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# **A Painful Epiphany**: Investing In a Post-Pandemic, Post-Global World

November 2023

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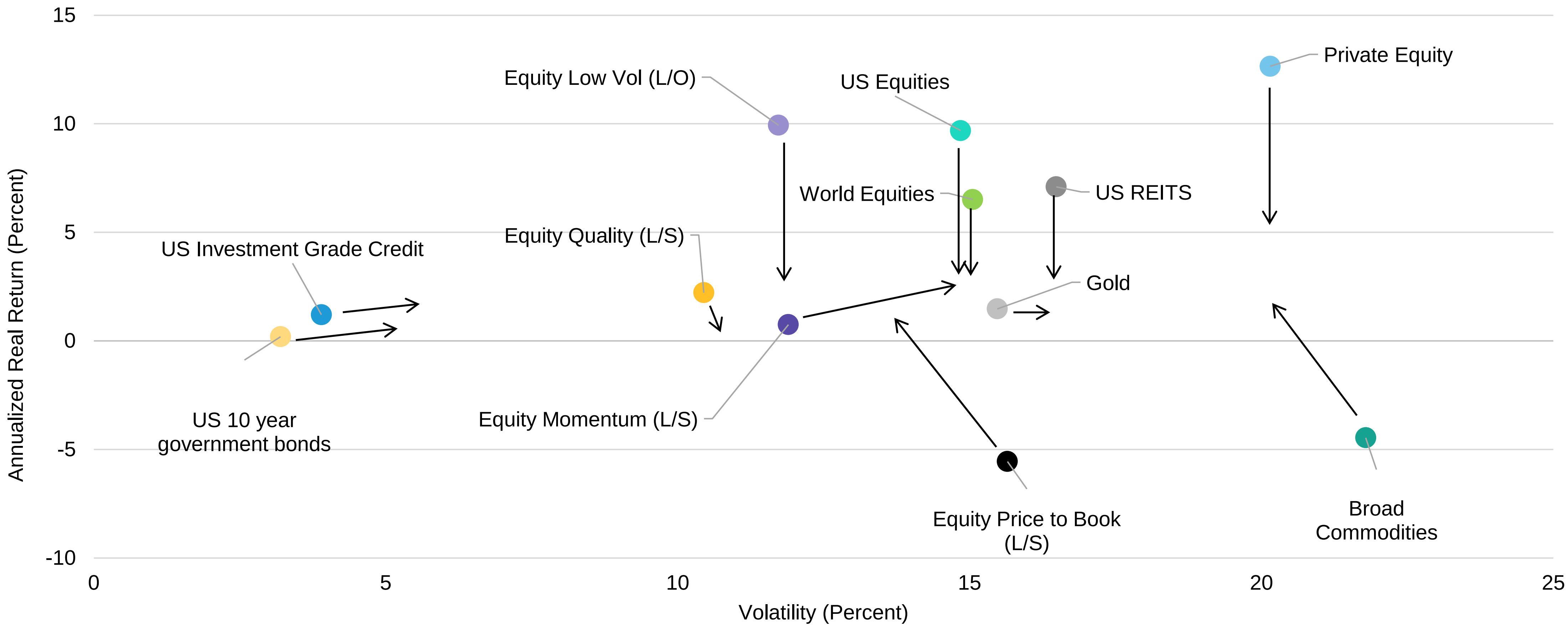
# A Painful Epiphany: Expect lower real Sharpe ratios

***If liabilities are in real terms then risk needs to increase***




**Historical analysis and current forecasts do not guarantee future results.**

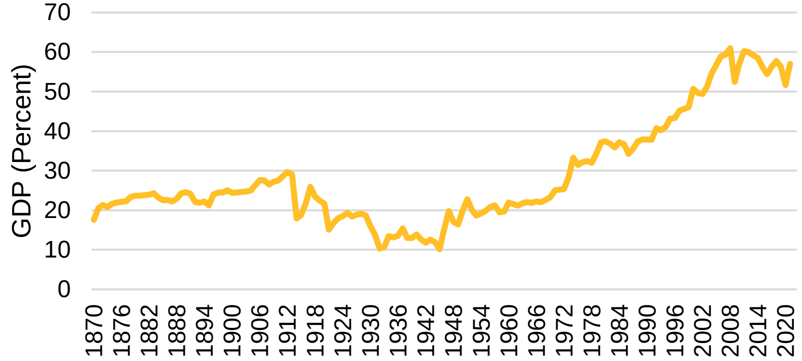
The dots represent real returns and volatility for January 2010 to December 2022 period for the major return streams that investors can buy. The arrows represent the AB Institutional Solutions team's forecasts for the next 5–10 years. Private Equity return data is the US Private Equity Index from Cambridge Associates, compiled from 1,562 funds, including fully liquidated partnerships, formed between 1986 and 2019. All returns are net of fees, expenses, and carried interest. Data are provided at no cost to managers. Private Equity volatility is estimated from MSCI US Small Cap Value index with 15% leverage.

