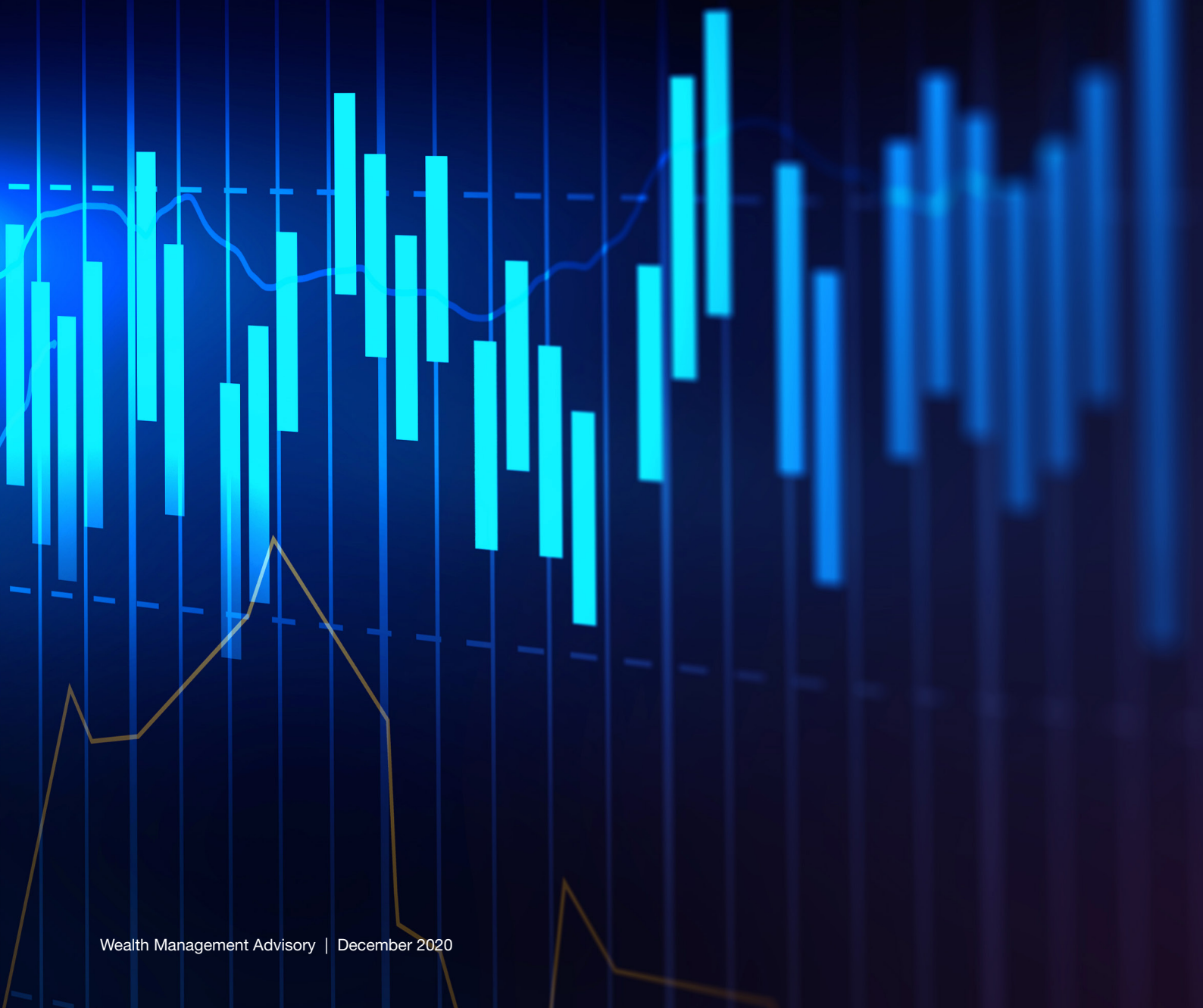


# In a world of yield-free risk



### Why this theme?

Generating returns and ensuring downside protection is becoming more challenging against the backdrop of low bond yields and lower long-term return expectations in risky assets. Therefore, we believe investors will need to take on additional risk and/or become more innovative in order to achieve their target risk and return objectives.

### Why does it matter?

Developed Market government bond yields are extremely low and, therefore, their ability to provide a significant buffer against sharp sell-offs in risky assets is likely reduced. Valuations in equities and bonds are at a higher starting point today compared with past cycles, likely resulting in lower long-term returns.

