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A catalyst for diversification

Five-year capital market assumptions | UBS Asset Management

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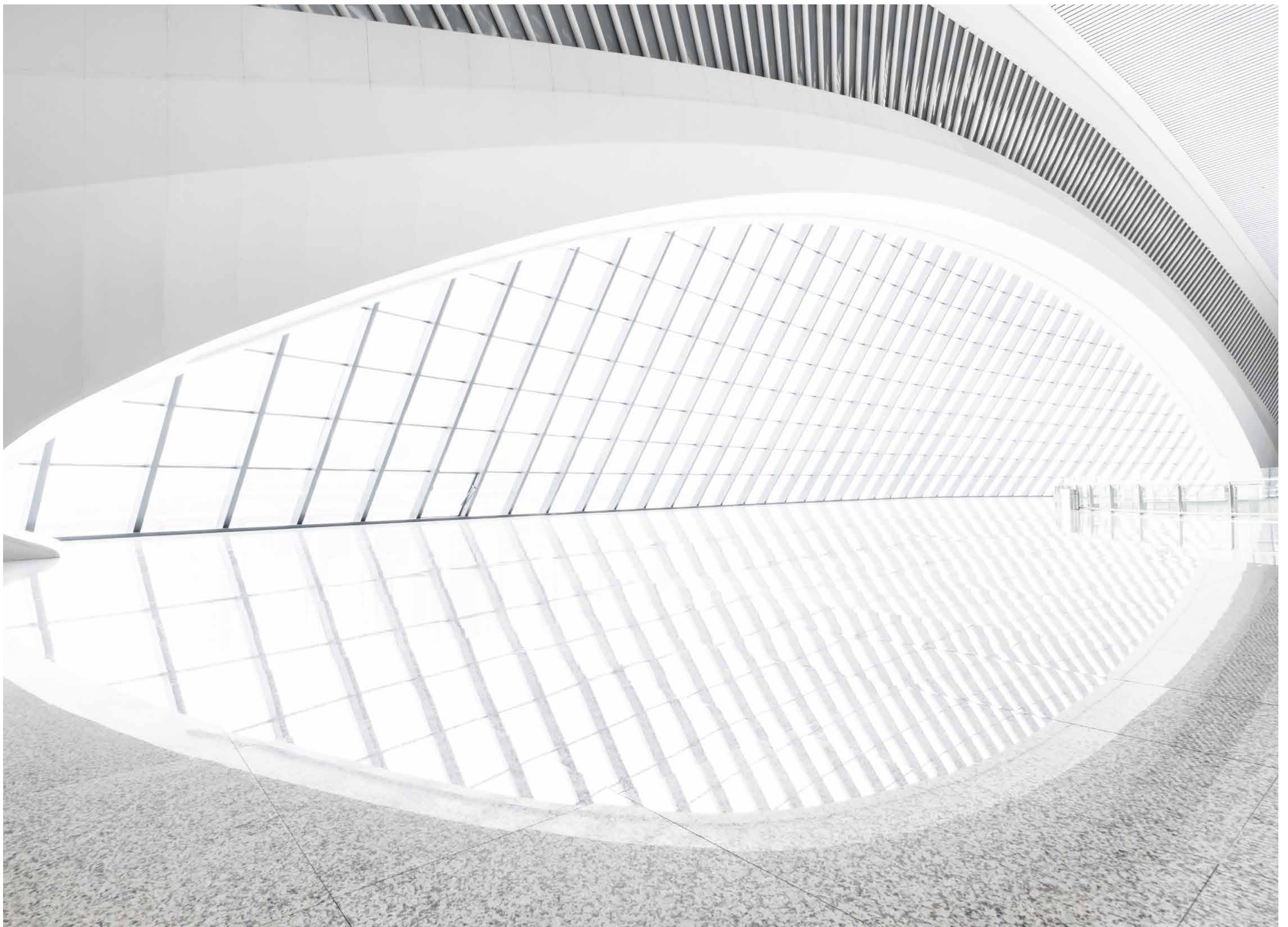


Highlights

– The performance of risk assets since May exceeded even our optimistic return scenario.
– Forward five-year returns across equities and credit are now sharply lower relative to six months ago.
– Global equities are expensive on an absolute basis, but fairly valued relative to bonds and cash rates.
– We expect the US dollar to continue to weaken. In general, US investors should not hedge their international exposure, but foreign investors should hedge their exposure to USD denominated assets.
– We believe that alternative assets provide increasingly important diversification benefits due to lower expected returns in public markets.

