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Overview

Many investors draw comfort from the fact that the world economy has a habit of defying gravity.

It has grown in 58 of the past 60 years, having overcome war, terrorism, political upheaval, energy crises and financial busts. And there is no reason to believe it can't build on that record over the rest of this decade. It will likely continue to advance year in, year out.

Yet plenty of those same investors will also have noticed that the economy's ongoing expansion rests on ever more fragile foundations. Gone are the days of the Great Moderation, when global trade was flourishing, and inflation and interest rates were heading inexorably lower.

That era has given way to a period that is decidedly less benign. In our 12th Secular Outlook, we find that as globalisation stalls, the world population ages and businesses struggle with the rising costs of net zero and labour shortages, productivity is unlikely to rise much over the remainder of this decade.

As such, we expect only modest GDP growth over the next five years. True, our models predict a solid economic expansion from some reform-minded emerging market giants such as India. But this will be offset by a sub-par performance from the US and China. Worldwide, we expect the economy to grow by just 2.6 per cent per year in real terms through to 2029, just below its long-term average.

Making matters potentially more complicated for investors is the likelihood that moderate growth won't translate into moderate inflationary pressures. We think inflation might prove a stubborn foe; although it will eventually settle within central bank target ranges by the end of this decade, it will be more volatile than policymakers would like. Not least because of labour shortages and the possibility that the net zero transition could push energy and commodity prices higher over the medium term.

All in all, it's an economic environment that will alter the dynamics of equity, bond and foreign exchange markets in a number of ways. First, equities' excess returns over corporate bonds will be below average. In absolute terms, stocks in the MSCI World Index will generate a reasonable return of some 7 per cent per year in local currency over the next five years. But relative to corporate bonds, our calculations show they will deliver an excess return of just 1 per cent per year versus around 10 per cent over the past five years – and this for roughly two times the risk.

Less obvious but no less important, the dispersion of returns across regional and national equity markets will decline. Our forecasts show that almost every equity market in the developed world will generate an annualised return that is either only marginally above or marginally below the 7 per cent mark.

The final major change will occur in the foreign exchange market. Here, the defining feature will be a steady but persistent depreciation in the US dollar. On a trade-weighted basis, we expect a decline of some 2 per cent per year through to 2029.

As these three trends coalesce, they present a slightly different course for investors to follow over the next five years. Corporate bonds should account for a larger share of portfolios while same can be said of assets that are negatively correlated to the dollar. Investors might also be better served by allocating capital along sectoral rather than regional lines.

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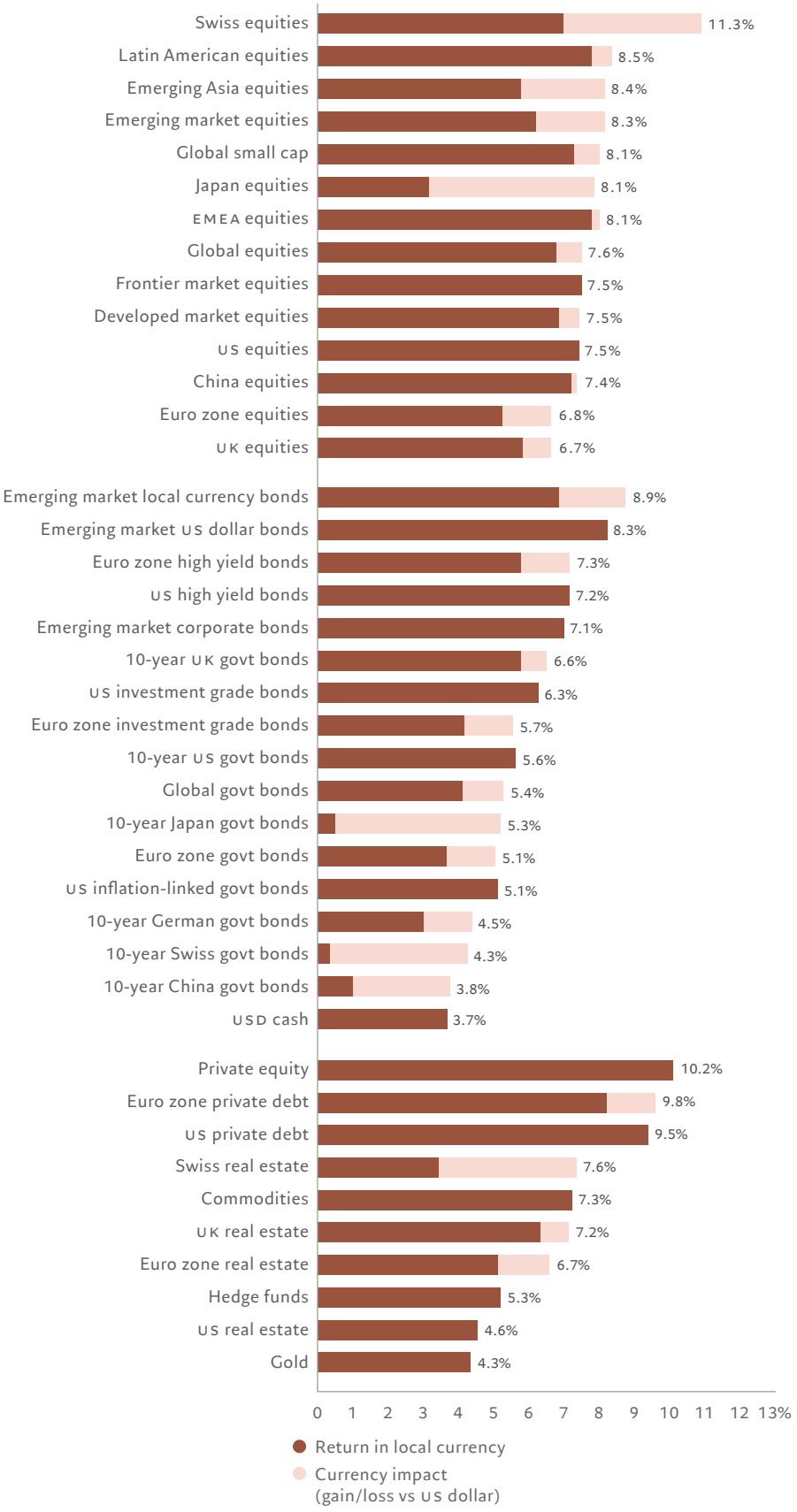
FIGURE 1

Asset class returns, 5-year forecast, %, annualised



Source: Pictet Asset Management; forecast period 31.03.2024-31.03.2029; for forecast assumptions and methodology, see Appendix.

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A more productive economy?

Global economic growth will be moderate over the next five years.

While a productivity boost from the widespread adoption of artificial intelligence (AI) cannot be ruled out, we believe that the downtrend in GDP growth seen over the past few years will remain largely intact, with anaemic productivity growth, an ageing population and plateau in globalisation and excessive public debt – the legacy of the 2008 global financial crisis and Covid-19 – set to weigh on economic activity.

Amid all this, the US economy will lose some of its effervescence, while India will emerge as the new source of global growth.

The moderation in growth will also be a necessary – if not sufficient – condition for inflation to return to levels that are both socially acceptable and broadly in line with central banks' targets.

The growth/inflation mix will ultimately be determined by the interaction of monetary and fiscal policy – with the latter likely to dominate the former. The dominance of fiscal policy will, in our view, result in more frequent boom and bust cycles and trade conflicts. Decarbonisation and the development of AI will become the focus of aggressive industrial policies worldwide, pitting China, the world leader in green technology, against the US, the dominant force in AI.

GLOBAL TRENDS

Over the past 20 years, global economic growth has been in a steep downtrend. At the beginning of 2000, economists' consensus forecasts pointed to trend global GDP growth being above 4 per cent over the long run; now, it is running at around 3 per cent (and even lower using our own forecasts and weights).

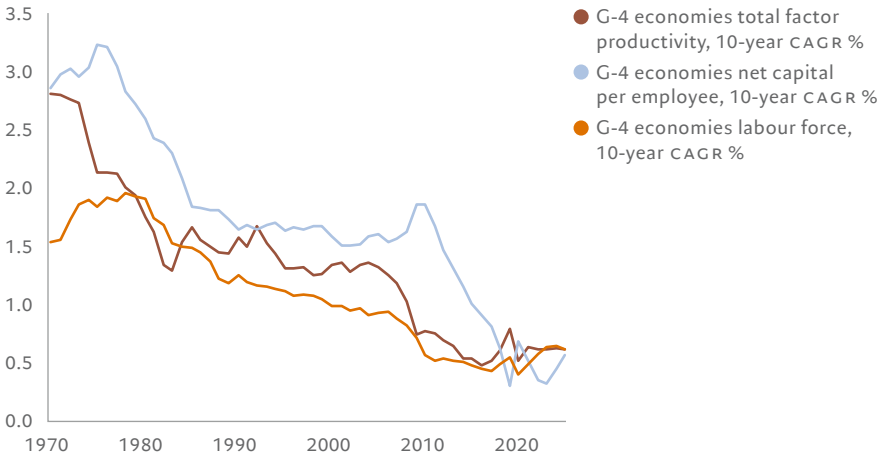
Some economists blame deglobalisation.

But we believe the role of deglobalisation in all this has probably been exaggerated. While trade in goods has plateaued, trade in services (tourism, digital data) is booming and is less vulnerable to protectionist measures. The value of global trade in digitally delivered services and goods – those delivered remotely or via computer networks – rose to USD3.82 trillion in 2022, accounting for a record 54 per cent share of all services trade. With an 8.1 per cent average annual growth rate for almost two decades, this category has outpaced all others according to IMF calculations. And what is more, we think that nearshoring or friendshoring will soon lose momentum.

So if deglobalisation hasn't been a major brake on growth, what has? There have been several forces at play: total factor productivity has declined, the labour force has been growing at a much lower pace (slower population growth but also lower participation rates in some countries) and the capital input per employee has stagnated.

FIGURE 2
Growth in capital, labour, total factor productivity, annual, %

A less dynamic global economy



Source: Refinitiv, DG ECFIN Ameco, Pictet Asset Management; data covering period 31.12.1969-31.03.2024

Looking ahead, we doubt that efforts at re-industrialisation in developed economies will have a material positive impact on growth and productivity.

If there has been one lasting side effect of the Covid-19 pandemic and the implementation of more muscular national security measures following Russia's invasion of Ukraine, it is the dramatic increase in the use and scope of domestic industrial policies.

This has some positives. One is that greater state intervention is badly needed to facilitate the decarbonisation of economies and the achievement of net zero targets.

On this particular matter, we continue to believe that governments will ultimately stick with their carbon reduction plans and will not backtrack – even if there are signs of policy fatigue and a voter backlash. That is because the work still needed to be done to hit net zero is both staggering and concerning.

Despite committing to decarbonisation, governments remain on course to produce more than double the amount of fossil fuels in 2030 than what the Paris Agreement's targets allow. Currently 80 per cent of the global

energy supply comes from fossil fuels. Meanwhile, the accord requires carbon emissions to be cut by 40 per cent by 2030 to keep global temperatures from rising 1.5 degrees centigrade above pre-industrial levels. That equates to a 7 per cent reduction per year and compares to a 1 per cent increase in emissions in 2023.

Yet while the green transition is imperative and makes financial sense over the long run, economic benefits are likely to be modest over the medium term.

Our economists believe that green investments will crowd out more productivity-enhancing investments, with no tangible impact on productivity. The green transition is more of a relative than absolute game as far as investors are concerned – in other words, there will be winners and losers. For more information on this, please see "A closer look at the transition risks of net zero".

So if the green transition will not provide a productivity boost, at least in the near term, could recent advances in technology and medicine step into the breach?

The extent of "US exceptionalism" has been exaggerated.

For many investors, hopes for a return to robust and non-inflationary economic growth appear to rest on the widespread adoption of AI and the success of medical breakthroughs such as the new "miracle" weight loss drugs.

The belief is that an investment surge in new technologies can result in a significant increase in productivity and, in turn, trend GDP growth. Yet it is still too early to discern any positive effects: the evidence is patchy at best.

This explains why we prefer to err on the side of caution and assume no material shift in trend growth over the next five years (even if we are more optimistic over a longer time horizon).

While it is clear to us that AI is a hugely transformative technology that will have a significant impact on our personal and working lives, less clear is how AI will impact GDP growth.

History doesn't paint a universally positive picture when it comes to the diffusion of tech.

The introduction of smartphones almost two decades ago, for example, has had a very limited, if any, impact on economic growth but immense social effects. And some advertised breakthroughs – think of virtual reality – never really took off.

The key question is whether AI is a productivity-enhancer or rather a labour-displacer and how fast the rate of adoption will increase. Most researchers agree that more than half of the jobs in developed economies are vulnerable to AI – and most of those are well-paid, service-related jobs – which is what distinguishes the employment impact of AI from that of other types of enhanced automation that pre-dated it. While generative AI appears to be more of a complement to human work, the potential emergence of general AI systems could be a massive game-changer for the labour market. Labour displacement will become an almost inevitable outcome once AI is able to outperform humans in all tasks – even those involving creativity and empathy. But when will artificial general intelligence (AGI) become a reality? There is a huge dispersion in experts' forecasts, but we can't rule out the possibility that this could happen in the next decade.

The rate of adoption of AI ultimately depends on its costs and benefits – and these can vary substantially across countries and industries. Just as importantly, there are several obstacles to the widespread diffusion of AI. Among them are:

- Energy use and electricity grid
  Some studies forecast that AI-driven global data centres will use as much as 5 per cent of all global energy supply by 2030. This could raise the cost of AI inputs but also necessitate substantial investments in the electricity grid, which may not materialise in the face of significant budget constraints.
- Data availability
  In a paper published last year, a group of researchers predicted the world will run out of high-quality text data before 2026 if the current AI training trends continue. Data is cheap but not infinite.
- Legal hurdles (copyrights and privacy)
  The question here is whether and how much AI models should pay for the data protected by copyrights used in their training. The US has been laissez-faire on this issue so far but tensions are building. The use of AI famously became a lightning rod for strike action among screen writers and actors, paralysing TV production for several months last year. Unions representing both groups ultimately reached a deal with the studios on securing protection against the use of AI – a cornerstone of the agreement was the required performer's permission at each step of the generative AI process.

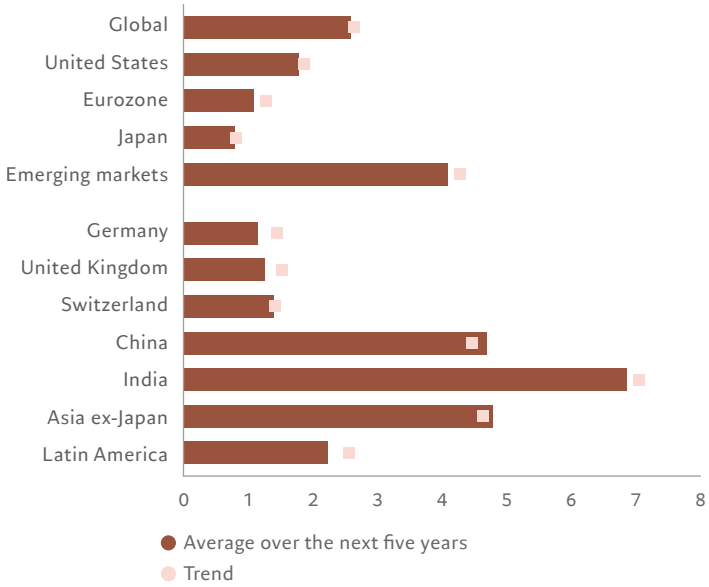
- Political and regulation
  Regulation of AI is in its infancy but a political and societal backlash against the widespread use of the technology is likely, particularly if job losses mount or some ethical red-lines are crossed. A notable example is the ban on human cloning following the creation of Dolly the sheep in 1997. However, we expect regulation to be slow, based on historical experience and the geopolitical reality. The US Congress has been extremely slow to introduce new regulation in the past – it took years to regulate railroads, telephone services, radio and the Internet - and governments are likely to refrain from enacting anything that would cripple an industry in which they want to build geopolitical supremacy. The political backlash is more likely to originate from a rising AI-induced income inequality and industry concentration – but again we don't see this happening over the next five years.

  So what might be AI's impact on growth within a five-year timeframe? Views among economists diverge significantly. Our economists believe that the impact of AI on actual and trend growth will be immaterial over the next five years. And the data currently available seems to validate this view: investment in tech is growing at a far lower pace than in the 1990s while US total factor productivity is up a mere 0.7 per cent year on year according to official data. In its World Economic Outlook 2024, meanwhile, the IMF said that AI could boost global productivity by just 0.1 per cent to 0.8 per cent – accounting for some 50 per cent of the expected rise in productivity it expects over the next six years. Significant, perhaps, but not enough to fully offset other productivity-reducing factors like ageing populations, trade sanctions and high public debt burdens. That said, if we assume that AI would indeed boost productivity by, say, 0.5 per cent, all else being equal, the impact on asset returns could prove significant. Based on our models, this would translate into a 10 per cent higher price-to-earnings ratio for global stocks and a higher real bond yield of 0.5 per cent, which would reduce the equity risk premium (ERP) by one percentage point over the long term, a fall that is 25 per cent steeper than our base case scenario.

