Julius Bär

SECULAR OUTLOOK

Economic and investment trends shaping the current decade

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Julius Bär

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The great normalisation

Dear reader,

Every year in October, Julius Baer's senior research and investment management experts, along with selected external guests, come together for a two-day Secular Outlook off-site seminar to reassess the key trends in the global economy and capital markets. The seminar, which is an integral part of Julius Baer's investment process, gives us an opportunity to take a step back from recent events and the daily news flow and examine where we stand in the grand scheme of things. As long-term investors, it is paramount to have a clear view of the structural forces at play in the economy and align our portfolios accordingly.

In last year's edition of the Secular Outlook brochure, we argued that since first holding the annual seminar some 15 years earlier, the world had never changed as dramatically as it had in the preceding 12 months. We concluded that the war in Ukraine marked the end of the peace dividend. It was a watershed moment for investors, as it had a host of geopolitical, economic, and financial implications. In the presence of such a paradigm shift, all previous investor reaction functions needed to be re-evaluated and revalidated. At the same time, however, we were very careful to distinguish between cyclical developments and truly structural changes. We noted that the challenge was compounded by the successive shocks of the Covid-19 pandemic and the monetary and fiscal stimulus provided in response, followed by the outbreak of the war in Ukraine. These shocks caused massive distortions in the economic and financial cycles and triggered inflation for the first time in decades. In the face of these developments, policymakers raised interest rates out of the realm of financial repression at an unprecedented speed and scale. Ultimately, the 40-year bull market in bonds came to an end, and the bursting of the bond bubble that started in early 2022 reached historic proportions in 2023.

Have we exited the era of financial repression for good? Not necessarily, in our view, although it is tempting to draw that conclusion after 5-year, 10-year, and even 30-year US Treasury yields breached the 5% threshold in October. Admittedly, we did not expect the abrupt exit from near-zero (or even negative) interest rates and from quantitative easing by the US Federal Reserve (Fed) and its central bank peers. If anything, we expected the exit from the free-money era to be gradual instead. No one really thought that interest rates could rise so quickly without causing a major crash or recession in the US. Nevertheless, we do not believe that the current higher-rate environment represents the new normal. The US and global economies have not changed to such an extent as to make interest rates above 5% sustainable. The world is simply too financialised and global debt too systemic to allow for interest rates to remain high for a prolonged period of time. The toolbox of monetary policymakers to fine-tune economic activity has expanded considerably since the Global Financial Crisis (GFC), with central banks increasingly using their balance sheets to nip flare-ups of systemic risk in the bud, as we witnessed during the US regional banking crisis in March of this year. The financial economy continues to dominate the real economy, given its disproportionate size, and central banks will continue to be constrained in their actions by the threat of systemic risk.

Beneath the surface, the post-pandemic normalisation is making good progress and structural visibility, which was unusually low in recent years, has been gradually improving. With hindsight, we were right about our take on some of the formative events of recent years, resisting the temptation to draw hasty conclusions from them for the decade as a whole. For example, there is now ample evidence that both the sudden rise in inflation and the energy crisis in Europe were largely due to temporary rather than structural factors. Supply chain bottlenecks have completely dissipated, and energy markets have proven to be truly globalised and resilient. A broad-based commodity super cycle looks increasingly unlikely in this decade. Nevertheless, we expect macroeconomic volatility to remain higher than in the previous decade, fuelled by the new geopolitical situation. Importantly, the new structural inflation regime is a matter of choice for Western governments and central banks. We expect them to settle for around 3%, on average, rather than 2%, while accepting higher volatility around this new average.

The transition from neoliberalism towards state-sponsored capitalism, a notion we introduced in 2019 for the first time, is now in full swing. This trend has been turbo-charged by the return of geopolitics. Today, we face a multipolar world, where strategic reshoring activities driven by national security concerns are gaining importance, facilitated by active fiscal and industrial policies. Fiscal dominance paves the way for a normalisation of interest rates at a faster-than-expected pace – a fundamentally healthy development in a capitalist system that creates opportunities. At the same time, we might be on the cusp of an innovation super cycle driven by the convergence of multiple technologies, including generative artificial intelligence (AI), which could enable massive productivity gains throughout the decade. Meanwhile, China is in a balance sheet recession and is facing further structural headwinds due to very adverse demographic and economic developments.

In this 2024 update of the Secular Outlook brochure, we first identify the key macroeconomic trends of the current decade and then outline the key capital market trends and related investment areas which we believe are bound to benefit from them. We conclude with a brief overview of the underlying risk drivers increasingly playing a role in investors' portfolios. We hope you enjoy reading the brochure and that it serves you as a useful guide for your investment decisions in the currently challenging environment.

