

A SECULAR OUTLOOK

2019

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Overview

It gives me great pleasure to introduce our 7th Secular Outlook.

With this publication, we aim to draw on past experiences to shed light on the future.

Looking back, the period since the 2008 financial crisis has been unusually kind to investors.

Buying and holding the S&P 500 index since March 2009, for instance, would have delivered an annualised return of some 16 per cent. Exceptionally loose monetary policy clearly boosted riskier assets. But so too did corporate tax cuts, which helped lift US profit margins to an all-time high of 11.7 per cent.

Yet as we look ahead, the next five years will provide investors with a sterner test.

Slower economic growth, limited fiscal and monetary firepower, the rise of protectionism and tighter regulation will weigh on financial markets, as will a decline in the world's working-age population.

For several reasons, developed-market asset classes will be particularly vulnerable to these trends: as our forecast table shows, US stocks will deliver lacklustre returns over the next five years. Another weak spot is the corporate bond market, where high valuations are starkly at odds with a deterioration in the creditworthiness of both investment and non-investment grade firms.

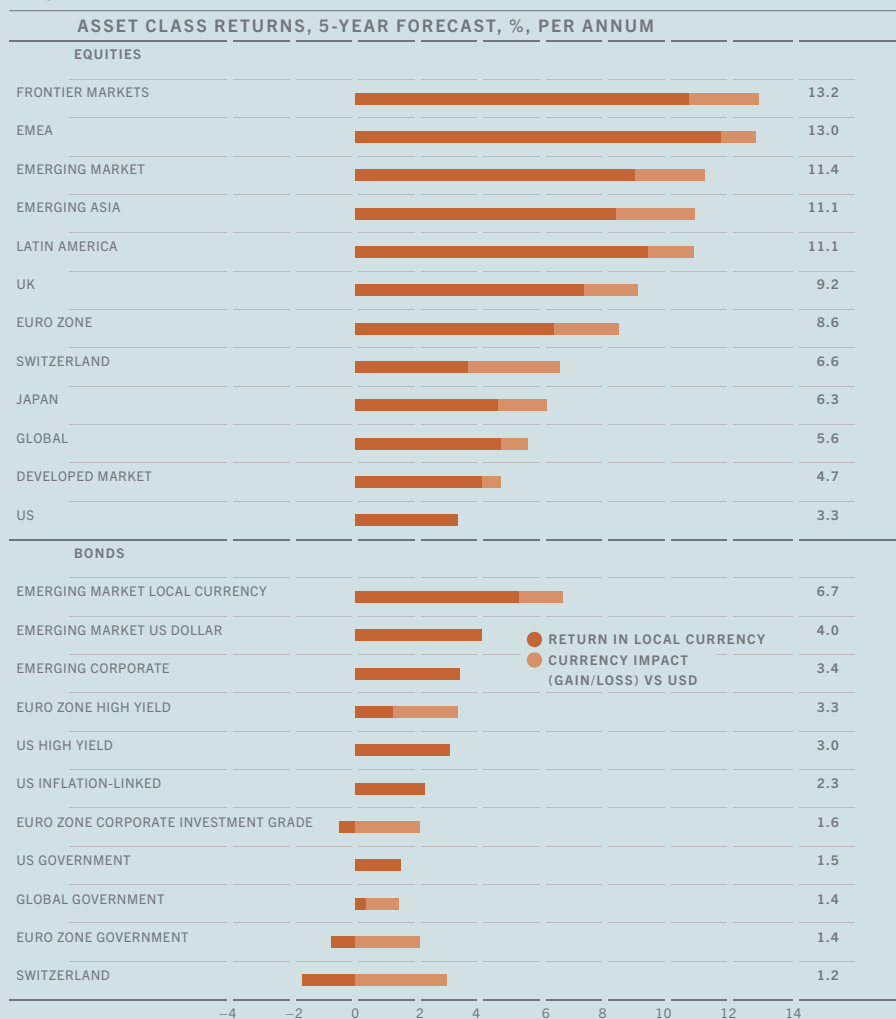
The prospects for European stocks and emerging-market assets are better. The euro zone should prove more stable than most investors expect, and we're also confident that reforms will gather strength in many large economies of the developing world, narrowing the discount at which these bond and stock markets trade to their US counterparts. Chinese local currency debt and equities should also gain as the country's financial footprint grows.

And if, as we expect, markets become more volatile thanks to trade disputes and unorthodox policymaking, then hedge funds could see an improvement in their risk-adjusted returns.

The next five years, then, will require investors to take a long hard look at their portfolios. What proved successful in the past is unlikely to bear fruit in the future. It's time to adapt to a different investment landscape.

LUCA PAOLINI,
CHIEF STRATEGIST

FIG.1



Source: Pictet Asset Management;
forecast period 31.03.2019-31.03.2024

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The global economy: an end to the US boom

The US economy has enjoyed fair skies during the past decade, but now they're beginning to cloud over – this will be a problem for the rest of the world. That's because even if other economies have further room for expansion in the current cycle, pedalling into an inclement American wind is bound to be hard work.

The US economy's weakness will weigh on developed markets more generally. We are forecasting average annual growth for developed economies of 1.4 per cent, two tenths of a per cent below trend. That will leave the onus on emerging markets to prop up global GDP growth.



LUCA PAOLINI,
CHIEF STRATEGIST

Corporate cracks

Unlike the 2008 global financial crisis (GFC), which resulted from the bursting of a property bubble, the US's next recession is likely to be triggered by problems with corporate leverage.

Corporate borrowing is already high relative to firms' free cash flow generation (see section 'Corporate finance: the deleveraging myth'). So far that hasn't mattered. Low interest rates have kept zombie companies alive,¹ while profits generally have been supported by a lax regulatory regime, favourable taxation, increasing industry concentration and, until recently, moderate wage growth.

This looks like it's going to change. A populist backlash against post-GFC policies that are perceived to have widened social inequality is likely to result in a beating for both US and non-US corporations over the coming years (see section 'The changing face of capitalism'). Taxes are likely to go up, while legislators take aim at overly powerful firms and sectors. As a result, margins are likely to come down from record high levels – the US net profit margin of 11.5 per cent is two standard deviations above its mean. Given the high rates of corporate leverage, that's bound to cause substantial pain and plenty of company failures with consequent effects on the wider economy.

Our forecast is for US economic output to grow by an average of 1.6 per cent a year over our five-year time horizon. Given the economy's long run growth potential is

¹ Banerjee, R. and Hofmann, B. "The rise of zombie firms: causes and consequences." BIS Quarterly Review, 23.09.2018 https://www.bis.org/publ/qtrpdf/r_qt1809g.htm

around 2 per cent, our forecast implies the risk of a recession followed by a rebound. It's a possibility that's also been flagged up by this year's inversion of the US Treasury yield curve.

Developing troubles

Although the US will be the first domino to fall, other developed economies will also struggle. We expect the euro zone, Japanese and German economies to grow at or below trend over the next five years.

And while we see the UK economy remaining relatively resilient, thanks in no small part to sterling's weakness, there are plenty of Brexit-associated risks to this forecast.

Low inflation ought to be a saving grace – consumer price growth should run below trend. But central banks are unlikely to be able to provide as much aggressive stimulus as they did during the GFC. Interest rates are already low and, in a number of cases, negative, and populist politicians are increasingly turning against more quantitative easing.

Despite decade-long expansion, real rates fail to rise

FIG.2



Source: Refinitiv, JPMorgan;
data covering period 31.12.1984-31.03.2019

Instead, governments are likely to fall back on fiscal stimulus, with central banks coming under pressure to monetise deficits.

Inflation is likely to remain moderate over the next five years while a global recession could potentially force central banks to rethink their inflation targets and devise a new monetary policy framework. A shift from core inflation targeting to price level or average inflation targeting is already being discussed at the Fed and in the euro zone. Should such policies be embraced, inflation expectations and trend inflation could rise over the medium to long term.

Chinese resilience

For all the developed world's coming malaise, we expect emerging-market economies to remain robust, growing at an annual 4.5 per cent, marginally above trend. Once again, China is set to be the driving force. While we expect growth in the world's second largest economy to decelerate to a 5.5 per cent annual rate over the next five years, roughly 1 percentage point below the current rate, it will still account for roughly 35 per cent of global growth, with two-thirds of that down to domestic consumption.

In their version of the "whatever it takes" pledge that European Central Bank President Mario Draghi used to reassure markets, Chinese authorities have consistently shown their determination to serve up enough fiscal and monetary stimulus to keep the economy growing at a steady pace. Subdued inflation – we are forecasting a 2.5 per cent annual rate over the next five years – should allow the People's Bank of China to trim bank rates further.

At the same time, Beijing is negotiating a transition away from dependence on investment. Household consumption will make up an ever larger share of the domestic economy. It's notable that China's recent fiscal programme

——— Unlike the 2008 global financial crisis, the US's next recession is likely to be triggered by problems with corporate leverage.

is tilted towards cutting personal taxes rather than spending on infrastructure.

But China has a way to go before it rebalances its economy. Its savings rate has already fallen substantially and its massive current account surpluses have evaporated. In 2017, its savings stood at around 45 per cent of GDP—even Germany, a major surplus economy, has a savings rate below 30 per cent. This decline is sure to continue.

Until these changes come about, it will be too much to expect China to fully liberalise its financial account. Trying to open up during a time of substantial balance of payments surpluses would threaten to unleash a tsunami of money to other jurisdictions and trigger a currency crash.

Towards a more balanced world: China's transition to a financial-market powerhouse



RICHARD DIAS,
SENIOR MULTI ASSET
STRATEGIST

A more balanced world? For years, developing countries in Asia and oil-exporting economies in the Gulf were saving more than they were spending. This imbalance, which former Fed chief Ben Bernanke famously described as a “global savings glut”, was blamed for depressing US interest rates and encouraging speculative borrowing – a contributing factor to the 2008 financial crisis.

That glut is now fast disappearing. Global savings, as a percentage of GDP, peaked in 2014 and have been shrinking ever since. At the centre of this trend sits China. Which is why this phenomenon could prove transformational for countries and financial markets far beyond the world's second largest economy.

Because of its export-led economic model and fixed exchange rate, China was able to build up its reserves to eye-watering levels. Now, not only are its increasingly wealthy citizens saving less, they are also having to meet the rising costs of caring for one of the world's fastest-ageing populations.

China's current account surplus—its trade balance plus net income from foreign investment – peaked at 10 per cent of GDP in 2007. By the beginning of 2019, it had almost vanished. China may soon find itself running its first current account deficit in more than a quarter of a century.

And as this gap widens, it will redraw the economic and investment landscape.

A current account deficit means that a country consumes more than it produces. When this occurs, capital must come from abroad to make up for the shortfall. This is what has been happening in the US for decades; the country's hugely efficient capital markets, its strong rule of law and the dollar's reserve currency status allow it to borrow money from overseas investors with relative ease.

China is about to follow a similar route. One reason is demography.