For the time being though, we believe it is too early to revise up our world economic growth forecasts on overly optimistic assumptions on AI but we will of course monitor the evolution of AI adoption in the coming years.

FIGURE 3
Expected GDP growth, by country and region, %

Below trend growth



Source: Pictet Asset Management; forecast period 31.03.2024-31.03.2029

To what extent can the global economy rely on the US for its growth?

There is no doubt that the US economy has emerged from Covid in a position of relative strength, rediscovering some of the animal spirits of the 1990s. US net capital growth is twice that of Europe's while its "allocative efficiency" – or how it efficiently it allocates capital resources – remains unmatched according to a recent IMF study. Since 2020, the US has attracted more foreign direct investment than any other country.

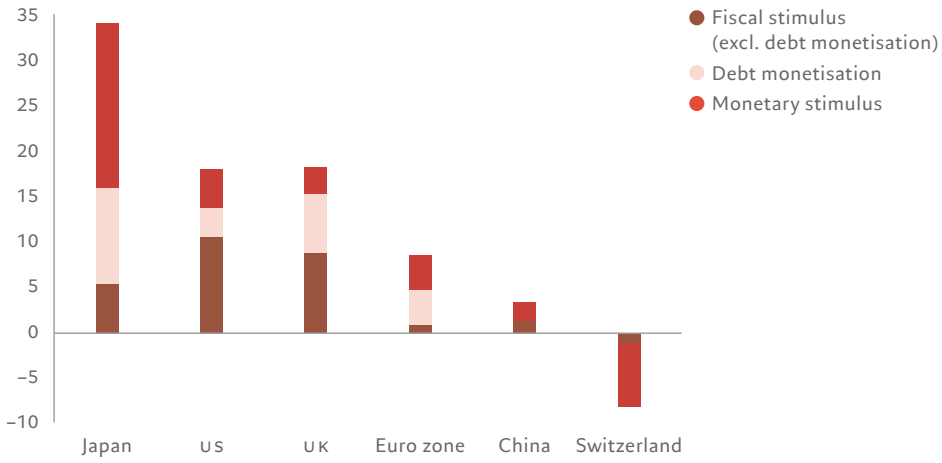
However, the extent of "US exceptionalism" has been exaggerated in our view.

For a start, the recent economic outperformance of the US economy is largely dependent on an unsustainable level of policy stimulus, a legacy of Covid-19. According to our calculations, the US has still a combined "legacy" excess stimulus (monetary and fiscal) of close to 17 per cent of GDP, compared with just 7 per cent in the euro zone and even less in China.

FIGURE 4

Fiscal and monetary stimulus, as % of GDP, by country since 2009

Years of abundant fiscal and monetary stimulus



Source: Pictet Asset Management; forecast period 31.03.2024-31.03.2029

This excess stimulus has resulted in a gigantic "twin deficit" – current account and fiscal deficit – of 8.5 per cent of GDP in 2023. Only Turkey has a marginally higher twin deficit among the world's largest economies.

A 7 per cent fiscal deficit in an economy operating at full employment is clearly not sustainable. For the first time in the last century, the US government will spend more on servicing its debt than on defence (3.1 per cent vs 3 per cent of GDP this year, respectively).

According to economic historian Niall Ferguson, when this happens, it is the beginning of the end for empires. He recently wrote it was "true of Hapsburg Spain, true of ancien régime France, true of the Ottoman Empire, true of the British Empire".

And while government finances have deteriorated across the world since the global financial crisis of 2008, the US fiscal sustainability metrics have deteriorated much faster. US net debt is up nearly 20 per cent of GDP over the past decade, Europe's is roughly at the same level; and the US has been running on a cyclically-adjusted primary deficit that is 3 percentage points worse than the euro zone since the 2008 financial crisis.

Just as concerning is the fact that the boom in US manufacturing construction has been very narrowly based, with the tech-related sector up 400 per cent over the past two years. The very latest data suggests the rate of growth in manufacturing construction is slowing down to 14 per cent year on year, partly due to a shortage of workers. Worryingly for the country's economic prospects, the US manufacturing sector still accounts for just 10 per cent of GDP, less than half the level of major industrialised economies (China, South Korea, Japan,

Mexico, Germany). The sector is barely growing at all: output volumes are at the same level as 10 years ago, manufacturing jobs have plateaued at pre-Covid levels and wages in real terms are still below the pre-Covid peak.

There are also features of the US growth story that are likely to fade from view. First, the shale oil boom that turned the US into the world's largest oil producer – oil production is now 13mbd (thousand barrels per day) vs a low 4mbd in 2005 – and the US is now for the first time since at least 1949 a net exporter of oil – a huge economic but also geopolitical gain. Then there are tax cuts and reshoring. Former President Donald Trump's 2017 tax cuts have boosted profits and investment, while the re-shoring trend evident both pre- and post-Covid has resulted in the US becoming the world's top destination for foreign direct investment.

Elsewhere in the developed world, Europe and Japan will grow at 1.1 per cent and 0.8 per cent per year, respectively, over the next five years – and they both look susceptible to deglobalisation and an ageing of their populations.

CHINA'S FADING EFFERVESCENCE

China's ability to boost world growth is waning – its boom years are behind it. We forecast its trend growth to be closer to 4.5 per cent per year and the IMF sees it dropping to just 3.5 per cent by the end of this decade. That compares to about 6 per cent per year over the previous 10 years.

While that won't stop China becoming the world's biggest economy by the end of this decade, structural problems will remain.

The country is inhibited by a shrinking labour force, an over-leveraged and over-regulated private sector, an economic policy driven by socio- and geopolitical considerations, US trade sanctions and a frozen property sector.

The transition from an investment-led to a consumer-led economic growth model is taking more time than we envisaged. The investment share of GDP is still above 40 per cent, and the consumption share marginally below that – a gap that has been fairly stable since 2016. The result is a chronic overcapacity in manufacturing. Note that China accounts for more than 30 per cent of global production, but only about 10 per cent of global consumption – which in turn makes China an easy target for trade sanctions. China is also struggling from the imposition of crippling restrictions on semiconductor trade by the US – an area that is key for China achieving its long-term ambitions of technological leadership.

That's not to say the picture is universally bleak.

For one thing, it has been able to counter some of the effects of US trade restrictions. It has rapidly and successfully developed an alternative China-centric trading architecture focused on the "Global South" and free-trade agreements – the network currently includes 28 countries and territories that account for close to 40 per cent of China's exports. Since 2023, China has been trading more with Southeast Asia than the US (China's trade with the BRI countries exceeded that with the US, EU and Japan put together).

Its technological expertise is also broadening and deepening. In e-commerce, fintech, high-speed trains and renewable energy, China is at or near the technological frontier.

The same is strikingly apparent in electric vehicles: China last year become the world's biggest exporter of cars.

China's ability to boost world growth is waning – its boom years are behind it.

More broadly, among the 64 "critical" global technologies identified by the Australian Policy Research Institute, a think-tank, China leads the world in all but 11, based on its share of the most influential research papers in those fields. The country is also number one in 5G and 6G communications, as well as in bio-manufacturing, nanomanufacturing and additive manufacturing. It is also a world leader in drone, radar, robotics and sonar technologies, as well as post-quantum cryptography. And it is even ramping up on semiconductors. So while it may lag behind the US in the race for AI supremacy, it is way ahead in green technologies and decarbonisation.

INDIA: THE GROWTH LEADER IN EMERGING MARKETS

As China's growth moderates, India's will gather pace. It is on course to become the world's third largest economy by the end of the decade. The subcontinent stands to reap the benefits of business-friendly policies, a still significant demographic dividend, a stable government and a massive infrastructure spending plan: India already has 149 airports, double the number a decade ago, and is adding 10,000km of new roads and 15GW of solar-energy capacity a year.

There are other factors in its favour too. Take services.

India is already a services exporter power – accounting for 4.5 per cent of overall services trade and a higher share of "value-added" services such as financial, tech and legal services.

It is also reaping the rewards of being in a geopolitical sweetspot – an ally of the US but close to Russia, a leader of the Global South and engaged in well-managed competition with China.

Southeast Asia has by far the best economic outlook of any region. Superior trend growth and moderate inflation – notably all major economies with a trend GDP to trend inflation ratio (our favourite metric) above 1X are located in Asia – Switzerland being the exception. ASEAN countries score even better.

Africa and LATAM are still stuck in a lost decade. Africa's share of global GDP is still at 3 per cent – the same as 10 years ago – and its per capita income is 6 per cent of the US level, lower than two decades ago. LATAM has done even worse. On a per capita basis, income is still 25 per cent of the US level and its share of GDP is 7 per cent vs 10 per cent in 1990 – two lost decades!

THE SECULAR OUTLOOK FOR INFLATION

We expect inflation rates to moderate over the next five years and eventually converge towards the typical 2 per cent target of central banks.

But it will be a bumpy road, with the risks for inflationary pressures skewed to the upside.

We see the recent surge in inflation as policy-driven and more cyclical than structural. Covid-19 has provided a textbook backdrop for an inflation surge: a boost in demand courtesy of massive fiscal and monetary stimulus and severe supply constraints caused by pandemic-inspired social mobility and trade restrictions. The war in Ukraine added to inflationary pressures. Now, thanks to tight monetary policy and the gradual normalisation of global trading conditions, inflation is slowly reverting to its long-term trend.

However, on balance, the upside risks are evident. Structural trends point to higher inflation abound. These include the economic disruption of the green transition, a shrinking global labour force and a likely increase in government spending.

Technically speaking, inflation is the sum of the growth in profit margins, unit labour costs and non-unit labour costs. In particular, in the US, unit labour costs are four times higher than margins. We expect profit margins to stop expanding but remain resilient due to high industry concentration and above-average operational efficiency. It is worth highlighting that flattening

profit margins are a powerful disinflationary force. By our calculations, margin growth accounted for approximately 50 per cent of the rise in inflation over the past five years in the US so any significant moderation in profit growth should result in lower inflation.

The stability of margins will partly offset some upside pressure on wages coming from a structural tightness of the labour market. But we do believe that wage pressures are somewhat overstated – we think that AI and automation, as well as outsourcing in the service sector will go a long way to limit domestic wage pressures originating from a shrinking labour force. US real wages are still some 5 per cent below pre-pandemic trends; US real wages have just recovered to the levels reached in 1972, when trade union power was at its peak. In the euro zone, negotiated real wages are rising but remain below the levels of a decade ago.

Contrary to conventional wisdom, the inflation surge seen in the wake of the pandemic has lifted corporate profits and rental income by more than it has wages. While low-income workers enjoyed higher-than-average pay rises in recent years, the overall share of GDP going to labour has not risen; in fact, the US capital share of private GDP is still at a record high of 40 per cent while our preferred measure of social inequality – the ratio of total employee compensation to US market cap – is fluctuating around its all-time low of 20 per cent. Until the mid 1990s, this ratio averaged at around 100 per cent.

By our calculations, which assume corporate margin profit margins will be flat, unit labour costs are set to rise by 3 per cent (marginally below the average of the last five years) and unit non-labour costs by 2.5 per cent. This indicates US inflation will decelerate to around 2.4 per cent, on average, over the next five years (see FIGURE 5).

Profit and wage growth show the way for inflation

FIGURE 5
Contributions to inflation

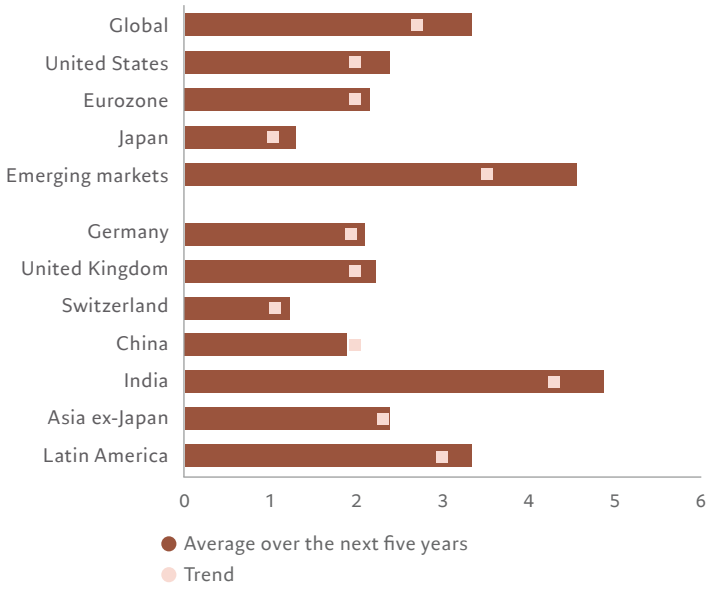
	UNIT LABOUR COST, %	UNIT PROFIT, %	UNIT NON-LABOUR COST	GDP DEFLATOR
Weight	57.0	17.0	26.0	100.0
Last 5 years	3.2	8.9	1.5	3.7
Next 5 years	3.0	0.0	2.5	2.4

Source: Pictet Asset Management

That said, relative prices will be worth watching as they will be key drivers of an individual industry's profitability. For tech and health, the respective secular trends we see having a bearing on earnings are the end of tech price disinflation and the start of disinflation in drug prices. In the US in 2022, prices across all categories of drug (brands and generics) were nearly 2.8 times as high as prices in comparison countries, so a moderation here is long overdue. For the first time in 40 years, trend inflation in drugs is below overall trend inflation while the provisions of the Inflation Reduction Act (IRA) – those requiring the government to negotiate "maximum fair prices" with manufacturers - will likely accelerate this shift (the IRA introduces limitations on increases in drug list prices to the rate of inflation and requires price negotiation for some older medications without generic or biosimilar competition). In the tech industry, by contrast, inflation is picking up. The US tech equipment deflator is in positive territory for the first time ever, with prices for semiconductor devices surging 5 per cent year on year.

FIGURE 6
Expected inflation rates, %, by country and region

Inflation to remain above the long-term trend



Source: Pictet Asset Management; forecast period 31.03.2024-31.03.2029

Impact of shifting fiscal and monetary regimes

The interaction between monetary and fiscal policy (or regimes, for long-term horizons) is a key determinant of the performance of financial assets.

Over the past four decades, investors have been, for the most part, operating in a regime of monetary dominance – in other words, monetary policymakers set the inflation targets and then actively strive to achieve them, while fiscal policy operates within the framework of debt sustainability. However, largely as a consequence of Covid and new political imperatives and priorities, the pendulum in our view may be shifting in favour of fiscal dominance, with governments regaining the upper hand over technocrats in setting the domestic political agenda.

In such a world, fiscal policy would actively reflate the economy, while monetary policy takes a more passive role, de facto aiming to stabilise debt rather than delivering on inflation targets. That, in turn, will mean lower interest rates than required, more volatile inflation and more volatility for financial markets.

While we believe that debt servicing costs are likely to remain relatively manageable, reducing government borrowing will eventually become the priority for much of the developed world. This will be achieved partly through higher individual and corporate taxes, although a serious debt reckoning is unlikely within the next five years.

"The only viable equilibrium is for economic growth to be slightly below potential… for interest rates to remain above the average… and for inflation to be on average slightly above 2 per cent."

LUCA PAOLINI
Chief Strategist
Pictet Asset Management

The US is the prism through which investors can most clearly see what a shift to fiscal dominance would mean in practice. Under a monetary-dominant regime, consistent with 2 per cent trend GDP growth, 2 per cent inflation and an interest rate of 2.8 per cent, the US should be able to run a cycle-adjusted primary balance of only -1 per cent of GDP. This would imply a 3.5 per cent to 4 per cent fiscal tightening from current levels – or around two-thirds of the cumulative tightening carried out after the 2008 global financial crisis.

In contrast, under a fully fiscal-dominant regime, the Fed would set an interest rate at a level that would help stabilise government debt levels. That would be around 1.25 per cent to 1.5 per cent across the cycle based on our calculations, resulting in consistently higher inflation. Fiscal policy, meanwhile, would be skewed towards more borrowing.

However, there are limits to governments' ability to spend and raise debt, even in the US. Having the dominant reserve currency and the most liquid risk-free market in the world does create a sort of foreign "captive" demand for US Treasuries but bond vigilantes and investors can force any government into fiscal discipline through higher interest rates.

That will mean lower interest rates, more volatile inflation and more volatility for financial markets.

The key question here is at what level of debt and, more importantly, net interest payments will governments' profligacy reach its limit?