Yours faithfully,

Yves Bonzon
Group Chief Investment Officer
Member of the Executive Board

Historical secular trends

In this chapter, we provide a synoptic overview of the key macroeconomic and capital market trends of the past seven decades. The trends which, in our view, are shaping the current decade will be elaborated on in subsequent chapters.

An overview

Every decade is characterised by a different economic and investment environment in which capital markets are shaped by different trends. As a result, some asset classes outperform while others lag behind, and market leadership tends to change from one decade to the next. While this basic assumption remains valid, we must acknowledge that such periods of dominance can be longer or shorter than exactly ten years.

Chart 1: Historical secular trends

	1960s	1970s	1980s	1990s	2000s	2010s	2020s*
Era	Bretton Woods	Neoliberal era (globalisation, financialisaton, digitalisation)					State-sponsored capitalism
What happened	Bretton Woods	Floating exchange rates Oil shock The Great Inflation	Falling inflation Plaza Accord currency agreement Deng Xiaoping's China reforms	Fall of the Berlin Wall Globalisation Internet Electronic trading	European Economic and Monetary Union Great global imbalance China's rise Structured credit	Managed deleveraging in Western countries Shift from inflation to asset-price targeting Emerging market divergence EUR crisis	Multipolarity and strategic reshoring Active industrial and fiscal policies Interest rate normalisation Innovation super cycle China's balance sheet recession
What profited	US Nifty-Fifty stocks: 50 most popular US large-cap stocks	Small caps Oil stocks Gold, CHF, and JPY	Government bonds Nikkei Index Hong Kong equities	Index funds Nasdaq Swiss stocks USD	Hedge funds Emerging market equities Commodities EUR	Developed-market quality equities Private equity High yield 60/40 FAANMG USD	The return of income investing 'Store of value' equity markets USD capital markets Nasdaq+

Source: Julius Baer
Note: Bretton Woods was established in 1944 and became fully functional in 1958; the Berlin Wall fell in November 1989; the European Economic and Monetary Union refers to the launch of the euro; 60/40 = 60% equities/40% bonds; FAANMG: Meta (formerly Facebook), Apple, Amazon, Netflix, Microsoft, and Alphabet (formerly Google); 'store of value' equity markets: equity markets in jurisdictions where property rights and shareholder value are well protected and which are characterised by solid institutions, sound governance, and efficient capital allocation; 'Nasdaq+' refers to the technology-heavy Nasdaq Composite Index as well as to selected companies listed elsewhere that are driving the next iteration of global technological progress. * Julius Baer projection.

Key macroeconomic trends

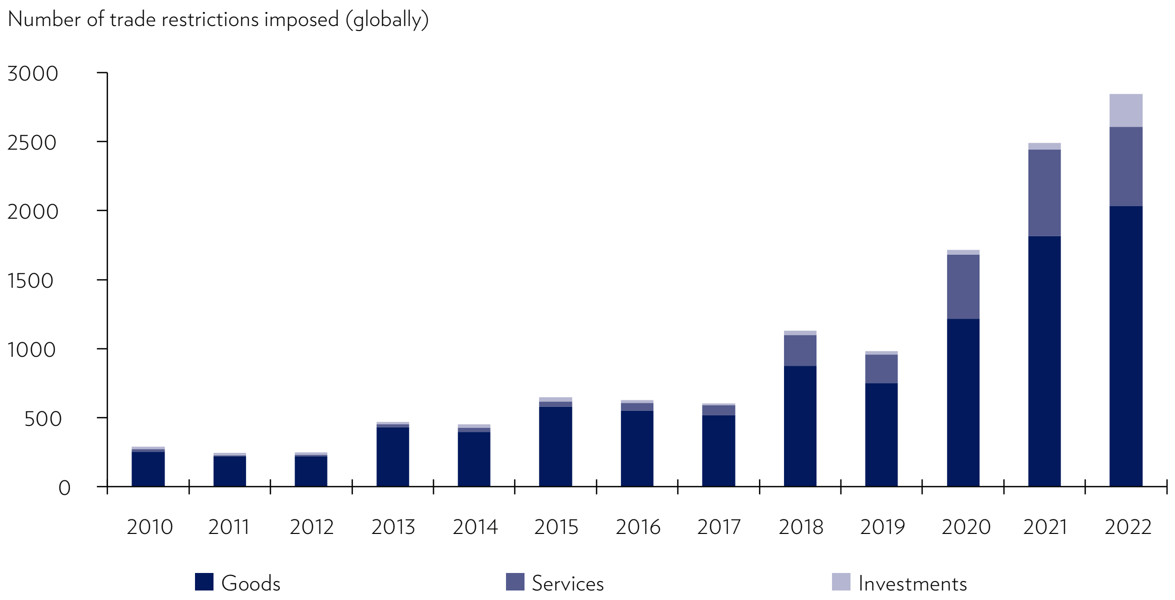
Having presented a historical overview of the secular trends, in this chapter we elaborate on the key macroeconomic trends shaping the current decade. The macroeconomic environment is the most important input when trying to assess which investments will profit most.

