On the road back to normality for asset allocation decisions

David Shairp
Global Strategist and Portfolio Manager,
Asset Management Solutions Group
J.P. Morgan Asset Management

Against an increasingly complex and uncertain market backdrop, the *J.P. Morgan Long-Term Capital Market Return Assumptions* have been designed to provide institutional investors with the guidance they need to make more informed long-term strategic asset allocation decisions.

The assumptions are clearly conceived, rigorously researched and easy to use, providing return forecasts for approximately 50 asset classes over a 10-15 year time frame. Quite simply, our long-term capital market return assumptions provide investors with the most comprehensive set of return forecasts across the broadest range of asset classes – making them an indispensable and vital source of information in an ever-changing world.

In this article, we summarise the main findings from our 2014 long-term capital market return assumptions report. You can download the full report from the J.P. Morgan Asset Management institutional website.

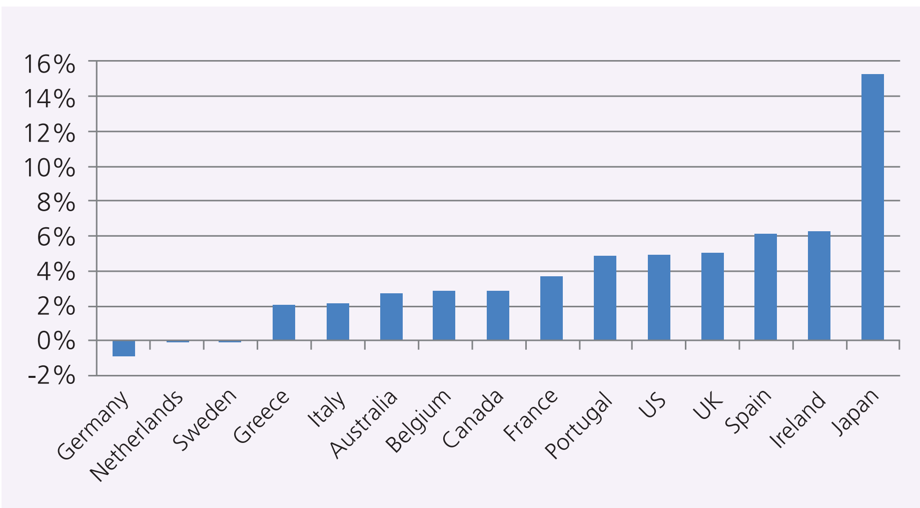
Given the ongoing challenging market backdrop, this year we focused particularly on the consequences of three longer-term issues when calculating our return assumptions: a prolonged period of public sector deleveraging in the US and in Europe, the question of global economic rebalancing, and the path of inflation.

Deleveraging: ongoing adjustment remains sizeable

The first issue, public sector deleveraging, remains an ongoing burden for the world economy, despite the extent of the fiscal adjustment that has already occurred. The October 2013 edition of the IMF's *Fiscal Trends* shows that the fiscal tightening required over the next seven years to reduce debt ratios remains sizeable.

There are five possible outcomes (or a combination thereof) to fiscal deleveraging over the next 10-15 years: growth,

Figure 1: Fiscal adjustment as a % of nominal GDP



Source: IMF Fiscal Monitor, October 2013. Note: The required fiscal adjustment is measured as the cumulative change in the cyclically-adjusted primary budget balance between 2013 and 2020 needed to bring the debt ratio down to 60% in 2030, or to stabilise debt at the end-2013 level by 2030.

repayment, inflation, restructuring and outright default. While the current window of accelerating activity holds out the hope that growth strategies can be followed to pay down debt ratios, the reality remains that several economies suffer from low rates of underlying nominal GDP growth, and are thus vulnerable to any upturn in interest rates.

A sustained upturn in bond yields will bring a deterioration in fiscal solvency statistics, risking a reversal of the recent progress made. While the environment looks brighter, it is still probable that the next downturn will bring more unorthodox methods to deal with the pressures of deleveraging in the latter half of our 10-15 year assumptions horizon.

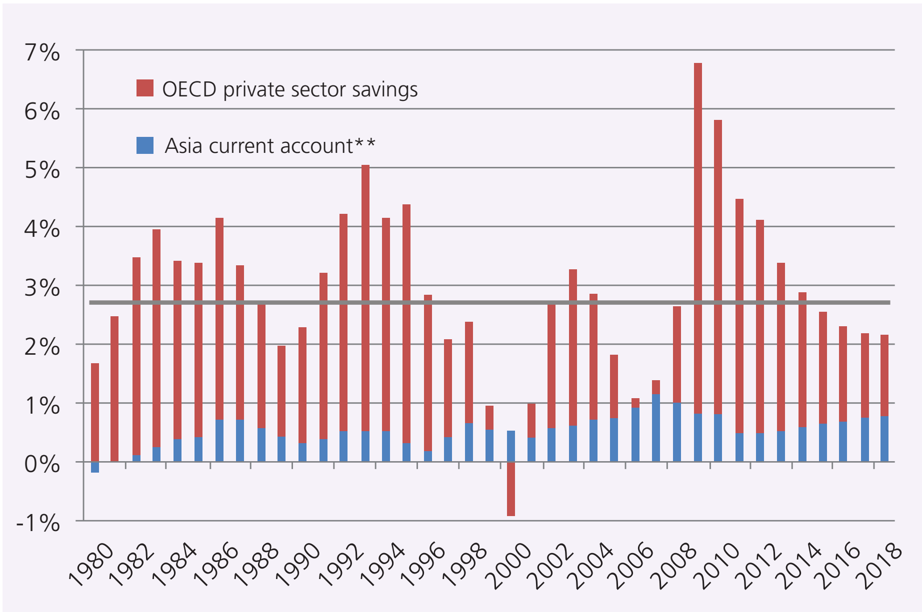
Global rebalancing: a challenging task

An optimistic outlook for the next 10-15 years requires a rebalancing of economic activity globally, with increased demand growth in the nations that run current account surpluses offsetting the drag on demand in the deficit countries. In the deficit economies, trend rates of growth will depend on the extent to which incremental private-sector demand can offset the drag from the public sector.