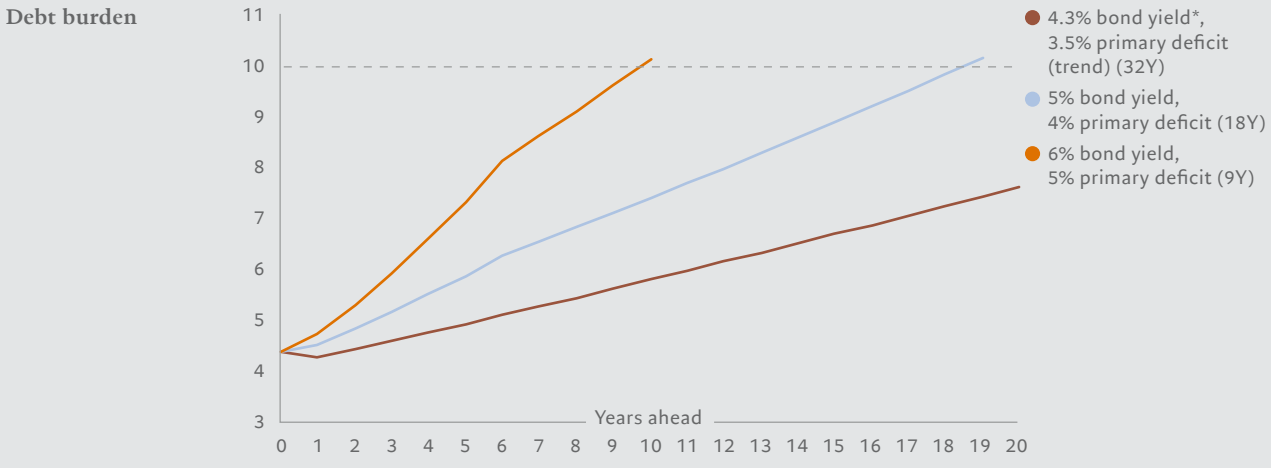
We think that 10 per cent of GDP spent on debt servicing is a good, conservative estimate. For the US, taking even local and state governments into the equation, this means a doubling of the interest bill – to the point where it will be higher than both Medicare/Medicaid and social security. Based on our estimates and current trends, this could take some 30 years but only if you assume stable trend GDP growth and no deviation of fiscal policy from its projected path – both of which are very optimistic scenarios. With a less sanguine assumption of bond yields rising to 6 per cent and the US primary deficit stabilising above 5 per cent – where it is currently – the wall could be hit within the next decade.

And even without the debt Armageddon, government profligacy has a cost. The IMF estimates that, all else being equal, a 1 percentage point increase in the US prima-

ry deficit is associated with a rise in term premiums of US treasuries of about 11 basis points in the quarters that follow.[1]

There will be other limits on excessive fiscal dominance too. Central banks will fight hard for their independence. And we believe that both the political establishment and the electorate will ultimately resist a return to debt-fuelled inflation. Inflation is unwelcome

FIGURE 7
US net interest payment as % GDP under selected scenarios



* 1Q average 5-year forward of US government bond yield of tenor closest to average debt maturity.
Source: Refinitiv, IMF, Pictet Asset Management. As at 1Q2024.

for either party. For the former, inflation is a big liability when it comes to elections; for the latter, inflation is a regressive tax.

Taking all this into account, we believe a mild form of fiscal dominance is the most likely outcome in the next five years, as governments still have some room before we hit the limit of fiscal spending. And a mild form of fiscal dominance – with an expansionary fiscal policy and a still tight but less so monetary policy is historically a benign environment for financial markets (as we saw in the 1980s and, to a lesser extent, in 2018).

However, central banks must follow a very narrow path. Faced with a structurally expansionary fiscal policy (due to rising ageing-related social spending, the green transition, increased military spending and low appetite for new taxation), monetary policymakers will find it increasingly difficult to stick to their inflation targets, achieve full employment and keep rates low enough to preserve the sustainability of public finances.

1 IMF Fiscal Monitor April 2024

So what is the optimal long-term outcome that allows economic growth without financial market instability?

In our view – looking at the US over the next five years – the only viable equilibrium is for economic growth to be slightly below potential to reduce underlying inflation pressures, for interest rates to remain above the average of the past two decades and for government deficit to be marginally lower. The Fed's balance sheet will remain high too – at around 25 per cent of GDP (versus 27 per cent now and 35 per cent at its peak).

Inflation rates will decline slowly and in a volatile fashion. This will allow a sort of passive fiscal tightening through fiscal drag (through the freezing of tax thresholds), but the tightening will fall well short of what is required to stabilise debt metrics.

To make up for too little tightening in the near term, barring a productivity boom, a significant increase in taxation seems inevitable in the coming decades. In our view, it will be skewed to where the money is – wealth (inheritance, capital gains) and corporations (e.g. taxes on corporate income, excess profits, buybacks, carbon emissions) – and where it is politically less painful (e.g. import duties, tourist taxes). Cuts in social benefits (higher retirement age, reduced access to free healthcare) or subsidies (e.g. of fossil fuels) will be very problematic.

For the next five years, though, the debt supercycle will continue and in our view will result in low but reasonable returns in financial markets – see SECTION 2.

2

Assessing the impact of economic and political systems on markets

This year 60 per cent of the world's population will be heading to the polls, and the overall electoral trend is towards market-unfriendly policies – including ever bigger governments. At the same time, geopolitical risks are on the rise. The conflict between Israel and Hamas could escalate into a regional conflagration and Russia's invasion of Ukraine and general belligerence could yet draw other countries into the war, while China and Taiwan are a perennial worry.

As a result, investors face a geopolitical "recession" that could convulse financial markets. But there are ways to hedge against these risks by applying what we know about the relationship between market performance and the nature of political and economic regimes.

VOTING FOR CHANGE?

In our view, election outcomes only truly become significant for financial markets when a country's economic structure and its institutional foundations – key determinants of domestic asset class returns – are at stake.

This is why a secular shift towards market-unfriendly populism, bigger governments and less economic freedom should be a concern for investors – over a longer time frame, they will need to hedge against these risks.

Fortunately, there are some solutions. The equity markets and currencies of countries with relatively small governments and a low and efficient regulatory burden tend to outperform over the long run. Combining these factors with our own valuation metrics, we find that Switzerland, Southeast Asia and Gulf Cooperation Council (GCC) countries are best placed to offer investors better returns over the medium to long term.

While we do not try to predict the outcomes of elections, we can identify countries at risk of having their markets undermined by a populist surge. The key variables we monitor in developed economies to gauge political risks are inequality, the growth/inflation mix, fiscal balances and migration trends.

The impact of entrenched political and economic models in the performance of financial markets is, we believe, significantly underappreciated. Conventional wisdom holds that investors prefer to allocate capital to a free-market economic system with light regulation, efficient judiciary, low taxation and low trade tariffs. They also like political stability and governments that refrain from being too obtrusive – directly or indirectly, by way of extensive redistributive economic policies.

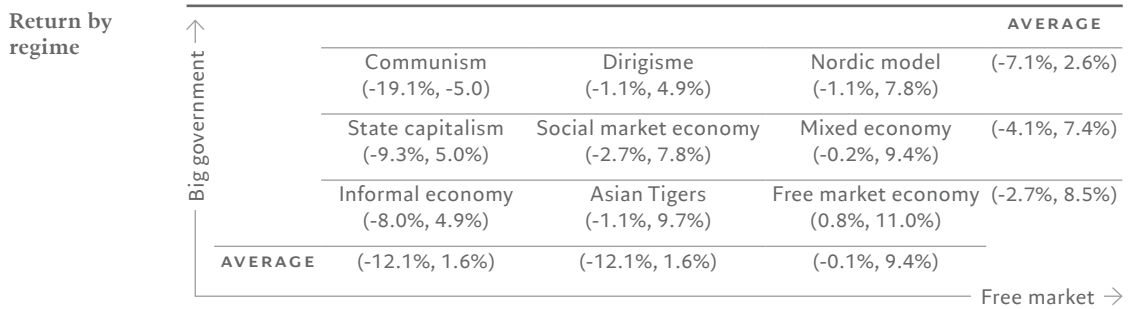
MAPPING FREEDOM

To assess the impact of government policy on financial markets, we first map countries and regions based on two simple metrics:

1. Economic freedom
   Here we use conservative US think-tank Heritage Foundation's comprehensive framework which incorporates trade freedom, business freedom, investment freedom and property rights. The higher the score, the closer a country is to a free-market economy. Interestingly, but not surprisingly, there is large overlap between economic and political freedom. With few exceptions, autocratic governments tend to resist the lack of control that is associated with a vibrant and innovation-focused private sector.
2. Government share of GDP
   This is measured as a ratio of government revenue to GDP – a proxy of how significant a role the state plays in an economy.

In FIGURE 8, we map the nine political/economic regimes based on those two metrics. The four corner quadrants – communism, informal economies, free market economies and the Nordic model – contain some obvious examples. The informal economies category covers some frontier markets, failed states and underperforming developing economies. Free markets are represented by the US, by Europe's most vibrant economies, notably Ireland and Switzerland, and by Asia's most efficient countries – Singapore and Taiwan. The Nordic model applies to Scandinavia but also core euro zone members.

FIGURE 8
Annualised currency and equity market return, %, by economic-political regime (in USD)



Source: Pictet Asset Management.
Data covering period 31.03.2009-31.03.2024

FREE MARKETS, SMALL GOVERNMENTS SPELL SUCCESS

Over the past 15 years, countries that scored better on economic freedom and where the state accounts for a smaller proportion of the economy have benefited from stronger currencies and stronger equity markets. This pattern is clear in the corner quadrants of our grid.

Currencies, more than domestic equities and bonds, are the most reliable barometer of a country's institutional and economic strength. Not by chance, the Swiss franc has been on an uptrend against the US dollar since the demise of Bretton Woods in 1971. Back then it took 4 CHF to buy 1 USD. Today it's less than 1 CHF, representing an average 3 per cent annual appreciation. Currencies need fiscal discipline, a history of political stability and low inflation, as well as solid productivity growth. Switzerland offers all of these. For instance, in 2003, it became the first country to adopt a constitutional debt brake.

Singapore, like Switzerland, is a small, open and growth-oriented economy, with GDP per capita higher than that of the US, stable and low inflation, government budget surpluses, zero net debt, massive trade surpluses and a history of political stability. As a result, the Singapore dollar has been one of only three major currencies to appreciate against the US dollar over the past 20 years, the others being the Taiwan dollar and the Swiss franc. And while Singapore's currency policy is a unique managed float system, its stability would not be possible without macroeconomic stability.

However, for equity investors, macroeconomic stability doesn't guarantee outperformance.

The cases of Switzerland and Singapore underline an important truth: geopolitics matters more for currencies than stocks. That's because any individual company's performance is to a great extent determined by its specific characteristics (valuation, profitability, leverage) and the nature of the industry it operates in. So a country's equities index can do no better than the sum of its constituent firms despite the presence of a geopolitical premium or discount.

Singapore's equities, for example, trade at record low multiples in relative terms and have tracked the performance of Chinese equities consistently in the past two decades. That's perhaps not surprising, given the proximity to China and the strong cultural and trade links.

Similarly, while the Swiss franc has surged over the years, Swiss equities have not – and they now trade at a 32-year low relative to the MSCI World Index. They also trade at a discount to this benchmark on a 12-month forward price-to-earnings basis – largely due to the com-

position of the Swiss index, heavily skewed as it is towards pharmaceuticals and consumer staples, with an absence of technology stocks.

Japan has experienced the opposite recently: a collapse in the yen but a secular reversal in the performance of domestic equities (see "Mind the gap"). This is not due to any geopolitical consideration but rather to a shift in monetary policy which has targeted a much weaker yen to end structural deflation.

AN EMERGING PROBLEM

In the emerging world, geopolitics too has had a strong impact on currency moves.

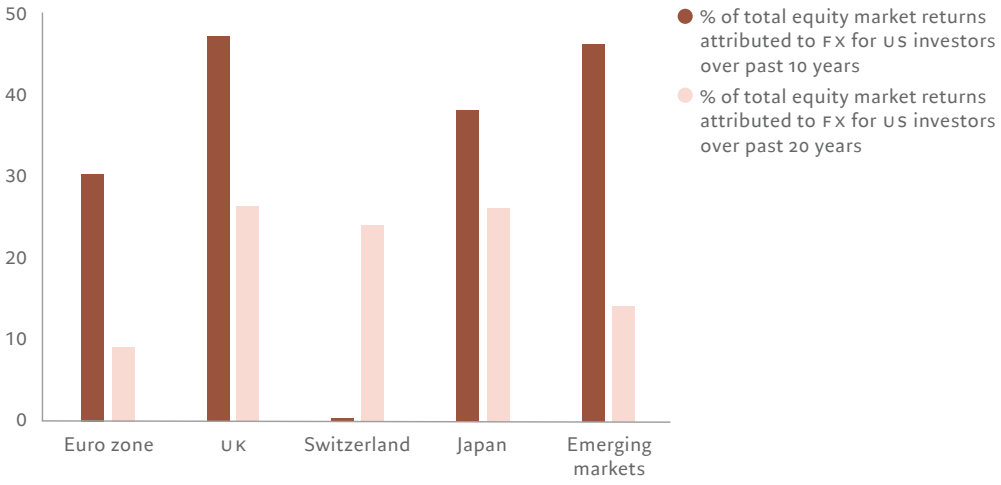
Emerging market countries that have evolved into market-oriented economies within the framework of a relatively stable and competitive political system – Uruguay, Costa Rica, Botswana and Taiwan, to mention one per continent – have been rewarded with an appreciation of their currencies over the past decades on a real effective exchange basis.

In markets heavily dependent on foreign capital inflows, the performance of domestic currencies against a basket of others has closely mirrored their performance against the US dollar over a 10-year period (see FIGURE 9).

FIGURE 9

Proportion of equity market's total returns attributable to gain or loss in currency over 10, 20 years, selected countries, %

Currency impact has become more important to equity returns over past 10 years



Source: Pictet Asset Management, Refinitiv; data covering period 31.03.2004-31.03.2024

However, here, currency strength has had a more direct impact on stock gains than in the developed world: foreign exchange movements account for nearly 80 per cent of total EM equity return over the past 10 years, while for the UK it's more than 50 per cent and in the euro zone and Japan it's around 30 per cent.

POLITICS MATTER

Our analysis also shows that no autocratic country's equity market or currency managed to outperform over the past 15 years.

The link between political systems and asset returns is not surprising, with a considerably large body of academic literature showing the tangible impact political systems have on economic growth – the ultimate driver of returns.

For instance, an IMF paper, Political Institutions and Output Collapses[2], found that growth is more likely to be sustained under democracy than under autocracy, output collapses are more persistent under autocracy and stagnation under autocracy can give way to outright collapse. In other words, democratic countries appear to be more resilient.

A second IMF paper, Geopolitics and International Trade: The Democracy Advantage[3] shows that democracy fosters international trade and moderates the potential negative impact of geopolitics. It is the structure of government more than geopolitical developments that affect trade flows, and in turn, growth.

MOVING IN REVERSE

Unfortunately, as far as financial markets are concerned, politics seems to be going in the wrong direction. Not only does the state account for an ever larger part of the economy globally, but economic freedom is also being eroded by increasingly obtrusive regulation, tariffs and subsidies in a bid to create national champions.

With US turning inward, Europe and the UK facing the challenge of rising populism, Latin America dominated by left-wing governments and China backtracking on economic reform, the countries with a credible business-friendly reform path are limited to India, the GCC and, potentially Japan. What's more, our analysis finds that the size of an economy's initial state footprint matters more than the degree of change, which suggests markets are slow to be convinced about shifts in countries' economic and political regimes.

2 https://www.imf.org/en/Publications/WP/Issues/2023/02/17/Political-Institutions-and-Output-Collapses-525757

3 https://www.imf.org/en/Publications/WP/Issues/2024/02/02/Geopolitics-and-International-Trade-The-Democracy-Advantage-544393?

In fact, economic freedom often follows political freedom.

The peak in the number of liberal democracies was reached at the cusp of the global financial crisis in 2008. This was followed by a peak in the proportion of countries that are democratic shortly before the Covid outbreak in 2019. A peak in economic freedom followed in 2020, partly as a consequence of the pandemic.