Part I: Capital market assumptions update

UBS Investment Solutions provides estimates of capital market returns across a wide array of asset classes and from multiple currency perspectives.[1] For this paper, we focus on our five-year baseline expected geometric returns.

Our last publication highlighted our May 2020 assumptions amid significant uncertainty due to first few months of the pandemic and the upcoming US elections. We used scenario analysis to explore our Base, Bull and Bear cases for the markets. Even as the public health crisis rages on, the equity market staged a recovery beyond what we forecasted in our optimistic scenario for the next 6 months. Another recent positive is the resolution of the US elections reducing policy uncertainty and tail risks.

These positives have been reflected in the recent strong price performance of global risk assets. As such, they come at a cost: financial asset appreciation has been pulled forward, and the outlook for forward returns is meaningfully reduced relative to six, or even two, months ago.

The main updates in our five-year capital market assumptions compared to our May 2020[2] report are:

– Equity returns in nominal terms are sharply lower – 1.0 percentage point lower. We expect a global equity portfolio to return 6.5% annualized in unhedged USD terms over the next five years. The main cause is the huge run-up in the equity market: the MSCI ACWI has returned 27.6% since the end of April (and up close to 50% from its March lows).

– The currency component of global equity returns has declined from 0.6% to 0.3%.

Exhibit 1: Five-year expected returns in USD terms
Annualized %

	May 2020	Nov 2020
Global Equities Unhedged	7.5	6.5
Global Gov Hedged	-0.1	-0.1
Global Corp IG Hedged	1.1	0.2
Global Corp HY Hedged	4.1	1.8
1-mo T-Bills	0.2	0.3
US Inflation	1.4	1.6

1 We provide Equilibrium, 5-yr and 10-yr estimates of the capital markets that will vary over time. By far, most interest from clients is on our 5-year expectations.
2 Technically, our report was a mix of end of April for equities and cash, but mid-May for credit and high yield. The latter asset classes faced extraordinarily large volatility, creating major changes in expected returns. We refer to these estimates as our 'May' assumptions.

- Current government bond yields – which are the primary determinate of expected returns – are about the same as in late spring. Government bond yields in the US and China have drifted higher, but European and emerging market yields declined, so the reaction in the markets has been mixed. Overall, the return to government bonds since our last report is about the same: -0.1% (hedged USD terms), unchanged from the May 2020 estimate.

- Credit spreads have had a roller-coaster ride in 2020. They troughed in early January approaching extreme lows before surging in February and March to their highest levels since the Global Financial Crisis (GFC). As the equity markets boomed, credit spreads compressed substantially and are now below median levels of the last ten years.

- The expected return for a global investment grade debt portfolio is 0.2% in hedged USD terms, a drop of 0.9 percentage points from our estimate in May.

- The expected return for high yield bonds declined to 1.8%, a large drop from 4.1% in May.

- In general, the dollar is down sharply since mid-year. The DXY index fell 6.9% from April to November. The dollar has declined 8.4% and 6.8% versus the Euro and Renminbi, respectively since April.

Economic fundamentals

After a sharp recovery during the summer, economic momentum has moderated amid seasonal upturns in COVID-19 cases across much of the developed world. In some countries, particularly the US, there are concerns about governments' willingness to use fiscal policy to mitigate pandemic-induced disruptions. For some particularly afflicted industries and their employees – restaurants, airlines, hospitality, and personal service industries – targeted support globally is still needed to reduce the amount of permanent damage. However, encouraging progress on vaccine development has provided greater visibility into a broad, durable economic recovery in 2021 and beyond.