How to spend it

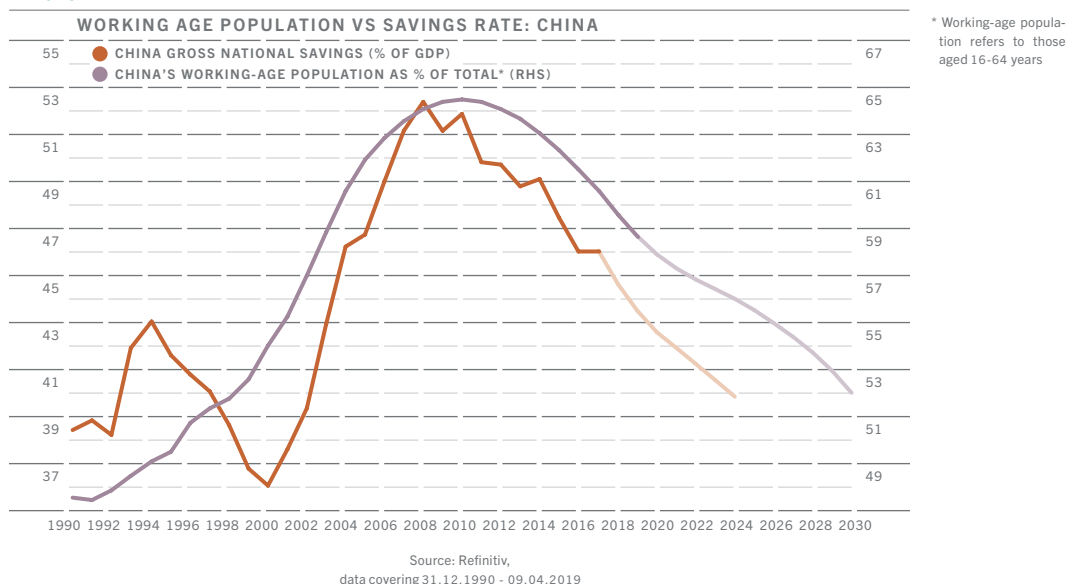
China is ageing fast. The proportion of the working age population—between 15 and 64 years old—peaked about a decade ago at 64 per cent and will decline to 52 per cent by 2030, according to UN projections (see FIG.3). Over the same period, China's savings rate will have declined from about 46 per cent of GDP to below 40 per cent.

As the population ages, overall spending increases, mainly on health care and pensions. But that's not the only reason for China's dissaving. Expenditure on education is also poised to increase considerably.

With millions of Chinese households no longer worrying about hunger and poverty, education becomes one of their main spending priorities. This shift – backed by government policy – should help to improve the quality of economic output and offset the loss of lower-earning rural migrant workers who were responsible for the economy's

As China's working-age population shrinks, the country will save less

FIG.3



runaway growth in the past decades.²

Beijing's efforts to rebalance its economy away from an export-driven model to consumption-led growth have also played a role in depleting savings. We expect the share of consumption in China's national output to rise to 45 per cent in the next five years from the current 39 per cent.

² This should help lift China's tertiary education ratio, or the ratio of total enrolment to the population that corresponds to the level of tertiary education, from the current 43.4 per cent, which is half that of the US. Source: Pictet Asset Management, World Bank, CEIC, data as at 05.04.2019

No more Great Wall

This new economic model will require China to attract more foreign capital. And that necessitates embracing reform. Beijing will have to liberalise its financial market, open up its capital account and integrate more fully to the world financial system.

China has already begun this transition on several fronts. Global bond index providers are incorporating Chinese debt, the world's third largest fixed income market, into their mainstream benchmarks.

The same is happening in the equity market. Global index provider MSCI, which included China in its global emerging-market benchmarks in 2018, plans to quadruple the weighting of Chinese mainland shares in the index.

Inclusion in major bond and equity benchmark indices is expected to generate combined inflows of more than USD300 billion,³ but the impact may be even greater: overseas investors will soon have no choice but to make Chinese assets a bigger part of their portfolio.

It is therefore inevitable that the renminbi (RMB) will

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become a major international unit of exchange over the coming decades. After a setback due to the introduction of tighter capital controls in China in 2017, the RMB's share of global payments and the proportion of China's trade settled in RMB both fell from the 2015 peak. But the currency should soon resume its ascent.

Currently, the share of RMB in global central bank reserves stands at just 1.8 per cent—a paltry sum compared with the US dollar's and the euro's respective figures of 60

³ Goldman Sachs and MSCI

per cent and 20 per cent. But its influence is growing as China's neighbouring trade partners increasingly settle contracts in the Chinese currency, creating what is known as the RMB bloc. Taking that bloc into account, our economists calculate that the RMB should command a global reserve share of at least 12 per cent.⁴

As China grabs a greater slice of international investment, portfolios will adjust to reflect this. One potential loser will be the US Treasuries market, where China has traditionally invested its substantial surpluses. The slow disappearance of this "Great Wall of Money" comes at a tricky time for the world's biggest economy: its financing needs in the coming years for both the government and US companies are unprecedented. Within the world's financial markets, the redback will begin to challenge the greenback.

⁴ "Redback vs Greenback",
Pictet Asset Management,
June 2016

China's role in Asian financial integration

China's financial footprint is already growing rapidly beyond its borders.

In a relatively short space of time, East Asia has effectively evolved into a renminbi bloc – in which the currencies of emerging Asian economies track the Chinese unit more closely than the dollar.

The region's banking dynamics suggest the renminbi's gravitational pull will strengthen; and with that, a greater number of currencies will come into its orbit.

There is already evidence that intra-regional banking activity in Asia is intensifying. The share of Asian-Pacific banks in international claims on emerging Asia rose to 57 per cent in 2014 from 31 per cent in 2007, according to the Bank for International Settlements (BIS).

In the syndicated loan market, Asian banks (including Hong Kong and Singapore banks, but excluding Japanese banks) account for a growing share of lending to emerging Asia-Pacific. The BIS says Asian banks' share of total new signings of syndicated loans to Asia-Pacific rose to 64 per cent in 2011 from 53 per cent in 2007.

Closer regional financial integration can also be measured by the extent to which returns in the region's financial markets are converging, which supports greater financial stability. In Asia, cross-country dispersion of equity returns has gradually declined – in periods outside of financial crises. The difference in equity returns between Asian markets is half of what it was during the previous cycle.

The changing face of capitalism: conditions will get tougher for corporations



LUCA PAOLINI,
CHIEF STRATEGIST

The past decade has been a golden age for corporations – share prices boomed as a handful of firms grew into behemoths and industries became ever more concentrated. Profits surged on lower corporate tax rates, falling financing costs and moderate wage growth, resulting in record high profit margins – 9.4 per cent for firms that make up the MSCI All Country World Index and 11.8 per cent for US firms.

The coming five years are set to be considerably tougher. A widespread perception that many of the measures pursued since 2008 have favoured society's richest and most influential has been stirring a backlash, ushering in an era of populist policymaking that will exact a heavy toll on equity markets.

Not only does it look likely that corporate tax rates will start to rise again after years of steep falls, regulatory forbearance should also reach its limits in the US and elsewhere. Meanwhile, wage inflation is creeping higher, not least as populations age and the relative proportion of working-age people shrinks across all major economies. For the first time since the late 1970s, the real unit cost of labour is not trending lower, which is to say real wages are rising more than labour productivity on a five-year rolling basis.

Central bank independence is also likely to be eroded, with a chance that monetary policy will be put into the direct service of fiscal authorities at the risk of squeezing inflation higher and raising the financing costs for corporations.

Together, all these forces are likely to put a severe squeeze on corporate margins and, therefore, on profitability.

Blaming the central banks

The policy reaction to the global financial crisis was to rely heavily on monetary levers and to end fiscal stimulus as quickly as possible in order to get government debt under control. Historically low policy rates, vast amounts of

central bank asset purchases and extremely generous credit terms to financial firms helped to stave off another Great Depression.

Central banks delivered a recovery, but they're also blamed for widening social divisions. The asset rich got richer. US net wealth is at a record 6.9 times disposable income. To get back to a long-term average of around 5.5 times, median wages would have to rise by an inflation-adjusted 5 per cent a year for the next five years, according to our calculations.

It's worth bearing in mind that over the past 40 years, incomes for the wealthiest 1 per cent rocketed while average wages have only crept higher.

In the US since 1980, average real wages for the bottom 90 per cent have grown by a quarter, while for the top 1 per cent they've increased by one and a half times.⁵

For years, an ever shrinking proportion of GDP has gone to labour. The gains generated by productivity growth have almost entirely flowed to businesses and shareholders at the expense of consumers and workers. It is telling that workers now have to earn three times as much to buy an average S&P 500 stock compared to the early 1980s.

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A new error?

This disenchantment has fed a populist backlash against society's elites; much of the blame has been laid at the door of the central banks, resulting in policy proposals that could erode monetary policymakers' independence.

All eyes are on how this process develops in the US, given the importance of the Fed to the global economy. The Fed's independence is increasingly under siege.

Direct political control of the Fed would allow the Treasury to fund deficit spending through the printing presses rather than having to sell bonds to the market. Ultimately, that sort of policy risks unleashing serious inflation. While

⁵ From Economic Policy Institute data, annual wages by wage group 1980 to 2017 <https://www.epi.org/data/#wagedeciles>

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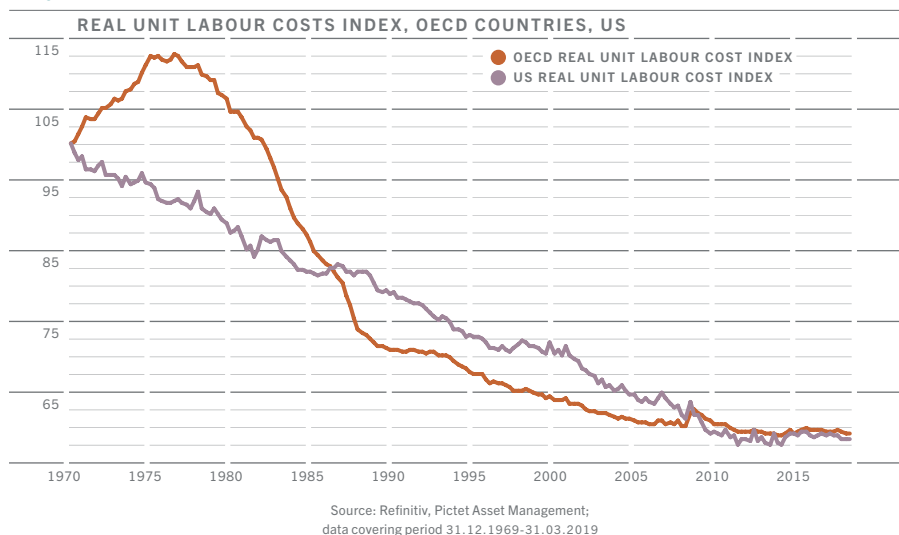
well short of this sort of extreme response, the Fed has made it increasingly clear that it would tolerate moderate overshoots of its 2 per cent pivot for personal consumption inflation. The Bank of England has been following a similar policy. It has allowed inflation to overshoot its target for long stretches, arguing that this was being caused by temporary factors and that price growth would return to trend in the medium term.

Companies in the firing line

A more significant risk for corporations in the US is that Trump's populism is replaced by a more left-leaning one. His pro-business approach could well be unwound by a Democratic administration – the next presidential election takes place in November 2020 and Trump's approval ratings remain consistently below those of past presidents at the same point of the cycle.⁶ Many of the leading Democratic party candidates are in favour of stricter regulation,

Wages to take a bigger bite out of profits?

FIG.4



breakup of monopolist firms, higher corporate tax rates and improved worker rights and wages, all of which would tend to drive down historically high profit margins.

Indeed, profits as a proportion of GDP have already started to edge lower – back (only just) to single digits after hitting a historic peak of 11.7 per cent in early 2012.⁷ But that's still three percentage points above the post-World War II average of a shade under 7 per cent.

Higher minimum wages and other interventionist policies could speed the return to historic trend. Record minimum wage increases have been announced in the UK, US,

⁶ Gallup <https://news.gallup.com/poll/203198/presidential>

South Korea and Spain, where they have been boosted by a whopping 22 per cent. Campaigns for living wages and experiments in universal basic income are likely to keep upward pressure on labour costs, particularly in Europe.

