium-term opportunity and risk reside across global capital markets.

We begin by outlining the fundamental backdrop for global economic activity and inflation, which determine the trajectories for short- and long-term interest rates, as well as the sustainable growth of corporate profits. We then consider valuations and how they may impact returns across asset classes. We conclude by identifying themes that we believe could produce superior returns over time, even regardless of the global business cycle.

Global growth and inflation

We begin with global growth, which pins down the equilibrium real rate of interest. Growth is determined by the supply side, which sets the speed limit for potential economic activity, as well as by the demand side, which determines whether the economy's productive capacity will be fully employed.

On the supply side, most signs point toward subdued growth of the global economy's potential to produce goods and services. Across the world's largest economies, aging populations imply tepid labor force growth. Immigration has been a helpful offset in the United States in recent years, but populism is a constraint. Deglobalization is another headwind.

Hence, if the global economy's speed limit is to be raised, productivity must surge. Eventually, that may occur if the promise of new technologies in artificial intelligence (AI), robotics, genetics and elsewhere is fulfilled. But so far, those innovations are macroeconomically insignificant, with productivity growth in the United States and globally mired in a two-decade long slump.

On the demand side, the world economy benefited from a massive fiscal policy boost during the COVID-19 pandemic. But fiscal tailwinds are fading. Meanwhile, the lagged impacts of monetary policy tightening in response to surging global inflation are still working their way through the world economy. High savings, built during pandemic-era shutdowns, are being whittled away, which should slow household spending.¹ Lastly, China's enormous debt burdens (linked to excess real estate investment) and Beijing's unwillingness to adopt policies that could meaningfully lift consumption, suggest that China's contribution to global demand will likely also remain subdued in the years to come.

The implication is that absent an autonomous investment boom, global demand is unlikely to race ahead of global productive potential. Inflation, in other words, is more likely to fall than rise.

The key investment implications we see are that real and nominal interest rates will decline over the next few years everywhere, but particularly in the United States, where the monetary policy response to inflation has been the most forceful. As central banks respond to lower inflation and moderating growth by easing, yield curves will likely normalize (i.e., return to their customary upward sloping configuration).

How far will interest rates fall? Provided recession can be avoided, policy rates should decline toward their neutral rates that neither excessively hinder nor stimulate growth. Estimates of the neutral policy rate vary, but most reside within a range of around 2.5%–3.5% for the United States and the United Kingdom, and lower for Europe and Japan. Accordingly, over the next several years, we would expect short-term interest rates to fall about 2–3 percentage points in the United States, United Kingdom and the eurozone (in Japan and China low rates already prevail).

In response, bond yields will also likely fall, though to a lesser extent than short-term rates as yield curves normalize. **Given these dynamics, we believe the return prospects in global government bond markets look attractive over the next several years.**

Finally, over the medium-term, corporate profits tend to move closely with economic activity. As nominal gross domestic product (GDP) growth slows (owing to disinflation and moderating growth), total corporate profits growth should also slow. Assuming a constant share of profits in GDP (note that measure is historically high in the United States²), aggregate corporate profits should likely grow by around 5%–6% per annum over the next few years, somewhat below the postwar average of 7.4%.³ In our analysis, **slower corporate profit growth will likely lead to more modest equity market performance in coming years, particularly in the United States where already-elevated valuations will likely constrain the scope for multiple expansion as interest rates fall.**

Risks to the view

Before turning to valuations, it is important to consider risks to the “base case” outlined above.

Clearly, unforecastable shocks—war, terrorism, social strife or natural disasters—could change outcomes. But among “known-knowns,” for which we already have data and some visibility, two stand out that could be game changers.

The first is fiscal stress. As a result of the global pandemic and the 2008 global financial crisis, the fiscal position of many countries has dramatically deteriorated over the past two decades. Accordingly, investors may one day balk at absorbing government debt issuance, particularly if governments act unpredictably or irresponsibly. That was the lesson learned from the Gilt crisis during the short tenure of the ill-fated Liz Truss UK government in 2022.

But even absent policy shenanigans, we believe fiscal positions are unlikely to improve much over the next few years. Weaker growth tends to worsen the fiscal balance for well-known reasons. Some relief, however, should come through lower interest rates and as global savings rise relative to investments owing to slowing world growth.

The bottom line is that fiscal positions in the United States, United Kingdom, much of Europe and Japan are more problematic and offer less flexibility in the event of an economic or financial crisis, in our analysis. But if we assume that governments avoid significant policy errors, lower interest rates and ample world savings suggest that debt and deficit financing should nevertheless proceed without duress.

The second “known-known” is political uncertainty.