Our current intermediate growth forecasts are similar to our mid-year projections. We still expect Western economies to grow just under 2.0% – a little higher in the US and a little lower in Europe and Japan. We continue to expect relatively strong growth in China, but even here, it is lower than the prodigious growth of the 1990s and 2000s. All these regions need to contend with lower population growth.

Intermediate inflation expectations remain muted. Central banks, especially the Federal Reserve, are concerned about persistent disinflationary forces and have expressed more tolerance for an acceleration in price pressures before considering policy tightening. The 5-year breakeven inflation rate for the US hit a post-GFC low of 0.5% in March before climbing back up to 1.7% by the end of November.

In inflation-adjusted terms, prospective returns have declined an additional 0.2 percentage points, as our inflation expectations have rolled off after a couple of low inflation numbers in the fall. Actual inflation in the US took an interesting twist with a short burst of inflation during the summer, but has cooled in recent months and aligning with our expectation of low inflation in the near term. We expect a similar experience in China – inflation subdued in the short term as the global economy still faces significant slack, but picking up to around 2.8% over time.

Equities

The rapid run-up in equities in the last few months has erased some of the premiums we expected earlier in the year. On an absolute basis, we view the equity market as slightly over-valued (especially the US). Relative to cash and bonds, however, equity returns are around historic averages. From that perspective, they are fairly valued.

We see attractive returns in several equity markets, in particular Europe and Japan, where we see above average returns boosted by currency appreciation by 1.0 percentage point to 2.0 percentage points. China, previously modestly attractive, is close to fair value and now has a slightly overvalued currency. The US remains the most over-valued market.

Emerging markets are close to fair value overall, but their currencies look under-valued.

Fixed income

We have not changed our intermediate projections of yields much from our May estimates. Consequently, we have only small changes due to different initial conditions. In general, we are projecting yields of about 1.1 percentage points higher for US and European markets. Emerging markets are in an increasingly similar position – like Western markets, they now face historically low yields as the region adjusts to lower nominal growth rates.

Exhibit 2: Equity market 5-year expected returns November 2020

	Local currency	Unhedged USD Terms
US Large Cap	5.0	5.0
Eurozone	6.8	8.1
Switzerland	7.0	7.1
United Kingdom	8.4	9.4
Japan	6.9	9.2
China	8.2	7.5
Australia	7.6	7.1
Canada	8.3	9.1
Global	–	6.5
Developed Markets	–	6.2
Emerging Markets	–	8.1
Dev Mkts ex US	–	8.6
Inflation	–	1.6

Source: UBS Asset Management. 30 November 2020.

Exhibit 3: 10-year Government Bond Yields and Expected Changes

	Sterling Yield	In 5-yrs	Rise in Yields
US	0.8	2.0	1.2
Australia	0.9	1.8	0.9
Canada	0.7	2.0	1.3
Germany	-0.6	0.5	1.1
France	-0.3	0.8	1.1
Italy	0.6	2.1	1.5
Spain	0.1	1.5	1.4
Japan	0.0	0.4	0.4
Switzerland	-0.5	0.4	0.9
UK	0.3	1.5	1.2
China	3.3	3.0	-0.3

Source: UBS Asset Management. 30 November 2020.

Exhibit 4: Selected Bond Market Expected Returns: 5-yr Baseline

November 2020 Baseline	5-yr Local	5-yr Hdg USD
Government Bonds		
US Treasuries	-0.5	-0.5
Australia Gov	-0.1	-0.2
Canada Gov	-0.6	-0.7
Eurozone Gov	-1.5	-0.6
Japan Gov	-0.3	-0.1
Switzerland Gov	-2.4	-1.3
United Kingdom Gov	-2.0	-1.9
China Gov	3.6	1.3
Global Government	-0.5	-0.1
Other Markets		
US Corporates	-0.6	-0.6
US High Yield	1.4	1.4
US TIPS	-0.9	-0.9
EMD Hard Currency	2.8	2.8

Cash markets
In general, cash rates in Western markets have been stable since mid-year. US 3-month Treasury Bill yields remain around 0.1%; while some European yields have fallen slightly with Germany and Switzerland approaching their lowest ever yields. Going forward, we expect three or four rate hikes by the Federal Reserve over the next five years, as the Fed has signaled its intent to be very patient in removing accommodation. We expect a similar rection function to prevail in Europe.