Changes in demographics are also altering the balance of power in favour of workers. A rising dependency ratio – the proportion of retirees and children to working-age population – will give wage earners increasing leverage in negotiating pay. That ratio will only grow over the coming years and across most of the world as populations age and birth rates fall. Meanwhile, there are growing labour shortages across a number of major economies where unemployment is near historic lows – not least the US, UK, Germany, Switzerland and Japan.

At the same time regulators are growing concerned at the fact that industries have become dominated by an ever smaller group of companies. More than 75 per cent of US industries have become more concentrated over the past two decades and firms in these industries benefited from higher profit margins and bigger stock returns.⁸ Amazon

————— Many of the leading Democratic party candidates are in favour of stricter regulation, breakup of monopolist firms, higher corporate tax rates and improved worker rights and wages. All of which would tend to drive down historically high profit margins.

controls some 50 per cent of US e-commerce, Facebook 77 per cent of social media traffic and Google 81 per cent of search engine use. Meanwhile, for all the post-crisis clamour about the need to ensure banks can't be allowed to become too big to fail, financial institutions have become even bigger.

⁷ Federal Reserve Bank of St Louis.
Corporate profits after tax (without IVA
and CCAAdj)/Gross Domestic Product

⁸ Grullon, G., Larkin, Y., Michaely, R.,
"Are US Industries Becoming More
Concentrated?" chrome-extension://
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dadm/https://finance.eller.arizona.
edu/sites/finance/files/grullon
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Governments are beginning to take note. In Europe, tech companies are facing increasing scrutiny while big mergers are less likely to be rubber stamped. Even China is reacting, shifting its stimulus policies away from industry and towards consumers—less will come in the form of infrastructure spending and more in personal tax cuts.

Taxing issues

Tighter regulation won't be the only problem facing corporations. Taxes look set to rise, too. Across the OECD, average statutory corporate tax rates dropped from around 50 per cent in 1980 to around 35 per cent a quarter century later.⁹

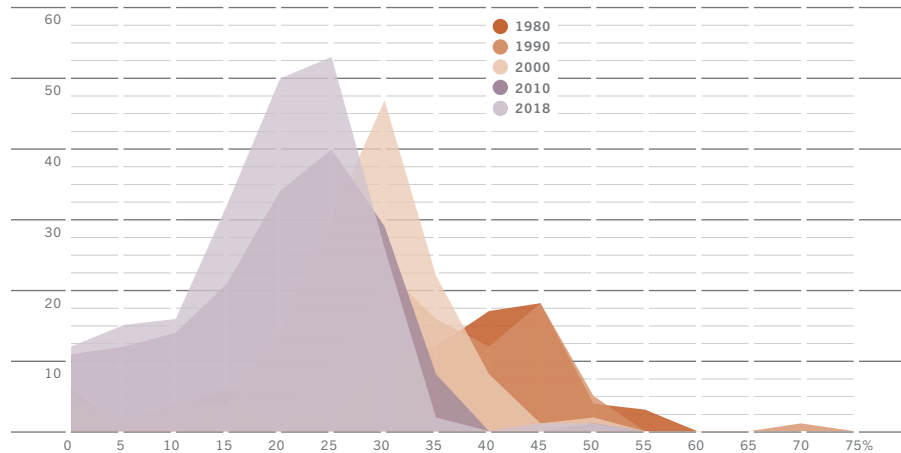
Taxes paid by US companies in 2017 were equivalent to 1.9 per cent of national GDP.¹⁰ In the late 1960s that rate was above 4 per cent. Amazon doubled its profits to USD11bn in 2018 but thanks to tax credits and tax breaks

The drive to boost [corporate] tax rates is being mooted on both sides of the Atlantic.

Untaxing times for corporations

FIG. 5

THE WORLDWIDE DISTRIBUTION OF STATUTORY CORPORATE INCOME TAX RATES 1980-2018 BY NUMBER OF COUNTRIES AND % RATE



Source: Tax Foundation. Data compiled from numerous sources including: PwC, KPMG, Deloitte and the US Department of Agriculture. Data covering periods 1980-2018.

for stock options, it received a Federal tax rebate of USD129m – which was roughly the same as in 2017. Which is to say, Amazon paid no taxes in the last two years. The story is similar in Europe.

The drive to boost tax rates is being mooted on both sides of the Atlantic. Some proposals are unrealistic, such as calls for a 70 per cent marginal rate on corporations. But others are being accepted, such as measures to limit companies' use of tax havens. The EU has pushed through rules to eliminate some common corporate tax avoidance loop-

⁹ See: <chrome-extension://oemmndc-bldboiebfnladdacbfmadadm/http://piketty.pse.ens.fr/files/The%20corporate%20income%20tax%20rate-revenue%20paradox.pdf>

¹⁰ OECD data <https://data.oecd.org/tax/tax-on-corporate-profits.htm#indicator-chart>

holes within member countries. Companies will no longer be able to shelter profits in low tax jurisdictions where they don't otherwise have operations. They also face limits to how much of their debt servicing costs they can use to reduce taxes. The OECD is working to reduce loopholes across developed economies more generally. Meanwhile, legislators are investigating new things to tax, such as data.

The cost of capital is also likely to rise as central banks seek to normalise policy, however slow and stop-start that process might be. And then there's the possibility that the US could outlaw buybacks, a major source of investor returns during recent years. That, by the way, wouldn't be new. Buybacks had been prohibited in the US as a form of market manipulation until Ronald Reagan's administration lifted the ban in 1982.

The winds are beginning to blow cold for the corporate sector. Ultimately, they will chill earnings – we expect profit margins to fall 1.7 percentage points from the current 10 per cent over the next five years – and, ultimately, investor returns too. The past decade may have been clement for equities. The next five years won't be.

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The future of the euro zone: bumping towards integration

Milton Friedman was famously not a fan. Neither is fellow Nobel Laureate Joseph Stiglitz. Yet the euro zone has somehow defied the odds and its critics, surviving a problematic infancy and turbulent adolescence to make it through to its 20th birthday.

It will continue to confound the doomsayers.

Not only will the single currency live to see 25, but it should reach that milestone with steadier foundations in place.

This optimistic view is not shared by the majority of investors. The forces testing the euro's durability are pretty formidable, after all.

Take the economic disparities between North and South. To a great extent, the single currency is still paying the price for mistakes made during its design phase. Its architects tied together a disparate group of economies while eliminating a reliable economic safety valve: currency devaluation.

This, and the failure to establish a euro-wide fiscal budget that could smooth out demand across borders, has meant that the benefits of single currency membership have been unevenly distributed. According to research from the Centre for European Policy, Germany's GDP per capita has increased 10 per cent as a consequence of joining the euro while Portugal, Italy, Greece and France, by contrast, have suffered a decline in prosperity in the order of 20 to 35 per cent.

For all this, there are sufficient grounds to believe the future will be brighter.

To begin with, although far from complete, reforms are generally heading in the right direction.

That's especially the case for the labour market. Thanks to a loosening of employment regulations, Europe's labour force participation rate has increased steadily over the past several years. The proportion of economically active adults in the euro zone has risen to 73 per cent from 67 per cent in 2000; in the US, it has fallen from 77 per cent to 63 per cent. What is more, one of the euro zone's most persistent weak spots, the gap in competitiveness between Southern European economies and Germany, has shrunk by 15 to 20 per cent since 2010. Such progress has been acknowledged by the World Bank, whose 'ease of doing busi-



LUCA PAOLINI,
CHIEF STRATEGIST



RICHARD DIAS,
SENIOR MULTI ASSET
STRATEGIST

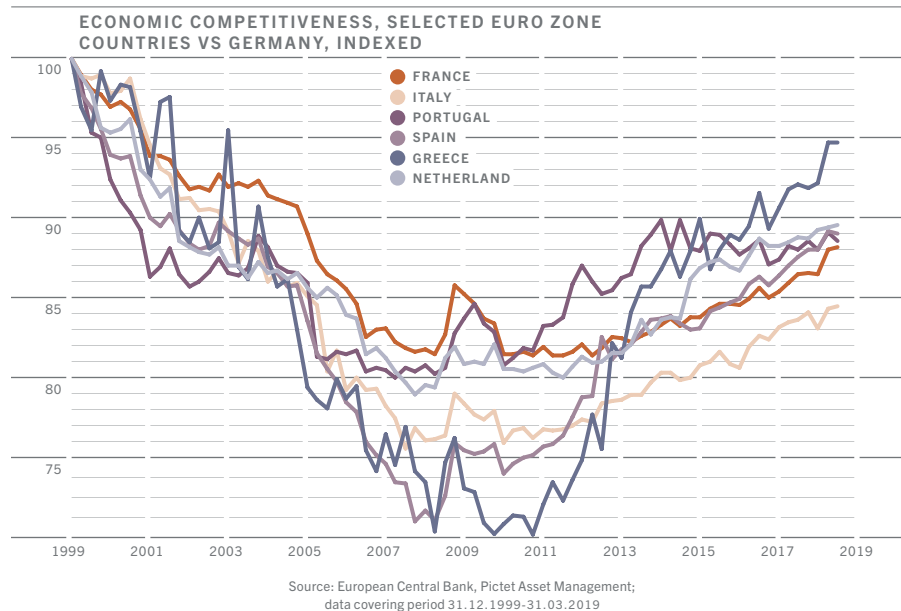
ness' scores for the euro zone have risen sharply in recent years, both in absolute terms and relative to the US.

Unsurprisingly, the most ambitious reform efforts emerged in response to the debt crises that erupted in the region's periphery. First came the euro zone's sovereign bailout fund – the European Stability Mechanism – which has provided billions of euros in emergency assistance to Greece, Ireland, Spain and Portugal. That was followed by its banking equivalent, the Single Supervisory and Resolution Mechanism, a backstop that has – so far – proved successful in insulating national governments from struggling lenders.

Strengthening these foundations requires the euro zone's political leaders to address two structural faults: the region's suffocating fiscal straitjacket and its fragmented banking system, which is responsible for anaemic levels of cross-border lending among member states

Playing catch-up with Germany

FIG.6



The fiscal problem is the thorniest. Although a growing number of euro zone leaders accept that co-ordinated public spending would help shore up demand during global downturns, there is little appetite for the kind of political integration envisaged by French President Emmanuel Macron. Pushing too far in this direction too quickly would risk a public backlash.

The proportion of economically active adults in the euro zone has risen to 73 per cent from 67 per cent in 2000; in the US, it has fallen from 77 per cent to 72 per cent

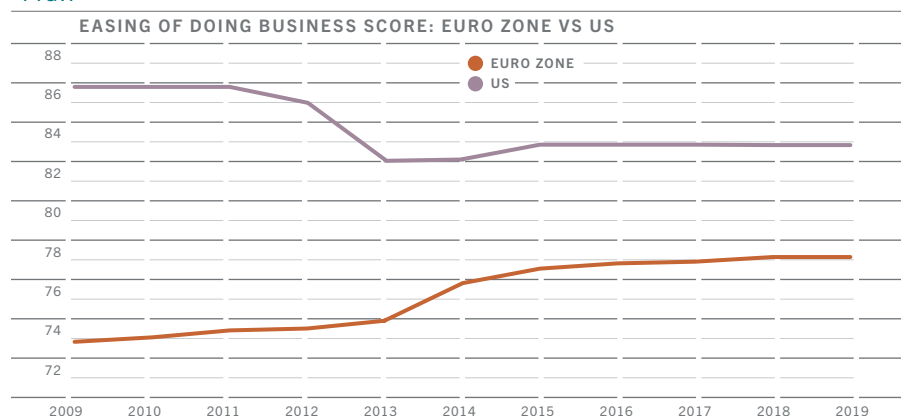
Even so, there are strong signs that fiscal stimulus will become a much bigger feature of euro zone economic policy in future. For one thing, the recently revamped European budget already gives policymakers the fiscal tools that could stabilise the economy should recession hit. Programmes such as the Cohesion Fund could be easily enlarged to safeguard countries from economic slumps. True, at an initial EUR22 billion, the size of the proposed euro zone budget is small. Yet the fact that it exists at all is an important milestone on the road to better fiscal co-ordination among member states.