As of May 30, 2023. Source: Cambridge Associates, FactSet, FRED, Ken French Data Library, Thomson Reuters Datastream and AB

# Three mega forces imply a new investment regime

## De-globalisation

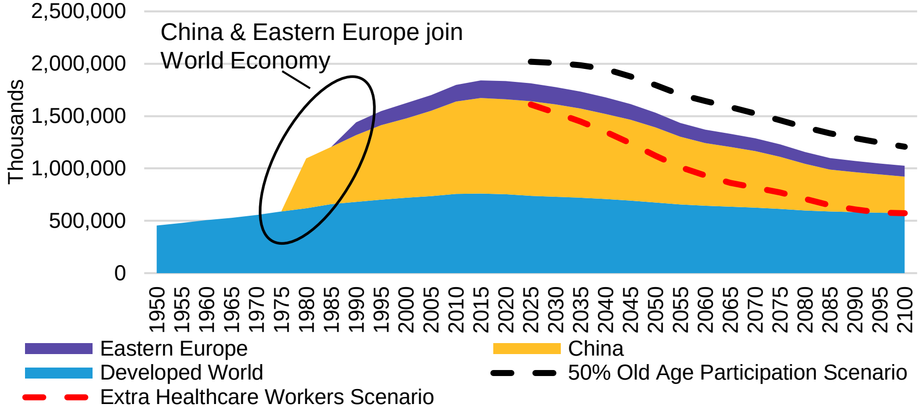
### World Trade




- Fragmented labour, supply chains, lower growth, increased risk premia

## Demographics

### A Shrinking Labour Force




## ESG (climate and social)

- Bargaining power moves from capital to labour
- Who pays for energy transition? Upstream commodity CAPEX constrained

***Bottom line: Higher equilibrium inflation, lower real growth, lower margins***

**Historical analysis and current forecasts do not guarantee future results.**

Left display: Trade is the sum of exports and imports of goods and services measured as a share of gross domestic product. As of December 31, 2021.

Right display: The shaded arears represent population in regions shown aged 20–65. The black dotted line represents a scenario where 50% of those aged 65 to 79 continue to participate in the labour force. The red dotted line represents a scenario where 0.9 extra healthcare and social assistance workers are needed for each person aged 75 and older. As of March 10, 2023.

Source: www.ourworldindata.org, The World Bank Thomson Reuters Datastream, UN Population Division and AB

# Mega-Trends' Impact on Growth

**Upward Forces**

- Expenditure on Green Transition provides a fiscal spending boost and spurs innovation
- Potential productivity boost from technology and AI

**Downward Forces**

- Deglobalization reduces growth via reduction in trade and addressable markets, lower knowledge transfer impacts productivity growth. Need to maintain higher inventory levels will depress margins
- Demographics: declining working age population and need for more social care
- Climate change direct impact in terms of land use, cost of extreme events, higher insurance costs
- Increased political uncertainty (migration, geopolitical tensions, competition for resources)

Source: AB

# Mega-Trends’ Impact on Inflation

**Deflationary Forces**

- Lower long term growth expectations implies lower inflation
- Technology and automation have been deflationary for years. Does AI revolutionise this and undercut the case for inflation?

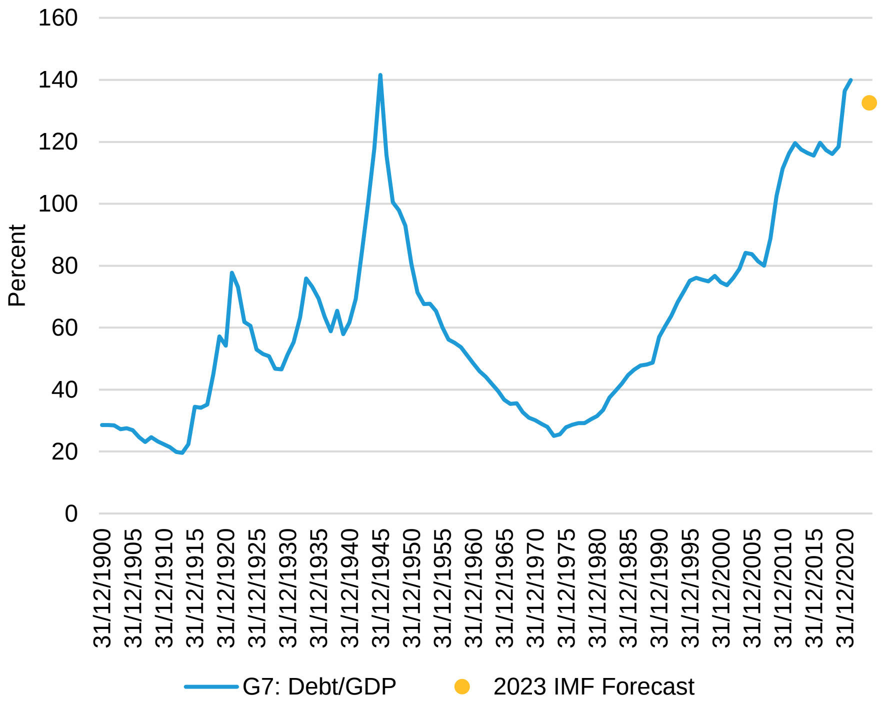
**Inflationary Forces**

- On strategic horizons inflation driven by 3 forces:
  - De-globalization (supply/labour cost impact)
  - Demographics (shrinking labour force)
  - The “S” in ESG shifting power from capital to labour
- Energy prices and cost of the energy transition high near-term, over longer horizons the inflationary impetus moves from “E” to “S”
- Monetise debt? With debt/GDP at its highest level since WWII, governments will prefer elevated inflation in order to keep debt under control