### What does it mean for investors?

One way for investors to enhance their returns is to move further along the risk curve, increasing exposure to riskier assets e.g. greater allocation to equities or in lower quality or longer maturity bonds. Leverage can also be considered to enhance returns judiciously. Investors may also want to consider expanding their opportunity set to include alternative assets such as Hedge Funds or private investments to capture opportunistic sources of diversification, income and returns.

### What are the risks?

Downside shocks to growth, inflationary shock, much stronger than expected fiscal stimulus that would significantly alter our expected long-term growth and return expectations from various asset classes.

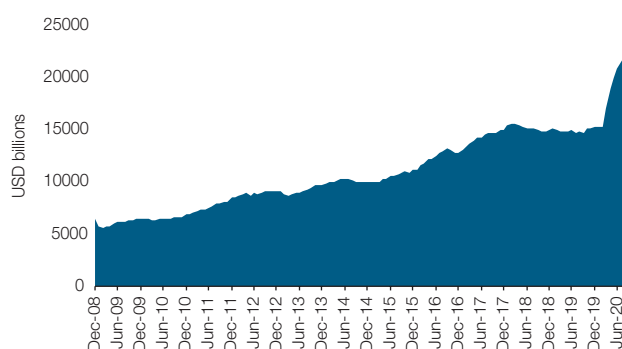
*‘The controversial Modern Monetary Theory (MMT) – which advocates greater coordination between monetary and fiscal policy – is, arguably, already being applied, which we believe will have implications well beyond the pandemic.’*

The global pandemic has brought about a dramatic shift in the market environment. We witnessed an exceptionally rapid fall in asset prices, but also saw one of the fastest rebounds ever. Unlike previous cycles, where expansive monetary easing was met with fiscal policy staying mostly on the sidelines, this time round, both central banks and governments are working in unison to mitigate the fallout from the pandemic. The controversial Modern Monetary Theory (MMT) – which advocates greater coordination between monetary and fiscal policy – is, arguably, already being applied, which we believe will have implications well beyond the pandemic.

Already, central banks such as the Federal Reserve (Fed) are adopting a new framework to manage the economy over a longer-term horizon. The race to the bottom during the pandemic has seen global central banks cut rates 205 times so far this year (Source: cbrates.com), against the backdrop of USD 17 trillion worth of negative yielding government debt.

#### The sharp expansion in G4 central bank balance sheets has pushed more than 70% of Developed Market government bonds into negative yielding territory

US, Euro area, UK and Japan (G4) central bank balance sheet



Source: Bloomberg, Standard Chartered

## Long-term expected returns point to lower returns and higher volatility, relative to history

10 years (2010-2020) of historical and 7-year expected return and volatility data

	HISTORICAL		7-YEAR FORECAST (2021 OUTLOOK)	
	Return (ann.)	Volatility (ann.)	Return (ann.)	Volatility (ann.)
Cash	1.2	0.3	0.7 ↓	1.0
Global bonds	2.2	4.6	0.5 ↓	6.1
DM IG Govt	1.8	5.0	0.1 ↓	7.6
DM IG Corp	4.0	5.6	0.9 ↓	6.3
DM HY Corp	5.6	8.1	2.7 ↓	11.9
EM USD Govt	5.2	7.9	3.4 ↑	7.6
EM LCY Govt	2.6	10.2	5.5 ↓	9.3
Global equities	7.9	13.7	5.9 ↓	17.7
North America	12.5	13.4	4.7 ↓	18.0
Europe ex-UK	3.9	17.0	7.5 ↑	24.2
UK	1.1	15.5	7.7 ↑	17.9
Japan	5.8	13.4	6.5 ↑	19.0
Asia ex-Japan	5.4	16.7	8.7 ↑	25.2
Emerging market equities	4.2	17.8	8.6 ↑	26.4
China	6.7	20.5	9.4 ↑	33.7
Gold	2.5	16.0	-2.4 ↓	15.0
Liquid Alternatives	0.9	4.4	3.7 ↓	4.0
Fund of Hedge Funds	--	--	3.7 ↓	7.4
Private Equity	--	--	8.4 ↓	21.9
Unlisted Real Estate	--	--	5.7 ↓	14.7
Listed Real Estate	--	--	5.8 ↓	20.7
Listed Infrastructure	--	--	5.3 ↓	16.2

Source: Mercer consulting, Bloomberg, Standard Chartered  
Arrows show changes relative to previous forecasts

## OPPORTUNITIES IN A LOW-RETURN ENVIRONMENT

Against this backdrop, long-term expected returns for public market assets have fallen, driven by low inflation, a lower starting point in yields and elevated valuations across most equity asset classes. Investors are increasingly pressed to seek alternative opportunities for income, return and diversification in their allocation. Refer to long-term capital market assumption on page 3.