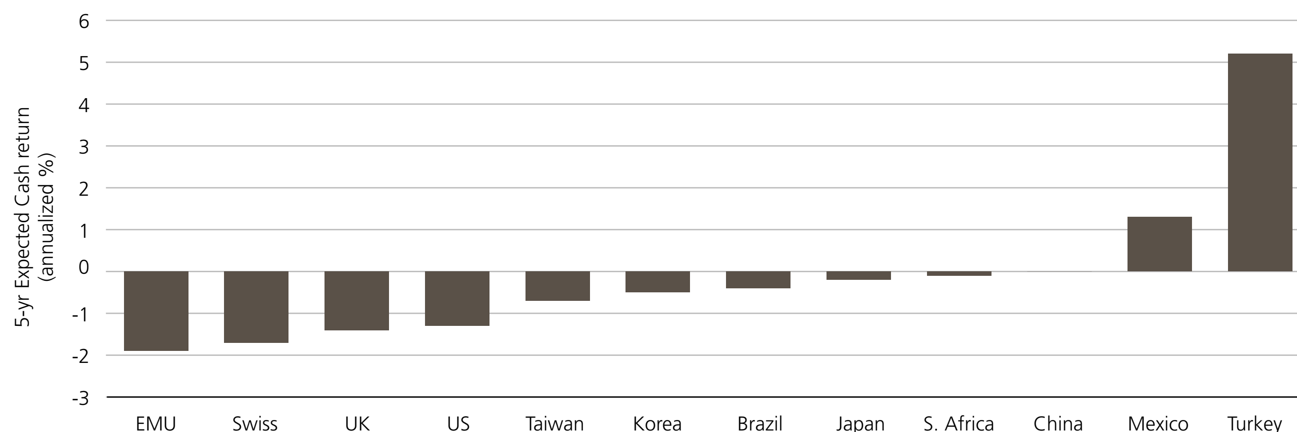
One area with a significant rebound in short yields is China. Short rates bottomed out in spring and are anywhere from 50 bps to almost 200 bps higher since then. The 3-month government bill yield in China was 0.9% in April and is 2.9% in November. We expect these rates to be stable from here, so there is a substantial discrepancy of real rates between China and Western markets.

Historically volatile emerging markets – Brazil, Turkey, and South Africa – remained volatile. Brazil and Mexico saw declining rates while Turkish rates bounced back into the low teens. Latin American countries in particular dealt with a hard hit from the virus-induced disruptions combined with large drops in commodity prices. We expect these rates to rebound as the after-effects of the pandemic subside in the next few quarters. However, like the developed nations, they may not reach previous 'normal' levels for quite a while.

The more mature Asian markets (Korea, Taiwan) have exhibited more stable rates in the last few months.

Going forward, we expect real cash returns to be negative for quite a while. Generally, expected real returns from cash are negative, with Europe and Switzerland being the most severe. In China, we expect cash rates to keep up with inflation, offering a 0.0% real return. Only in some emerging markets – Mexico and Turkey, for example – do we expect positive real rates of returns.

Exhibit 5: 5-yr Expected Real Cash Returns



Source: UBS Asset Management. 30 November 2020.

Currencies

In the past six months the US dollar fell against most currencies with the DXY declining 6.0%.

Overall, we view the US dollar as slightly overvalued on a long run basis against the EUR and EM currencies. We expect the USD to decline slightly in the coming years. We expect emerging market currencies to remain reasonably close to levels we see today. In general, USD investors should not hedge, while European and EM-based investors should hedge the dollar.

In the following table we compare the changes in currency effects from a USD investor's perspective. In April of 2020, a USD investor in Eurozone equities or bonds should have expected an additional return of 1.9 percentage points per year due to the euro rising in value relative to the dollar. Interest rate differentials were quite large at that point in time, so hedging would have improved expected returns by 0.8 percentage points. Since then the dollar has depreciated and interest rate differentials widened slightly. Consequently, by November 2020, we expect that this same investor now expects holding euro investments to boost annual returns by 1.3 percentage points, while hedging 'income' adds 0.9 percentage points to returns annually.