Just as significant is the fact that Germany is beginning to question its decades-long adherence to fiscal prudence. Authorities there have acknowledged a chronic underinvestment in public infrastructure, and have already set aside more than EUR160 billion for critical repairs.

At the same time, there is a growing belief that the German economy needs a fiscal boost to cope with a series of

Euro zone's improving business credentials

FIG.7



Source: World Bank, Pictet Asset Management;
data covering period 31.12.2008-31.03.2019

potentially heavy blows to its exporters. A study by Insee in April 2019 found that Germany's GDP could suffer a 0.9 percentage point hit from a hard Brexit. Proposals from the US to impose tariffs of 25 per cent on auto imports, meanwhile, could wipe off an additional 0.6 percentage points. Germany's export industry is also vulnerable to technological change. As the world moves away from the internal combustion engine towards electric and self-driving vehicles, there is a nagging fear that German car manufacturers could be left behind. In a recent report, the OECD found that Germany's manufacturing base is more vulnerable to automation than any other economy bar Japan.

So the euro zone's economic development over the next five years could include a larger role for public spending. According to the IMF, that trend is firmly in place: it estimates that fiscal easing in 2019 should provide a 0.5 percentage point boost to GDP – a level of stimulus last seen 10 years ago.

The euro zone's prospects would look brighter still with the completion of a banking union and full integration of its capital markets. A region-wide deposit guarantee scheme looks likely to become a reality over the next five years, as does a harmonisation of insolvency laws and securities regulations. Such measures would boost cross-border lending and transform the euro into a global investment currency.

The ECB backstop

Another reason for optimism is the ECB. Under the eight-year stewardship of outgoing president Mario Draghi, it has done more than any other institution to protect the integrity of the single currency. Deftly overcoming the legal hurdles of Germany's Constitutional Court, among others, it has built and legitimised the tools that enable the monetary union to function, including quanti-

————— The euro zone's economic development over the next five years could include a larger role for public spending.

tative easing, outright monetary transactions and negative deposit rates.

Whoever replaces Draghi – leading candidates for the ECB presidency include board member Benoît Coeuré and the Bank of Finland head Olli Rehn – can reasonably be expected to inject greater flexibility into policymaking. And even if the more hawkish Jens Weidmann were to succeed Draghi, the Bundesbank president would, we believe, adopt a more pragmatic approach than he has hitherto advocated. That said, having a more hawkish ECB chief would not necessarily be a bad thing. It might serve as an impetus for euro zone reform, boosting efforts to improve the co-ordination of fiscal policymaking among member states.

There remains no consensus to abandon the single currency

Also in the euro zone's favour is the support it enjoys, particularly among those living in countries that have benefited least from its adoption. Although many member states have seen populist parties grow in strength over the last three years, it is striking that there remains no consensus to abandon the single currency. A record proportion of the population thinks the euro is a good thing for the region as a whole (74 per cent) and their own country (64 per cent), according to the most recent Eurobarometer survey, which was carried out in November 2018.

The fact that the single currency enjoys a high approval rating even among the citizens of recession-hit Italy and Greece suggests the Brexit debacle has drawn attention to the costs of exit.

For all this, the euro zone cannot fully guarantee a prosperous future until it clears the path for Italy to reduce its debts to more manageable levels. Weighed down by the one of the largest government debt piles in the world (133 per cent of GDP), the monetary union's third largest economy faces an uphill battle to keep its debt servicing costs in check.

————— Also in the euro zone's favour is the support it enjoys, particularly among those living in countries that have benefited least from its adoption.

Among the more radical solutions being debated in euro zone policy circles is a possible restructuring of Italian government debt. Under a proposed reform of the ESM unveiled earlier this year is the introduction of contractual obligations in all euro zone public bond issues (known as single-limb collective action clauses) that would allow a restructuring of bonds should the need arise.

Yet there are reasons to believe such radical measures could be avoided altogether. Clearly, Rome's partners could help by boosting their own domestic demand. That's more likely now given that Germany acknowledges the need to loosen its purse strings. The Italian government could also facilitate the process with more effective policies such as boosting capital expenditure, reducing income tax and increasing wealth taxes.

Then there's the ECB. It's unlikely the central bank would stand idly by in the event of a sustained rise in Italian borrowing costs.

So those envisaging a break up of the monetary union ignore its resilience at their peril.

Battered and bruised it may be, but the euro zone's ability to bounce back from crisis has been truly remarkable. The policymakers tasked with managing the single currency have learned several important lessons over the past 20 years. We're confident they will spend much of the next five applying them.

Corporate finance: the deleveraging myth



SUPRIYA MENON,
SENIOR MULTI ASSET
STRATEGIST

It's all about debt. Since excessive borrowing led to the global financial crisis in 2008, deleveraging has been widely seen by economists as the only route out of the mess. Companies don't appear to have taken any notice.

Firms have borrowed money in record amounts, a lot of it via the bond market. In some ways this is a rational choice, given how low interest rates have been. And it comes with benefits for the economy. However, it could also store up trouble for the future: the IMF has warned that "with debt at historically high levels, the corporate sector is vulnerable to large economic and financial shocks".¹¹ We agree.

Investors are partly to blame for the build-up of debt. Faced with lacklustre economic growth and ample central bank stimulus, owners of capital have allocated a net USD1.4 trillion into bonds over the past decade – twice as much as into equities.¹² Regulations have also played a part, with institutional investors such as insurers increasingly obliged to have large fixed income allocations, particularly in Europe, in order to meet their liabilities.

As a result, the cost of capital as well as its availability has shifted markedly in favour of debt over equity. This is true for the US and, even more so, for Europe (see FIG.8).¹³

For companies this has created an incentive to choose the cheaper funding on offer in the debt market – an option that becomes even more attractive considering the favourable tax treatment of interest payments, which are deducted from pre-tax income. Since 2009, US companies have borrowed a net USD3.2 trillion via debt securities and loans, while buying back a net USD3.8 trillion of equities.¹⁴

A case in point is Saudi oil giant Aramco, which scrapped plans for an initial public offering in favour of a bond issue and attracted USD100 billion of demand for USD12 billion of paper.

¹¹ Global Financial Stability Report, IMF, April 2019

¹² EPFR

¹³ We calculate the ERP ourselves for the US and Germany (as a proxy for EMU), and add that to the risk-free rate as the cost of equity. The cost of debt is the BBB yield. Note that they refer to the respective equity and corporate bond universes

¹⁴ US Fed Flow of Funds data

For investors, returns from corporate bonds have been positive—for now.

Yet the preference for debt over equity could soon throw up problems—not least because the volume of borrowing far outstrips companies' cash generation.

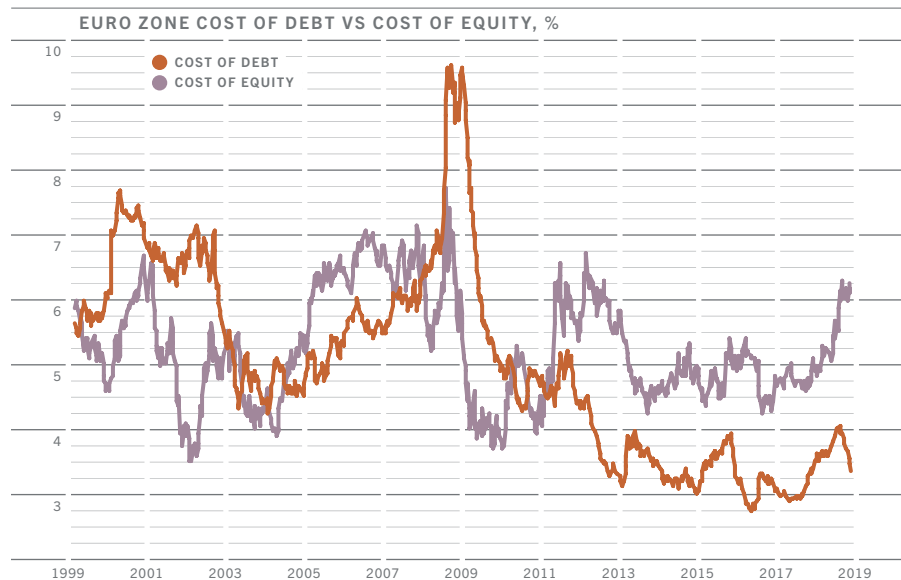
On the positive side, corporations have become less reliant on banks, with the bulk of financing now coming from bonds and institutional loans. Institutional investors originated 70 per cent of leveraged loans in 2017 versus 56 per cent in 2010.

That's a favourable shift because these marginal lenders tend to have a longer-term horizon than banks, better matching the needs of corporate borrowers. It could be argued that this brings greater balance to the economy, reducing the risk of a credit crunch. Institutional investors tend to be much less leveraged than banks and are thus less likely to be forced to reduce their lending in order to

Since 2009, US companies have borrowed a net USD3.2 trillion via debt securities and loans, while buying back a net USD3.8 trillion of equities

Debt the cheapest financing option

FIG.8



Source: Pictet Asset Management, Refinitiv, Bloomberg.
 Cost of equity calculated as equity risk premium for Germany (as a proxy for euro zone) plus the risk-free rate; cost of debt as BBB yield.
 Data covering period 01.01.1996 – 20.03.2019.

protect their balance sheets in periods of market volatility.

Less positively, the levels of debt building up in some segments—and the specific nature of that debt—are a real cause for concern.

¹⁵ <https://www.am.pictet/en/globalweb-site/global-articles/2018/insights/multi-asset/leveraged-lending-and-private-debt>

For a start, the rapidly growing leveraged loans market is already showing signs of stress in the form of weakening creditor covenants and deteriorating creditworthiness of issuers.¹⁵

The disintermediation of the financial sector – a structural trend set in motion by curbs on bank lending – has brought its own risks, with lending activity often falling outside regulators’ orbit.

So, while the Fed cracked down on debt ratios in bank-originated leveraged buy-outs (LBOs), the majority of these loans are now held outside banks and the proportion of highly levered deals has actually risen.¹⁶

How institutional investors respond to defaults, credit rating downgrades and financial restructurings has yet to be seen. We believe this is a risk both for investors in the asset class and for financial markets more broadly.

Certain types of companies are looking particularly stretched. US small caps have experienced a significant worsening of credit fundamentals. By their very nature, these small businesses are vulnerable to sudden declines in earnings or a rise in financing costs. Nearly a third of the companies in the Russell 2000 index have interest costs in excess of their annual earnings.¹⁷ Such companies—known

————— How institutional investors respond to defaults, credit rating downgrades and financial restructurings has yet to be seen.

as “zombies”—are able to stick around for longer thanks to access to credit, even though their business models may in some cases be unsustainable.

The ability to pay back debt will decrease further if – as we expect – corporate margins start to decline.

Sticking to investment-grade companies won’t necessarily offer investors iron-clad protection, either, as those companies too have become relatively more risky. The lowest rated BBB debt now makes up around half of this universe, up from a third of a decade ago.¹⁸

Among sectors, too, some are particularly exposed. Consumer staples companies stand out: current leverage is high relative to both their own history and to other sectors.

¹⁶ LCD/S&P Market Intelligence

¹⁷ Based on 3-year average EBITDA levels

¹⁸ <https://www.am.pictet/en/globalweb-site/global-articles/2018/market-views/in-brief/bbb-rated-debt-proportion>

Sticking to investment-grade companies won't necessarily offer investors iron-clad protection, either, as those companies too have become relatively more risky.