Regardless of origin, populism is intrinsically unsettling for business and financial planning. Populism and its close cousin, nationalism, also increase the risk of global conflict. Significant economic and market dislocations could therefore ensue in the United States, Europe or China if populist extremists come to power and create greater uncertainty. That is why 2024 election outcomes in France and the United States, as well the evolution of China’s policies and other forms of geopolitical risk must remain key considerations for investors.

But even if populists remain at the fringes of power, they act as a restraint on the “creative destruction” that capitalism otherwise exerts. Populism opposes globalization, immigration, technological advance, and public investment in infrastructure and health care—all avenues that tend to lift the productive potential of the economy. In that sense, populism acts as an additional drag on potential growth of the economy and, ultimately, on the growth of corporate profits.

Equity valuations and continuity

There is a Wall Street adage that valuations are meaningless in the short run and are everything in the long run. Just as growth and inflation pin down the sustainable paths of interest rates and corporate profits, valuations can provide a roadmap for long-term returns. As countless studies demonstrate, excessive valuations are typically followed by periods of subdued returns, and higher returns are more likely to arise from a starting point of low valuations.

However, asset price misalignments (in either direction) are rarely the sole catalyst for market course corrections. Returns can also be persistent (“momentum”). Expensive can become more expensive, cheap can remain cheap. To paraphrase a quote generally attributed to John Maynard Keynes, “markets can remain irrational longer than (contrarian) investors can remain solvent.”

Hence, valuations alone cannot be the only guide for investment decision-making. When considering the impact of valuations on medium-term returns, we must also consider what might (or might not) change to produce investor reassessments of worth.

Based on historical standards, high valuations do not automatically lead to underperformance in a predictable fashion. Look no further than the so-called Magnificent 7,⁴ which trade collectively on a price-to-earnings multiple of over 50 times, yet continue to lead the bull market higher.

We cannot say for certain, therefore, that over the next few years stocks with elevated multiples will underperform those with low valuations. Nor can we say that Europe’s 30%–40% valuation discount to the United States’ provides assurance that European stocks will outperform their US counterparts over the next 2–3 years.

Moreover, there is a reason why persistence of large valuation divergences exists. The Mag 7, unlike other high-priced stocks in the past, enjoy enormous profit growth driven by near-monopoly power and superior products. They fundamentally differ from stocks of earlier bubbles—the Nikkei of the 1980s, biotech stocks of the early 1990s, or dot-com stocks of the late 1990s—because of their dominant business models that, thus far, have proven durable. Instead, the Mag 7 have more in common with some of the Nifty Fifty⁵ stocks of the late 1960s (e.g., General Electric, IBM and Xerox).

However, that observation is both instructive and sobering. Those 1960s market darlings were also innovative, at the forefront of new technologies, and had near monopoly power in their respective markets. But each eventually succumbed to competition or management failure, leading to extended periods of underperformance or even disappearance (Xerox).

The upshot is this: Relative valuations alone are unlikely to drive relative performance. Unless new competitors arise, gross mismanagement is revealed, or governments take effective action to restore competition, large-capitalization technology stocks are unlikely to underperform. Nor are other countries likely to challenge US equity return leadership.

Moreover, in a world of slower profit growth, investors will likely continue to pay up for durable profits offered by stable

companies with strong business models and compelling growth opportunities. Value is unlikely to be realized without the catalyst of its own positive earnings surprises.

In short, for fundamental and valuation reasons, our key takeaway is one of equity market continuity. Barring unforecastable shocks, we believe the coming few years will likely resemble the past more than many might like to admit.

Fixed income valuations

As previously noted, interest rates are presently too high relative to likely outcomes for growth and inflation. Accordingly, government bond markets, especially in the United States, offer what we consider attractive prospects for investors willing to extend the duration of their fixed income holdings.

Within credit, however, valuations are less attractive, in our analysis. Both investment-grade and high-yield markets present historically tight spreads over government bonds. Too tight, in our view, to account for some increased risk of downgrades and defaults that will likely emerge as growth continues to slow.

Yield spreads and all-in yields are considerably higher in private credit, including direct lending. That is also warranted, insofar as private credit markets have yet to prove their resilience to a more significant economic downturn or a rise in overall default risk.

Accordingly, we prefer private credit to public credit, even if private credit allocations present conservative investors with intrinsically greater risk than they may prefer.

Emerging market (EM) debt denominated in local currencies also offers both risk and therefore opportunity. As global interest rates fall in developed markets, various EM central banks will have latitude to ease, creating opportunity for EM debt investors. But other factors are less clear. Will emerging currencies appreciate against the US dollar (typically a significant source of EM return potential)? Can EM debt issuers avoid an increase in credit risk premiums as global growth slows? In our view, EM debt is attractive, but primarily for investors with a relatively higher tolerance for risk.

Secular themes

Most of the preceding discussion has focused on how we see major asset classes performing against a backdrop of moderating world growth, receding inflation and lower interest rates. Yet some key investment themes will emerge regardless of the business cycle, and they merit attention.