**Low-to-negative expected returns from government bonds.** A much lower starting point in yields translates to meagre expected returns across Developed Market (DM) government bonds over the next 5-7 years. We expect about zero return on US government bonds and negative returns across Developed Market sovereign bonds as a whole. Given the commitment from global central banks to keep rates low for an extended period of time, we have also pushed back expectations of rate normalisation to beyond 2022. Bond volatility is likely to remain anchored by central bank interventions, in our view.

**Better equity returns outside the US.** The expected 5-7 year returns for global equities has declined to 5.9% from 6.2% last year. This year, our view of a weak USD could lead to an increase in dispersion between US and non-US equities. For US equities, elevated valuations are likely to be a drag on long-term returns. At 4.7% expected return over the next 7 years, it is below the 5.9% and 8.6% we expect from DM equities and Emerging Market (EM) equities, respectively.



**We expect a rebound in non-US equity markets** as they are not only cheaper than the US, but their currencies are relatively undervalued too. In fact, most equity regions outside of the US are expected to see higher long-term returns this year as compared to 2019, largely thanks to improving growth expectations and cheaper currencies.

**Central bank support will likely cap downside risks in DM investment grade bonds.**

A lower starting point in US Treasury bond yields and reversion of current corporate bond yield premiums to higher equilibrium levels suggest lower expected returns across non-government bond markets. In the US Investment Grade corporate bond segment, higher interest rate sensitivity is likely to weigh on returns, while High Yield bonds are likely to benefit from their generally shorter maturity profile. That said, the recent sharp tightening in HY bond yield premiums suggests muted expected returns going forward.



**EM debt is one of the relatively brighter spots in fixed income.** On a 12-month horizon, we have a preference for EM assets, including Equity, FX and local currency bonds. In a yield-starved world, EM bonds (FX-hedged) may be increasingly considered as an alternative to DM bonds for hedging, especially with the inclusion of China into EM government debt indices.

**Downtrend expected in USD, more notably against other DM, rather than EM, currencies.**

Conditions have fallen in place for a weaker USD – the Dollar's reduced yield advantage and stronger policy responses elsewhere are likely to growth differentials in favour of economies outside the US. The USD is also overvalued, in our assessment. The new Fed monetary framework suggests the real yield advantage of the US vs its major partners is likely to remain depressed, given the Fed's policy shift towards tolerating higher inflation, especially relative to the Euro area and Japan.



## WHAT ARE THE IMPLICATIONS FOR PORTFOLIO CONSTRUCTION?

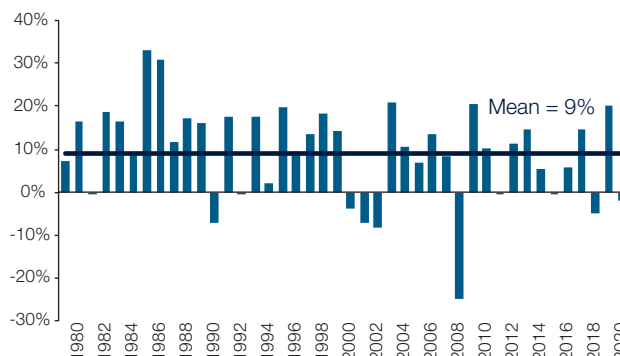
The traditional 60/40 portfolio is expected to earn barely a 4% annual return in the coming 7 years, much lower than the 9% average annual return over the past 40 years. Equity valuations are elevated and government bonds, which have been the reliable counterweight to equities in a market sell-off, are now very unlikely to provide the protection investors need.

For investors today, there are no easy choices for generating returns or income comparable to history, or ensuring a similar level of diversification. Investors are increasingly skewed in their options towards taking higher risk, or accepting lower returns. Often, they end up with a combination of both. It is all about trade-offs and one needs to balance the need for higher returns, against the potential of higher risk to an allocation.