The latest forecasts by the IMF throw into doubt the prospects for successful rebalancing. The projections suggest that the aggregate savings ratio in the developed world will rise relative to GDP through to 2018 (the end of the forecast horizon), while the output gap is projected to remain sizeable.

However, the so-called Eurasian savings surplus is expected to gradually decline during the next five years to below the long-term average. This aggregate comprises private-sector savings balances in the OECD and current account balances in East Asia.

Figure 2: The global savings glut – normalising



Source: IMF World Economic Outlook (September 2013), Lombard Street Research. Note: Based on an approach by Charles Dumas, Globalisation Fractures: How Major Nations' Interest are now in Conflict (Profile Books, 2010). ** China, Japan, Korea, Taiwan and Hong Kong.

Inflation: limited risk over the medium term

Inflation is not seen as much of an issue over the medium term. Our long-term capital market return assumptions, unusually, have not changed the inflation rates projected over the next 10-15 years in either developed or emerging markets.

Rates of spare capacity are expected to remain large during the first five years of the outlook, though with some reduction thereafter. The eventual restoration of fully functioning credit mechanisms is also expected to improve growth and demand. In the meantime, we continue to see limited inflation risk over the medium term.

Crunching the numbers – the implications for asset class returns

Fixed Income

Given the challenging macroeconomic backdrop and lack of inflationary pressures, we expect policy rates to remain low for at least another two to three years, before commencing their long and arduous journey back to equilibrium levels. Bond yields are likely to rise significantly from today's levels, although not for a while.

Corporate bonds are expected to be supported by limited excess credit build up, strong investor demand for income and yield, and narrower credit quality differentials relative to government debt. Overall fixed income returns are expected to be dampened by the rise in yields towards the expected higher equilibrium levels in the latter part of our forecast 10-15 year horizon.

Equities

Equity returns are likely to benefit from higher dividend yields, while we expect a mixed outlook for valuations following continued strong performance in 2013. In the US, average annual real returns of 5.25% are expected, after subtracting our core inflation estimate. This is respectable, but below the long-term average of 6.3% pa. We continue to look for western companies, especially those in Europe, to benefit from fast-growing markets overseas. Emerging markets are expected to remain the top performers, but we have reduced our assumed total return expectations.

Alternatives

Alternative strategies are generally expected to be lower going forward, reflecting primarily above-average performance in 2013 for real estate, a lower outlook for the core market risks (or betas) of a given strategy of hedge funds, and in the case of commodities, a new supply/demand dynamic that is moving towards more of a long-term equilibrium.

We maintain our stance that successful alternative investing is about manager selection/due diligence rather than the modest median manager expectations modelled for our long-term return/risk assumptions.

Private equity returns should continue to maintain a small premium to large capitalisation public investing despite a number of positive and negative forces at play over the evaluation time frame. Hedge fund returns are marked lower going forward, capturing the underlying market exposures that dominate each strategy's risk profile.

Real estate and infrastructure returns, after an above average year in 2013, are expected to be lower in the case of core assets, while extended real asset risk such as value added should see promising returns, as risk profiles increase as the real estate cycle matures and the economy continues to grow.

We have materially reduced our commodity outlook to capture the significant rise in supply that has been building over the past 10 years. Reduced global demand, particularly from China, and a spike in supply across much of the commodity spectrum, has produced a volatile and unexciting return outlook, though still technically within the realm of a super cycle as real returns are still expected.

Currencies

Our exchange rate assumptions are derived by drawing on a broader set of widely accepted theoretical concepts such as absolute and relative purchasing power parity (PPP), productivity differentials and the terms of trade, to develop assumptions that reflect the future fair value of a currency exchange rate.

Towards the end of 2013, many of the major currencies, including the US dollar, the euro and sterling, were trading close to long-term fair value, with only the Japanese yen looking significantly undervalued. Our currency assumptions suggest long-term appreciation of the yen, with a small depreciation for the euro and sterling.

Emerging markets

In our view, emerging markets are currently more complex than a straightforward play on global growth. From a macro perspective, the eight mainstream emerging markets seem to have arrived at an inflection point after a decade of rapid development. As these countries place a greater emphasis on meeting domestic demand, as opposed to exporting, their large current surpluses may dissipate.

Our coverage in the long-term capital market return assumptions has been extended to eight of the largest and most significant emerging markets – Brazil, China, India, Korea, Mexico, Russia, South Africa and Taiwan. The combined GDP of these eight economies amounts to USD 18.4 trillion, or 25% of the global total (though on purchasing power parity-adjusted estimates, this percentage would usually be significantly higher). Their combined equity market capitalisation amounts to USD 3.9 trillion, 83% of the MSCI Emerging Markets Index.

In this year's report, we have downgraded our assumptions for real GDP for most of the emerging market countries under our coverage (the exceptions being Mexico and South Africa). The next few years could bring challenges to those countries due to excess investment capacity, which has been fuelled by credit booms.