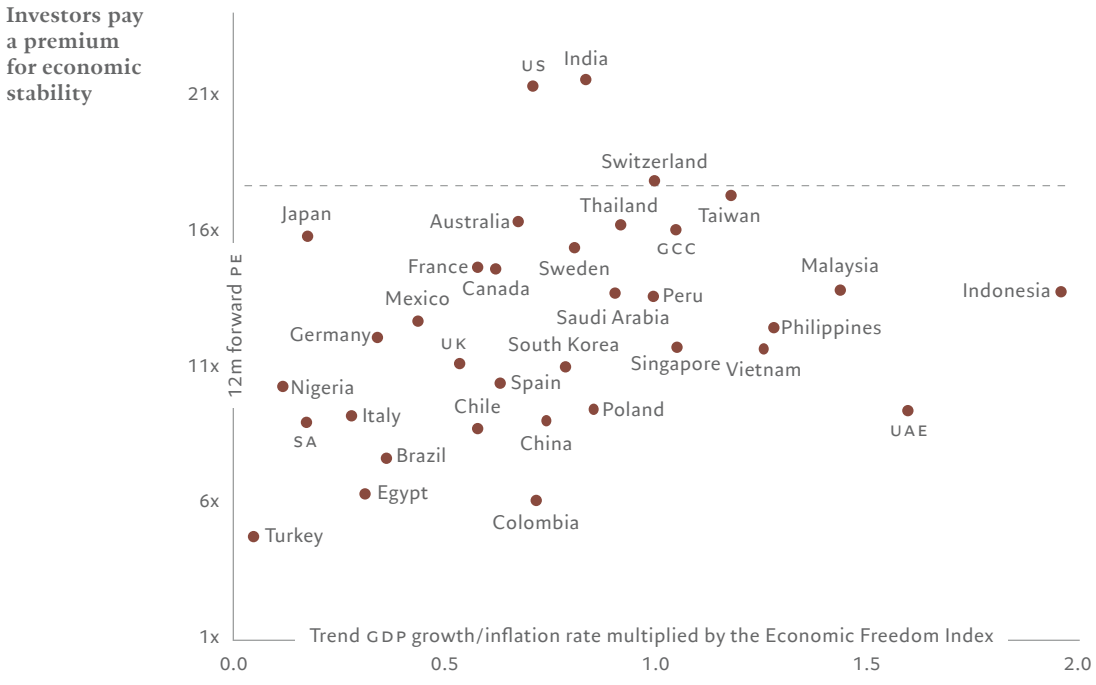
According to the Economist Intelligence Unit's (EIU) measure of democracy, 45 per cent of the world's population live in a democracy of some sort, but less than 8 per cent reside in a full democracy, as defined by scores above 8.00. At the same time, a shade under 40 per cent of the world's population live under authoritarian rule.

HEDGING GEOPOLITICAL RECESSION

How do investors navigate this geopolitical recession and hedge against the risks of political black swan events like Russia's invasion of Ukraine?

Our analysis suggests that long-term investors should be happy to pay a significant premium for political and economic stability but should also take into consideration the "cruising speed" of the economies – which we define as the ratio between trend growth and trend in-

FIGURE 10
Stocks' valuations vs political and economic stability rating



Source: Pictet Asset Management, Refinitiv; data covering period 31.03.2004-31.03.2024

flation. High growth tends to lead to higher profits, low inflation to a lower cost of capital and higher earnings multiples (see FIGURE 10).

Combining the three metrics of economic growth, valuation and business-friendly policies, the equity markets and related domestic currencies that offer the best returns for long-term investors are Switzerland, Southeast Asia and GCC.

For GCC, we are aware that the net zero transition could prove a big headwind, but the region's governments are taking bold and significant steps to reduce their dependence on fossil fuels. The World Bank recently noted that "GCC countries are pursuing ambitious targets for achieving electricity generation from renewable resources. For example, Saudi Arabia aims to have 50 per cent of its energy mix from renewable energy by 2030, while Oman targets 30 per cent of electricity from renewables by 2030."

India and the US are special cases, if only because of their size. The former is set to become an ever-larger global growth driver in the next five years. Prime Minister Narendra Modi's government has announced transformative growth plans and Indian companies are delivering on earnings. India is also in a geopolitical sweet spot – equidistant between the major superpowers allowing it to benefit from economic opportunities that arise, such as cheap Russian oil. As for the US, its enduring economic preeminence is looking uncertain and domestic politics could become a big headache for investors. But it has leadership in technology and innovation, including being on the right side of the AI boom, and its top companies are sporting unassailable market power with high and resilient margins.

In a nutshell, we believe investors should stick with countries with a reliable record of political stability and free markets .

Mind the gap: Japan, China and corporate governance overhaul

Asia's equity markets are experiencing one of their biggest shake-ups in years.

Japanese stocks, long unloved by foreign investors, are staging a furious comeback. The Nikkei and TOPIX indices have reached peaks not seen in 30 years, becoming among the best performing equity markets in 2023.

In contrast, their Chinese counterparts lost more than 16 per cent as international investors, disappointed by sluggish economic growth, regulatory crackdowns and persistent geopolitical tensions, turned their backs on the world's second largest equity market.

On one measure, the valuation gap between Chinese and Japanese markets has shrunk to the lowest since 2015.[4]

Such a divergence may in part be explained by the contrasting monetary policies of the two economies. The Bank of Japan has flooded the market with cash; the People's Bank of China has refrained from large-scale money printing to deleverage and avoid weakening the renminbi. Investors are becoming more optimistic that Japan is emerging from deflation, while worries are growing about a property market slump in China.

But we think there are other forces at play too: particularly the diverging standards of corporate governance practices.

According to the Asian Corporate Governance Association, Japan has just recorded the biggest improvement in corporate governance practices anywhere in the world, jumping to second place in the 2023 ranking from fifth in 2020.[5]

In contrast, China's position was unchanged at tenth place, while Hong Kong slipped to sixth from second place.

"Japan is a testament to the influence of improvements in governance on shareholder returns. And we believe it is a template China could follow."

JAMES UPTON
Senior Corporate Governance Specialist

4 MSCI Indices with IBES consensus 12-month forward EPS. Source: Refinitiv, MSCI, IBES. Data as at 07.06.2024

5 https://www.acga-asia.org/cgwatch-detail.php?id=482

JAPAN INC'S RENEWAL

Japan's improvement illustrates that the country is finally starting to reap the rewards of reforms aimed at modernising itself and improving its competitiveness.

Originally launched more than a decade ago as one of the three pillars of the "Abenomics" economic policy under then Prime Minister Shinzo Abe, Japan Inc's overhaul has seen companies cut red tape, increase productivity and improve return on equity.

The introduction of the Stewardship Code in 2014 was transformative in delivering wide-ranging changes, such as increasing the diversity and independence of company boards. Most significantly, the code has helped reduce opaque stock ownership structures, which had led to inefficient capital allocation and a persistently low return on equity.[6]

As business management has improved, shareholder activism is also taking hold. Activist shareholders are forcing a number of changes to improve corporate governance and, ultimately, boost valuations for public firms in Japan, where about half of listed companies have for many years traded below their book value. The total market value of Japanese companies targeted by activists more than doubled to USD252 billion in 2023 from USD117 billion in the prior year.[7]

Greater activism has led to a much-needed change in the ownership structure of Japanese companies. Institutional investors – pension funds, insurers and sovereign funds which typically invest with a long-term horizon – now hold 30 per cent of Japanese stocks, compared with around 22 per cent before the reforms were introduced.

That figure is still low compared to advanced equity markets such as the UK and the US, yet compares favourably with China and other emerging markets.

CHINA: TAKING THE FIRST STEPS

Japan is a testament to the influence of improvements in governance on shareholder returns. And we believe it is a template China could follow. Indeed, recent developments show Beijing is becoming more serious about transforming the governance of China Inc, trying to follow Japan's footsteps.

Among a series of key laws passed in the past six months alone, amendments to China's Company Law that come into effect in July perhaps represent the most significant change to the legal set-up governing Corporate China. Crucially, the revised legislation allows more flexibility in corporate structures and more specifically defines the roles and duties of directors and executives.

6 Cross-shareholdings occur where one publicly-traded company holds a significant number of shares in another public company

7 Bloomberg

Also this year, China's State Council issued a sweeping set of guidelines to strengthen regulatory supervision and investor protection and plug corporate governance loopholes.

Notably, Beijing's efforts to revamp its state-owned enterprises (SoEs) appear to be paying off. The government wants the SoEs – which represent nearly a third of the benchmark CSI 300 index – to become leaner, improve profitability, lift shareholder returns and communicate better with investors. The government has also added "lifting the dividend payout ratio" as one of the key performance indicators for SoEs, which should benefit minority shareholders.

Mainland-listed state firms have gained 19 per cent since November 2022 – the time of China's post-Covid reopening – outperforming the benchmark index by 14 per cent.[8]

All this represents the first step in the long journey China has to travel if it is to emulate Japan's reform process. But if it is successful in delivering a programme of changes, this may allow the country to start translating its GDP growth into corporate earnings. This may prove a welcome surprise for investors who have continued to shun the USD9 trillion equity market, unlocking some of its persistent discount.

8 Shanghai Stock Exchange State-owned Enterprises 100 Index and benchmark Shanghai Stock Exchange Composite Index, Refinitiv, data covering period 01.11.2022-07.06.2024

3

Tech, health, industrials: the secular winners

A global economy hobbled by weak productivity should not prevent investors from securing double-digit annual returns.

Our analysis has identified three industries with above-average growth potential. Technology, industrials and healthcare companies could, we believe, see their shares outperform the MSCI world equity index by a cumulative 20 per cent over the next five years.

Not only are these three sectors standouts on innovation, but each is supported by powerful megatrends. These industries are pivotal in resolving some of society's greatest long-term challenges, namely climate change, fraught geopolitics and growing labour shortages. In other words, in times of increasing uncertainty, it may be prudent to invest in the industries we see as problem solvers.

TECH

The tech sector's share of global corporate revenue will continue rising. It has been growing at some 6 per cent per year over the past 15 years. And it's a trend that's set to continue given the growth in global tech spending 5.4 per cent this year according to research group Forrester.

There are several forces contributing to that growth. For one thing, there's widespread recognition that semiconductors are increasingly the engine of innovation across the economy – which then feeds productivity growth. They are geopolitically important – they're one of the prime reasons Taiwan's security has become a top concern for governments worldwide– and have thus become a focus of industrial policy through measures such as the US's USD39 billion CHIPS Act and the EU's own semiconductor support package.

Then there are advances in AI. Its adoption is still at an early stage, but as AI takes off, the capital expenditure cycle will shift into high gear. Google, Meta and Microsoft have each recently raised their capex targets for the year by more than USD10 billion above the previous guidance.

For prospective investors in AI, it is important to understand how this tech investment cycle differs from its predecessors. Critically, it favours incumbent technology companies over new entrants. Today, established firms are frequently the ones leading in AI. There are several reasons why. To begin with, AI requires large amounts of data and training AI models is extremely expensive - making it easier for large, scaled companies to develop than for start-ups. Similarly, almost every firm can integrate with the large language models (LLMs) – there is no natural advantage for start-ups here. Finally, AI fa-

vours companies with large existing user bases, since new AI capabilities will be easier to roll out across well-established products. For investors, that means there are many attractive opportunities to gain exposure to the AI theme via larger, established listed technology companies.[9]

So far, chip maker Nvidia has been the biggest winner from the AI boom, but as it develops, gains will spread out to other direct enablers of the technology – other semiconductor manufacturers, cloud infrastructure providers, server and networking providers, makers of security software – as well as the firms that apply AI to generate value such as interactive media, professional and enterprise software makers, consumer hardware producers and providers of IT services.

While Edge AI is still infant technology, hardware companies could learn to deploy it to achieve real-time insights, such as making it possible for self-driving cars to take split-second decisions, or machinery equipment to be fully and continuously self-monitoring. Successful application would reduce costs and improve privacy safeguards.

Investors have many attractive opportunities to gain exposure to the AI theme via larger, established listed technology companies.

Privacy and security will be essential. The proliferation of connected devices and AI are set to make cyber attacks more ubiquitous and sophisticated – the World Economic Forum's latest global risk perception survey found that AI-generated misinformation is the second most severe global risk anticipated over the next two years. As a result, spending on security software and services continue to grow.

Finally, the growing footprint of services in global trade is bound to favour tech. Value-added services trade growth is underpinned by a global labour shortage and is less politically contentious than blue-collar outsourcing and would serve to boost margins of incumbent IT and consultant services.

In a nutshell, AI, digitalisation and geopolitical factors that make governments favour national champions are the key megatrends set to drive the tech sector for years to come. Some areas show greater potential for expansion than others. Companies within the semiconductor supply chain are obvious beneficiaries, but other sectors should see strong growth too.

9 https://am.pictet/en/globalwebsite/global-articles/2023/expertise/thematic-equities/thematic-investing-in-digital-and-ai

E-commerce currently accounts for less than a fifth of the USD26 trillion global retail market. Cloud computing, meanwhile, accounts for just 10 per cent of total IT spend. And only 6 per cent of card transactions are settled through fintech digital payments, such as those made on mobile devices. Each of these markets is forecast to grow at a double-digit compound annual growth rate (CAGR) over the next five years. In a low growth world, this represents a compelling business and investment opportunity.

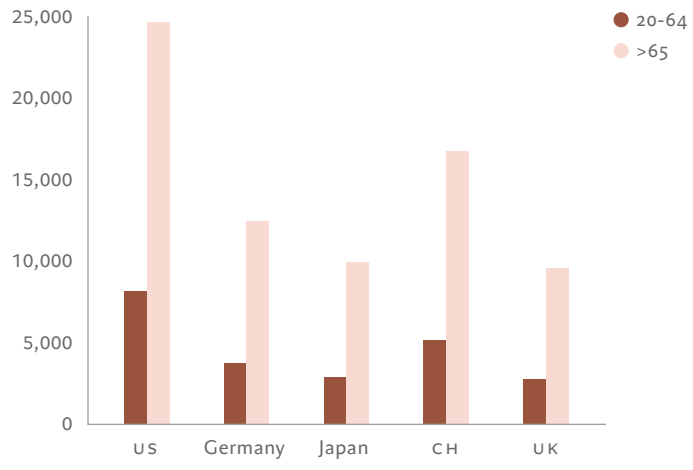
HEALTHCARE

Healthcare is often overlooked as a "growth sector". Shares in such companies tend to trade at a discount to the market on a growth-adjusted price-to-earnings (PEG) basis. And yet, healthcare equipment and services has been the strongest revenue generating sector globally over the past two decades, with growth running at more than 9 per cent annually. And it is set to become stronger still thanks to two structural trends: changing demographics and technological innovation as research shifts to biologics and AI.

Take demography first.

Ageing populations in the developed world and in China along with the simultaneous growth of middle classes in emerging markets will underpin demand for healthcare and diagnostic services. In Europe and the US, for instance, the population is growing at a pace of 2.5 per cent per year. Their healthcare spending per capita is more than three times that of their younger compatriots in advanced economies.

FIGURE 11
Healthcare spending* per capita, by age group in US dollars



*Values are in purchasing power parity–adjusted 2015 US dollars.
Source: NCBI

At the same time, the global epidemic in obesity – which has affected some 40 per cent of the US and 10 per cent of the Chinese populations – has triggered a boom in demand for GLP-1 anti-obesity drugs as governments and insurers see huge cost benefits.

Elsewhere, mRNA vaccines that target cancers that develop mostly among older people are showing promise.

Another, potentially more powerful source of growth for the health industry is AI. Its effects are multifaceted, serving to improve the reach of products and services, increase productivity and lower costs. Above all, it is set to help with innovation and technological breakthroughs in their various applications in diagnostics, medical support and training, drug development and administrative efficiency.

Demographic challenges and AI solutions look set to shape the healthcare industry for years to come.

Biotech is by far the best placed sector to benefit from AI, not least because it has been an early adopter – there are already some 1,500 vendors in health AI – and because of the huge volumes of data and models the industry has generated on which to train AI systems. AI has already made inroads into discovering possible cures for chronic diseases and has accelerated drug discovery. For instance, in just the past few years, Meta's AlphaFold and rivals have predicted 600 million protein structures which are key to drug development. By contrast, just some 200,000 were discovered in the 50 years before AI.

AI also represents a solution to the global shortage of health workers. The World Health Organization estimates a shortfall of 10 million health staff by 2030 as a result of chronic underinvestment. AI-powered solutions could help bridge the gap. For instance, Ada Health provides an AI-powered symptom assessment app used by 13 million users globally. And Butterfly Network, a company in the medical imaging field, is using AI-powered systems to enable non-experts to provide expert-level services. They envision their products being used by nurses to offer ultrasound services in outpatient settings, which could unlock a market potential of over USD10 billion, against a current doctor-driven market size of USD2 billion– there are four times as many nurses in the US as doctors.