Multipolarity and strategic reshoring

As evidenced by the current wars in Ukraine and the Middle East, geopolitical rivalries have returned with a vengeance in the last few years, extending well beyond a strategic confrontation between the US and China. The new geopolitical landscape is complex and fragile, as countries tend to deviate opportunistically from seemingly strong alliances driven by national interests. With the peace dividend having run out, we expect strategic reshoring initiatives focused on critical supplies to continue.

While the notion of the end of globalisation, widespread at the beginning of this decade, was certainly exaggerated, it has become apparent that the peace dividend ended with the Russian invasion of Ukraine in February 2022. Globally, conflicts continue to rage, with the war in Ukraine ongoing after more than 18 months of fighting and the tragic escalation of violence in the Middle East being the latest prominent examples. In last year's edition of the Secular Outlook brochure, we noted that the unquestioned leadership of individual countries on the world stage – as exhibited, for example, by the US and the Soviet Union during the Cold War – is firmly a thing of the past. Today's world is fundamentally multipolar instead, with more and more countries starting to opportunistically prioritise their

Chart 2: Protectionism is on the rise



Source: Global Trade Alert, International Monetary Fund, Julius Baer
Note: The chart shows the number of trade restrictions imposed worldwide by year and type.

own objectives instead of habitually adhering to one block or another. Geopolitical confrontation as a permanent condition is fertile ground for mishaps, as the more actors there are, each with their own national interests, the harder it is to predict their behaviour towards each other.

Yet even if global trade is subject to fragmentation as protectionism proliferates (see chart 2) and geopolitical tensions are likely to continue to send tremors through economies and markets, we still believe that a full-fledged deglobalisation and broad-based decoupling of world powers such as the US and China remains unlikely. International supply chains are simply too intertwined, complex, and mutually profitable for countries to fully reshore their businesses. The greatest incentive for a decoupling exists in key strategic sectors that are important to national security, such as technology (which can be weaponised) or energy. In these sectors, we are likely to continue to see government policies designed to boost domestic production, increase resilience, and curtail efforts by 'the other side' to succeed. However, goods that are of lesser strategic importance, as well as those where competitive suppliers are scarce, are unlikely to see their supply chains reshored.

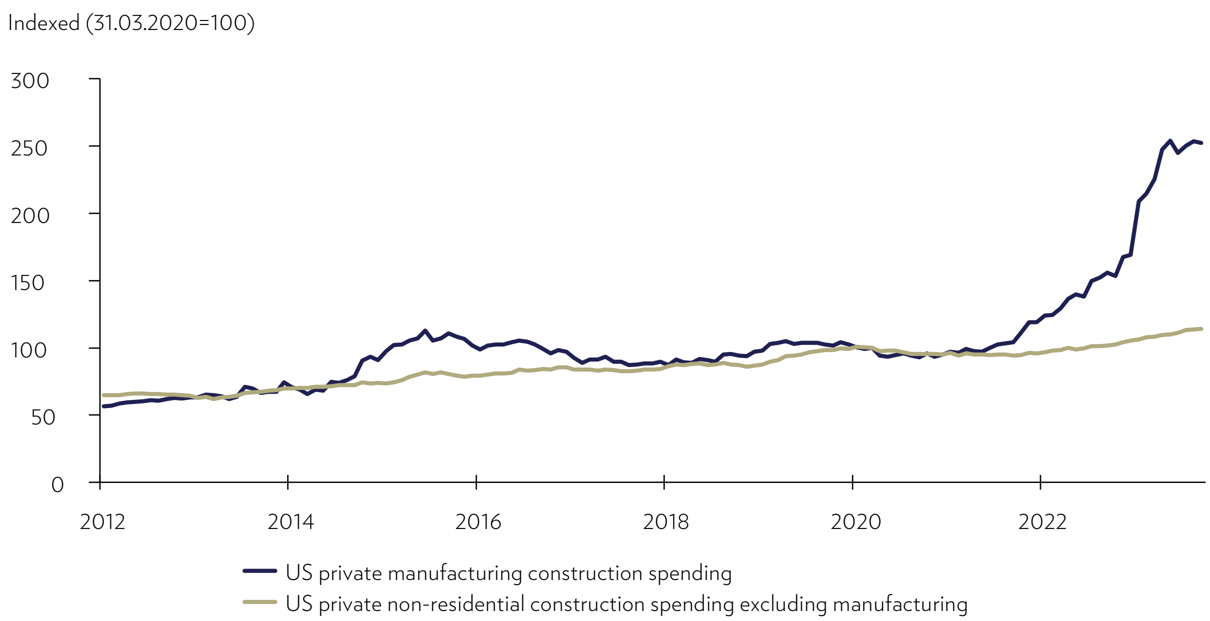
Today's world is fundamentally multipolar, with more and more countries starting to opportunistically prioritise their own objectives instead of habitually adhering to one block or another.