Even if they avoid the riskiest areas, investors may find it hard to meet their goals from credit over the coming years. For a start, after a decade of benign inflation, price pressures are starting to build steadily, which will eat into the value of bond coupons. Secondly, the significant shift in the comparative cost of capital means that companies with a similar risk profile offer much greater returns to equity investors than to bondholders.

Risk, of course, could be worth taking if there is adequate compensation. That is not necessarily the case here: we forecast average annual returns of -0.5 percent and 2.1 per cent for European and US investment-grade credit, compared with 6.4 and 3.3 per cent for European and US equities over the next five years.¹⁹

The debt landscape has changed over the past decade, but not in the way many had expected in the wake of the global financial crisis. The deleveraging story has proved to be a myth: it's not so much that there is less debt, but that the debt has shifted from one area of the economy to another. Whether it causes another crisis remains to be seen.

¹⁹ In local currency terms



Equities: US passes the baton

After a record bull run over more than a decade, developed-market equities are likely to lose steam during the next five years. Not only will they generate modest returns but a rise in market volatility will compound investor disappointment. Emerging market stocks should do much better.

Our forecast is for global equities to generate average annual returns of 4-5 per cent nominal, or around 2 per cent stripped of inflation. That's 5 percentage points below the long-term average. Such lacklustre returns will reflect weak corporate earnings growth – a consequence of subdued economic activity – and a modest decline in the price to earnings ratio as real rates edge up.

Strained geopolitics, particularly rumbling trade wars, and weaker investment from debt-laden corporations are likely to ensure a recession at some point during the coming half decade, and probably sooner rather than later, as indicated by the recent inversion of the US yield curve.

The emergence of more stringent regulatory and tax regimes will also weigh on business sentiment.

Not only will corporate tax rates rise from record low levels as tackling income inequality becomes a top political priority, but regulators can also be expected to take a more muscular approach when it comes to keeping industries competitive.

And all the while, the slow normalisation of monetary policy will drive the cost of capital higher.

Making the environment more difficult still, US share buybacks look like they're peaking. During each of the last three years, companies purchasing their own shares have boosted earnings per share growth by 2 per cent. The number of S&P 500 shares outstanding is back down to levels of 20 years ago. In all, we estimate that buybacks have accounted for some 15 per cent of the entire US bull market. Indeed, corporations have been buying more shares than investors, taking advantage of cheap financing and relatively cheap stock prices. US companies announced USD1 trillion of buybacks in 2018 compared to a total net flow of all active and passive funds of "merely" USD100 billion.

Strained geopolitics, particularly rumbling trade wars, and weaker investment from debt-laden corporations are likely to ensure a recession at some point during the coming half decade.

Bear in mind that European companies have been much less keen on share buybacks: the number of shares in issue in the euro zone is up 35 per cent since 1999, compared to just 5 per cent in the US—which goes a long way to explaining the 40 per cent underperformance of euro zone earnings per share over the same period.

With US equity indices marching to ever higher highs, valuations are once again stretched on cyclically adjusted terms and certainly compared to other countries' markets – US shares make up a record 63 per cent of the MSCI World Index. One indication of how much froth there is in the market is that 80 per cent of companies coming to the market for the first time are loss-making, a proportion only briefly seen once before: during the tech bubble of the late 1990s.

Throw in the fact that the US is further along in the business cycle, that its growth gap relative to other economies will shrink, that the US dollar is significantly overval-

US stocks: sub-par

FIG.9



Source: World Bank, Pictet Asset Management; data covering period 31.12.1999-31.03.2019

ued and that the erratic Trump administration represents a significant political risk, and it's starting to look like a great time to diversify away from US stocks.

We expect European equities to generate the best returns in the developed world, with euro zone shares delivering an annualised 8.6 per cent in dollar terms. About a quarter of that performance would come from the euro's gains against the dollar as fears fade that the single currency region will unravel. The UK, however, offers the best return/risk profile. Brexit worries have left this a particularly cheap market, offering dividend yields of some 5 per cent, in a cheap currency, made even more attractive by a sector composition. Although we don't see Japanese

shares doing quite as well, they should still outperform the US with a 6.3 per cent annualised return over the next five years. Japan's biggest advantage is that it's virtually debt free and is in the right part of the world – Chinese growth may be slowing, but it will still outperform other major markets.

Emerging market stocks to shine

Aggressive reform agendas have been announced in Indonesia, India and Brazil, among others

Emerging-market (EM) equities (we prefer EM Asia and EMEA to Latin America) look particularly attractive. Not only do emerging nations grow faster than developed ones, but inflation has trended down across these economies. The dampening of inflationary pressures is set to push real bond yields lower relative to their developed market peers, in turn leading to a re-rating of EM assets.

Both factors are supportive in the long run. And as their economies mature, shifting away from commodities and simple manufactured exports to domestic services, their investment potential improves.

Take China. Fast-developing economies that demand high levels of investment tend to generate strong GDP growth, but poor equity market performance. Only after

————— Emerging-market equities look particularly attractive. Not only do emerging nations grow faster than developed ones, a differential that's been widening in recent years, but inflation has trended down across these economies.

GDP growth settles at more normal rates and demand for investment slows do corporate margins and earnings blossom and equity markets boom. As the Chinese economy shifts from investment-driven growth to consumption – we forecast consumption will account for some 80 per cent of China's growth over the next five years – those same dynamics could take over. That could prime a perennially disappointing Chinese equity market for boom times. Also encouraging is that aggressive reform agendas have been announced in many large developing nations, including Indonesia, India and Brazil. Full implementation of India's plans would be particularly encouraging for the global economy, given the scale of the country's population.

Bonds: gasping for air

From almost every vantage point, bond investing is about to get more complicated.

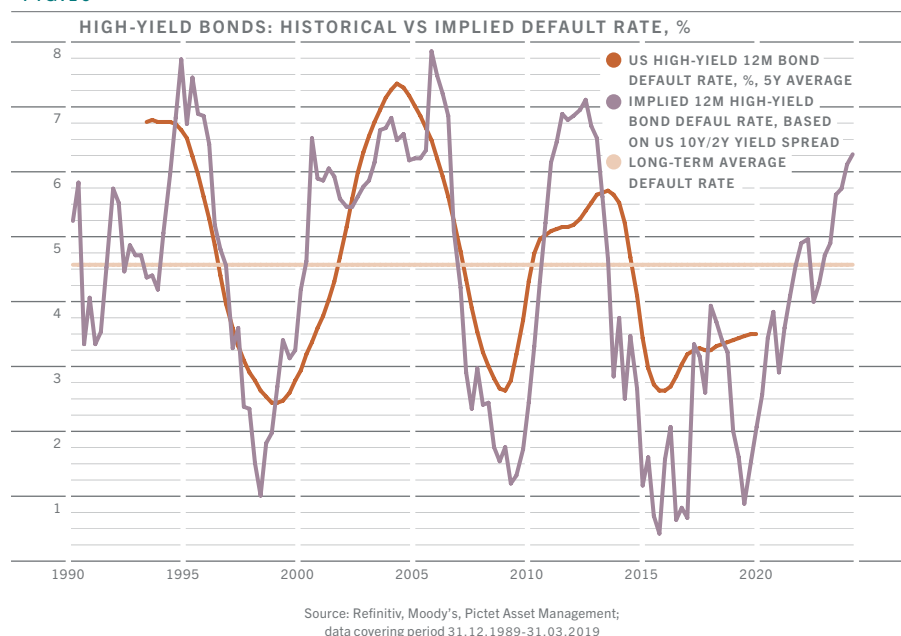
Lofty initial valuations, persistently high levels of bond supply and declining sovereign and corporate creditworthiness are among the factors that will trouble fixed income investors over the next five years.

Testifying to bondholders' dilemma, a record USD7 trillion of government bonds, accounting for some 30 per cent of the JP Morgan Global Bonds Index (GBI), have negative yields.²⁰

Even without taking inflation into account, we expect to see benchmark sovereign bonds in Germany, the euro zone, the UK, Switzerland and Japan deliver losses on average

High-yield bonds are not in a good place

FIG.10



over the next five years. The same goes for investment-grade bonds.²¹

Adjust that for inflation and, based on our forecasts, returns for US Treasuries, US investment-grade and European high-yield credit also slip into negative territory, as do those for global bonds in aggregate.

At the same time, the creditworthiness of issuers looks more likely to deteriorate than improve. When it comes to sovereign borrowers, the emergence of populist govern-

²⁰ As at 31.03.2019

²¹ Average annual returns over next five years in local currency terms

Governments across the world are warming to spending.

ments across the globe signals increased fiscal spending—and thus more borrowing.

On the corporate side, too, leverage has been rising while covenants have weakened. And corporate margins will come under severe pressure as wage costs rise and the global economy loses momentum. We feel that these risks are not reflected in yield spreads.

Indeed, for the first time in 30 years, spreads and corporate leverage have headed in opposite directions, suggesting complacency among investors about companies' ability to service an ever rising level of debt.

The US yield curve suggests the high-yield default rate will more than double over the next half a decade to 5.5 per cent. Based on historic correlations, that would suggest a spread of 575 basis points in five years' time compared to around 350-400bps now.

The risks could be aggravated by an influx of fallen angels—bonds which are downgraded from BBB and thus lose their investment-grade status. Our analysis shows that a credit downturn could create at least an additional USD150 billion worth of fallen angel bonds in the US alone.²² In a deep recession, the number could be much greater.

———— Even without taking inflation into account, we expect to see benchmark sovereign bonds in Germany, the euro zone, the UK, Switzerland and Japan deliver losses over the next five years.

Similar trends are at play in Europe, but there valuations are even higher. We see European investment-grade bonds returning -0.5 per cent a year, on average, over the next half a decade, with high yield achieving a positive 1.2 per cent. While returns in US should be higher, at 2.1 and 3.0 per cent, respectively for investment grade and high yield, inflation of 2.5 per cent will take a hefty chunk off that in real terms.

Slowly does it

For developed-market sovereign bonds, the theme of the next half decade will be the shift in the source of liquidity—from central banks to governments.

²² <https://www.am.pictet/en/globalwebsite/global-articles/2018/market-views/in-brief/bbb-rated-debt-proportion>

We expect that the Fed fund rates in five years' time will be roughly at the same level as it is today, and also see little movement elsewhere. ECB rates are likely to rise only as far as 0.75 per cent, with the UK at 1 per cent and Japan at zero.

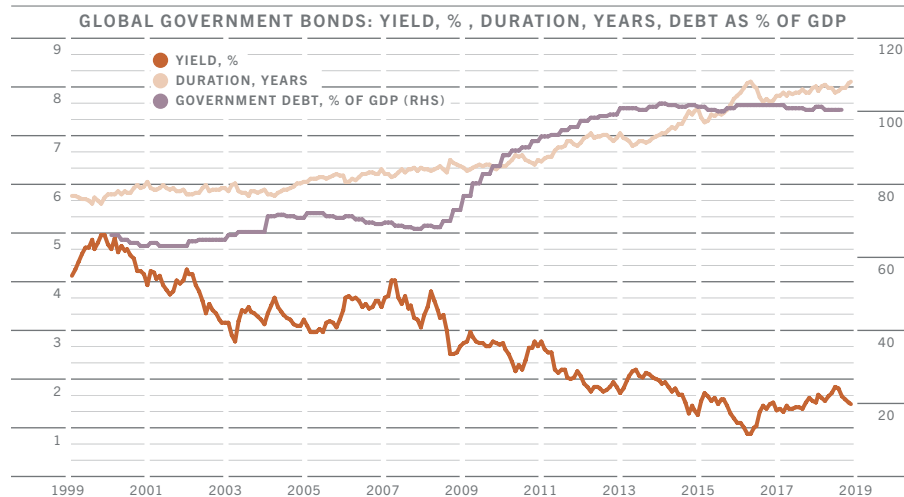
In contrast, governments across the world are warming to spending. That in turn will mean more supply of government bonds and bigger deficits. Even Germany—traditionally a beacon of fiscal prudence—has approved a package of infrastructure investment.