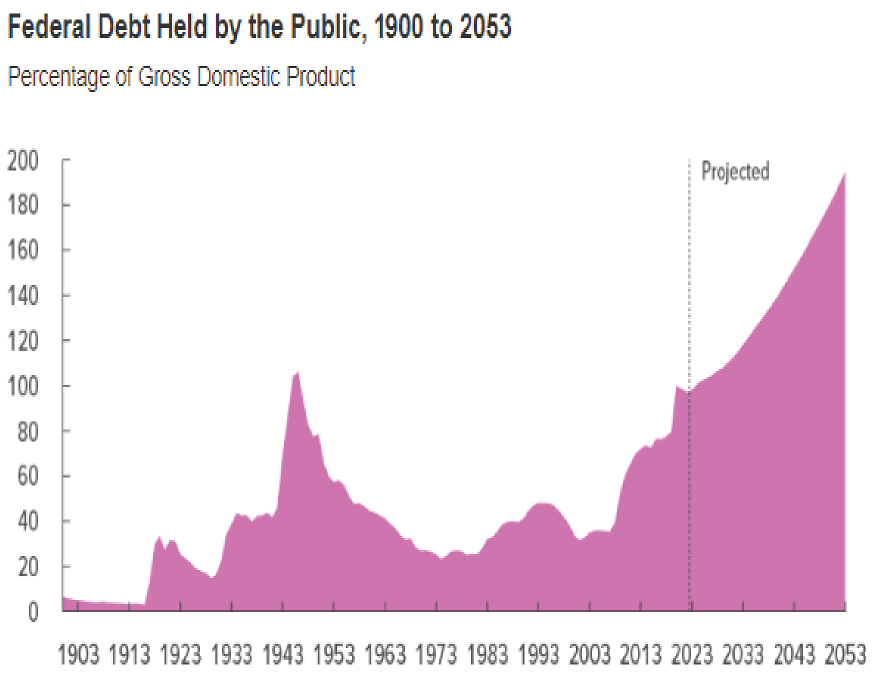
Source: AB

# We will need to learn to live with high levels of government debt

## G7 Government Debt to GDP (GDP-Weighted)




## CBO US Government Debt forecast

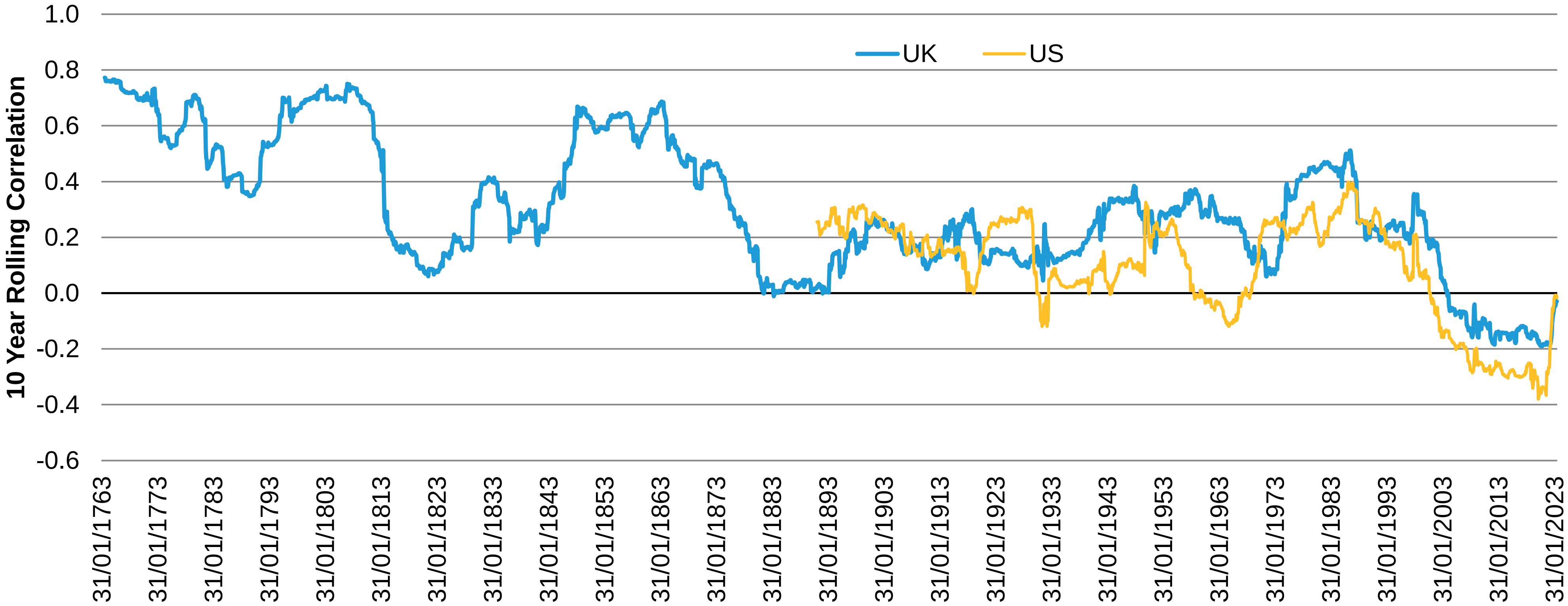



**Current analysis does not guarantee future results.**
The chart shows Government Debt/GDP for G7 countries, weighted by Nominal GDP denominated in USD. Data from 1900-2021 is from Global Financial Data. 2023 forecast is from IMF.