Active industrial and fiscal policies

Supercharged by the Covid-19 pandemic, fiscal policy has taken centre stage in the management of economic cycles. Active industrial and fiscal policies are central elements of state-sponsored capitalism, the new era we have entered after 40 years of neoliberal orthodoxy. The appetite for fiscal activism is amplified when geopolitical collisions become the new norm rather than the exception.

Macroeconomic policymaking has undergone a major paradigm shift since the beginning of this decade. After 40 years of globalisation, liberalisation, financialisation, and digitalisation, during which large-scale state interventions were seen as undesirable and inefficient, we are witnessing the return of fiscal policy dominance. Advanced economies continue to suffer from record inequalities, ageing demographics, and stagnating growth, and there is still tremendous pressure on governments to alleviate these problems. The Covid-19 pandemic decisively accelerated this trend. Significant financial support measures were enacted globally, and on a particularly large scale in the US. In fact, the US government has adopted a more activist fiscal stance with a focus on strengthening domestic industrial capacity that goes beyond the immediate response to the global health crisis. Domestic manufacturing plant construction has increased sharply in recent years (see chart 3). Since President Biden took office

Chart 3: US fiscal policy spurs boom in domestic factory construction



Source: US Census Bureau, Bloomberg Finance L.P., Julius Baer
Note: US private non-residential construction expenditure is broken down into manufacturing and all other categories excluding manufacturing. Data as at 30.09.2023.

in January 2021, significant resources have been directed to clean energy investments through the Inflation Reduction Act, to subsidies for advanced manufacturing such as semiconductors through the Chips and Science Act, and to infrastructure upgrades through the bipartisan infrastructure bill. Previously, US fiscal policy was predicted to be one of the biggest drags on US economic growth over the next few years. Contrary to that forecast, US fiscal programmes have actually contributed positively to US real gross domestic product (GDP) growth in both the first and third quarters of this year. This comeback of fiscal dominance makes it much harder for investors to read economic cycles given that there are regularly significant discrepancies between announcements and actual implementation. Nevertheless, the direction is clear, and these measures are part of a larger deliberate shift in US economic policy, with more active industrial and fiscal management intended to help increase labour supply and productivity growth while reducing environmental damage and also inequalities – one of the most prominent negative side effects of the neoliberal era. Importantly, while heated budget debates have become the norm in the US Congress, there is support across the political spectrum, not just from the Democrats, for a more active role for the government in promoting investment in productive capacity.

Meanwhile, in China, the central government has historically played a major role in steering and stimulating domestic investment. Government subsidies have been a feature for years in industries deemed strategically important. Furthermore, since the private sector remains reluctant to borrow and invest, the public sector increasingly has to step in to prevent the country's economy from coming to an abrupt halt. And even in Europe, the voices of dogmatic austerity have quietened as the bloc is working towards greater energy and military security. As far as dogmatic austerity is concerned, the consequences of such a policy stance are well known, having been painfully experienced not long ago during the eurozone debt crisis.