We also apply the same methodology when looking at multi-currency baskets such as global equities or global government bonds. For example, a USD investor investing in developed market equities ex-US would have expected 1.8% gains per year from foreign currency appreciation in April, but this fell to 1.2% by November.

Although we have seen significant movement for currencies, which has translated into about a 0.6 to 0.8 percentage point reduction in currency effects, we see little movement in the hedging effects. This is no surprise as our cash estimates have changed by a small amount overall.

Exhibit 6: Currency impacts in USD terms
Expected 5-yr effects in percent

	June 2019 Currency		April 2020 Currency		Nov 2020 Currency	
	Unhedged	Hedged	Unhedged	Hedged	Unhedged	Hedged
EUR	0.8	2.4	1.9	0.8	1.3	0.9
GBP	1.0	1.4	1.9	-0.1	1.0	0.1
JPY	2.6	2.3	2.7	0.6	2.3	0.3
CHF	0.0	2.8	0.5	1.0	0.1	1.1
CAD	0.8	0.3	1.5	-0.2	0.8	-0.1
AUD	0.3	0.7	0.8	0.2	-0.4	0.0
CNY	-0.2	-0.5	0.0	-1.3	-0.7	-2.3
Index baskets						
Dev Mkt Eq ex US	1.1	1.9	1.8	0.4	1.2	0.2
Global Equity	0.4	0.4	0.7	-0.1	0.3	-0.1
Global Equity ex US	0.9	0.9	1.5	-0.2	0.8	-0.2
EME	0.2	-1.9	0.7	-2.0	-0.1	-1.9
Global Gov	0.9	1.4	1.4	0.4	1.0	0.4
Global Gov ex US	1.4	2.2	2.1	0.6	1.5	0.6
Global Credit	0.2	0.3	0.4	0.0	0.2	0.1
EMD Local	0.3	-2.1	1.3	-2.9	0.6	-2.9

Source: UBS Asset Management. 30 November 2020.

Part II: The prospects for alternatives

Alternative investments are becoming a larger and larger component of investors' portfolios. The Yale University endowment – which pioneered heavy alternative investments – is now up to 75% alternatives. Alternative investments have backed their reputation with strong historic performance.

The key attraction for alternatives is the ability to improve the return and risk profile of a portfolio, which is especially valuable in this low return environment. Cash rates are near zero or negative for most countries and the long end of many yield curves are still near historic lows. With such low rates and expanding equity valuations, investors will continue to turn to alternatives to improve portfolio performance.

Different alternatives asset classes can improve the return/risk profile in different ways. One, private equity, offers the ability to improve return; the rest – real estate, hedge funds, infrastructure – offer the ability to diversify and lower risk of the portfolio for the same level of return. (Of course, individual funds can do as well as equities, but we are considering what well-diversified portfolios should return. More concentrated and focused funds can offer returns in any environment.)

Private equity

Historically, private equity has earned premiums of 2.0% to 3.5% over the public markets. We expect the private equity market to continue to deliver premiums over the public markets, though perhaps at the lower end of this range. It is the one asset class that will continue to improve the return of the portfolio; most of the other asset classes provide more diversification benefits than return.

Private equity continues to enjoy tremendous innovation, offering ever more opportunities for investors. For example, Special Purpose Acquisition Corporations (SPACs) and direct listings now provide other means for investors to convert their private holdings into public entities. Additionally, we see more and more specialization and niches – equity and debt in infrastructure, for example – and more co-investment opportunities. Finally, we are encouraged by the growth of the secondary market. There is a complete 'ecosystem' developing around the private asset world.

The pandemic has slowed fund-raising in the private capital markets, but it began to recover and regain momentum as the year progressed with large funds getting ever larger. Dry powder levels continue to grow, now totaling over USD1.7 trillion in private equity and over USD 2.0 trillion in all of the private asset market. So there is a lot of capital to deploy. This will dampen, but not eliminate the premiums we expect in this sector.