Source: Global Financial Data, IMF, FRED, CBO and AB

# The Diversifying Power of Bonds Likely to Reduce…

...and increase risk of 60:40

**Stock-Bond Correlation Has Recently Been More Negative than Prior 250 Years…***
**…unlikely to persist**



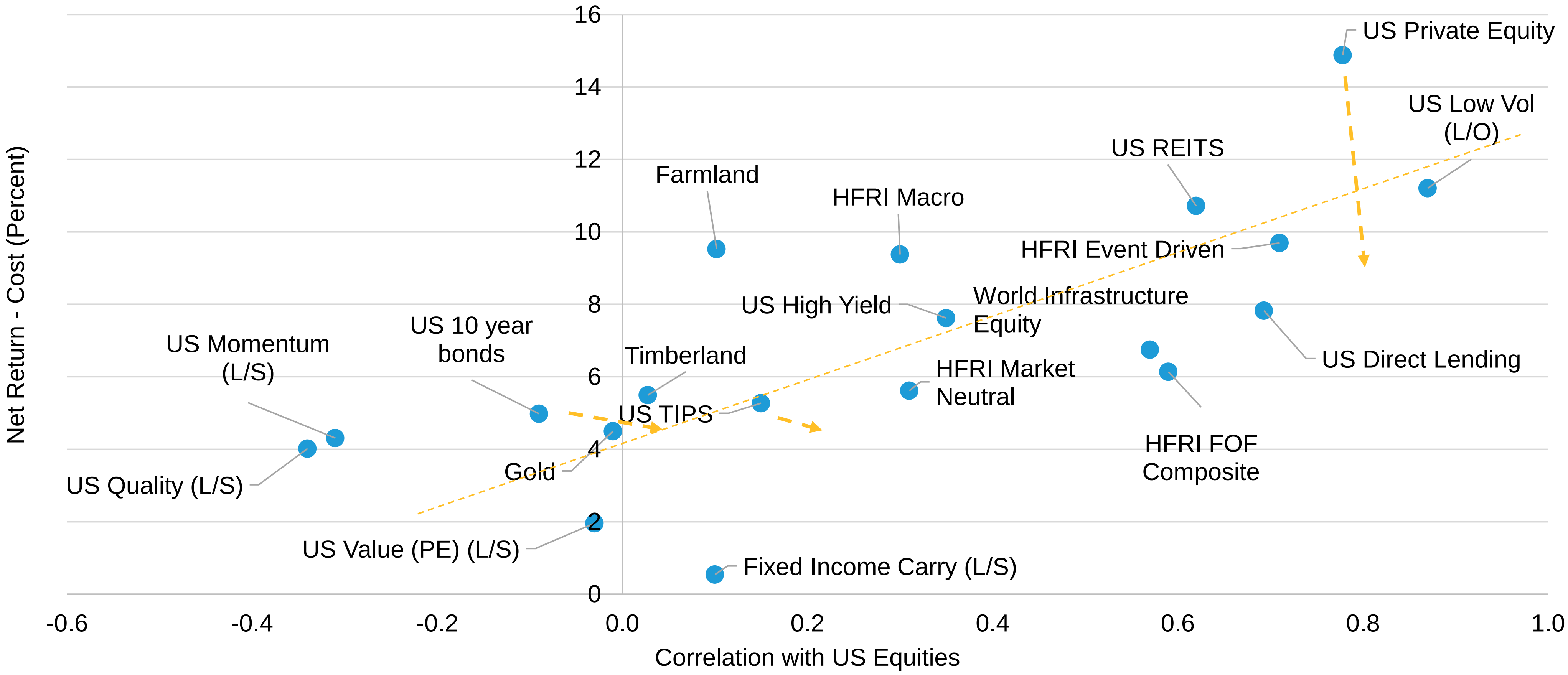

**Past performance does not guarantee future results.**
*Rolling 10-year correlation between stock and bond returns.
As of July 31, 2023
Source: Datastream, Global Financial data, Shiller's database and AB