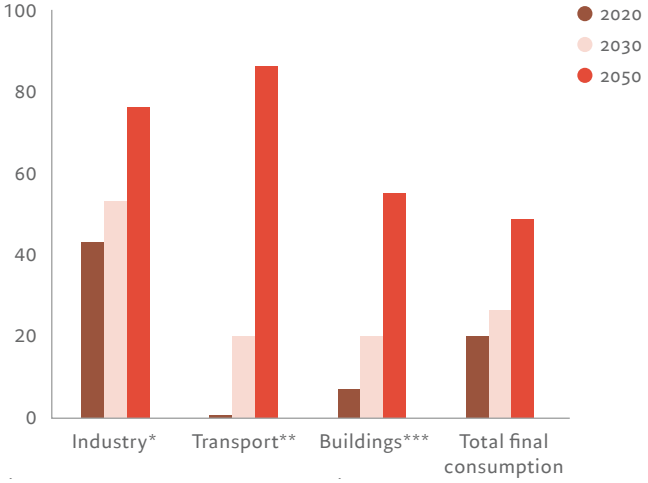
Demographic challenges and AI solutions look set to shape the healthcare industry for years to come, with major winners likely to be makers of healthcare equipment, diagnostics and services providers, and the biotech industry.

INDUSTRIALS

Demand for automation and robotics will only grow as demographically-driven shortages in skilled labour become worse. Their capabilities will, in turn, expand thanks to AI. Industrial robot installation has been growing by 8 per cent on average over last five years. Given that just five countries account for 80 per cent of installed robots, there's plenty of scope for expansion.

More broadly in the industrial landscape, electricity demand is about to ramp up thanks to electric vehicles, to the electrification of heating and to the expansion of data centres – AI and crypto currencies alone will add some 3 per cent of electricity demand by 2026, according to the International Energy Agency. Beneficiaries of this jump in demand go beyond grid utilities to firms supplying hardware, cables transformers and the like, and even software companies.

FIGURE 12
Electrification milestones to achieve net zero emissions by 2050, by sector, %



*electricity share of light industry, **share of EV cars in stock, ***share of heat pumps in energy demand for heating
Source: IEA, Pictet Asset Management

The growing popularity of near- and re-shoring of industries as well as a push for energy independence will provide an additional boost. At the same time, adoption of net zero necessitates investment in excess of USD100 trillion in power and industrial sectors by 2050. Continuing investment in carbon intensive sectors will lead to orphaned assets – this capital misallocation will create opportunities for investors to generate excess returns.

Finally, the green transition is hungry for metals, creating a demand that existing operations will be unable to meet – for instance existing mines and those under construction will only satisfy 80 per cent of copper demand and 50 per cent of cobalt needs by 2030. The pressure will be on mining companies to ramp up technological innovation and investment – such as remotely-operated soil sampling robots – to improve productivity.

Industry is being driven by a number of megatrends. Decarbonisation, AI, geopolitics, massive government investment programmes and labour shortages are all shaping the landscape. The winners will be makers of robots and robotic systems, of mining equipment, of capital goods and those that contribute to the grid infrastructure.

A boost from biotech

The healthcare industry is set to boom over the coming decade. And a substantial part of that will be driven by innovations in biotech.

Overall, healthcare spending makes up some 10 to 20 per cent of GDP across the world. As people grow older and richer, demand for newer therapies will only increase – not least to treat diseases of age, like cancer, and wealth, like diabetes. At the same time, the advent of advanced AI and other cutting edge technologies makes it increasingly possible to create bespoke therapies and those for rare diseases. This could prove a golden age of medical innovation, and biotech will be at the forefront.

This will be a godsend for the pharmaceutical industry. Facing a cliff of patent expiries – affecting some USD150 billion of revenue over the coming few years – mega-pharmaceutical groups have the cash to ensure their future by investing heavily in biotech, be that internally or by buying up smaller, innovative companies in the sector. And where at times in the recent past biotech could have been accused of chasing wild geese, the period of easy capital that ended two years ago has brought an era of capital discipline that has, in turn, put the industry on stronger fundamentals.

The AI boom is likely to drive a considerable amount of this innovation. It has vastly accelerated the discovery of how proteins fold – knowing this is crucial to the creation of new drugs. It has the potential to make clinical trials faster and more effective. And it can make sense of vast and complex data sets to, for instance, discover how existing drugs might be repurposed.

"This could prove a golden age of medical innovation and biotech will be at the forefront."

SHANIEL RAMJEE
Senior Multi Asset Investment Manager

Drug discovery is well known for being a time-consuming and costly endeavour. On average it takes over 12 years to develop a drug, costing an average of more than USD2 billion in research and development spending – a resource-intensive effort given only 1 or 2 of every 10,000 substances synthesised in labs ever eventually pass all stages of development.[10] AI has the potential to accelerate advances in drug design, predict target affinity, identify potential toxicity and mine large datasets to identify potential targets leading to faster drug development. In 2021 more than 100 drug and biologic applications submitted to the US Food and Drug Administration included AI or machine learning components compared to 14 in 2020 according to Morgan Stanley. Similarly AI could also help improve operational efficiency in clinical trials such as informing adaptive trial designs, streamlining patient enrolment, predicting drug effects and potentially reduce the cost burden involved in running clinical trials.

One fruitful area of investigation is liquid biopsy. This is a new technology that allows clinicians to diagnose, treat and monitor cancer earlier and more effectively by looking at circulating tumour DNA contained in patients' liquid samples such as blood, urine and cerebral spinal fluid. Liquid biopsies output data is large and complex and only the advent of machine learning has made it possible to extract relevant patterns out of these enormous datasets.

There are, of course, hurdles. AI is unlikely to lift all boats; specialist areas, rare diseases and gene therapy will probably benefit most. There will be varying regulatory issues to overcome, with geopolitics also coming into play as governments worry about biosecurity. But with the new tools at scientists' and researchers' disposal, this looks to be the start of a golden age for biotech.

10 Source: European Federation of Pharmaceutical Industries and Associations, 2023

4

A closer look at the transition risks of net zero

Most investors would agree that transitioning to a net zero economy makes financial sense over the long run. The most reliable climate models show that the future gains of containing global warming far outweigh the investment required to reduce carbon emissions to safe levels.

Research conducted by Oxford University for Pictet AM in 2020 suggests that the world could lose up to half of its potential economic output by the end of this century if effective measures to mitigate climate change are not put in place. A loss of such magnitude would far exceed the costs associated with developing a sustainable green economy.

Net zero investment could potentially add over USD215 trillion to governments' debt piles by 2050, accounting for over one-third of the projected increase.

Yet even if these long-run assumptions aren't in dispute, there is a serpent lurking within the net zero paradise. The energy transition could cause considerable – if not severe – disruption over the medium term.

A study undertaken on behalf of Pictet AM by the Institute of International Finance (IIF) identifies three specific transition risks that investors will need to attend to over the next five to seven years.

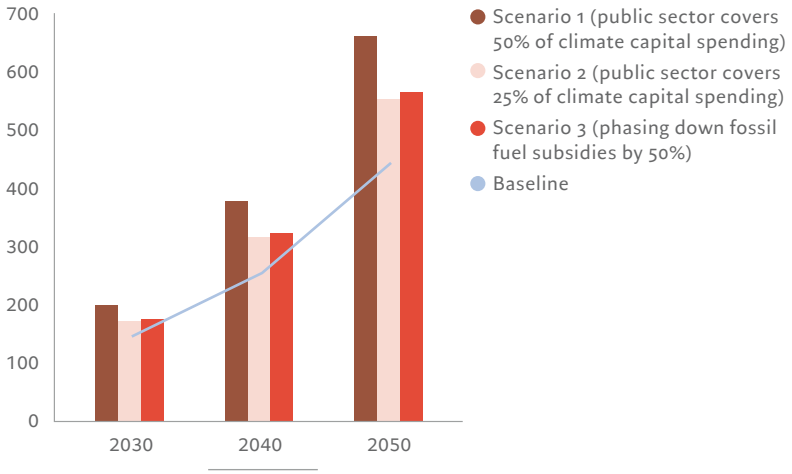
Chief among them is a surge in government debt.

Assuming governments continue to fund half of all the climate spending required globally, net zero investment alone could potentially add over USD50 trillion to governments' debt piles by 2030 and over USD215 trillion by 2050. This would account for over one-third of the projected increase in government debt through 2050. Growing debt burdens are likely to have a negative effect on the credit profiles of the many countries that are already financially stretched in the wake of the Covid pandemic.

The second transition risk confronting investors is economic disruption. The laws and regulations designed to penalise carbon emitters – such as carbon taxes and the EU's border adjustment tax – will inevitably add to the cost of doing business. Currently carbon taxes are applied to less than 25 per cent of human carbon emissions; extending their reach and raising the amount of

FIGURE 13
Climate spending adds to debt pile,
government debt,
in USD trillion, by scenario

Debt burden on the rise



Source: IIF; forecast covering period 31.12.2021-31.12.2050

tax from the current rate of less than USD10 per tonne on average to well above USD150 would likely increase input costs for almost every industry. While companies may absorb some of that transition expense, much of it will inevitably be passed onto households in the form of higher prices for goods and services, the IIF study says. This could weigh on consumption and, ultimately, GDP growth. The IIF's calculations show that real GDP could be lower by some 1 to 4 per cent by 2030 under this scenario – depending on the region – than would otherwise be the case.

Economic disruption might also come in the form of volatile inflation. According to the IIF, even if lower real GDP growth could act as a brake on inflation, supply bottlenecks for commodities essential to the energy transition could reignite prices pressures.

Estimates from the International Energy Agency (IEA) show that switching to renewable energy will require a dramatic increase in mining activity. By 2040, the IEA estimates that the world will need a 41-fold increase in nickel production, a 28-fold rise in copper and graphite supply and a 21-fold increase in cobalt availability. Yet on current trends, the mining industry will not reach these production volumes, implying supply shortages and higher prices for transition-critical minerals.

The IEA warns that copper demand could outstrip supply as soon as 2025, and it is a similar picture for many other energy transition materials. Further complicating matters is the introduction of new environmental and labour regulations designed to improve the mining industry's environmental and worker safety standards.

These inadvertently extend the timeline for new mines to become operational. So if metal shortages become a persistent problem, the resulting surge in commodities prices could lead to a significant period of greenflation.

A third side-effect of the net zero transition is financial market instability. Capital projects, particularly those directed in part by governments and state institutions, are always vulnerable to mismanagement. And the greater the amounts being invested, the greater the potential waste and damage.

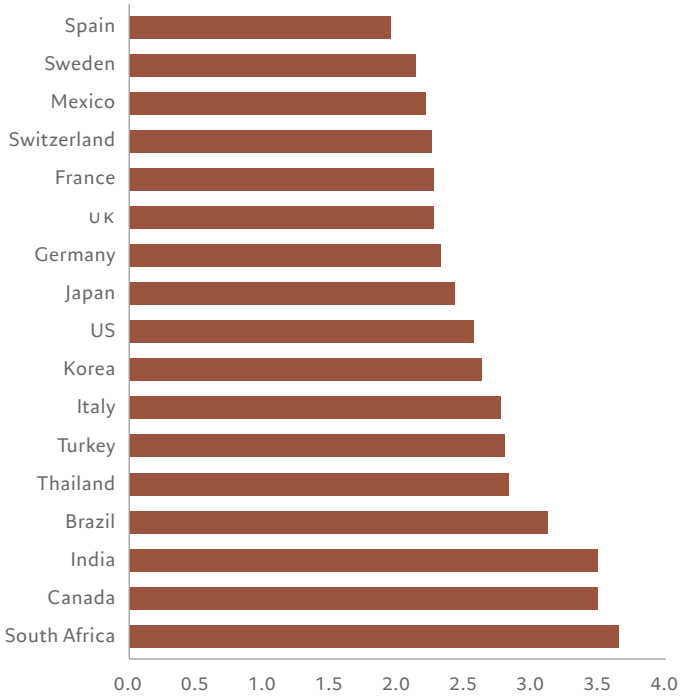
This can make life especially difficult for investors. To reduce carbon intensity, they must be prepared to either channel capital to nascent technology or direct investment to companies whose track record on carbon reduction is poor in the expectation that the situation improves. Or both.

Yet it is difficult to know in advance which of today's "brown" investments will turn "green" and which environmental technologies will prove commercially successful. This becomes more complicated still considering

FIGURE 14

Companies still some distance away from net zero

Listed companies'* impact on global warming, by country, expressed as implied average temperature rise attributable to corporate activities



Source: IIF, Bloomberg, MSCI;
*excludes financial and Chinese companies;
as data at 31.12.2023

that many listed companies still need to engage in costly and potentially disruptive restructuring if they are to hit net zero goals.

All of which means that the potential for capital misallocation – the emergence of asset bubbles, on the one hand, and unjustifiably cheap assets, on the other – grows considerably. While this could give rise to numerous investment opportunities, it could also lead to even more frequent bouts of severe financial market volatility.

None of this is to downplay the importance of the world's commitment to net zero. It is vital to the world's future prosperity. Yet the journey to a net zero economy is complex and fraught with risks. Investors face significant challenges – particularly in the initial phase of the energy transition – that could disrupt economic activity and financial markets. Overlooking these threats could be costly.

Asset class return projections

Equities: whither US exceptionalism?

Equities won't deliver stellar gains over the remainder of this decade. But they shouldn't disappoint investors either.

Stock markets in the developed world in particular have had a remarkable run in the past few years – overcoming heightened geopolitical uncertainty and sharp increases in interest rates – yet there are many reasons to believe they can build on those gains, even if today's lofty valuation could feasibly act as a brake on future returns.

Our analysis shows the MSCI World Index delivering a return of around 7 per cent annualised in local currency terms over the next five years. True, that's a modest outcome compared with an over 10 per cent gain in the past few years, but it is still above the long-term average.[11]

In surveying the prospects for stocks, several positives stand out.

HIGHER VALUATION FOR LONGER

Global equities are expected to sustain above-average valuations while corporate profit margins should also remain healthy over the next five years. This should be particularly true for US stocks, which are an anchor for global equity valuations. We expect them to trade an at average price-to-earnings multiple of 19 times in the next five years – above the long-term average since 1990 of 16 times and but slightly below the current multiple of above 20.[12] Hopes for any AI-related pick up in productivity, coupled with ongoing disinflationary trends and declining interest rates, will also keep multiples elevated.

Mega cap stocks should retain their premium as such companies benefit from solid cash flow generation and strong business models. What is more, corporate balance sheets remain in good shape while profit margins – which have been trending higher since 1990s thanks to a number of factors including cheaper labour costs from outsourcing, lower taxes and increased deficit spending – are expected to decline but only very gradually.[13]

11 The average five-year return since 1990 is 5.9 per cent

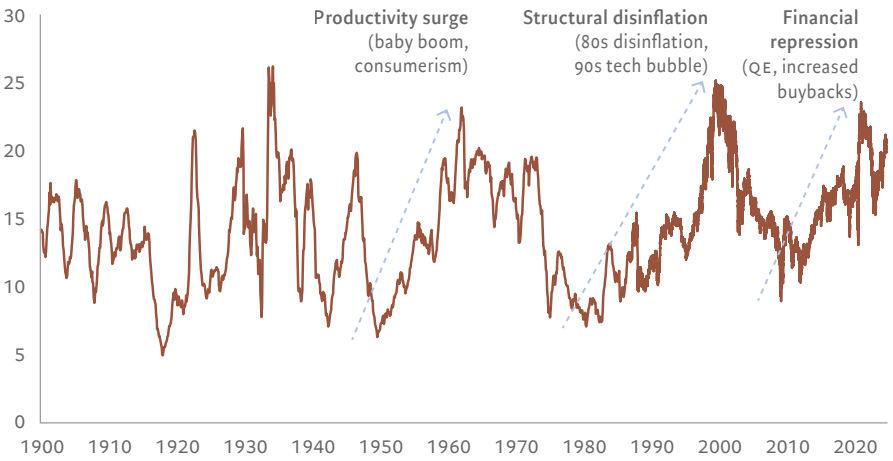
12 Our fair value estimates are based on US 10-year Treasury yields at 3.75 per cent, equity risk premium at 3.75 per cent and US trend growth of 1.8 per cent

13 Increased deficit spending tends to boost corporate profits, as explained most prominently by the Kalecki Profit Equation: Profits = Investment - Household Saving- Foreign Saving - Government Saving + Dividends

FIGURE 15

S&P 500 12m forward price-to-earnings ratio

US stocks do not look terribly overvalued



Source: Refinitiv DataStream, Pictet Asset Management; data covering period 31.12.1899-31.03.2024

Equities are also likely to benefit from favourable supply and demand dynamics. Sustained share buyback activity, should continue to reduce the supply of equities relative to other assets, including bonds.

FADING US LEADERSHIP

For all this, the 7 per cent return we expect from global stocks does mask some important new market developments that could have serious implications for investors.

Perhaps the most significant is fading US exceptionalism. After delivering among the strongest returns on record in the past few years, valuations for US stocks have limited room to rise compared with their counterparts in the developed world.

Also likely to hold US stocks back is the tailing off of share buybacks. While repurchases are becoming more popular in other markets, the signs are that US companies will struggle to maintain the current rate of buybacks.