All that should weigh on sovereign bond returns. In Europe, we see these averaging -0.7 per cent per year over our forecast horizon. Even peripheral bonds—which have had a great run of late—will not escape the gloom, given the extremely low levels of sovereign spreads (circa 100bps in Spain and Portugal).

Italian bonds, at a 2.5 percent yield, look optically attractive but the country rating is under review and at risk of

The problem with bonds: more risk, less income

FIG.11



Source: Refinitiv, JPMorgan Global Government Bond Index, Pictet Asset Management; data covering period 31.12.1999-31.103.2019

falling below investment grade as early as the end of this year. A protracted recession and the populist government's failure to address the structural causes of economic weakness could once again stoke fears of a restructuring and/or redenomination of Italian debt, all the more so if the new ECB president is a hawk.

Structural reform in emerging economies is starting to pay off, not least in China.

In the US, our models point to a 3.5 per cent yield on benchmark 10-year Treasuries by March 2023 – up from today's 2.5 per cent. This will go some way in removing a longstanding anomaly – the gap that exists between US yields and nominal US GDP growth. US inflation-linked bonds should outperform their mainstream peers, but we still see total returns well below their historical norm.

Saving grace

In this environment, emerging-market bonds are a rare bright spot, and we would expect the asset class to draw in flows from investors who would ordinarily be content with developed market credit.

Structural reform in emerging economies is starting to pay off, not least in China. Inflation across large parts of the emerging world is subdued, domestic demand is solid and currencies are at some of the cheapest levels seen for the past two decades – undervalued by 15 to 20 per cent versus the US dollar according to our calculations.

Within the emerging markets universe, prospects look especially good for local currency-denominated Chinese bonds, an asset class that is supported by central bank poli-

———— In this environment, emerging-market bonds are a rare bright spot, and we would expect the asset class to draw in flows from investors who would ordinarily be content with developed market credit.

cy, foreign investor demand and the rising prominence of the renminbi on the world stage. Allowing for a modest pick-up in Chinese inflation, our models suggest an average real return of circa 2.5 per cent per annum for a US dollar investor.

Currencies: dollar in the doldrums

Twin deficits, double the trouble. The US current account deficit and the widening government budget shortfall – the twin deficit is already at a cyclically adjusted 6 per cent of GDP – are storing up problems for the dollar.

Until now, the dollar has been able to rise in the face of a persistent US current account deficit. That's partly because this element of the balance of payments ledger has remained remarkably stable over the past decade, reflecting a narrowing of the US petroleum trade deficit.

But the dollar's problem over the next five years will be the emergence of a large public sector deficit alongside the current account one.

For the first time since the 1950s, the US budget balance is deteriorating while the economy is booming, with the government on course to run a deficit of nearly USD1 trillion in the fiscal year 2019.

That this is happening at a time when the US economy

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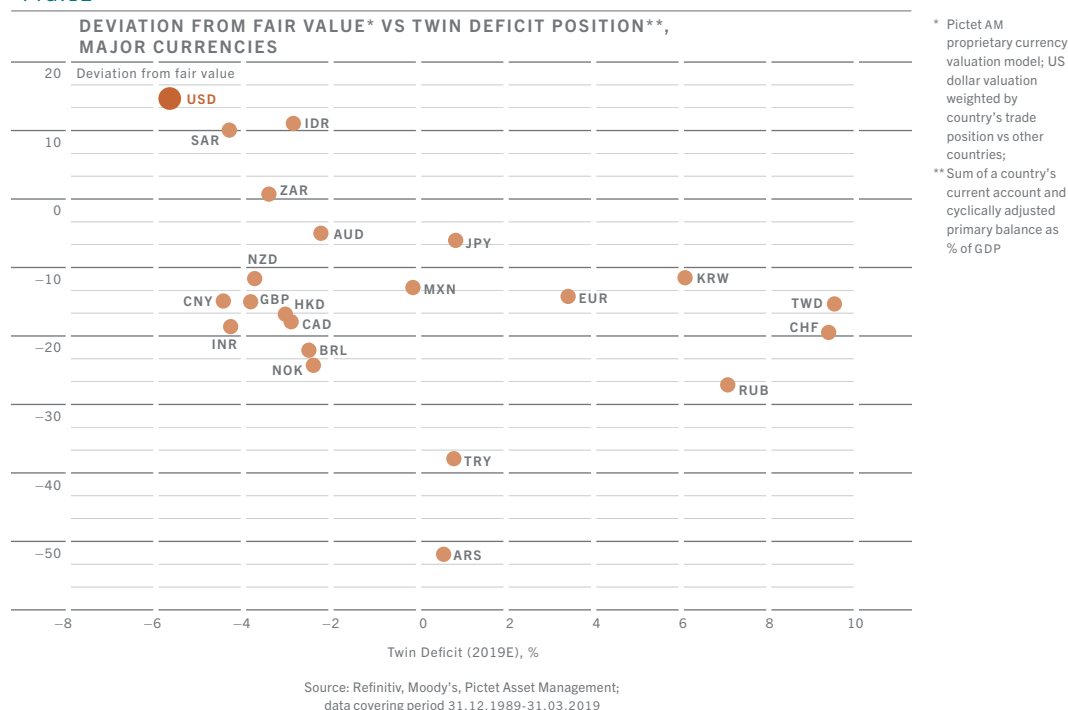
is growing at potential – its output gap is positive – is worrying for the US dollar. Historically, when the economy is running close to maximum speed, tax receipts are high and public borrowing is low. But that relationship has been turned on its head.

Based on our analysis of the US output gap and budget deficit over the past 50 years, we calculate that US government spending is over-stimulating the economy by an amount equivalent to 2.6 per cent of GDP, the highest since 1973. Such fiscal largesse may have given the dollar a boost over the short term but longer term it represents a significant headwind.

Eventually a currency must pay heed to its economic fundamentals: the US has the worst twin deficit among major economies.

High-yield bonds are not in a good place

FIG.12



cies on average rise 4.7 per cent against the dollar per annum.

Additionally, they benefit from unusually attractive valuations: our model shows EM currencies in aggregate are trading by as much as 20 per cent below fair value against the dollar.

Within EM currencies, we think the Indian rupee is likely to strengthen the most, thanks to India's impressive economic growth spurt. We calculate that the rupee will appre-

ciate by 1.6 per cent per year on a trade-weighted basis in the five years to 2024. China's renminbi should also benefit from the dollar's depreciation; it is likely to appreciate by 0.8 per cent on a trade-weighted basis but by even more against the greenback.

Several developed-world currencies are likely to benefit from the dollar's broad weakness, with the euro appreciating by an annual 4 per cent and the yen and sterling by 3 per cent.

Alternatives: an uphill struggle for private equity, but a hedge funds revival

Dial down private equity. Allocate more capital to commodities, real estate and hedge funds. That's the conclusion investors should draw from our assessment of the long-term prospects for alternative investments.

Private equity is among the alternative investments that might struggle to match the returns of previous years, particular when compared to listed equity. Debt could be a problem. Taking advantage of low interest rates, private equity firms have borrowed record amounts to finance acquisitions. On average, such funds are making acquisitions at a price equal to 10.8 times company earnings (EBITDA, earnings before interest, tax, depreciation and debt amortisation). That ratio is marginally below the all-time high of 11 times, and amounts to a 30 per cent premium to that of listed companies.

This wouldn't be troublesome if the firms acquired could be relied upon to deliver an increase in earnings year in, year out. But there's no guarantee of that.

Corporate profit margins are certain to come under pressure over the next five years due to a combination of higher taxes, increased labour costs and tighter regulation. This means companies will find it harder to service their debts, weighing on investors' returns.

Another possible red flag is that asset-holding periods – the time it takes for a private firm to be sold on after a buyout – are falling. On average, private equity firms currently take just 4.5 years to sell on their investments, according to data from Preqin. That's down from five years in 2017 and represents the most rapid turnaround time for a decade. There could be several reasons for the decline – it might indicate that sentiment remains buoyant. But it might be interpreted as a signal that private equity investors see trouble ahead, and prefer an early exit. That would be a repeat of the pattern seen in the months leading up to 2008, when holding periods fell below four years.

An additional problem is that viable acquisition targets are in increasingly short supply. With company valuations

rising, private equity funds are struggling to deploy their cash. They are holding on to a record USD2 trillion of dry powder—double the amount a decade ago.

All this is beginning to affect returns.

Private equity has outpaced listed stocks by less than 2 per cent per year over the past five years compared to the long-term average of 8.3 per cent. We expect that trend to hold over the next five years.

While private equity will struggle to beat listed stocks, commodities apart from oil could deliver a pleasant surprise. Metals in particular. That's largely thanks to efforts aimed at building a low-carbon economy.

As a report from the World Bank shows,²³ many of the technologies that can reduce greenhouse gases require large amounts of metals and minerals. Aluminium and copper, for example, are used extensively in solar panels and wind turbines as well as carbon-capture technology and electric motors. Electric vehicles use up to 50 kilogrammes of copper each. High-capacity batteries depend heavily on lithium, nickel and cobalt. Metals prices will see an additional boost from the depreciation in the US dollar and an

———— While private equity will struggle, commodities apart from oil could deliver a pleasant surprise. Metals in particular. That's largely thanks to efforts aimed at building a low carbon economy.

increase in public spending on infrastructure in countries such as Germany. Valuations are also encouraging: prices for many industrial metals are some 50 per cent below their inflation-adjusted highs, which were hit in 2007.

Gold also looks set to receive a shot in the arm. Not only should it gain in value as the dollar declines, but the prospect of continued political upheaval should also bolster demand. Central banks have been buying the precious metal at the fastest pace in 50 years—causing a supply-demand imbalance that we expect to endure. According to

²³ See The Growing Role of Minerals and Metals for a Low Carbon Future, The World Bank, July 2017

Gold is also set to receive a shot in the arm.

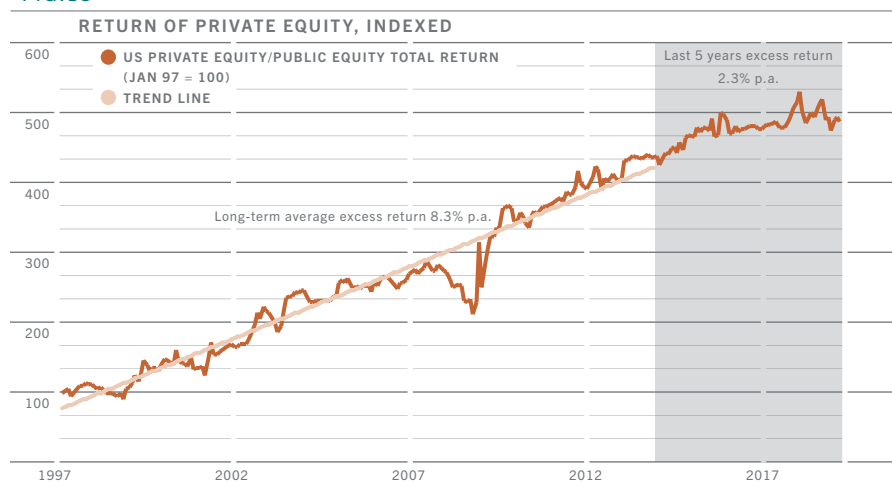
our forecasts, the gold price should rise by some 7 per cent per year through to 2024, delivering a higher return than both developed-market stocks and bonds.