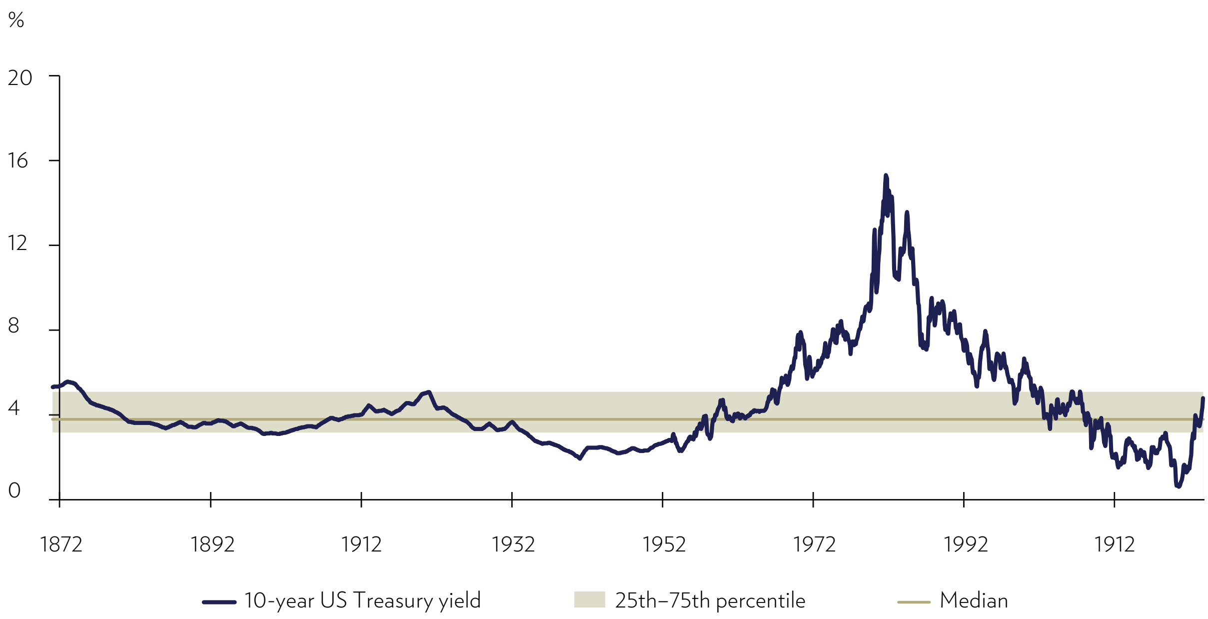
Interest rate normalisation

Faced with inflation for the first time in decades, Western central banks have raised interest rates out of the realm of financial repression and have also begun to unwind their balance sheets. The speed at which interest rates have moved back to more normal territory without causing major collateral damage is testament to the resilience of private sectors in Western economies. Fundamentally, while the return of the cost of money is painful in the short term, it is a blessing in the medium term.

After the GFC, Western central banks began using ultra-low or even negative interest rates in combination with large-scale asset purchase programmes to prop up ailing economies. Such action was required to prevent deflationary tendencies as private sector agents were repairing their balance sheets. Put in historical context, both the US federal funds rate and the 10-year US Treasury yield reached record-low levels during that time. Over the past 150 years, the 10-year US Treasury yield has mostly hovered around 3%–5%, with a central tendency towards 4% (see chart 4). At the same time, the US federal funds rate has on average been slightly below 5% since 1954, when official Fed data first became available. In that sense, the recent moves have been a return to the mean for both measures.

In retrospect, the last decade has been an experimental period for monetary policy. The range of tools available to steer economic activity has expanded considerably during this period. The big question confronting investors is whether interest rates have moved sustainably higher or whether we will return to the realm of financial repression further down the road. With the 10-year US Treasury yield having breached the 5% threshold in October and

Chart 4: US long-term interest rates are back to more normal territory



Source: Robert Shiller data, Julius Baer
Note: Data as at 31.10.2023. Past performance and performance forecasts are not reliable indicators of future results. The return may increase or decrease as a result of currency fluctuations.

short-term rates expected to stay above 5% going into 2024, it certainly would not be far-fetched to say that we are done with zero-to-negative interest rates, quantitative easing, and policies inspired by Modern Monetary Theory. However, we believe that such a conclusion would be premature. Fundamentally, we see insufficient evidence that would warrant interest rates remaining structurally 'higher for longer'. The private sector remains a net saver in most developed economies. The decline of private sector borrowers that began after the GFC continues, putting structural downward pressure on the cost of capital. Crucially, we also maintain the view that the 'tail is wagging the dog', i.e. given the exponential value of financial assets in relation to global GDP, changes in asset prices still disproportionally influence the real economy. Given the sheer volume of financial assets and global debt, a continuous rise in yields could lead to systemic problems. The good news is that central banks' ability to respond to systemic risk flare-ups has substantially improved. For the record, back in March of this year, the Fed was quick to prevent potential contagion effects, as it came up with a new facility to alleviate the US regional banking crisis, allowing affected entities to receive liquidity by exchanging their US Treasury holdings for cash. Such an ability to fine-tune monetary policy responses is not just a 'nice to have', but a key requirement, given the lightning-fast progress in the current tightening cycle and the magnitude of financialisation.