The 1 per cent excise tax on the value of corporate share repurchases, net of issuance, imposed by the IRA, is a good example of how authorities in the US are looking to restrict share repurchases. At the same time, higher borrowing costs means US companies are no longer incentivised to replace equity funding with debt.

The second important development that stands out from our forecasts is that European and Japanese equity markets are likely to close the performance gap with the US.

The leadership of US stocks has owed a lot to the exceptional ability of US corporations to translate domestic and global growth into corporate revenue; US sales growth has outpaced our model forecast by 1.5 percentage points on average over the last decade based while piers have disappointed.[14] But we see evidence that companies in Europe and Japan are beginning to catch up. In part this is thanks to an improvement in the economic environment outside the US – Europe is recovering from twin supply shocks (Covid and the Ukraine war), while Japan is emerging from a deflationary spiral.

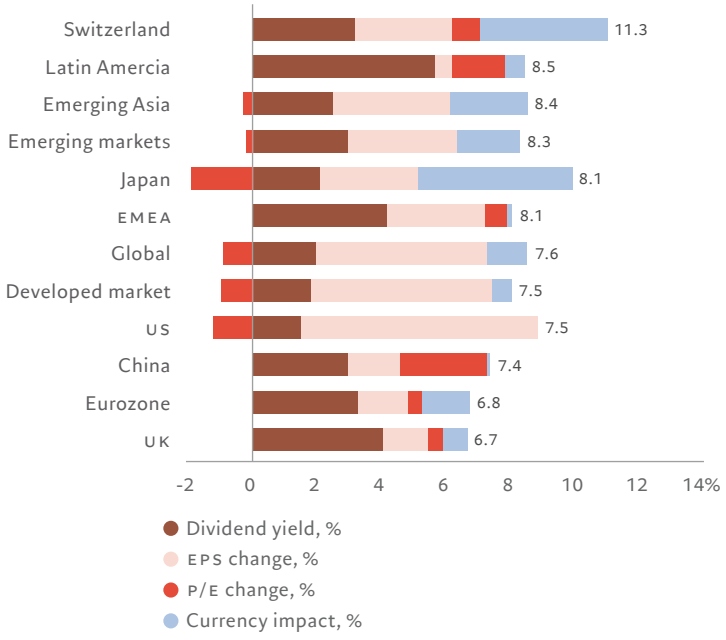
But this is also a function of changing sector composition. In Europe, for example, dynamic sectors that can generate sales more efficiently – such as technology and industrials – now represent over 30 per cent of the benchmark index, higher than financials and resources and double the 2010 level.[15]

LOW REGIONAL DISPERSION

The relative decline of the US stock market compared with Europe and the US brings with it another change in the dynamics of global equities – a sharp decline in the dispersion of returns across regional and domestic markets.

Dispersion lacking among developed equity markets

FIGURE 16
Forecast decomposition of equity returns, by region, 5-year annualised, % in USD



Source: Pictet Asset Management; data covering period 31.03.2019-31.013.2024

14 Our current model forecast for sales growth is 5.6 per cent for the US, versus 3.5 per cent for DM ex-US and 6.4 per cent for EM

15 MSCI EMU index

We expect returns of all major equity regions (except Switzerland) to be within 1 percentage point of US equities in USD terms. The US will deliver 7.5 per cent, compared with Japan at just over 8 per cent and Europe and the UK just short of 7 per cent.

The decline in regional dispersion leaves active investors with two possible options to secure superior returns.

The first is to become ever more active, frequently rotating regional allocations in a bid to capture outperformance.

The other, and possibly more rewarding path, is to use a sector-based approach to asset allocation. Our analysis shows there are a number of sectors with the potential to deliver superior returns. These three industries – tech, health and industrials – are leaders in innovation, are supported by strong megatrends and should gain a larger share of global corporate revenues. We expect this group of secular winners to outperform the broader market by as much as 20 per cent in our forecast horizon (see SECTION 2).

EMERGING MARKETS – BE SELECTIVE

Another conclusion equity investors should draw from our analysis is that they should become more selective when allocating capital to emerging markets. Emerging market companies have largely failed to translate attractive GDP growth into higher profits in recent years. Low corporate governance standards – including the treatment of minority shareholder interests and dilution of passive shareholders – have partly explained the persistent underperformance of emerging makret stocks.

But we see signs of improvement in some areas, particularly Asia. China is pulling out all the stops in its effort to enhance shareholder rights and improve the governance of its companies (see "Mind the gap: Japan, China and corporate governance overhaul"). South Korea has also unveiled a “Corporate Value-Up” programme aimed at improving shareholder value and tackling the comparatively low valuations seen in the domestic stock market. If these programmes are successful, they would deliver a positive surprise to our earnings and return forecasts.

For now, we prefer to be selective. We prefer India for its secular growth, progress on reform agenda and good momentum in near-term earnings growth. We also like South Korea and Taiwan for their leadership on technology, which allows their markets to benefit from secular growth in digitalisation and AI. We also like Gulf markets for their favourable growth and inflation outlook as well as for diversification.

Fixed income: credit in the ascendancy

The conflagration that swept through the bond markets starting in 2020 was the most brutal in living memory. But like a forest fire, it cleared the ground for new growth, leaving fixed income in a healthy position to generate solid returns over the coming years.

From their highs at the start of this decade, US 10-year Treasury bonds have lost 20 per cent of their value – 35 per cent after inflation.

For 30-year Treasury bonds, that cumulative loss has been close to 55 per cent after inflation, which compares to the worst equity bear markets since the mid-1960s. German government bonds suffered even more – a function of the fact that yields on the 10-year Bund started at a historic low of -0.85 per cent.

Those extremely low initial yields coupled with a rapid pace of monetary tightening – 525 basis points in 16 months by the US Federal Reserve, for instance – in response to a post-Covid inflationary surge were toxic to the market.

But that means bond markets are now a much more attractive long-term proposition for investors.

After a decade of being pinned to near zero by central banks, interest rates and bond yields have now returned to historically normal levels that are consistent with economic theory. Yields on 10-year bonds are roughly in line with trend economic growth rates and real interest rates (policy rates above core inflation) are at 2.5 per cent in the US and 1.6 per cent in the euro zone.

In the past, real yields at current levels have marked the end of monetary tightening. Interestingly, almost all major government bond markets are exhibiting a similar convergence to trend, even though economic growth trajectories have diverged. Yield curves are also unusually convergent.

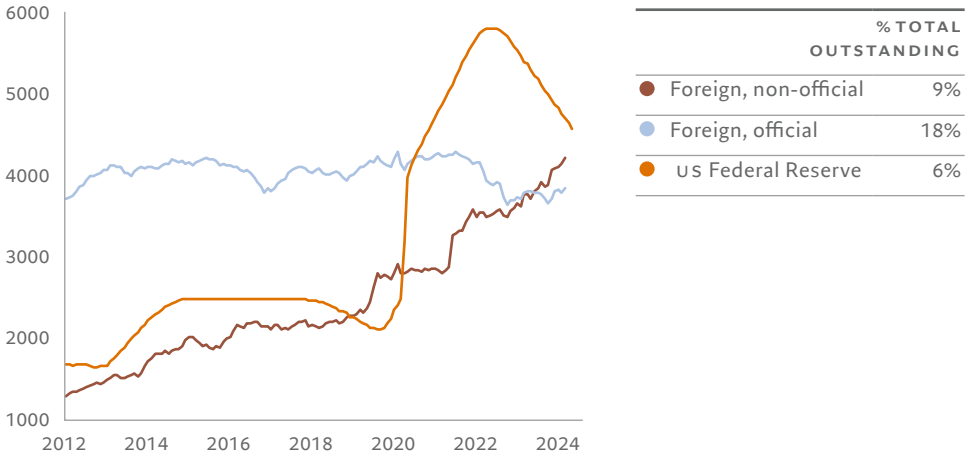
This matters because the initial yield explains nearly 80 per cent of the variance of a US Treasury bond's total return over a five-year period in the US, and about 60 per cent for euro zone instruments. On our calculations based on an initial yield of 4.4 per cent, there's an 80 per cent probability that US 10-year Treasury bonds will deliver positive returns over our forecast horizon – that assuming inflation averages 2.4 per cent, which is the market consensus expectation. By contrast, back in March 2020 the US 10-year bond only had around a 30 per cent probability of delivering positive returns over five years.

Since trend economic growth generally remains broadly stable over a given five-year period, it's the direction of inflation – which tends to be more volatile – that sets the tone for the bond market. The good news here is that the recent inflationary episode has passed and the path is back towards the inflation target of central banks – though we expect this to be a slow and bumpy journey. It's also relevant that US unemployment has stopped falling; increasing bond exposure at these inflection points has always been a reliable and winning strategy.

The bullish case for bonds over the next five years rests on two further factors. The first is the level of official rates.

FIGURE 17
Breakdown of owners of US Treasuries, by investor type, USD billion

As the Fed reduces its bond balance sheet, other buyers step in



Source: Bloomberg;
data covering period 31.12.2011-30.04.2024

In the past 10 monetary policy cycles, which is to say since 1954, the Fed funds rate has on average been half of the level of the previous cyclical peak. An extrapolation of this would imply an average Fed funds rate of 2.75 per cent over the next five years, with a potential low of 1 per cent in the event of a recession – assuming that the current 5.5 per cent rate is indeed the cycle peak.

Another positive for bonds is latent investor demand. Private investors have been eager to buy Treasury bonds (see FIGURE 17). As the US government floods the market with an unprecedented amount of debt to finance its spending, private buyers have been stepping up, easing concerns of a buyer's strike. In part, US investors are starting to make up for the fact that bonds only account for 14 per cent of household assets, according to US flow

of funds data – a very low share for a rapidly ageing population. Also, for the first time on record, non-official private investors overseas have overtaken foreign central banks as the second-largest holders of US government debt.

That should mitigate the fact that the Fed is cutting its holdings of Treasury bonds as part of its quantitative tightening programme, while foreign central banks are also doing so to diversify away from the US dollar. Data from February showed holdings of long-term US Treasuries by non-official foreign investors jumped about 52 per cent over the past three years to around USD4 trillion, equivalent to 12 per cent of the total market for US government bonds.

The danger, of course, is that this time it's different, that risks facing the market trump these positive factors.

Firstly, while talk of a significant rise in the natural rate of interest (or R*) seems overblown to us, the balance of evidence points to at least an end of the downtrend in the R* that we have seen starting in the 1980s. That matters because, broadly speaking, the natural rate acts as an anchor for bond yields.

The two key determinants of R* – trend productivity growth and the gross savings ratio – have stabilised after trending lower over recent years, but are at levels consistent with an R* at well below the historical norm.

As a consequence, we have revised up our forecast of R* in the US to 0.75 per cent, and have also revised our forecasts for the "equilibrium" Fed rate and US 10-year Treasury yield to 2.75 per cent and 3.75 per cent, respectively. We assume that the US 3-month to 10-year yield curve will steepen but will remain marginally flatter than the historical average. The Fed has revised up its own estimate of R* from 0.5 per cent to 0.8 per cent this year, while the implied market estimate is between 1 per cent and 1.5 per cent. In the euro zone, we believe the R* is still very close to zero, which is also the market's thinking.

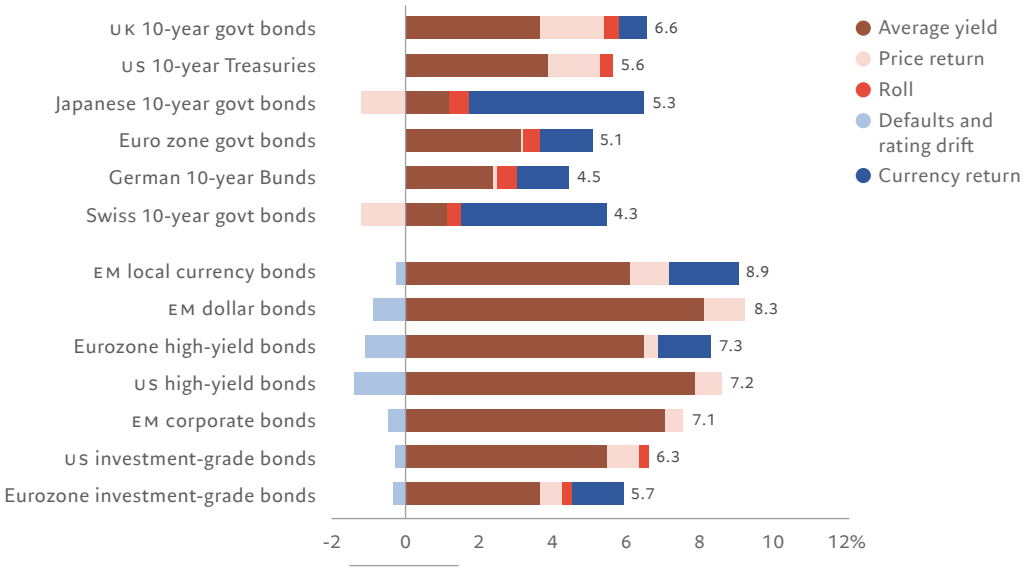
The biggest risk facing bond investors is the emergence of a phase of unconstrained "fiscal dominance", where central banks are directly or indirectly forced to accommodate an expansionary fiscal policy. This would lead to a structural rise in inflation and a significant loss of central bank inflation-fighting credibility, which, in turn, would drive bond yields significantly higher and cause the yield curve to steepen.

But a sustained rise in inflation is unlikely in an ageing society. Just as unlikely is a rise in central banks' inflation targets, an idea that was mooted in the aftermath of the global financial crisis but looks far less likely now.

Moving goalposts like this is hazardous to central bank credibility while the benefits are questionable. True, central banks could introduce relatively broad target ranges, but we think the most likely outcome will be a re-run of the "opportunistic disinflation" strategy of the 1980s-90s, whereby central banks patiently wait for a cyclical loss in demand (i.e. recession) to bring inflation back to trend.

FIGURE 18
Forecast decomposition of return, government and corporate bonds, %, 2024-2029

Breaking it all down



Source: Pictet Asset Management; forecast period 31.03.2024-31.03.2029; for methodology please see Appendix

Taking all this into account, we expect developed market government bonds to deliver returns of some 4 to 5.5 per cent per year over the next five years in US dollar terms. The aggregate return for developed market government debt is forecast to come in just under 5.5 per cent per year.

Elsewhere in sovereign markets, emerging market dollar and local currency bonds are expected to deliver returns of over 8 per cent per year over the same period. In emerging market local currency debt, we particularly like Mexico – an economy that stands to benefit from nearshoring and fiscal discipline. We also like Turkey, which our fixed income colleagues see as a huge turnaround story as the country moves away from Erdoganomics.

The case for emerging market debt is based on the assumptions that the dollar will decline, the Fed will cut rates and emerging market economies will perform better than the developed market counterparts. Further

support comes from the fact that real interest rates are still very high and emerging market central banks have already started their easing cycle.

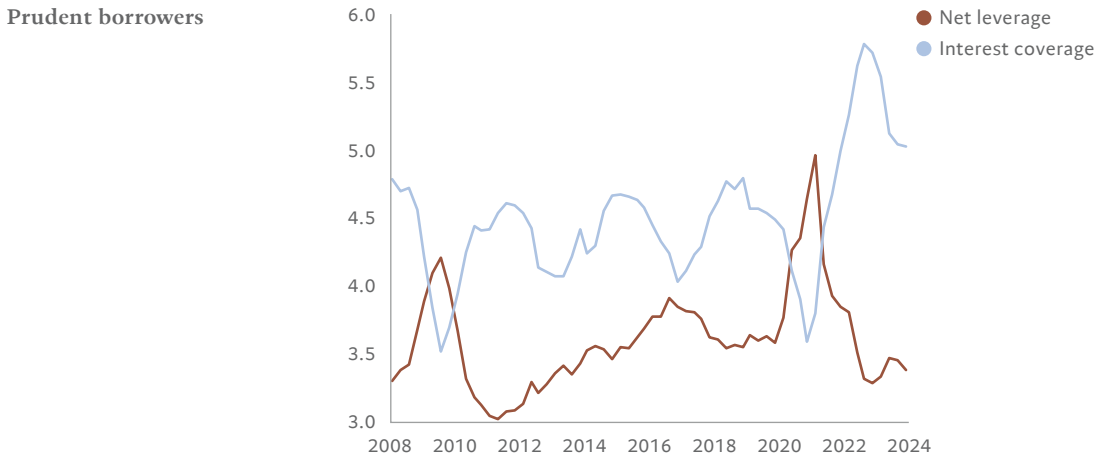
CREDIT: THE ASSET OF CHOICE OVER THE NEXT FIVE YEARS

From US high-yield bonds to European private debt, we believe that credit markets offer among the best prospects for risk-adjusted returns over the next half a decade.