**Below we explore a few strategies that an investor can consider against this backdrop.**

### A 60/40 portfolio is now expected to barely earn 4% returns, much lower than the historical 9% returns over the past 40 years

Historical returns of allocation using 60% MSCI World equity index and 40% Barclays global aggregate bond index



Source: Bloomberg, Standard Chartered



### Move further along the risk curve for higher potential returns

To achieve a higher return, the traditional approach for most investors is to increase their exposure to riskier assets. In the case of a multi-asset investor, this can translate to increasing the allocation to equities. For a pure bond investor, it can mean concentrating on lower-quality or longer-maturity bonds to generate higher yields. However, both involve risks.

For one, assuming more market risk may not be the most efficient trade-off. A heavy concentration to a single asset may also expose investors to wild swings in asset value. Secondly, the level of returns available today does present a dilemma, even as we believe the new recovery cycle will support risk assets.

To be clear, we still see pockets of opportunities in EM, high yield corporate bonds and alternative assets, but each involve their own unique risk-return trade-offs.



### Prudent use of leverage to enhance returns

For many investors, leverage is simply about increasing risk. However, when used judiciously, it can be a useful tool to structure sources of return differently in an allocation.

For example, an investor who targets a higher return can choose to leverage a diversified moderate allocation instead of taking on greater concentration risk in equities. This levered allocation would have achieved similar returns as a more aggressive allocation, but at slightly lower levels of volatility.

In deciding whether to employ leverage, one needs to consider 1) one's investment objectives and risk tolerance, 2) the volatility of the assets being leveraged, and 3) the outlook for borrowing costs.

As a rule of thumb, applying leverage to assets exacerbates the absolute risk inherent in these assets.

The levered position may also sustain losses in excess of the initial investment during adverse market conditions. For this reason, given the increased risk of leverage, it may make more sense to employ modest leverage only for investments with lower volatility or to a diversified allocation.





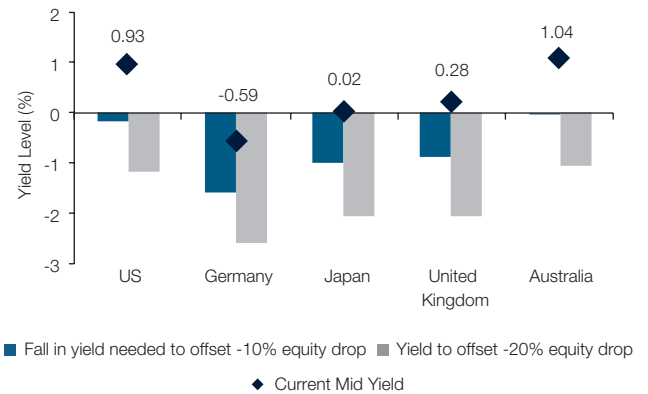
### For protection, look beyond government bonds...

Historically, government bonds have been reliable and attractive instruments for both income and protection – providing a high positive yield, while offering protection (due to their negative correlation with equities) from sell-offs in equity markets. However, the decline in yields and less negative correlation with equities have reduced the diversification benefits of bonds.

Government bond yields would need to go into deeply negative territory to generate the returns required to offset losses from equities. For example, the 10-year German bund yield would need -2.5% in order to offset an equity market decline of 20% in a 60/40 portfolio. These sort of moves may be unrealistic, in our view. As seen in the most recent COVID-19 risk-off episode, German bunds significantly underperformed against US Treasuries as bond yields approached the lower bound.

### Less cushion from bond yields to offset equity losses in a 60/40 allocation as yields approached the zero lower bound

The extent to which yields need to fall to offset 10% and 20% equity losses in a simple 60:40 equities and government bonds allocation



Source: Bloomberg, Standard Chartered



### ....though bonds can still act as a volatility dampener

While the negative correlation of government bonds to equities has reduced, an allocation to government bonds can still make sense, given how low bond volatility is. Including bonds in an allocation still dampen the overall allocation volatility, making it easier for investors to have greater staying power.

In fact, any less volatile asset that is less correlated with equities can act as a potential replacement in a diversified allocation. EM bonds (FX-hedged) and corporate credit, particularly lower-quality credit, stand out as potential diversifiers, with decent long-term expected returns.



## Consider Alternative assets

Investors are increasingly accessing Alternatives for differentiated, less correlated complementary sources of returns. This trend is already underway with rising interest in allocating to Alternatives among institutions and high net worth investors.



**Alternatives as an income source:** Core alternatives are assets that deliver a large part of their returns from stable cash flows and are often less correlated with traditional asset classes over a longer period of time. These include the likes of private credit, Developed Markets real estate and infrastructure, as well as long-term leases on clean energy and transportation assets.