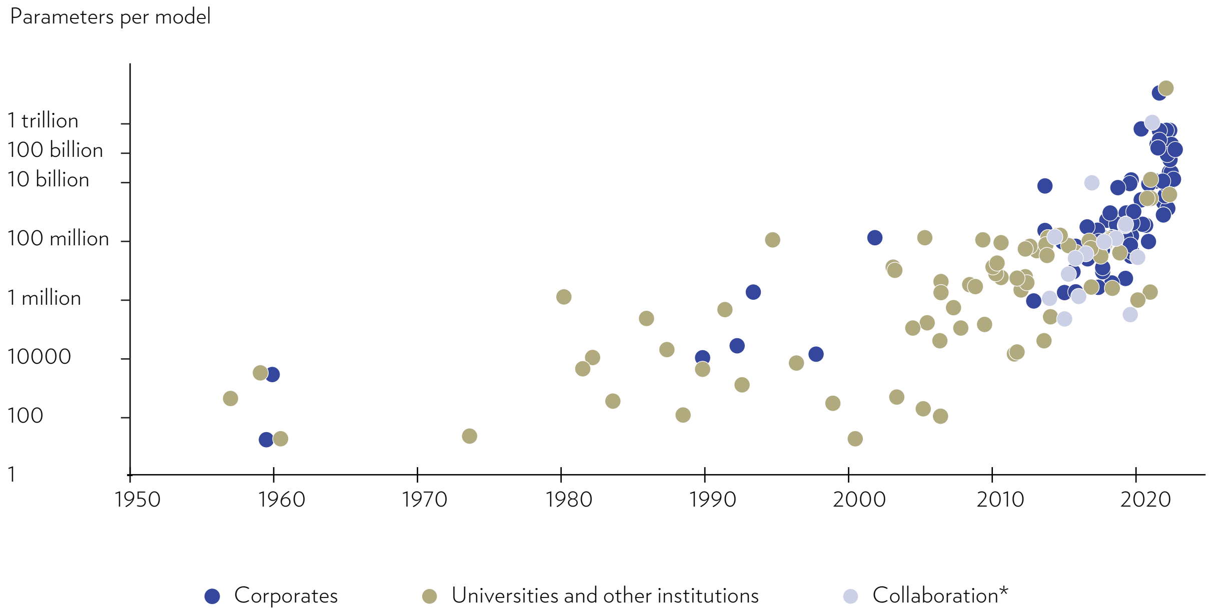
By and large, the fact that money has a price again is a fundamentally healthy development. While the normalisation of interest rates is painful in the short term, it is a blessing in the longer term. When money is cheap, or even free, there is a risk that economic agents will be less disciplined in how they allocate capital, e.g. by using it for potentially unproductive purposes such as speculation in financial assets and financing questionable business models that are only viable under generous liquidity conditions. In this sense, the return of the cost of money has a desirable disciplinary effect. We do not mourn the end of the era of 'free money'. On the contrary, we welcome it as a necessary condition for reigniting creative entrepreneurial destruction and sustainable economic growth going forward.

Innovation super cycle

The pace of innovation has accelerated in recent decades and is expected to continue to do so in the future. The combination of exponential growth in computing power at decreasing costs and the proliferation of big data provides fertile ground for increasingly powerful generative AI systems. As a result of the convergence of several disruptive technologies, we expect to see profound breakthroughs across multiple industries that will reshape the way we live and work.

To suggest that innovation is a key trend confined to a single decade would be preposterous. Innovation has always been the driving force propelling humanity forward, igniting economic progress, and fostering evolution in countless domains. What makes the current decade special is that the pace of innovation has markedly accelerated, partially due to external shocks such as the Covid-19 pandemic, which exacerbated the need to innovate as the world came to a temporary standstill. Beneath the surface, we see a convergence of multiple technologies leading to severely disruptive forces. The combination of exponential growth in computing power at decreasing costs and the growing abundance of data provides a fertile ground for disruptive change, including through increasingly powerful generative AI systems. The latter have arguably gained strong momentum over the past 12 months, as the launch of ChatGPT signalled the advent of the generative AI era. Generative AI models, as exemplified by ChatGPT, have been adopted at an unprecedented speed, and the associated use cases are plentiful. AI in its conventional form is a general-purpose technology that is already applied

Chart 5: Rate of innovation in AI models accelerates as the corporate sector takes the lead



Source: Sevilla, Villalobos, Cerón, et al. (2022). 'Parameter, Compute, and Data Trends in Machine Learning'; Julius Baer
Note: The performance of a model can be assessed by the number of parameters it contains, i.e. the number of factors or variables it considers when generating an output. The greater the number of parameters in a model, the better the quality of its output. * Collaboration between corporates, on the one hand, and universities and other institutions, on the other.

across a multitude of industries. In the last decade, we have seen a major shift in stakeholders' interest, with corporates rather than academia driving progress and training increasingly sophisticated models (see chart 5). As a result, the pace of innovation has accelerated, and the combined forces of data availability, increasingly powerful parallel processing units, and improvements in generative AI technology are expected to lead to transformative advances across multiple industries, reshaping the way we live and work. Against this backdrop, we may find ourselves on the cusp of the next 'innovation super cycle' that will profoundly impact both productivity and economic growth in this decade.

