LONG-TERM RETURN EXPECTATIONS

SUMMARY

H2 2020

BAILLIE GIFFORD

IMPORTANT INFORMATION AND RISK FACTORS

Risk Factors

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CM14051 Long-Term Return Expectations Summary version H2 2020 WP 0820
Ref: 48721 INS AR 0738

INTRODUCTION

This short summary of our Long-Term Return Expectations sets out the Multi Asset Team's views, as at 30 June 2020, on the prospective returns for asset classes over the next 10 years and beyond.

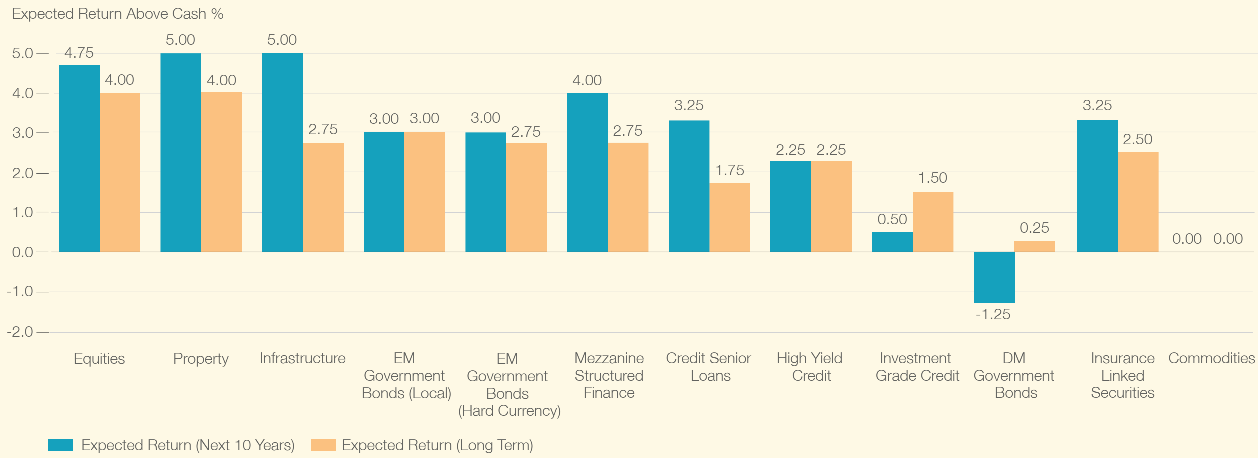
The first half of 2020 was a dramatic and unusual six months. Financial markets saw significant volatility with many suffering substantial drawdowns in the first three months, only to recover most of the losses back in the second three months. Behind that volatility has been the emergence of a global pandemic, coronavirus (Covid-19), which in addition to the high human cost, has resulted in a significant, unexpected hit to global growth, employment and confidence. At the time of writing, it is unclear how this event will develop, albeit that we are optimistic that a set of medical and policy solutions will be found to allow the vast majority of the next decade to be more 'normal'.

Our central economic case continues to be one of moderate global growth. Beyond the immediate impact of the coronavirus pandemic, higher debt levels and an anti-globalisation trend (most visible in the continuing disagreements between the US and China) are just two potential threats. However, while these will garner plenty of attention in the financial media and may affect economic activity in the short term by weighing on confidence, our central expectation is that these issues will ultimately be resolved and that the global economy will return to trend growth in the medium term, supported by very easy monetary and fiscal policy. As it does so, we expect inflation rates gradually to move up towards central bank targets.

While there have been some substantial changes in expected returns for asset classes, what is perhaps most noteworthy about the current environment is the increased level of dispersion and differentiation amongst regions, sectors and instruments within asset classes. This increases the potential returns available from astute active management and from sector and regional selection.

OUR LONG–TERM RETURN EXPECTATIONS

Expected returns for cash*: 1.25% over next 10 years, 2.00% over the long term.*



*UK Bank of England.
Note: Baillie Gifford estimates for asset class returns as at 30 June 2020. Expected returns are passive and do not take into account potential alpha. We view these return estimates as broadly sensible indications of likely returns. They should not be interpreted as high precision forecasts nor are they likely to bear much resemblance to returns over shorter time horizons.

NOTABLE CHANGES SINCE DECEMBER 2019

Unsurprisingly, given the dramatic rethink of how we work and interact with one another in the wake of the emerging coronavirus pandemic, one of the most notable changes this year has been an acceleration of the shift towards an online economy. For example, bonds associated with traditional energy, hospitality and travel, and discretionary physical retail industries have generally been marked down and in some cases defaulted, whereas those associated with ecommerce and technology have often done very well. The same trends have been seen within equities, reflecting both the specific disruption to international travel and domestic retail resulting from lockdown policies and the resultant surge in online shopping and consumption of home content and media streaming.

In the shorter term, the pandemic is resulting in a substantial rise in unemployment and spare capacity in the international economy. This is expected to lead to a hit to growth and inflation and, by consequence, much lower policy rates than we would have previously predicted. This has impacted on a number of asset classes.