# The forces at work on stock-bond correlation

| | **Uncertainty** | | **Level** | | **Combined Level** | |
|---|---|---|---|---|---|---|
| | Inflation Uncertainty ↑ | Growth Uncertainty ↑ | Growth Level ↓ | Inflation Level ↑ | Growth & Inflation ↑ | Inflation ↑ & Growth ↓ |
| Equity Return | ERP ↑ ⇒ Equity Return ↓ | ERP ↑ ⇒ Equity Return ↓ | Dividends ↓ ⇒ Equity Return ↓ | Non Linear | Dividends ↑ ⇒ Equity Return ↑ | Dividends ↓ ⇒ Equity Return ↓ |
| Bond Return | Team Premium ↑ ⇒ Bond Return ↓ | Term Premium ↓ ⇒ Bond Return ↑ | Unclear | Bond Return ↓ | Bond Return ↓ | Bond Return ↓ |
| Equity Bond Return Correlation | ↑ | ↓ | ? | ? | ↓ [1990-2020] 2020 | ↑ [New Regime] |

**Historical analysis and current forecasts do not guarantee future results.**
Source: AB

# Net return vs correlation with US equities




**Historical analysis and current forecasts do not guarantee future results.**

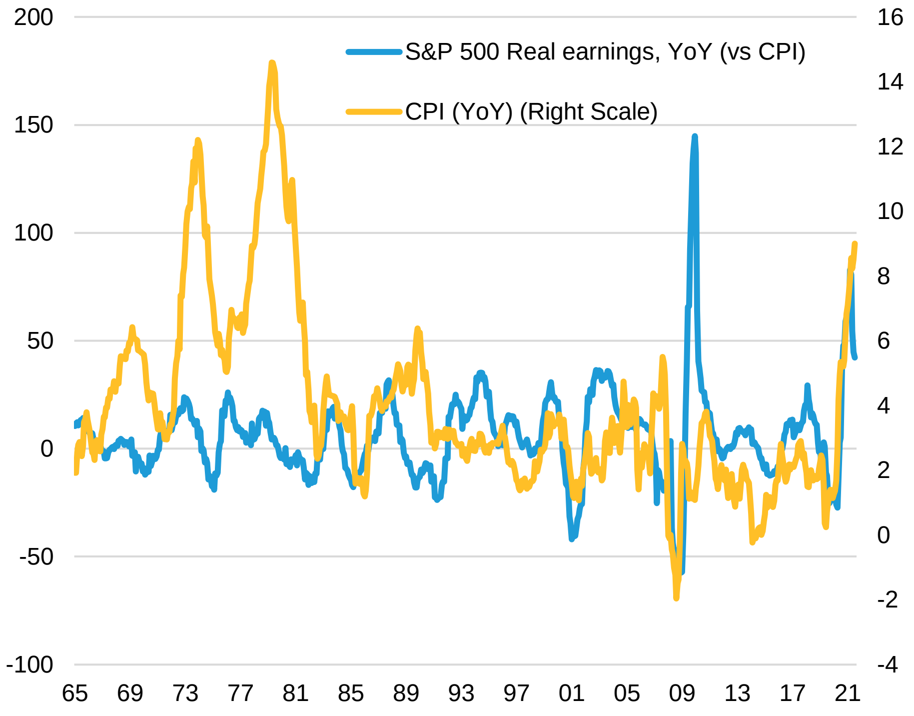
Note: The chart uses monthly data from Jan 1990 (or longest available history) to Dec 2022. Private Equity, Direct Lending, Farmland and Timberland series are quarterly. We assume 10bps fee for US 10 -year bonds, Gold, REITS, TIPS and High Yield bonds. We assume 20 bps fee for Long Only factors and 50 bps fee for Long/Short factors. For Timberland and Farmland we assume 150bps fee. For Direct Lending we assume 150bps fee.

As of March 17, 2023

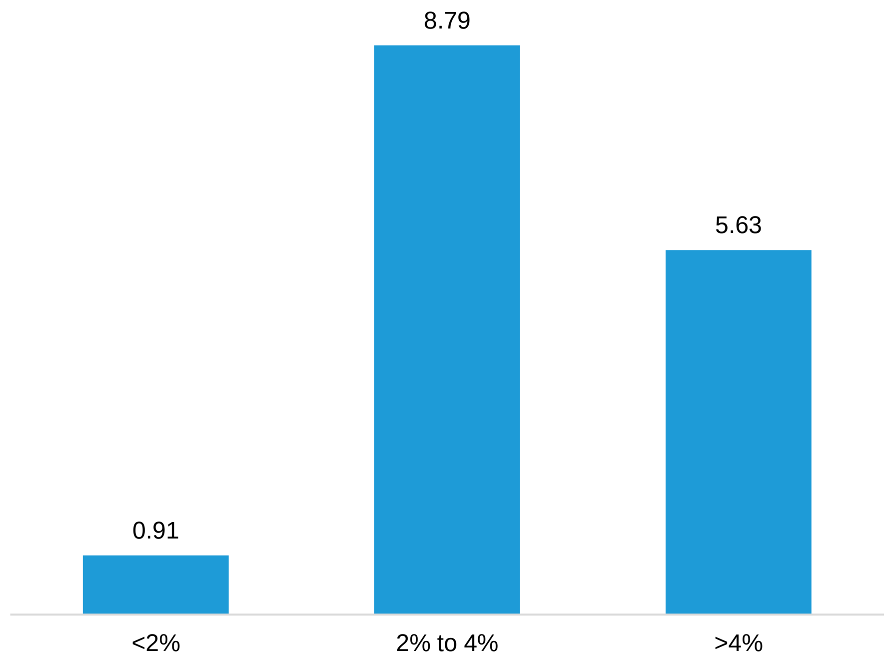
Source: Bloomberg, Cambridge Associates, Cliffwater, Global Financial data, NCREIF, Thomson Reuters Datastream and AB