When it comes to real estate, globally the picture doesn't look particularly encouraging – not least because property prices, when compared to rent and household income, are some 5 to 10 per cent above the historic trend. But there are some bright spots.

Europe looks attractive, especially when compared to the US. This is partly because the European property market is at an earlier phase of its cycle than its American counterpart. Occupancy rates for offices in some of Europe's cities have reached 95 per cent or above, suggesting potential for a rise in rents. In the US, by contrast, commercial property vacancy rates are twice the long-term average. Demand in Europe's residential sector can also be expected to be supported by a number of structural trends. For instance, construction activity in Europe has

Private assets losing their advantage

FIG.13



Source: Refinitiv, Pictet Asset Management; index used for private assets
Total Return Equity Buyout Index, index used for public assets MSCI US equity index;
data covering period 31.12.1996-31.03.2019

failed to keep pace with the rise in the number of single households across the region. At the same time, the ageing of Europe's population has led to an increase in demand for specialised retirement accommodation.

Taking this into account, and with bond yields struggling to nudge above inflation, we expect a return of 3 per cent per year from European real estate, which makes it an attractive investment proposition relative to domestic bonds.

Elsewhere in the alternatives sector, hedge funds appear well positioned to deliver strong volatility-adjusted returns. With the financial market likely to become more volatile, and the dispersion of returns across individual securities set to rise from unusually low levels, investment strategies that do not depend on market gyrations for returns should do well. Over the next five years, we expect hedge funds to deliver among the strongest returns of any asset class on a volatility-adjusted basis, even if absolute returns per year are likely to be in the 3 to 4 per cent range.

Conclusion

It's been an incredible run. Over the past 10 years, investors have witnessed the longest equity bull run in history as asset prices have been boosted by exceptionally loose monetary policy and corporate profits have surged thanks in part to a reduction in tax rates. Financial markets have also been unusually well behaved – the volatility of bonds and stocks has been below average for much of the last decade.

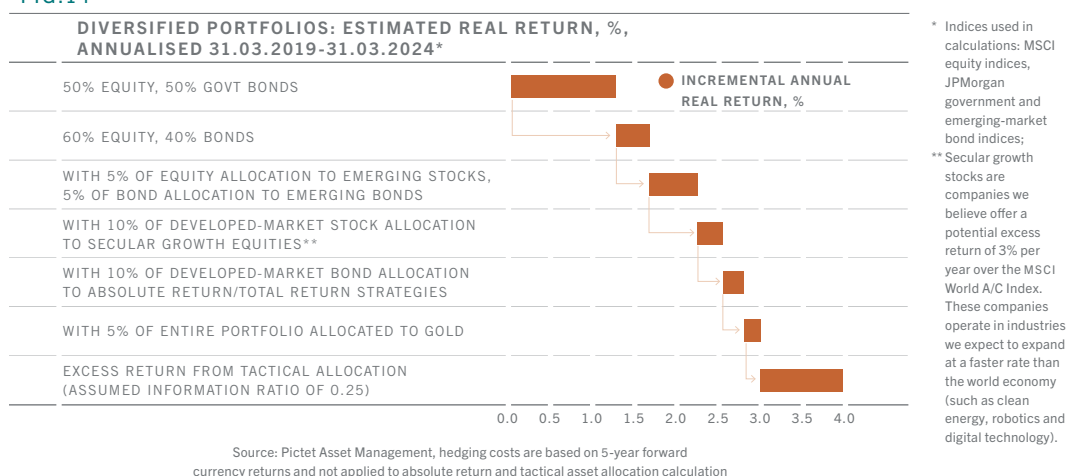
But this is about to change, and for several reasons.

For one thing, economic growth, particularly in the developed world, will slow as the US boom gives way to a recession. Global growth peaked at the end of 2017 and will head inexorably lower over the next five years.

Fiscal and monetary stimulus will be also in short supply. Government debt remains at record levels while central banks have fewer weapons at their disposal—to the ex-

How to get decent
inflation-adjusted
return

FIG.14



tent that some may be forced to rethink long-held policy dogmas, not least inflation targeting.

The embrace of economic nationalism across the developed and developing world is another risk, threatening everything from central bank independence to global trade.

Investors will also have to contend with the disappearance of the demographic dividend. The ratio of the non-working-age to working-age population is rising for the first time since the 1970s as baby boomers retire. This will result in a decline of the savings ratio, which could redraw the investment landscape. At the same time, rising labour costs, higher tax rates and tighter regulations will squeeze corporate profit margins.

The upshot is that a traditional portfolio split 50-50 between developed-market equities and government bonds will struggle to deliver positive inflation-adjusted returns over the next five years.

Investors will therefore have to reconfigure their asset allocation. As our return forecasts show, US stocks can no longer be expected to provide strong inflation-adjusted returns. The US is an expensive stock market, priced in an expensive currency. The country's growth gap relative to the rest of the developed world will shrink.

All of which supports the case that now is an opportune time to diversify away from US stocks.

The question is, where to? European stocks, traditionally a wild card, look in good shape. Notwithstanding the risk of political fragmentation, we think the euro zone could be a source of positive surprises. It would be wrong to write it off.

Emerging markets stocks also look attractive, especially in Asia. China's growth will slow from the heady pace of recent decades, but it will be of superior quality. The country's consumption will be the big engine of global growth in the next decade, and the renminbi will increasingly take on the status of a reserve currency as financial reforms gather pace. This will also enable Chinese stocks to outperform the broader market.

Within fixed income, development-market corporate bonds look particularly vulnerable.

Bond yields are still largely below inflation and corporate leverage is at record highs. As part of their fixed income allocation, investors will have to take on more risk to generate positive returns; this will mean investing more in emerging market debt.

With many traditional asset classes set to generate below-average returns over the next five years, currencies will become a key source of alpha. After reaching a point where it is overvalued by some 15 to 20 per cent, the dollar will steadily decline against most currencies. Among alternatives, hedge funds, some real estate markets and commodities, especially gold, should do well. Private equity, meanwhile, will struggle to beat listed stocks by as much as it has done in the past. The next five years, then, will lead to a redefinition of the diversified portfolio.

We believe...

understanding how the economic landscape changes over time is both a fundamental component of strategic asset allocation and crucial for investment success over the long run.



OLIVIER GINGUENÉ

The Secular Outlook is produced by Pictet Asset Management's Strategy Unit (PSU). The research embeds, and is a reflection of, the PSU's investment philosophy.

————— We believe...

Macroeconomic forces have a bigger influence on asset class returns over the medium and long term than any other

factor; understanding how the economic landscape changes over time is both a fundamental component of strategic asset allocation and crucial for investment success over the long run.

Over the short run, markets are more volatile than is warranted by underlying economic conditions.

Moreover, the relationship between asset classes is not stable through time. This leads to a mispricing of assets, which presents opportunities for tactical asset allocation.

Every asset class carries a risk premium, which rises and falls as the business cycle progresses from one phase to another.

The focus of our research is to identify how the macroeconomic environment is changing and how this is likely to affect the risk premium attached to each asset class.

The skilled deployment of both strategic and tactical asset allocation can deliver superior investment returns over the long term.

Economic forecast

Our bond yield forecasts are based on a ratio of bond yield-to-nominal trend GDP growth of 0.75 times for US and UK and 0.7 times for Germany (using euro zone GDP); for Japan we assume the bond yield rises in line with trend inflation by 2024. To calculate the future annualised roll, we take Bloomberg curve data and adjust the roll for year 5 based on where we expect the 10-year policy rate to be. Return forecasts assume a recovery rate of 40 per cent for developed-market bonds, 50 per cent for EM sovereign debt and 30 per cent for EM credit.

The following benchmarks are used: JPMorgan indices for developed/emerging government bonds and emerging corporate bonds; SBI Index for Swiss bonds; Barclays Euro Aggregate Corporate Index for euro zone investment grade; BoFA Merrill Lynch indices for euro zone/US high yield, US 10-year TIPS.

For equity market forecasts, sales growth is proxied by our forecast of nominal GDP growth (average 2018 to 2022), adjusted for regional revenue exposure. Our profit margin change forecasts assume a reversion to long-term mean over the next 10 years, adjusted by business cycle (output gap) and expected currency appreciation. Earnings per share growth is adjusted for dilution effects.

Fair value is based on 12-month PE for the S&P 500 index, with the model incorporating forecasts for bond yields, inflation, and trend GDP growth. The forecast assumes P/E ratio reverts to long-term average discount to US (post-1999 for euro zone, Switzerland and Japan). Frontier market PE is the same as emerging market PE.

Asset class return forecasts

Our GDP forecasts are based on estimating countries' current potential growth, and adjusting that by current production factors—which determine how effectively economic inputs are being translated into outputs.

Potential output is defined as the highest real GDP level that can be sustained over the long run.

First, we decompose raw GDP data into cyclical and trend components. Then we apply the Phillips curve approach to determine the natural level of output, which is consistent with stable inflation (NAILO) and/or with a stable unemployment rate (NAIRU).

Production factors such as the state of the labour market, the availability of private capital and the degree of technological advancement are then applied to the potential output figure to determine the pace of potential—or trend—economic growth in five years' time. We then use linear interpolation to determine growth estimates for the preceding four years.

To forecast inflation, we combine three approaches. The first is based on the current inflation trends, using the Hodrick-Prescott filtering method. The second calculates optimal inflation based on the assumption that neutrality of money prevails over the long run. The third considers the variations in the transmission dynamics between money supply and inflation depending on the state of the economy (expansion, financial crisis). Our final inflation forecast is an average of the three calculations.

Pictet AM Strategy Unit

Management



Olivier Ginguené
Chairman of
Strategy Unit, CIO,
Multi Asset &
Quantitative Investment