For example, we now expect lower negative returns from developed market government bonds and positive returns from investment grade credit. High yield credit and emerging market hard currency bonds, which are both priced by risk-free yields plus a spread, benefit both from expected lower government bond yields and elevated levels of spread, with the result that our expectations for both have moved to more attractive levels over cash. For example, we now project that high yield bonds will bear an excess return over cash of 2.25% p.a., up from 0.25% p.a. in December 2019.

Infrastructure and real estate are both fundamentally yield-based asset classes, and both also benefit from a lower long-term yield environment. Indeed, we now see infrastructure as offering similar returns to listed equities on a passive basis – at 5% p.a. over cash for the next decade. That increased return reflects not just yields but also the attractions of infrastructure in a world where fiscal stimulus is more prominent. Many governments will choose to deliver that stimulus through investment in infrastructure projects, which typically carry high economic multipliers.

1 Equities

↑ 10-Year Returns: 4.75% over cash
→ Long-Term Returns: 4.00% over cash

Equities remain one of the most attractive asset classes in our investment universe in terms of return prospects over the next decade. We project an expected excess return of 4.75%, slightly higher than we forecast in December 2019. A few factors have contributed to the higher expected returns, including less pressure on corporate margins given we have recently seen a reduction in margin levels, and an acknowledgement that valuations are modestly lower (albeit rapidly moving).

It is interesting to see the impact that the coronavirus pandemic is having on individual sectors, styles and other equity factors, and how its legacy might affect those sectors going forward. One particular angle of interest to us is that of 'growth' versus 'value'. While growth stocks have tended over time to be high beta and therefore have suffered in moments of market panic, the current crop of growth stocks may be benefitting from the pandemic, in as much as it appears to be acting as a huge catalyst to accelerate a number of long-term trends.

2 Emerging Market Government Bonds (Local Currency)

→ 10-Year Returns: 3.00% over cash
→ Long-Term Returns: 3.00% over cash

The heterogeneity of the emerging market (EM) local currency government bond universe makes the concept of a single fair value less useful than with some other asset classes. Some countries, such as Poland, are relatively developed, low inflation economies that offer low nominal and real yields, while others, such as Brazil, are less mature, with higher inflation and generally weaker institutions, and so offer higher yields.

Over the first half of 2020, the local currency EM bond market yield has fallen alongside developed market bond yields, currently standing at 4.5%. This is below our estimated long-run fair value of 5.75%. On average, across the index, we expect nominal currency depreciation of just under 1% per annum, which results in a rounded expected return of 4% per annum over the next 10 years, which in turn is 3% over developed market cash returns.

3 Property

↑ 10-Year Returns: 5.00% over cash
↑ Long-Term Returns: 4.00% over cash

In assessing prospective returns from property markets, we expect the starting yield and net rental growth to be the primary return drivers in the long run. We estimate that growth in net rental income (from an established portfolio) will lag inflation by around 1%, reflecting the impact of new supply and the tendency of established properties to experience erosion in their real rental value, as well as the disruptive effect of new, internet-based business models.

Our analysis shows a substantial difference between individual sectors – with the prospects for physical retail and commercial office real estate heavily impacted by the crisis, while those for logistics and fulfilment property have been enhanced. Within the office sector, newer, flexible, suburban buildings are likely to benefit at the expense of older, less flexible city-centre towers as tenants consider the need for space per worker and the desirability of requiring employees to transit through major transport networks and hubs to commute to their workspace.

4 Developed Market Government Bonds

↑ 10-Year Returns: -1.25% over cash
→ Long-Term Returns: 0.25% over cash

To estimate returns over the next 10 years, we add our expectations for terminal policy rates in each of the major developed markets to our term premium (0.25%), giving us an expected yield in a decade's time. We then compare the resulting figures to current yields in each of the major markets. In all cases these yields are substantially below the anticipated yields in 10 years' time, suggesting capital losses. (This is offset, to various levels, by the yield component, assuming a linear progression from current to projected levels over the decade.)

For example, the current yield for 10-year French government bonds[1] is around -0.1%. This compares with our expected 10-year yield in 10 years' time of 1.75% (made up of a terminal policy rate of 1.5% and a term premium of 0.25%). This implies a rising and flattening yield curve over the period, giving investors who maintain exposure to 10-year OATs an expected total nominal return of around -0.75% p.a. This is around 1.25% p.a. under our expected cash rate of 0.5% p.a.

Following the same approach for the other major markets, and averaging across them, we expect an annual return of around 1.25% below cash for developed market government bonds over the next 10 years.

5 Infrastructure

↑ 10-Year Returns: 5.00% over cash
→ Long-Term Returns: 2.75% over cash

The infrastructure asset class is particularly interesting just now as governments look to roll out fiscal stimulus programs, often with a key concentration on infrastructure projects, which are generally seen as having a high economic multiplier (i.e. they are an effective way for governments to spend money for the biggest impact on their respective economies). This increased demand, in combination with a particular focus on 'green' projects (to the benefit of renewable energy operators, developers and those involved further along the electrification chain), is raising growth prospects at a time when valuations look unchallenging due to lower yields in other asset classes, most notably developed market government bonds.

[1] We use French bonds as a proxy for average government bond yields across the Euro Area.

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