# Are Equities Real Assets?

## Real Growth in Total Earnings and Inflation




## Average Real Growth in Total Earnings by Inflation Band

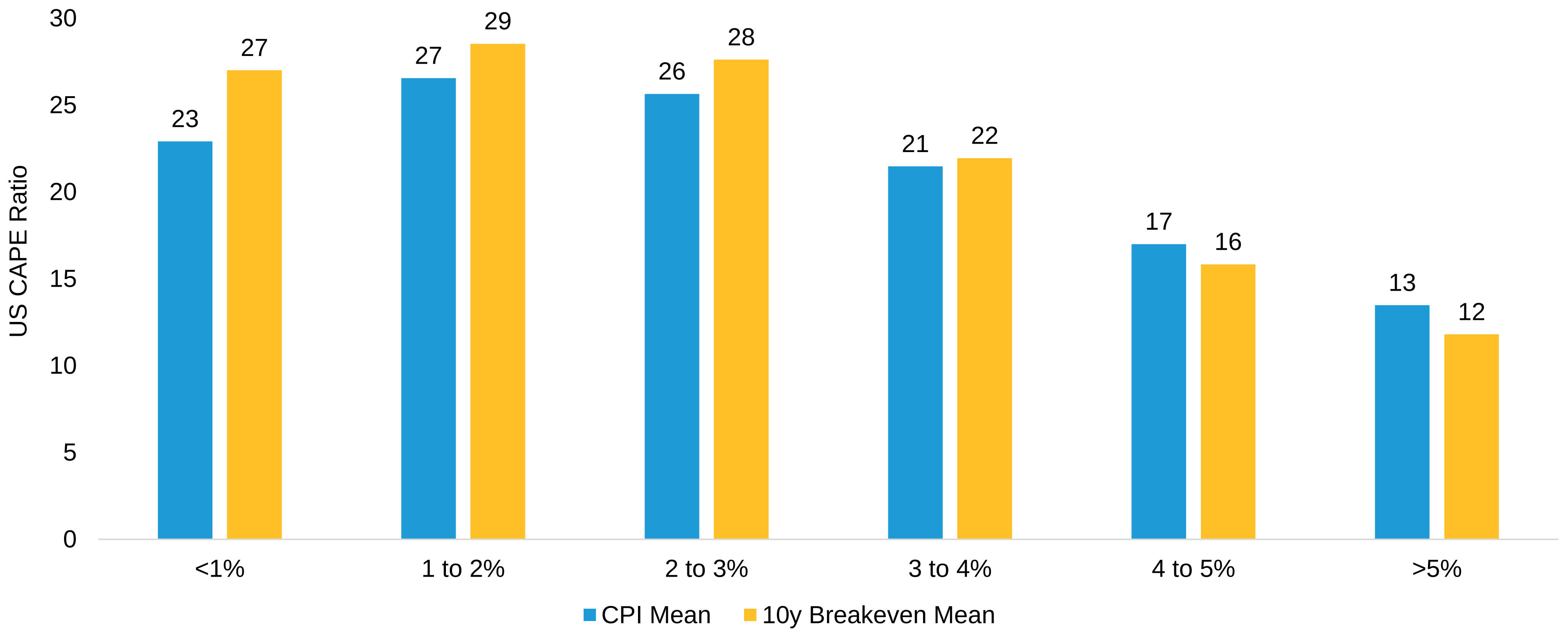



**Historical analysis does not guarantee future results.**
Data as of December 31, 1964 through June 30, 2022
Source: FactSet, Thompson Reuters, Datastream and AB

# Moderately High Inflation Supports Equity Multiples

**Moderately High Inflation Has Supported Equity Multiples**

Cyclically adjusted price-earnings ratio of US equities by inflation regime (US CAPE ratio)