Renaud de Planta
Managing Partner

Sébastien Eisinger
Managing Partner

Philippe de Weck
CIO, Equities

Raymond Sagayam
CIO, Fixed Income

Investment Managers



Eric Rosset
Head of Multi Asset
Switzerland, Geneva

Andrea Delitala
Head of Multi Asset
Euro, Milan

Andrew Cole
Head of Multi Asset
UK, London

Hiroshi Matsumoto
Head of Multi Asset
Japan, Tokyo

Andres Sanchez-Balcazar
Head of Global Bonds
Geneva



Anastassios Frangulidis
Head of Multi Asset
Zurich

Marco Piersimoni
Multi Asset Euro,
Senior Investment
Manager Milan

Shaniel Ramjee
Multi Asset UK,
Senior Investment
Manager London

Andy Wong
Multi Asset Hong Kong,
Senior Investment
Manager Hong Kong

Research



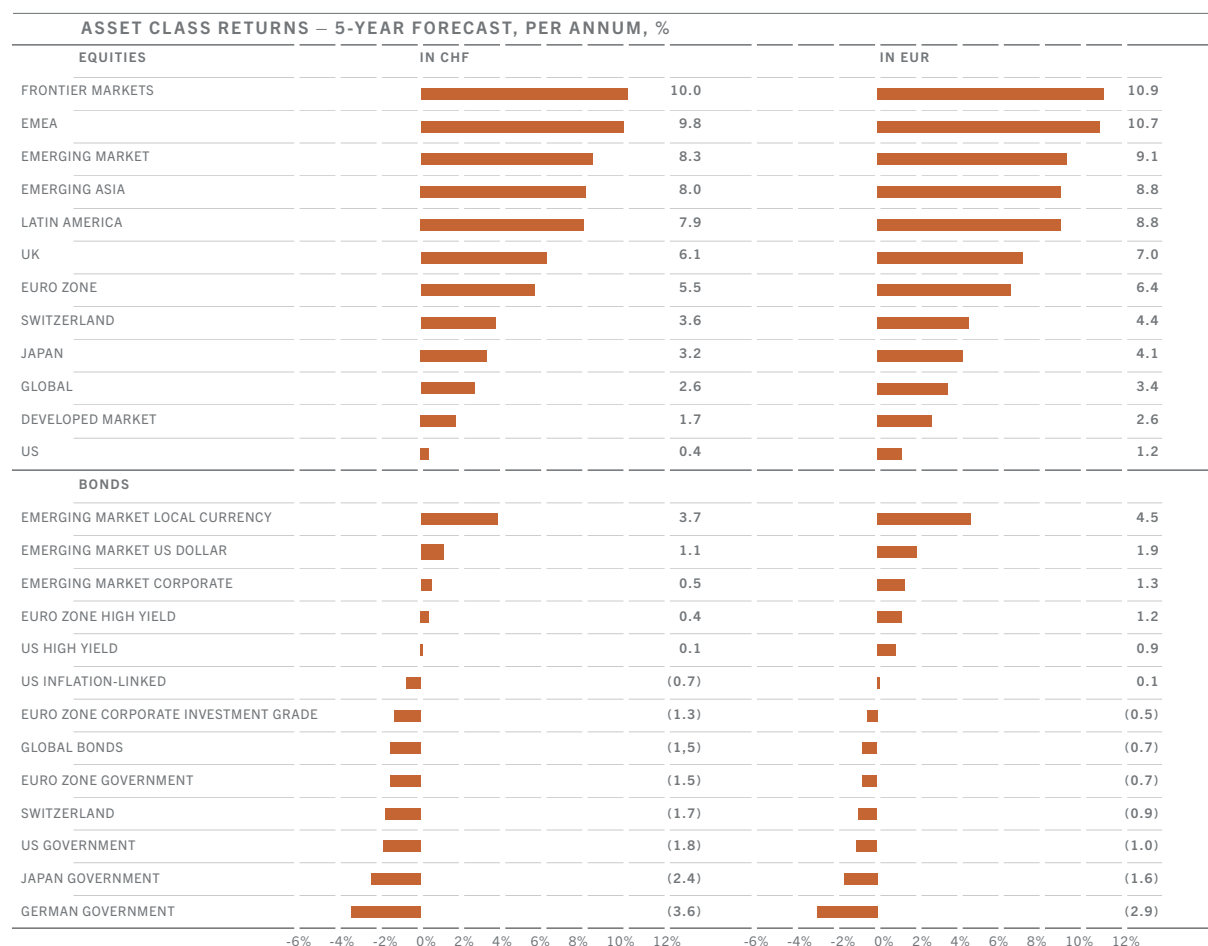
Patrick Zweifel
Chief Economist
Geneva

Luca Paolini
Chief Strategist
London

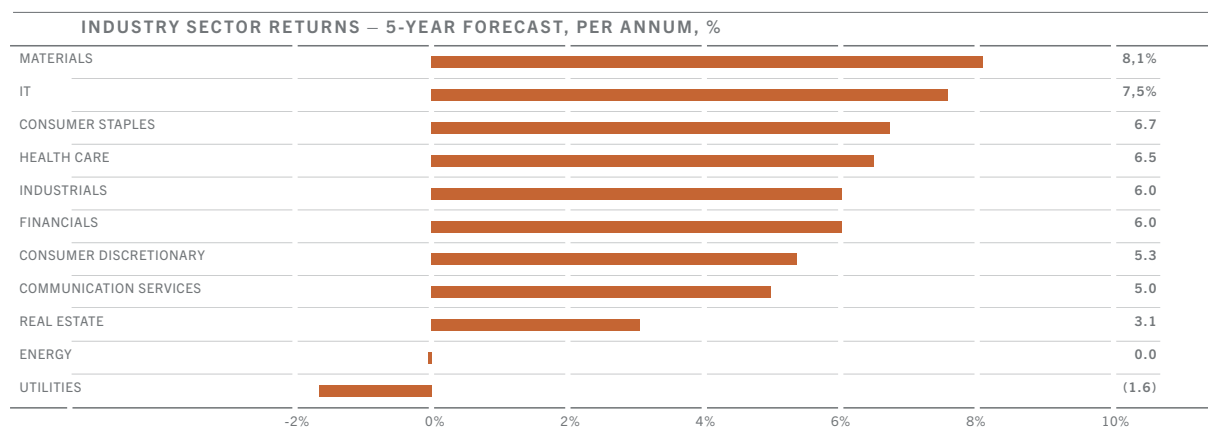
Supriya Menon
Senior Multi Asset
Strategist London

Steve Donzé
Senior Macro Strategist
London / Geneva

Stefano Nora
Head of Sector Research
Dev. Markets
London



Source: Pictet Asset Management (forecast horizon 31.03.2019-31.03.2024)



Source: Pictet Asset Management (forecast horizon 31.03.2019-31.03.2024), returns in local currency terms

ECONOMIC GROWTH AND INFLATION – 5-YEAR FORECAST			
%	AVERAGE REAL GDP GROWTH 2019-2024	TREND REAL GDP GROWTH BY 2024	AVERAGE INFLATION 2019-2024
WORLD	2.8	2.9	2.6
DEVELOPED ECONOMIES	1.4	1.6	2.1
EMERGING ECONOMIES	4.5	4.4	3.2
DEVELOPED ECONOMIES			
UNITED STATES	1.6	2.0	2.2
EURO ZONE	1.2	1.4	1.7
GERMANY	1.5	1.7	1.9
JAPAN	0.8	0.9	0.9
UNITED KINGDOM	1.4	1.4	2.0
SWITZERLAND	1.5	1.5	0.8
EMERGING ECONOMIES			
CHINA	5.5	4.8	2.2
INDIA	7.3	7.5	4.2
ASIA EX-JAPAN	5.4	5.0	2.2
BRAZIL	2.1	2.2	4.0
LATIN AMERICA	2.5	2.7	4.0
RUSSIA	1.7	2.0	4.1

Source: Pictet Asset Management (forecast horizon 31.03.2019-31.03.2024)

GOVERNMENT, CORPORATE AND EMERGING-MARKET BONDS – 5-YEAR FORECAST							
	DURATION (YRS)	CURRENT YIELD (%)	FORECAST YIELD IN 5 YEARS' TIME*	ANNUALISED ROLL**	OUR RETURN FORECAST %	CURRENCY GAIN P.A. %	USD RETURN P.A. %
US GOVERNMENT	6.6	2.5	3.5	0.4	1.5	0.0	1.5
GERMAN GOVERNMENT	7.9	0.1	2.2	0.9	(2.1)	2.1	0.0
EURO ZONE GOVERNMENT	8.0	0.9	2.8	0.9	(0.7)	2.1	1.4
UK GOVERNMENT	12.6	1.4	3.0	1.6	(0.9)	1.7	0.8
SWISS	7.5	0.1	2.1	0.8	(1.7)	2.9	1.2
JAPAN GOVERNMENT	10.8	0.2	1.3	0.9	(1.1)	1.6	0.5
EURO ZONE INVESTMENT GRADE	5.1	0.8	3.9	0.6	(0.5)	2.1	1.6
EURO ZONE HIGH-YIELD***	4.1	3.9	7.4	0.5	1.2	2.1	3.3
EMERGING-MARKET USD	7.0	6.0	7.2	0.4	4.0	0.0	4.0
EMERGING MARKET LOCAL CURRENCY	5.2	6.2	7.3	0.0	5.3	1.3	6.7
EMERGING-MARKET CORPORATE	4.6	5.5	7.5	0.3	3.4	0.0	3.4
US INVESTMENT GRADE	7.0	3.7	5.4	0.4	2.1	0.0	2.1
US HIGH YIELD	4.4	6.7	9.2	0.2	3.0	0.0	3.0
US INFLATION-LINKED	4.7	0.6	0.9	0.1	2.3	0.0	2.3
GLOBAL GOVERNMENT	7.9	1.5	2.8	0.8	0.3	1.1	1.4

Source: Pictet Asset Management (forecast horizon 31.03.2019-31.03.2024)

* Assumes a bond yield to nominal trend GDP growth ratio of 0.75 for US, 0.7 for Germany (using euro zone GDP); for Japan we assume bond yield rises in line with trend inflation by 2023. Benchmarks: JPMorgan indices for developed/emerging government bonds and emerging corporate bonds; SBI Index for Swiss bonds; Barclays Euro Aggregate Corporate Index for euro zone investment grade; BoFA Merrill Lynch indices for euro zone/US high yield, US 10-year TIPS

** Adjust roll for year 5 based on where we expect 10-year policy rate to be; earlier years use roll calculation from Bloomberg curve data

*** Assumes recovery rate of 40% for developed-world bonds, 50% for emerging-market sovereign bonds and 35% for emerging-market corporate bonds

EQUITY MARKET RETURNS – 5-YEAR FORECAST											
	YIELD, P.A. %	SALES GROWTH, P.A. %*	MARGIN CHANGE, P.A. %**	EPS GROWTH, P.A. %***	12M P/E RATIO			% P/E CHANGE P.A.	TOTAL RETURN P.A.		
					CURRENT P/E	LONG-TERM AVERAGE	FORECAST IN 5 YRS****		LOCAL CURRENCY %	CURRENCY GAIN %	IN P.A. USD %
UNITED STATES	2.1	4.5	(1.8)	3.1	16.5	16.1	15.0	(1.8)	3.3	0.0	3.3
EURO ZONE	3.8	4.4	(1.5)	2.8	12.9	13.9	12.7	(0.2)	6.4	2.1	8.6
SWITZERLAND	3.3	4.6	(1.2)	3.3	16.9	15.2	14.6	(2.9)	3.6	2.9	6.6
UNITED KINGDOM	4.9	4.6	(2.4)	2.1	12.4	14.3	12.7	0.4	7.4	1.7	9.2
JAPAN	2.6	3.2	(1.3)	1.8	12.6	18.7	12.7	0.2	4.6	1.6	6.3
DEVELOPED MARKETS	2.6	4.4	(1.7)	2.9	15.4	15.9	14.4	(1.4)	4.1	0.6	4.7
EMERGING ASIA	2.7	7.0	0.2	6.6	12.6	12.0	12.0	(0.9)	8.4	2.5	11.1
LATIN AMERICA	3.7	6.3	0.1	5.8	12.1	11.1	12.0	(0.1)	9.4	1.5	11.1
EMEA	4.9	7.8	(1.3)	5.9	8.8	9.7	9.3	1.0	11.8	1.1	13.0
EMERGING MARKETS	3.1	7.0	0.0	6.5	11.8	11.3	11.5	(0.6)	9.0	2.2	11.4
FRONTIER MARKETS	3.9	8.5	0.0	8.0	12.1	10.5	11.5	(1.1)	10.7	2.2	13.2
GLOBAL (MSCI ACWI)	2.6	4.7	(1.5)	3.4	15.0	15.2	14.0	(1.3)	4.7	0.8	5.6
LAST YEAR GLOBAL (MSCI ACWI)	2.6	5.3	(1.6)	3.5	14.9	15.4	13.9	(1.4)	4.4	0.4	4.8

Source: Pictet Asset Management (forecast horizon 31.03.2019-31.03.2024)

* Proxied by our forecast for nominal GDP growth (average 2019-2023), adjusted for regional revenue exposure.

** Based on a reversion to long-term mean, adjusted by business cycle (output gap) and expected currency appreciation.

*** Adjusted for dilution effects (0.0% in developed markets and 1% in emerging markets).

**** Fair value based on 12-month PE S&P 500 index (model incorporates forecasts for bond yields, inflation, and trend GDP growth). Forecast assumes P/E ratio reverts to long-term average discount to US (post-1999 for Euro zone, Switzerland and Japan). Frontier market PE is the same as emerging-market PE.



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