Our analysis shows that bonds' initial yield and relative yield are historically reliable pointers to future returns. At 5.9 per cent,[16] the starting yield for BAA-rated US corporate bonds (the average rating of US credit) is close to the highs reached immediately after the 2008-09 credit crisis, both in absolute terms and relative to equities. Spreads, meanwhile, are the tightest they have been in this monetary cycle and are unlikely to widen much. This creates a very attractive entry point into the credit market.

The fundamentals are positive too. Corporate borrowers have more solid balance sheets than in recent years. Consequently, the average ratings of US and European high-yield indices have improved over last two decades, heading in the opposite direction to those of

FIGURE 19
US high-yield companies, trailing 4-quarter net leverage vs interest coverage ratio



Source: J.P. Morgan, Pictet Asset Management.
Net leverage defined as net debt/EBITDA,
interest coverage as EBITDA/interest expense.
Data covering period 01.01.2008-31.12.2023.

16 As at 30.04.2024

government bonds which have continued to decline (the percentage of AAA bonds in Bloomberg's global treasury bond index has dropped to 10 per cent from 70 per cent 20 years ago).

While governments have indulged in debt-funded spending sprees (rising pressure on term premium), corporations are showing greater financial discipline, with corporate leverage near historic lows and abundant cash on balance sheets. Interest rate coverage has deteriorated somewhat from historical peaks, but remains at a healthy level despite the aggressive central bank tightening of recent years.

We expect both leverage and interest rate coverage to remain largely stable over the next half a decade as solid corporate earnings growth offsets modestly higher funding costs and as executive boards remain relatively conservative when it comes to share buybacks and M&A. We also expect inflation to be slightly higher than average, helping corporations to sustain high margins.

While governments have indulged in debt-funded spending sprees, corporations are showing greater financial discipline, with corporate leverage near historic lows and abundant cash on balance sheets.

The default outlook is relatively benign. The distressed ratio – the percentage of all speculative grade securities spread above 1,000 basis points – implies a relatively shallow default cycle ahead. This is consistent with our forecast for a 2.7 per cent average default rate over the next five years. Most of the debt maturing over the next two years was issued by BB or B rated companies that tend to have good access to funding in public markets. Major central banks in essence provide a floor to credit markets, thanks to proven backstop mechanisms to preserve market access and dampen the depth of defaults. The "Fed put" is thus a "credit put".

With interest rates in major economies having peaked, market access for borrowers should continue to improve, creating opportunities for early refinancing. That, in turn, could lead to the prices of high-yield bonds rising towards par value – something that usually happens as maturity approaches, but could now occur sooner, especially at the short end of the market (known as the pull to par return).

Another positive is that the macroeconomic backdrop should remain fairly stable. While modest economic growth limits earnings prospect for equities, it could prove good news for credit, as it should cap the rise of liquidity premiums and support carry-driven excess return.

The valuations are supported by strong demand among income-oriented investors. Annuity sales hit record highs in both the US and the UK in 2023 due to more baby boomers retiring – a trend we expect to continue. High interest rates are driving additional demand for credit from pension funds, especially for long-term investment-grade bonds. There is also huge amounts of dry powder in money markets (including USD6 trillion in the US), and some of this will likely move up the risk spectrum and the maturity curve into credit as the Fed embarks on an easing cycle.

UNDERAPPRECIATED BENEFITS FOR PORTFOLIO CONSTRUCTION

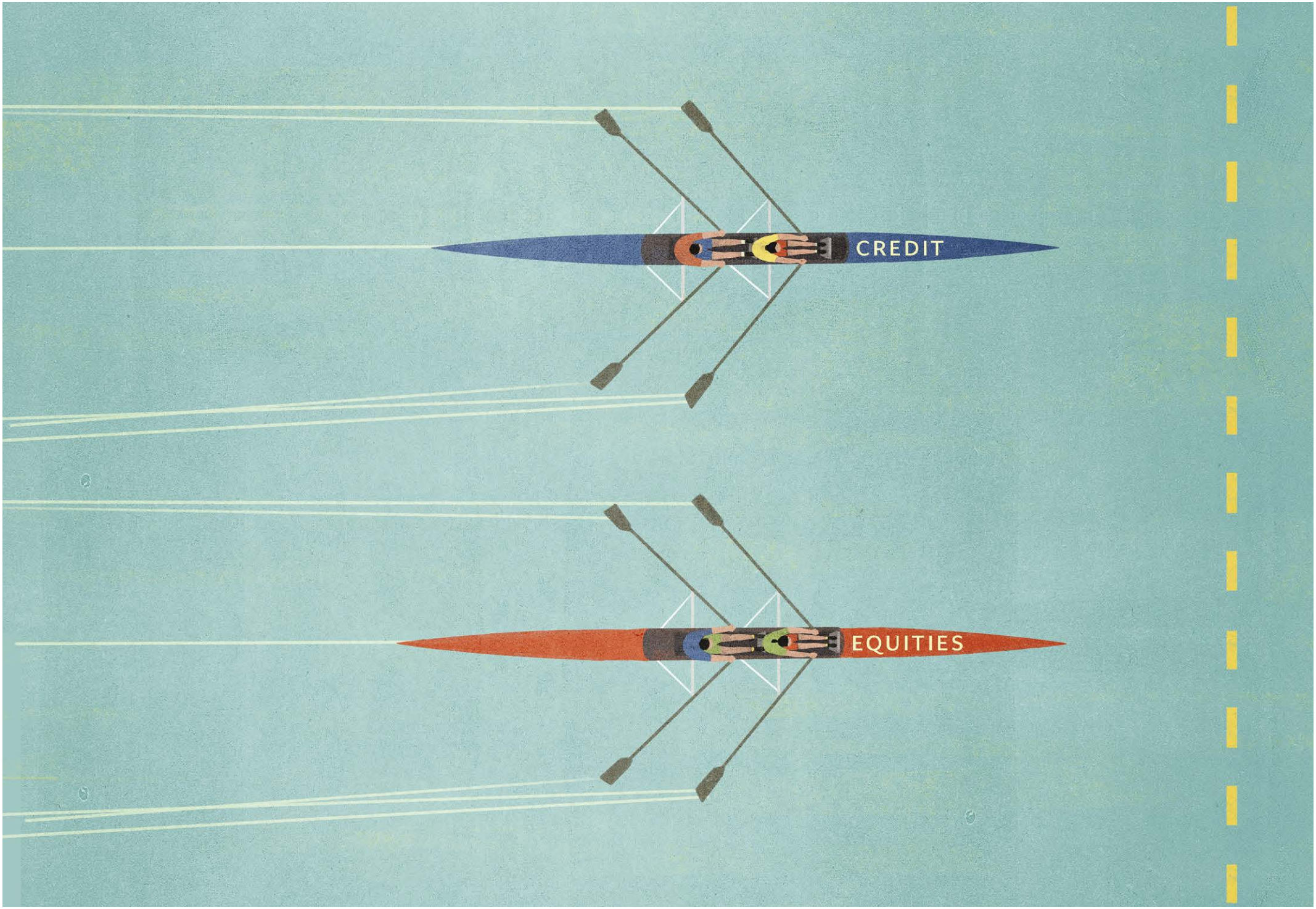
Credit offers significant value within a diversified portfolio. Historically, it has better risk-adjusted returns compared to government bonds, and smaller peak-to-trough falls than equities. Adding credit to a traditional portfolio of equities and government bonds would thus result in a higher efficient frontier.[17]

Looking at typical risk profiles of global balanced portfolios in US dollar terms, our analysis shows that adding global high yield to the risk allocation (equity) and global investment grade to risk-free allocation (bonds) notably enhances portfolio return, while keeping both the notional risk allocation and portfolio volatility the same (see FIGURE 20).

These characteristics are likely to become all the more valuable as the negative correlation between government bonds and equities – to which investors have become accustomed in recent years – becomes more unpredictable in the face of greater inflation volatility and higher term premiums. Combine that with higher realised volatility, and it may undermine the ability of sovereign debt to act as a shock absorber in a portfolio, instead making it more of a tactical recession hedge.

In such an environment, instead of seeking diversification from negatively correlated assets, investors should look for high and stable income to better dampen equity risk over the medium term. We believe credit offers precisely that, with the added benefit of being more diverse than the equity market. The top five companies now account for 25 per cent of the US equity universe, but only 2 per cent of high-yield credit and less

17 Maximum return for a given level risk.

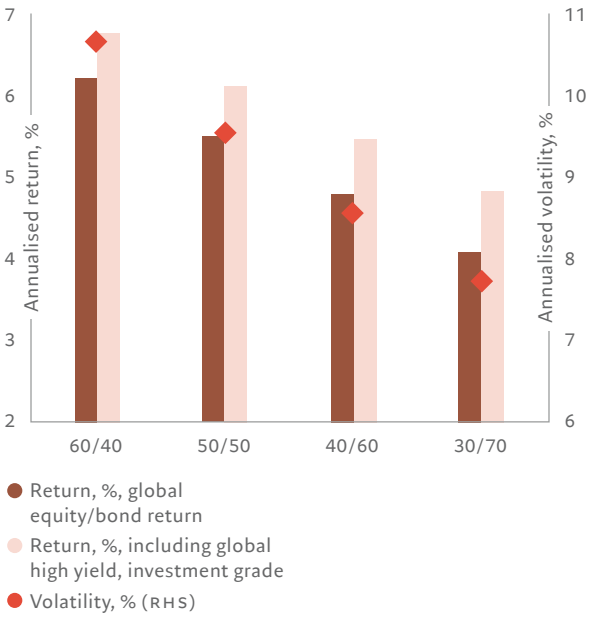

CREDIT
EQUITIES

than 1 per cent for investment-grade. The credit universe is also more evenly spread between different sectors, giving better exposure to the whole economy than major stock markets (such as, for example, the tech-dominated S&P 500).

FIGURE 20

Annualised USD return, volatility, %, for global equity/sovereign bonds, portfolio vs enhanced portfolio with global investment-grade and high-yield credit

Credit gives better balance



Source: LSEG, Bloomberg, Pictet Asset Management. Based on volatility matching portfolio, with global high yield added to risk allocation and with global investment grade added to risk-free allocation, while keeping notional risk allocation the same. For optimised portfolio, allocations are as follows: for 60/40, 47.2% equities, 12.8% HY, 40% IG; for 50/50, 34.3% equities, 15.7% IG, 50% HY; for 40/60, 21.4% equities, 18.6% HY, 60% IG; for 30/70, 8.5% equities, 21.5% HY, 70% IG. Benchmarks are MSCI ACWI, FTSE WDBI, ICE BofA Global HY, ICE BofA Global IG. Data covering period 01.05.2004-30.04.2024.

Currencies:
dollar's gentle decline

At first glance, the US dollar appears to be on solid ground. It draws support from higher domestic interest rates and a resilient US economy while its status as a haven has exerted a gravitational pull on non-US investors in recent years.

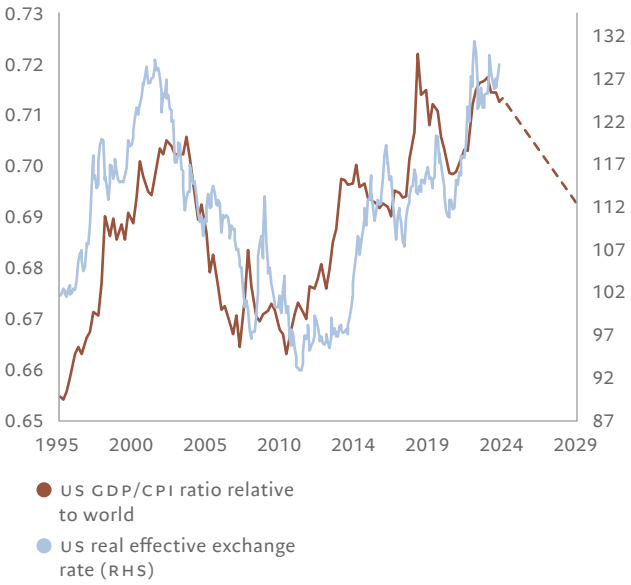
But on closer inspection, the greenback rests on shakier foundations. Not only do we think its valuation on a trade-weighted basis has peaked, but the US's weakening fundamentals point to a period of protracted weakness. Our calculations show the dollar should lose around 2 per cent per annum against major currencies over the next five years.

There are several reasons why. First, there's growth. The US economy will lose some of its exceptionalism over the remainder of the decade. Its real GDP over the next five years will drift lower relative to other nations, leading to weaker capital inflows.

Our analysis shows the US economy's growth/inflation mix is set to deteriorate relative to the rest of the world, which tends to weaken the dollar (see FIGURE 21).

FIGURE 21
US dollar real effective exchange rate vs US economic performance

US economic fundamentals point to weaker dollar



Source: Pictet Asset Management;
data and forecast covering period 31.12.1994-31.03.2029

Another negative for the greenback is that the US's twin deficit – the combination of its fiscal and current account deficits – is deteriorating. The US scores at the bottom among major and emerging economies when it comes to the twin deficit, which represents a key source of economic stability. Our historical analysis suggests these twin deficits typically lead to a significant depreciation of the dollar in the coming years.

Add to this a longer term trend of de-dollarisation within the global economy. While diversification away from the dollar is gradual, the erosion of the currency's status in international financial markets is becoming more obvious. The US currency's share of allocated foreign exchange reserves fell to 58 per cent in 2024 from around 72 per cent at the start of the century as central banks diversified their reserves away from G5 currencies to add gold, the Chinese renminbi and the, Australian and Canadian dollars.

The dollar's decline will be more pronouced against the Japanese yen and Swiss franc.

Our analysis shows the dollar's decline will be more pronounced against a certain group of developed currencies, particularly the Japanese yen and the Swiss franc.

Japan is likely to emerge as the most attractive destination for foreign capital flows as it emerges from deflation. An improvement in corporate earnings growth from Japanese companies, supported by positive corporate governance reform and a benign inflation backdrop, should continue to make Japanese stocks a magnet for foreign investors. And Japanese investors will also feel confident enough to repatriate some of their significant foreign assets.

The yen is trading at nearly 20 per cent below what our model considers to be a fair value. On a purchasing power parity basis, it is some 40 per cent below its fair value. This valuation gap is likely to begin to close, especially as the Bank of Japan starts raising interest rates for the first time in 20 years.

All of which should end up offering strong support to the yen, which we think will rise the most against the dollar in the next five years, delivering annual gains of 4.8 per cent every year between now and 2029.

We expect the Swiss franc to appreciate by 4 per cent per annum in the coming half decade. Other European currencies, such as the euro and sterling, will see more modest gains against the dollar.

Elsewhere, emerging currencies are likely to rise moderately against the dollar, with Asian units outperforming most Latin American and eastern European counterparts.

The Chinese renminbi has experienced protracted weakness in recent months as outflows from the country's capital market gathered pace and the People's Bank of China allowed the currency to weaken to gain export competitiveness. But this should change as the economy stabilises, and there are tentative signs that capital is flowing back into the world's second largest economy. We expect the Chinese currency to rise 2.8 per cent per annum in the next five years against the dollar.

Another winner against the dollar will be the Chilean peso. The currency's strong fundamentals are a reflection of the country's position as an exporter of key commodities, including copper, which is crucial to the energy transition. The Korean won, meanwhile, should benefit from increasing demand for semiconductors. Elsewhere, efforts by European countries to nearshore their production should boost the manufacturing-heavy Turkish economy and help the lira, which is also supported by a more orthodox monetary policy and attractive interest rates.

Alternatives: private debt and industrial commodities to shine

Alternatives deserve a sizeable allocation in investor portfolios as they will continue to provide diversification benefits and exposure to secular trends that may not be so easily accessible via public investments.

PRIVATE DEBT

Private credit is an attractive investment on several fronts. The floating rates on offer in private debt funds help boost income and shorten portfolio duration. With high short-term policy rates and wider spreads than public credit, private credit offers yield that's now competitive with historical average equity return.

The illiquidity of private debt offers not only an additional premium, but better downside protection as well. That's because private credit is largely funded with long-term capital invested in closed-end funds, which mitigates maturity transformation risk and prevents investors from selling at the bottom of the market.

Tailored covenants and the scope for active engagement with the investee companies offer lenders a level of direct control and the ability to proactively address amendments throughout life of the loan and in, case of defaults, to achieve more favourable outcomes. The recovery rate for the private senior syndicated loan is around 70 per cent, significantly higher than the 40 per cent for US high yield bonds.

The market is also supported by the growing private capital eco-system. The growing dry powder in private equity presents a strong source of potential demand for private debt while the majority of private credit borrowers are sponsored by private equity capital, providing a potential source of additional capital in times of transient stress and thus reducing the risk of defaults.