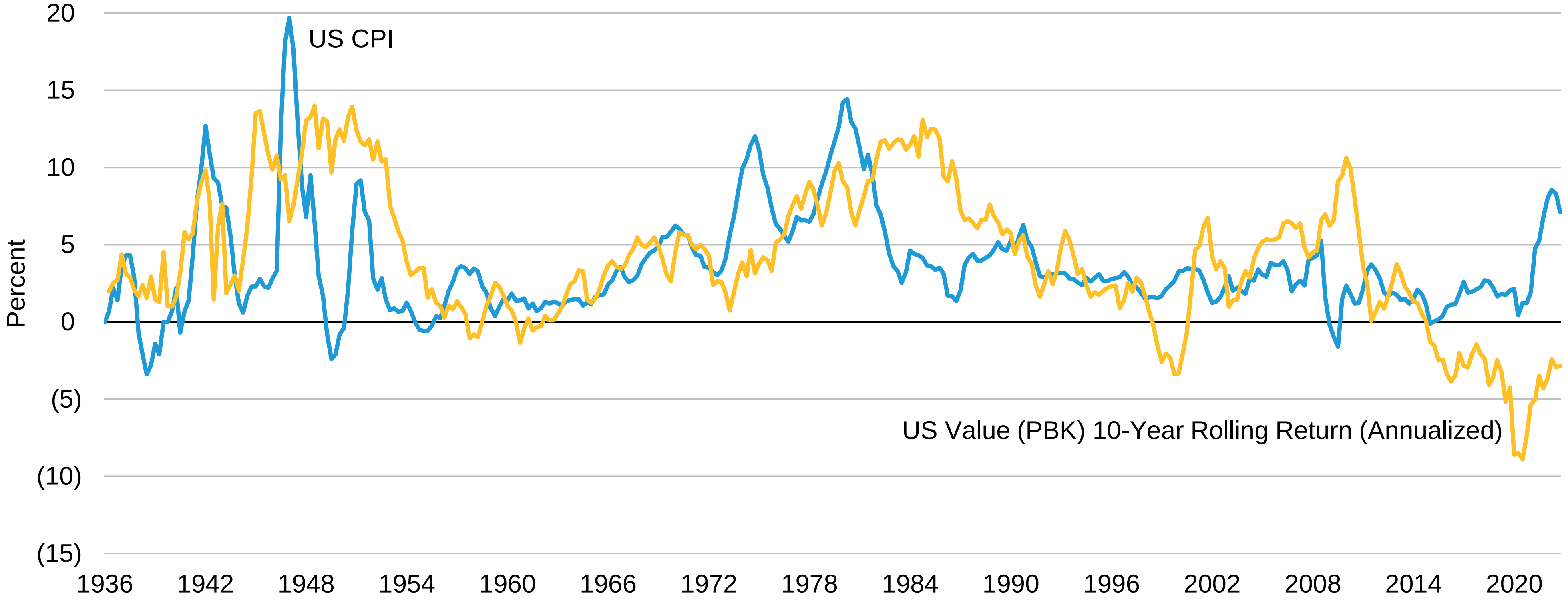

**Historical analysis and current forecasts do not guarantee future results.**

Data from 30th of September 1971 to 31st of August 2022. Pre 1997 the 10y breakeven rate is a backcast of implied inflation calculated by NY FED.