One area that we continue to see as ripe for disruptive innovation is life sciences, driven by the proliferation of data sciences in healthcare and the convergence of technology and biology. The current environment, however, remains incredibly challenging for biotechnology stocks. After a strong 2020 for the Nasdaq Biotech Index, the sector posted only modestly positive performance in 2021, followed by a dismal 2022 and an underwhelming 2023. The sector has not shared in the excitement surrounding AI despite its potential to permeate biomedical science, particularly when it comes to AI-assisted drug discovery. While growth prospects have been reassessed and repriced accordingly, the underlying long-term trends remain firmly in place.

Another key topic that has been with us for some time now is the energy transition, which aims for a shift towards net-zero carbon emissions. We have argued that the energy transition will be inflationary in the short term given the required investments but deflationary in the long term due to expected productivity gains. While this view still holds, we might actually be already further advanced in transitioning our economies than commonly assumed. Both solar and wind energy costs have fallen dramatically and are expected to continue to do so, as driving electric vehicles has become cheaper than driving their petrol-powered counterparts, and the energy market continues to prove its resilience thanks to its truly globalised nature. While this does not mean that we will become independent of fossil fuels in the 2020s, it does mean that we could see an additional structural disinflationary impulse come into play sooner than previously expected.

The pace of innovation has accelerated, and the resulting technologies are expected to reshape the way we live and work.

China's balance sheet recession

China's economic recovery following the post-pandemic reopening has been short-lived, and the recent policy easing has failed to revive confidence. With the highly indebted private sector focusing on hoarding cash rather than spending or investing, signs are mounting that China is entering a balance sheet recession. Additionally, adverse demographic and economic developments provide further structural headwinds, reinforcing our cautious view on Chinese capital markets.

In 2017, when we first attempted to identify the key trends that would shape the 2020s, we expected China to rise to core-asset-class status for global multi-asset investors. There were essentially two main factors that led us to this assessment. The first was China's unmistakable potential to rise to the levels of technological innovation and corporate profitability previously only reached by the US. The second was the increasing diversification benefits in a world where the US and China lead the global economy but do so in substantially different economic, financial, and technological ecosystems. However, this storyline started to unravel quickly in 2021, when the Chinese government shifted its strategy towards 'common prosperity', with the objective of tackling the country's rising inequalities and building a social safety net by highly regulating digital platforms, especially those vulnerable to US regulations. Additionally, in light of the financial ramifications that followed the Russian invasion of Ukraine, investor capital is now at risk of impairment not only due to increased regulation by the Chinese government but also as a consequence of Western sanctions should diplomatic relations turn sour.

These unforeseen developments prompted us to reduce our strategic positioning in Chinese assets in 2021 and eventually to remove them altogether from our strategic and tactical asset allocation in early 2022. In hindsight, it was the right decision, especially since we are now presented with broad evidence that China has entered a balance sheet recession. Such a situation is characterised by the private sector prioritising debt minimisation over profit maximisation despite low or zero interest rates, which would normally encourage new borrowing.[1] It typically occurs after the bursting of an asset bubble, which leaves a large number of private sector agents with negative equity (as they carry liabilities on their balance sheets while the assets they have bought using the borrowed funds have collapsed in value). In a balance sheet recession, conventional monetary policy is essentially powerless. As long as the private sector is repairing its balance sheets, the public sector must step in, borrow the private sector's excess savings, and make the necessary investments to avoid potentially devastating deflationary outcomes. In fact, fiscal stimulus becomes a necessity to avoid secular stagnation. However, since 2016, the Chinese government has already run a budget deficit of 9% of GDP to make up for the lack of private sector borrowing and spending. This means that any further fiscal stimulus by the authorities to support the economy in the face of a balance sheet recession will have to come at a time when fiscal deficits are already large, with potentially severe consequences. In addition, China's population is shrinking, the country faces geopolitical tensions with the West, its regulatory environment has become unpredictable, and its economy is increasingly likely to be subject to a 'middle-income trap', i.e. fail to make the transition from a middle-income to a high-income economy. Even if the Chinese authorities were to act quickly and efficiently to address the balance sheet recession, structural issues are a major concern, reinforcing our cautious view on Chinese capital markets.