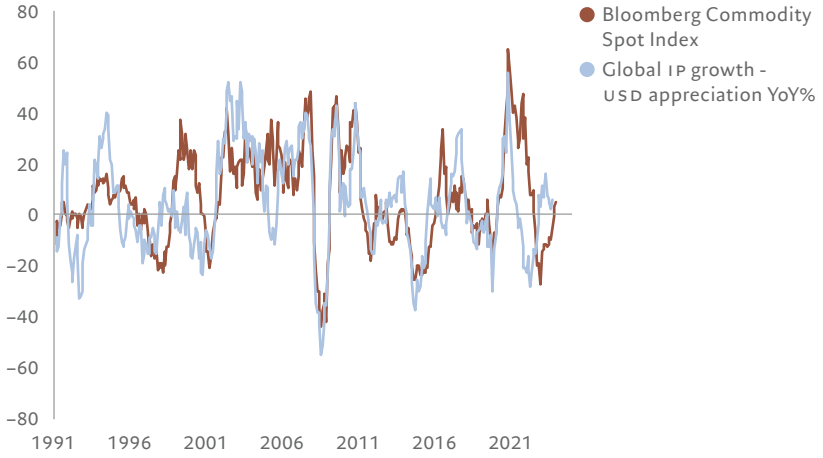
Overall, we believe the rise in private credit doesn't diminish need for public credit, but instead serves to diversify the sources of liquidity, hence reducing systemic risk and the risk premia for the wider credit universe.

We forecast a five-year return of close to 10 per cent per annum for both US and European private debt. Defaults will remain low and the asset class will also benefit from a general decline in interest rates. Having said that, the returns will be capped by increasing competition among lenders thanks to surging investor inflows.

18 Our models use a supply proxy variable (capex to depreciation for energy and materials companies over the past five years) that has predicting power over the level of future production

Close links

FIGURE 22
Commodity prices, global industrial production and USD



Source: Refinitiv Datastream, Bloomberg, Pictet Asset Management.
Data covering period 01.12.1992-30.05.2024

COMMODITIES

The combination of stronger demand, constrained production,[18] a weaker dollar and positive (if modest) economic growth should support commodities, helping them deliver returns of around 7 per cent per annum – only slightly below global equities on a dollar basis.

Industrial metals, particularly those needed for the shift to net zero, have the biggest upside. The green transition has barely started, geopolitical considerations are leading to a duplication of commodity-heavy supply chains and supply constraints are intensifying. We expect double-digit returns here.

Gains for gold are likely to be more modest, having been the best performing asset class over the past five years (12 per cent annualised), even outperforming global equities. While the fundamentals remain supportive, valuation looks very stretched to us. Our analysis shows the current gold price implies a 20 per cent depreciation of the US dollar and 100 basis point decline in US 10-year TIPS yield – well ahead of our own forecasts. However, we do believe that the unprecedented rise in public debt across the globe – and the associated risk of fiscal dominance (see "A more productive economy?") – as well as the risk of an escalation of geopolitical hostilities will underpin demand for gold as a hedging tool. Gold is and will continue to be the only true hedge against extreme political and economic risks. Overall, we forecast an average return of 4.3 per cent annualised, good enough to keep the asset class to remain in a global multi asset portfolio.

The outlook for oil is much less optimistic than for any other commodity. We forecast an oil price of USD65-70 a barrel in five years' time – in line with the futures market. Oil demand growth is more closely linked to developed rather than emerging economies. Based on our forecasts for developed markets growth (1.5 per cent annualised), global oil demand should be stable, while increasing supply could push balances into significant surplus. Low official US reserves and moderate investment in new supply cannot, in our view, fully offset the secular headwinds for the sector – critically including a still very high spare capacity among OPEC members (5.8 million barrels per day out of global oil demand of roughly 100mbd).

HEDGE FUNDS

For hedge funds, we expect returns of 5.3 per cent per year on average. This may not look exciting at face value, but in risk-adjusted terms, hedge funds should deliver some of the best performance in our analysis.

We expect current conditions to be particularly favourable for market neutral strategies to generate alpha.

REAL ESTATE

We forecast property will deliver returns of some 5 to 7 per cent per year across all major economies over the next five years. Investment in real estate needs to be very selective and based on local factors, however.

One sector that is doing particularly well is industrial real estate, capitalising on secular growth trends such as demand for data centres and for last mile logistics.

The situation in residential real estate is more mixed. House prices have declined much less than expected following tightening by central banks – partly because the share of cash buyers has increased but also because homeowners have locked in very favourable rates following the global financial crisis and Covid.

However, house prices in the OECD area are on simple valuation measures (price to rent and income), still 15 to 20 per cent overvalued. This will limit the benefit from interest rate cuts.

PRIVATE EQUITY

In private equity, we think that manager selection will be key for maximising returns. As managers can no longer rely on low borrowing costs and multiple expansion, they will instead have to rely on generating tangible profitability and efficiency gains. The dispersion of

returns across private equity funds has always been much higher than in the public equity sector, by a factor of around three times, and we think the structural headwinds will result in an even bigger dispersion.

Two areas where private equity could thrive are AI and the green transition. In the example of AI, it's a two pronged impact: private equity funds can benefit from AI advances in processes such as due diligence and operations and secondly, AI opens up a new world of investment opportunities.

Overall, we forecast private equity returns to exceed those of public equities by a marginal amount over the next five years – at 2.6 percentage points per annum, the excess return will be less than half its historical trend. But the greater dispersion will mean that some funds can deliver considerable outperformance, particularly if they use limited leverage and focus on nurturing their investee businesses.

BITCOIN

Last but not least, a word on bitcoin. The scandals surrounding FTX and Binance, coupled with unprecedented monetary tightening by the Fed were expected to mark the beginning of the end of bitcoin. But the cryptocurrency has shown remarkable staying power and received an additional boost with the introduction of spot bitcoin ETFs by the SEC – a move which has made it a de facto mainstream asset class. We continue to be very sceptical on the long-term sustainability of bitcoin but we note that if its correlation with gold, Nasdaq and trade-weighted US dollar remains unchanged (the three variables explain circa 85 per cent of the bitcoin variance over the past five years), there is still some upside as the dollar weakens, while tech stocks and gold gain.

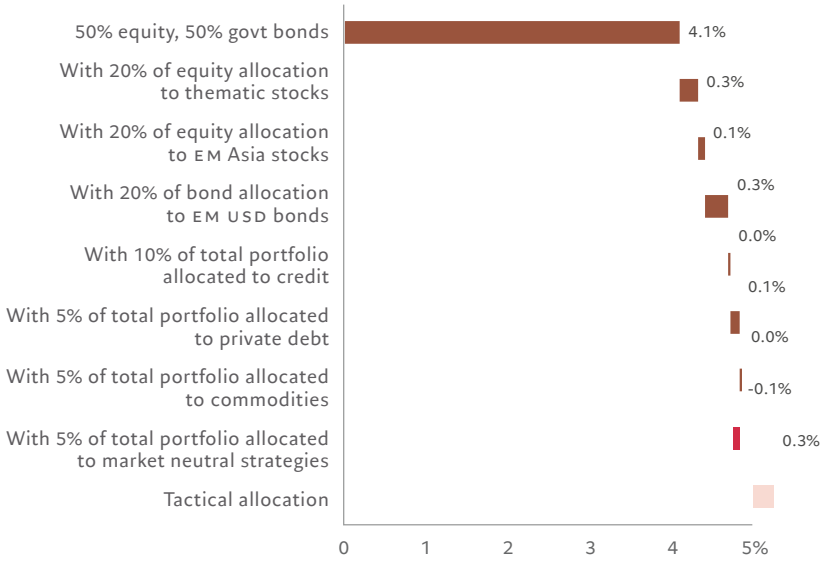
Modelling an allocation for the next five years

PORTFOLIO ILLUSTRATION

Below we present our model portfolio, which illustrates how diversifying away from a traditional portfolio split evenly between global equities and developed market government bonds could potentially improve inflation-adjusted returns.

FIGURE 23
Diversified portfolios: estimated real return, %, annualised, over 5 years

Portfolio returns: investors will need to move away from traditional balanced portfolios



Source: Pictet Asset Management

ASSET CLASS FORECASTS

Our Secular Return forecasts (5-year) are based on models combining our expected evolution of key macroeconomic variables (growth, inflation), our assumptions on interest rates and our assessment of initial valuation, adjusted for factors related to fiscal policy, trend factors and index composition.

Our forecast for developed market government bond returns is derived from our forecast of the annual roll yield and the terminal bond yield in every major market, which is, in turn, determined by our estimated trend growth of nominal GDP, to which we apply a discount dependent on the prevailing monetary policy stance and the historical norm (0.9X for the US and UK, 0.8X in the euro zone). For EM and corporate bonds, the return forecasts are based on fair value models of the corresponding spreads and expected recovery rates in the 40 per cent to 50 per cent range depending on the index.

Currency forecasts assume that currencies will revert to their fair value over the next 10 years, where the fair value is an estimate by our Economics team based on relative productivity, inflation and the evolution of current account balances.

The following benchmarks are used: J.P. Morgan indices for developed/emerging government bonds and emerging corporate bonds; SBI Index for Swiss bonds; BofA indices for euro zone/US corporate and high-yield bonds, US 10-year TIPS.

Equity returns are calculated by adding the average dividend yield, expected sales growth (derived from nominal GDP considering regional sales exposure) and margin change (adjusted for anticipated changes in taxation), a dilution effect and the expected change in P/E multiples. We use MSCI indices for all markets and IBES consensus on 12-month forward earnings for P/E.

We first estimate the 12-month P/E of the US market in five years' time with a model based on trend growth, inflation and bond yields.

Then we forecast the P/E for the remaining markets assuming a return to trend relative multiple versus the US, adjusted for a change in trend driven by our relative growth forecast.

For alternatives, the forecasts are based on models using the expected returns from traditional asset classes, initial relative valuation and some specific factors as inputs.

ECONOMIC AND CURRENCY FORECASTS

Our GDP forecasts are based on estimating the current potential growth of countries 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).

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 the optimal inflation rate based on the assumption that the 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 Asset Management's Strategy Unit (PSU)

The PSU is composed of Pictet Asset Management's most experienced multi-asset and fixed income portfolio managers, economists, and strategists and research analysts located in various offices. This investment group is responsible for providing asset allocation guidance over the short-term and long-term horizons across stocks, bonds, commodities and alternatives.

Every year, the PSU produces the Secular Outlook: a publication providing asset class return forecasts for the next five years. The research embeds, and is a reflection of, the PSU's investment philosophy.

> "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
Chairman of Strategy Unit, CIO, Multi Asset & Quantitative Investment

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.

Equity forecast

			12M P/E RATIO			12M P/E RATIO			TOTAL RETURN P.A.		
	YIELD, P.A. %	SALES GROWTH, P.A. *	MARGIN CHANGE, P.A. % **	NET BUY-BACKS	EPS GROWTH, P.A. % ***	CURRENT P/E	FORECAST IN 5YRS ****	% PE CHANGE P.A.	TOTAL LOCAL CURRENCY %	LOCAL CURRENCY %	IN USD %
United States	1.5	5.6	0.1	1.5	7.3	20.2	19.0	(1.2)	7.5	0.0	7.5
Eurozone	3.3	3.6	(3.1)	1.1	1.5	13.2	13.6	0.5	5.3	1.4	6.8
Switzerland	3.2	2.8	(0.9)	1.2	3.0	17.3	18.0	0.8	7.0	4.0	11.3
UK	4.0	2.3	(2.0)	1.2	1.4	11.3	11.6	0.4	5.9	0.8	6.7
Japan	2.1	3.6	(1.3)	0.8	3.0	15.0	13.7	(1.9)	3.2	4.8	8.1
Developed markets	1.8	4.9	(0.8)	1.4	5.6	18.7	17.8	(1.0)	6.9	0.6	7.5
China	2.9	3.4	(1.1)	(2.0)	1.7	9.3	10.6	2.6	7.3	0.1	7.4
Emerging Asia	2.5	6.7	(0.9)	(2.0)	3.7	12.7	12.5	(0.3)	5.8	2.4	8.4
Latin America	5.6	4.6	(2.9)	(1.0)	0.6	8.9	9.6	1.6	7.8	0.6	8.5
EMEA	4.2	5.6	(1.4)	(1.0)	3.0	10.5	10.8	0.7	7.9	0.2	8.1
Emerging markets	3.0	6.4	(1.1)	(1.8)	3.4	11.9	11.8	(0.2)	6.3	2.0	8.3
Frontier markets	4.0	5.2	(2.0)	(2.0)	1.0	8.3	9.4	2.5	7.5	0.0	7.5
Global (MSCI ACWI)	2.0	5.1	(0.8)	1.0	5.3	17.9	17.1	(0.9)	6.8	1.2	7.6
Global small CAP	2.2	4.3	(0.8)	0.5	4.0	22.5	23.8	1.1	7.3	1.2	8.6

Source: Refinitiv Datastream, MSCI, IBES, Pictet Asset Management (forecast horizon 30.04.2022-30.04.2028)

* Proxied by our forecast for nominal GDP growth (average 2024 to 2028), adjusted for regional revenue exposure. Reflecting historical trend, structural tech leadership and regulatory environment we adjust for a market's ability to translate nominal GDP growth into revenue growth.

** IBES net profit margin, based on reversion to current trend level in 5 years (margin trend to turn flat from here), a global convergence adjustment and FX impact.

*** Expected buybacks net of dilution from secondary issuance (forecast net buyback yield moderates to 25% below 20 year average in DM, -2% in China, EM Asia and frontier markets and -1% for rest of EM).

**** US PE based on our forecasts of 10Y bond yield, inflation, trend growth. DM regional PE forecast a combination of return to trend multiple relative to US (66% weight) and return to 10 year average absolute PE levels. EM regions to return to average of current, mean and trend relative multiple to MSCI EM.

Fixed income forecast: government, corporate and EM bonds

	DURATION (YRS)	CURRENT YIELD (%)	FORECAST YIELD IN 5YRS TIME*	ANNUALISED ROLL**	OUR RETURN FORECAST %	CURRENCY GAIN P.A. (%)	USD RETURN P.A. (%)
10-year US Treasuries	8.1	4.7	3.75	0.3	5.6	0.0	5.6
10-year German Bunds	8.2	2.6	2.5	0.5	3.0	1.4	4.5
Eurozone govt bonds	7.2	3.2	3.2	0.5	3.7	1.4	5.1
10-year Swiss govt bonds	7.9	0.8	1.5	0.4	0.3	4.0	4.3
10-year Japanese govt bonds	9.3	0.8	1.5	0.5	0.5	4.8	5.3
10-year UK gilts	7.9	4.4	3.25	0.4	5.8	0.8	6.6
10-year Chinese govt bonds	8.9	2.2	3.5	0.1	1.0	2.8	3.8
US inflation-linked bonds	4.4	2.3	1.5	0.3	5.1	0.0	5.1
US investment-grade bonds	6.6	5.8	5.2	0.3	6.3	0.0	6.3
US high-yield bonds	3.9	8.3	7.4	0.0	7.2	0.0	7.2
Eurozone investment-grade bonds	4.5	4.0	3.4	0.3	4.2	1.4	5.7
Eurozone high yield	3.1	6.8	6.2	0.0	5.8	1.4	7.3
Emerging market dollar bonds	6.4	8.5	7.7	0.0	8.3	0.0	8.3
Emerging market local currency bonds	4.9	6.6	5.6	0.0	6.9	1.9	8.9
Emerging market corporate bonds	4.2	7.3	6.8	0.0	7.1	0.0	7.1
Global govt bonds	7.0	3.7	3.4	0.4	4.1	1.2	5.4
US dollar cash	0.0	5.6	2.8	0.0	3.7	0.0	3.7

Source: Refinitiv, J.P. Morgan, BoFA Merrill Lynch, Pictet Asset Management. Data as at 31.03.2024

* Policy rate assumption: US and UK at 2.5%, eurozone 1.5%, Switzerland at 1.25% and Japan at 1%. Terminal bond yield assumes yield to trend nominal GDP ratio normalise to long-term average of 0.9x in US & UK and 0.8x in Germany (vs eurozone GDP). Assume Swiss govt bond 50bps spread below Germany, JPM EMU govt 75bps spread above JPM Germany (assuming 165bps BTP spread, 110bps ODE spread). YCC lifted in Japan and BoJ target 0% real rate. WGBI weighted average used on roll, yield change and return calculation for global bonds.

Credit spreads and EM bond yield based on our respective fair value models and default estimates. Recovery rate assumed to be 40% for DM HY and EMD HC, 50% for EMD LC.

** Adjust roll yield according to pace of central bank normalisation and our expectation of curve steepness in year 5. IG corp roll assumes curve steepens proportionally with government bond.

Benchmarks: J.P. Morgan indices for government bonds and EM USD bonds, FTSE WGBI for global bonds, ICE BoFA indices for DM corporate bonds, US 10Y TIPS for US inflation-linked bonds.

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