Source: Robert Shiller's Database, Datastream, NY FED and AB

# We See a Strategic Case to Hold Equity Value Exposure in the Medium Term

US consumer price inflation and US equity value factor returns

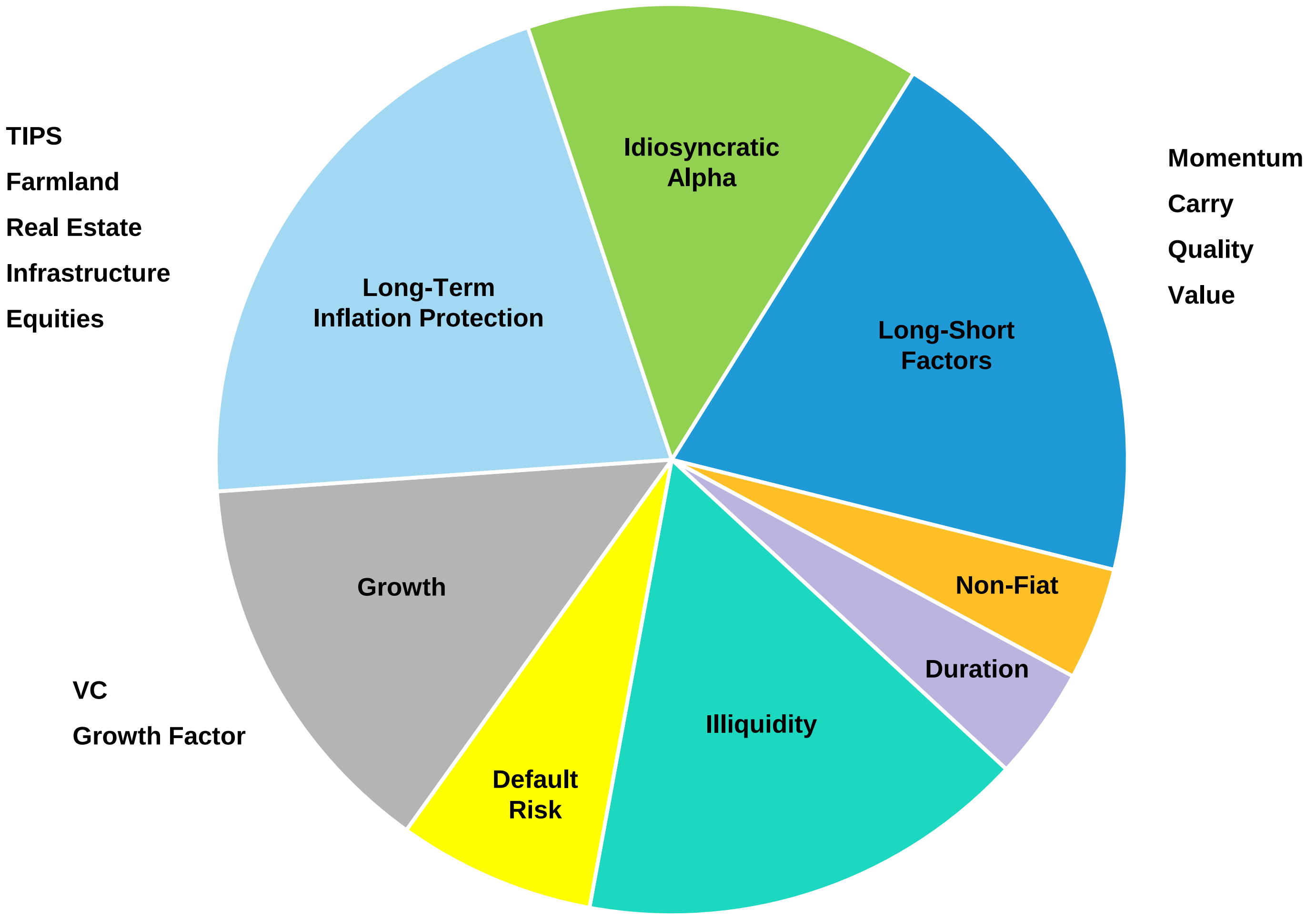



**Historical analysis does not guarantee future results.**
Data from January 1, 1936, through December 31, 2022
Source: Datastream, Ken French Data Library and AB

# A possible template for strategic asset allocation?

The future of ACTIVE asset allocation

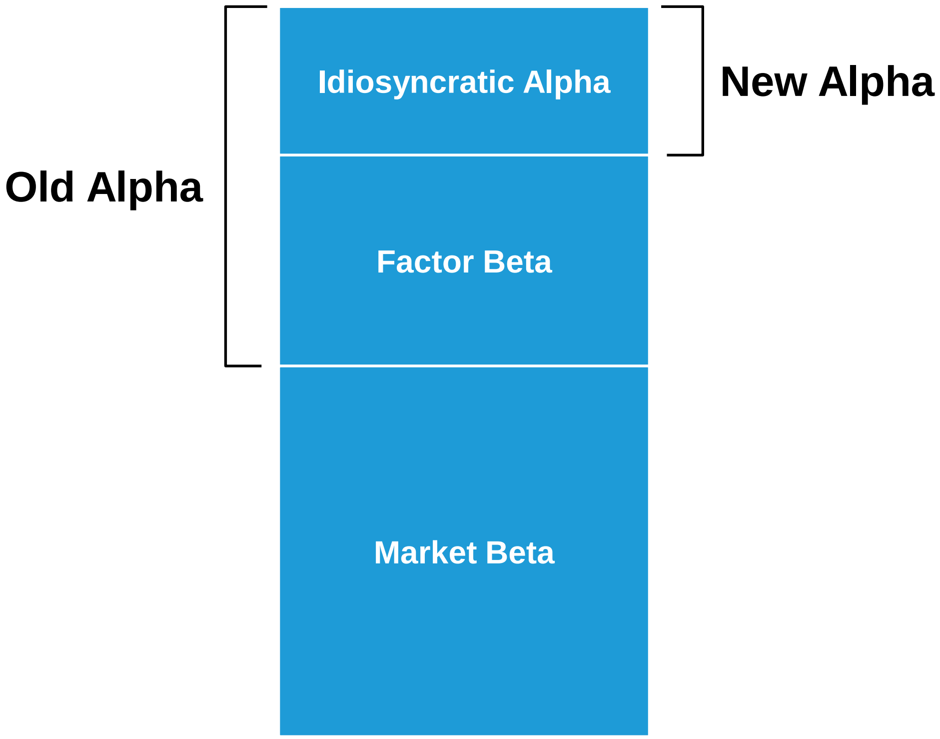
**The Building Blocks for Asset Allocation**




Source: AB

# The Need for Idiosyncratic Returns

What counts as alpha is shrinking




- Timing:
  - Market
  - Themes
  - Factors
  - Countries
  - Sectors
- Portfolio construction
- Risk control
- Implementation (trading)
- Factor combination (for quants)
- Stock selection

Source: AB

# Key Takeaways

- Painful epiphany – expect lower real returns and higher volatility and lower stock/bond diversification compared to recent decades
- If focus is retaining purchasing power then portfolio risk levels will need to increase
- Longer-term inflation still likely to remain above pre-pandemic levels
- Future of asset allocation is active and diverse, including sources of idiosyncratic alpha, factors and real assets
- However, equities will remain a core part of investment portfolios. With “moderate” inflation and real rates remaining low in long run historical context valuation does not necessarily need to mean revert to historic average
- We believe significant shifts in portfolio allocation are still to come
- Not only investor positioning but also the SAA methodology needs to evolve to adapt to a new investment regime

**Current analysis and estimates do not guarantee future results.**
Source: AB

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