We expect a global private equity portfolio to provide returns of 2% to 3% above the public markets. This is not a pure premium, but a fair compensation for the overall economic and liquidity risks taken. For investors with very long time horizons (25+ years) a dedicated exposure to private equity should help performance. But, as noted, the secondary markets are getting deeper, offering liquidity in both building a portfolio as well as winding one down. Consequently, time horizons for viable private equity portfolios could be as short as 10 or 15 years.

Real estate

The pandemic has disrupted real estate markets, but it has not changed our expected return for this sector. It has merely changed the composition of winners and losers in the marketplace. Denser urban investments, many malls and hospitality investments, have had a brutal pandemic, while many suburban locations are benefiting. Trailing 1-year performance for US real estate was around 1.4% to 2.0%[3] as of September 2020, down from some high single digit returns seen in late 2018.

Across the globe, real estate has delivered solid returns with low volatility. Most institutional private real estate is in funds with moderate amounts of leverage. With financing costs relatively low, the benefits of leverage are improved.

We expect real estate returns to wobble for another quarter or two before rebounding to 5% to 6% net returns for investors in core funds. More aggressive investors should see returns approaching the expected 6.5% return for global equities. Note that these returns are well above bond and cash returns.

3 One-year return from September 2019 to September 2020 for the NCREIF Property Index and NCREIF ODCE indices.
Source: Morningstar Direct. Analysis by UBS Asset Management.

Hedge funds
The prospects for hedge funds are encouraging. With low interest rates and low credit spreads across the world, the costs of borrowing are extremely inexpensive. This leverages the alpha opportunity set for all sorts of hedge funds – long/short, market neutral and macro funds – and previously unprofitable trades now look attractive. Additionally, most yield curves are steeper relative to May, which offers all sorts of opportunities in fixed income, such as carry trades and roll return. This low borrowing cost environment should last for a few years, as central banks have indicated high thresholds for any rise in short term rates.

Another boost for hedge funds will be greater dispersion of returns, which will benefit strategies like equity long/short and relative value. Additional tailwinds are fits of volatility and regime changes. These will allow trading-oriented macro managers to exploit uncorrelated trade opportunities. It is synchronous moves in markets and within markets that make it difficult for hedge fund managers to benefit from their winners-versus-losers investment approaches.

Finally, after moving sideways for a few years amid a decline in the number of hedge funds, the industry is starting to regain momentum. We see positive cash flows as investors rebalance from other asset classes in the wake of the high equity returns and low government bond yields. Alternative investments that offer steady income or steady NAVs increases will be very attractive.

Infrastructure
Infrastructure investing has evolved into an asset class that offers higher, steady income with some chance at moderate price appreciation. With government budget deficits at elevated levels, we expect more 'public-private' initiatives, which should provide attractive opportunities for infrastructure investors.

Projections of risk and return

Our approach is to develop two measures: appraised risk and economic risk. While appraised risk relies on the volatility in appraised returns, economic risk reflects the underlying, unsmoothed risk inherent in these investments, generally referring to analogous assets that are listed on the market (e.g., micro-cap stocks and venture capital). Investors should be aware of both measures to estimate risk and correlations for these assets in a portfolio construction framework.

Since alternatives cover a wide array of investment opportunities with different economic rationales, we need to use a wide array of approaches to formulate prospective returns.

To model real estate, we start with expected unlevered property returns and then adjust for leverage. Basic property has an income component and a price return component. Historically, in the US the income component for the NCREIF Index, which is the benchmark on direct property, has been around 4% to 5%. With inflation around 2.0% and a small real appreciation (after maintenance and capital improvements) of 0.3%, we currently estimate that unlevered global property has a net expected return of 5.2%. When we adjust for fees, alpha and leverage, we get returns in the 5.9% range for a global core real estate portfolio, which is not far from our projection for listed equity.

Our approach to setting private equity assumptions uses a multi-factor capital-asset pricing model approach and assigns higher betas to the relative public equities and additional idiosyncratic risk. When we include some mezzanine financing and special situations, we estimate that a private equity portfolio would have economic risks around 24% compared to our volatility of 15.0% to 16.0% for global equity portfolios. This is reasonable given the composition of the aggregate, which is mostly buyout (often mid-cap stocks taken private) and venture (nascent companies, somewhat analogous to micro-caps).