Unsurprisingly, the top secular themes reside in areas of technological innovation: AI, robotics and genetics. These are well-known trends, with readily identifiable investment opportunities (e.g., the Mag 7).

But investors should always be on the prowl for new secular opportunities. Among the candidates that we favor are investments in electricity infrastructure and digital finance.

Globally, momentum has shifted toward the adoption of alternative energy as a substitute for carbon-based sources. China (solar panels), Europe (wind) and the United States (owing to subsidies in the misnamed Inflation Reduction Act) have made considerable strides. But the production of alternative energy will also require massive investments in its distribution, principally across the electricity grid. That means more demand for copper (wiring) and other basic materials (used in batteries) as well as for software and engineering skills to develop smarter and more reliable electricity transmission systems.

In finance, the industry is poised to make the third major transition in its infrastructure (the first being human-based exchanges and the second electronic exchanges). The next generation will be based on digital finance.

The financial payments system and its platforms for buying and selling assets are ripe to be scaled more efficiently and more securely, requiring the adoption of alternative ledgers and computing systems relative to today's standards. The driving forces are both technological innovation (blockchain, faster computing) as well as economic (an "arms race" to develop hyper-efficient, scalable transaction platforms among financial institutions). Investment opportunities will likely arise among the providers of the required hardware and software, but will ultimately also manifest in lower cost, more profitable financial institutions across banking and asset management.

For both electrification and digital finance, many potential opportunities may be found in private equity and venture capital investments. Private equity, which has grown far more rapidly than public equity over the past quarter century, has become the primary vehicle for early-stage financing, driving what we consider impressive returns. Private equity is also well-suited to the longer investment horizons associated with secular themes. It is also becoming more accessible, including via secondaries that shorten payback horizons and enhance liquidity.

Finally, although some traditional areas of real estate (e.g., commercial lending or residential mortgage-backed securities) face challenges owing to excess supply (commercial) and affordability (housing), subsets of real estate remain attractive, including space devoted to multi-family housing, warehousing and life sciences. In our analysis, together with select managers in private credit, these secular drivers of returns are also less correlated with traditional asset classes (stocks and bonds), enhancing their portfolio appeal.

Investment conclusions

In sum, we believe the outlook for capital markets over the coming few years is a combination of continuity and change.

In terms of continuity, we believe that dominant firms in growth sectors could continue to offer high relative returns. The underperformance of value as a style will likely persist, given the absence of a catalyst in the form of increased profitability. The United States, by virtue of better relative growth, innovation and profitability, will likely continue to offer compelling equity returns relative to other major markets.

Change will most likely be driven by a slowing of global growth and falling inflation, which will permit central banks to ease and long-term interest rates to fall. In our opinion, the primary beneficiary will likely be duration fixed income. Returns for potential credit risk and downgrades, however, are mostly too low, diminishing the appeal of broad corporate bond indexes.

In a world of modest earnings growth, investors will likely continue to pay up for earnings visibility and growth. Secular themes, existing and new, will offer what we consider attractive returns to medium-term-oriented investors. We favor AI, robotics, genetics, electricity investment and digital finance as the most compelling themes in the coming few years.

Endnotes

1. Source: "Pandemic Savings Are Gone: What's Next for U.S. Consumers." Federal Reserve Bank of San Francisco. May 3, 2024.
2. Source: "Shares of gross domestic income: Corporate profits with inventory valuation and capital consumption adjustments, domestic industries: Profits after tax with inventory valuation and capital consumption adjustments." Federal Reserve Bank of St. Louis. October 26, 2023.
3. Source: "Corporate Profits After Tax (without IVA and CCAAdj)." Federal Reserve Bank of St. Louis. June 27, 2024.
4. The Magnificent Seven (Mag 7) comprises Alphabet, Amazon, Apple, Microsoft, NVIDIA, Meta Platforms and Tesla.
5. In the United States, the term Nifty Fifty was an informal designation for a group of roughly 50 large-cap stocks on the New York Stock Exchange in the 1960s and 1970s that were widely regarded as solid buy-and-hold growth stocks or blue-chip stocks.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. The allocation of assets among different strategies, asset classes and investments may not prove beneficial or produce the desired results. Equity securities are subject to price fluctuation and possible loss of principal. Fixed income securities involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls. Low-rated, high-yield bonds are subject to greater price volatility, illiquidity and possibility of default.

Large-capitalization companies may fall out of favor with investors based on market and economic conditions. Securities issued by utility companies have been historically sensitive to interest rate changes. When interest rates fall, utility securities prices, and thus a utilities fund's share price, tend to rise; when interest rates rise, their prices generally fall.

International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. The government's participation in the economy is still high and, therefore, investments in China will be subject to larger regulatory risk levels compared to many other countries.

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