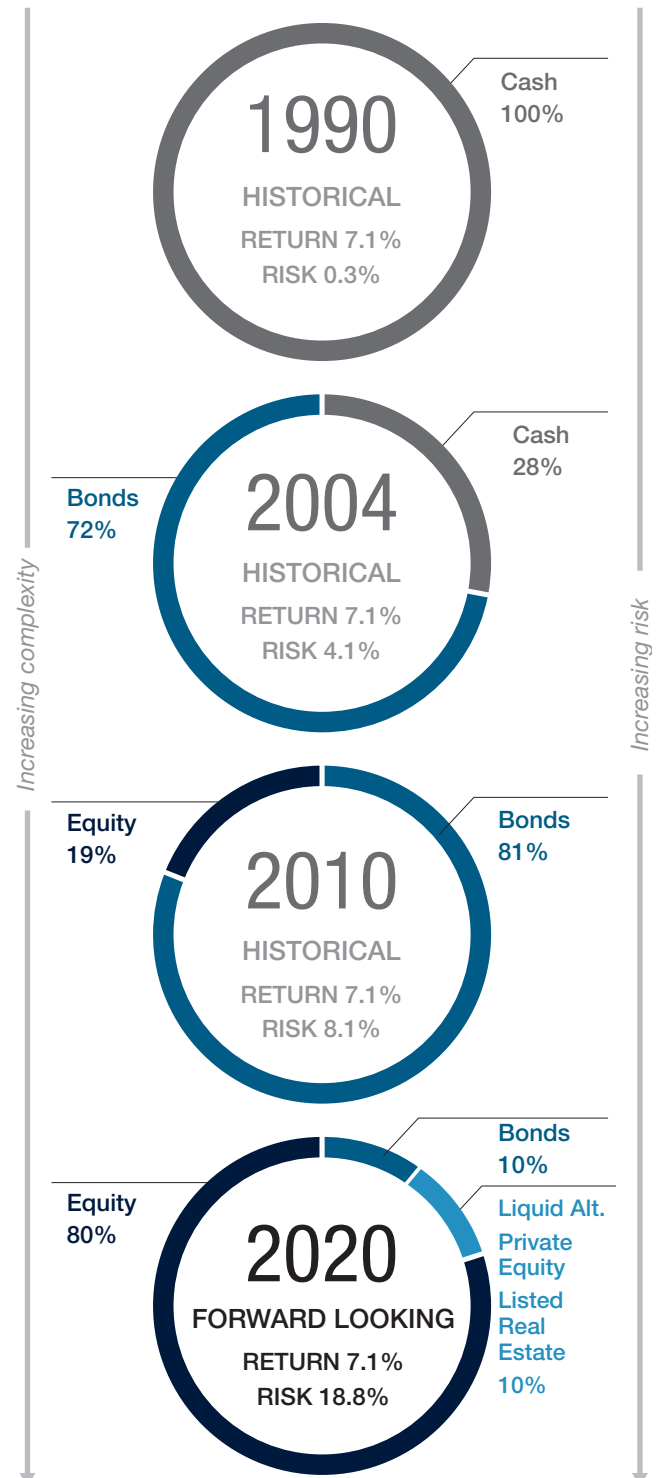
**Private markets and hedge funds are potential return enhancers that can capture illiquidity or complexity premium:** Private equity, non-core real assets and hedge funds can be a source of opportunistic returns, complementing traditional allocations. Furthermore, dispersion is wide among non-core alternative asset classes, which implies opportunities for alpha potential.



**Diversification:** Including Alternatives in a multi-asset allocation may allow greater diversification and drawdown protection during periods when traditional asset classes exhibit high correlations.

While alternative assets do come with their own set of trade-offs, they offer an expanded range of opportunities across strategies, both in private and public markets, for investors to draw from. With elevated valuations and lower long-term returns expectations, we believe it is increasingly important for investors to utilise the Alternatives opportunity-set to address the potential shortfall in returns from traditional asset classes.

Even as recently as 2004, investors did not need growth assets to generate more than 7% expected returns. An investor today will need to include a variety of growth assets in order to expect to earn a similar return, while assuming almost 5x more volatility compared to 2004



Source: Standard Chartered

# UNDERSTANDING THE RISK/RETURN TRADE-OFF

A less attractive risk/return dynamic suggests the need for a more thoughtful approach towards portfolio construction.