Like real estate, we view infrastructure as a hybrid of equity and fixed income. The median IRR for infrastructure funds by vintage year has been consistently below that of private equity by an average of 3.9%. Consequently, one simple approach is simply to discount the return to private equity by an appropriate amount and set economic risk appropriate for such risk-bearing. This gives us net expected returns around 6.2% – similar to real estate, but with a different risk profile.

We rely on a combination of historic relationships and basic heuristics to model hedge funds. Indeed if we look at historic performance, fund-of-fund composites of hedge funds returns in the last 10 years have been about 2.5% to 3.8% above cash with equity betas around 0.30.

Investors are ultimately interested in net-of-fee performance and we need to assess both the fees and expected alpha from alternative investments. Because of the research costs and expertise needed to implement alternative portfolios, the management fees are extremely high compared to what is seen in public assets classes. The 2 and 20 model remains the norm in private equity. Investors have pushed back on some of the GP friendly terms in the contracts, so the implicit costs are not as large as they used to be, but the top line 2 and 20 is still the prevalent form of investing.

As can be seen, the appraised volatilities of real estate, private equity, and infrastructure make them highly attractive relative to public asset classes. Instead by projecting economic risk we move these asset classes more in line with the overall return and risk trade-off we expect in the capital markets.

Exhibit 7: Return and risk assumptions: USD terms – November 2020

Asset Class	5-yr Expected Return	Economic Risk	Appraised Volatility
USD Cash	0.3%	1.3%	–
Global Investment Grade Fixed Income	0.0%	5.5%	–
Global Equities Unhedged	6.5%	16.0%	–
Global High Yield Hedged	1.8%	10.5%	–
Global Private Equity Unhedged	8.8%	24.5%	15.0%
Global Infrastructure (Equity) Unhedged	5.5%	14.0%	8.0%
Global Core Real Estate Unhedged	5.2%	12.6%	7.2%
Hedge Funds (Hedged)	4.0%	4.3%	–

Note: Expected returns are geometric. We develop 5-year expected returns in the capital markets based on current market markets and our expectations of inflation, growth and the path of interest rates. We then overlay our assessment of fair value and the reversion and how quickly the market will react. From here we extrapolate to the different sectors of the capital markets. Global Equity, Private Equity, Infrastructure and Core Real Estate are assumed to be unhedged. Cash, fixed income and hedge funds are assumed to be hedged.
Source: UBS Asset Management. 30 November 2020.

Summary

The pandemic of 2020 has dramatically shifted the path of the economy. It is unlikely that we will maintain the elevated level of returns enjoyed over the last eleven years.

In general, equity returns – ever more muted – still command a respectable premium over cash and government bonds. Expected equity returns have declined significantly in both absolute and relative terms (relative to inflation and cash).

Expected government bond returns are near the lowest level ever, but do provide some downside protection when stress events occur. Government bond returns and cash returns have essentially stayed the same. We do expect rates to rise as the recovery gains traction.

Credit markets have rallied and seem content with the low interest rate policy by central banks amid moderate growth and inflation. Similarly, credit has exhibited that same effect as equities: expected returns have declined substantially since May. This illustrates one of the risks of credit: its moderately-high correlation with equities.

The lower return environment will require investors to expand into alternatives to improve their return/risk profile. Private equity can provide a boost over public equities (but with commensurate increases in economic risk). In fact, forward-looking returns in PE look attractive amid the creative destruction of the pandemic. Real estate offers highly divergent returns and stable income. Hedge funds should clearly outperform fixed income and offer a diversification away from pure equity beta. All of these should also enjoy the very low financing costs due to accommodative central bank policy.

Our expected return for the fabled 60% equities and 40% fixed income, which has performed so admirably in the last few decades will decline – just because of the low starting point for fixed income and cash. Over the last 10 years, a 60/40 portfolio of global equity and fixed income returned 7.5% per year. Going forward, we expect such a portfolio to earn 4.1%.

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