In the chart below, we have used broad asset classes to construct two “efficient frontiers” using the last 10 years returns and incorporating our updated return assumptions. There are two clear findings for investors.

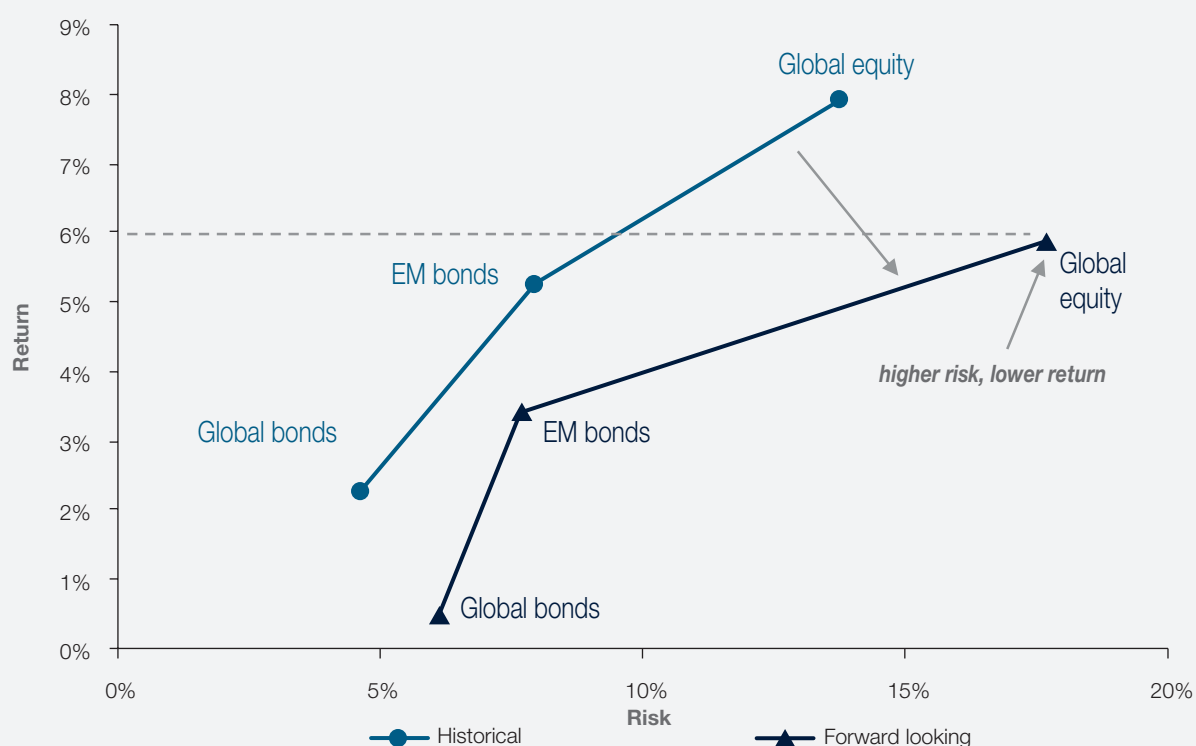
First, the “efficient frontier” has fallen dramatically and continued to shift further to the right. The implication is that similar allocations will deliver a lower level of return for an increased level of risk compared to previous years. This means investors need to take a position further along the risk frontier to earn returns close to historical levels. For example, in the past, global bonds delivered 2.2% with 4.6% volatility, while looking forward, we expect them to earn 0.5%, with a higher volatility of around 6.1%.

Second, investors need to be positioned to capture future drivers of growth and earnings. Traditional market-weighted benchmarks, by nature, tend to be backward looking. They overweight companies which have performed well historically and potentially under-represent those exposed to future drivers of growth. Thematic investing, therefore, will become increasingly important for investors who wish to future-proof their investment allocation.

Depending on one's risk appetite, investors can consider a small allocation of between 10% and 20% to thematic strategies. Besides this theme, we have discussed in depth five other key investment themes that are likely to shape the landscape of 2021 – (i) USD weakness; (ii) Race for income; (iii) Golden equity themes for 2020s; (iv) The time for climate investing; (v) Ready, Steady, Rotate?. Please refer to these reports for further details.

## Investors will have to adapt their allocation decisions in response to shift in risk/return characteristics of asset classes

Efficient frontiers using 10 years of historical and 7-year expected nominal returns



Source: Bloomberg, Standard Chartered



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