[1] For a comprehensive overview of the theory of balance sheet recession, see Dr Richard Koo's book 'The Other Half of Macroeconomics and the Fate of Globalisation' (Wiley, 2018).

Key capital market trends

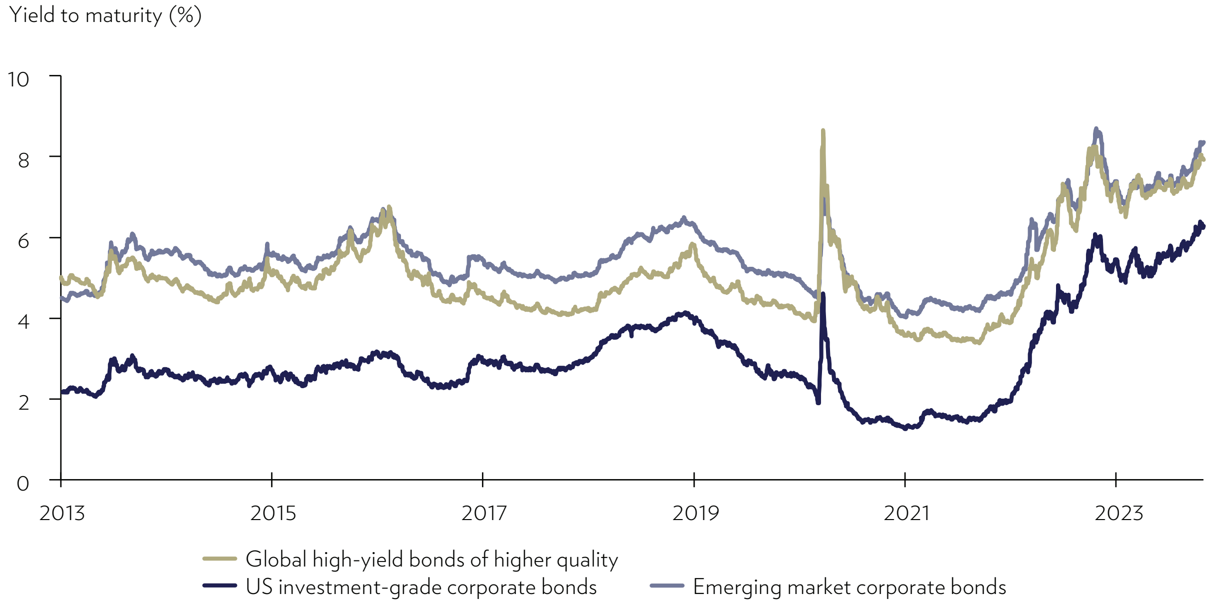
Having identified the prevailing macroeconomic trends, in this chapter we outline the key capital market trends shaping the current decade and the related investment areas we believe are bound to benefit from them.

The return of income investing

With interest rates returning to normal at lightning speed, bonds are no longer priced for confiscation. This opens the way for a revival of income investing, with the currently depressed state of bond markets providing a window of opportunity for the asset class to perform as attractive yields can be locked in.

2022 marked the start of the great reset in the cost of capital. Fast-forward to today, the normalisation of interest rates is well under way, and they are close to long-term averages again. In the post-GFC era, characterised by an abundant capital supply, fixed income investors were increasingly pushed into the riskiest segments of the fixed income market to avoid confiscation of their capital. In fact, as a result of the support measures taken by central banks to stimulate their economies, first in the wake of the GFC and later with the outbreak of Covid-19, the value of negatively yielding debt peaked at over USD 18 trillion globally in December 2020. Since the start of 2023, however, negatively yielding bonds have been diminishing and have by now almost completely disappeared thanks to the abrupt end of the era of free money. Today, for the first time in half a generation, investors can once again lock in and harvest high income streams not only in the speculative but also in the investment-grade segment of the fixed income market. More importantly, they can do so sustainably over longer-term investment horizons. The current investment-grade bond yield environment has become historically attractive

Chart 6: Historically attractive investment-grade bond yield environment



Source: Bank of America, J.P. Morgan, Bloomberg Finance L.P., Julius Baer
Note: The chart is based on the ICE Bank of America Merrill Lynch 1-to-10-Year US Corporate Bond Index, the J.P. Morgan Corporate Emerging Market Bond Index, and the ICE Bank of America Global High Yield (BB) Index and is intended only for illustrative purposes. Data as at 30.09.2023. Past performance and performance forecasts are not reliable indicators of future results. The return may increase or decrease as a result of currency fluctuations.

(see chart 6), with quality segments compensating investors comfortably above expected inflation levels. Admittedly, the combination of inverted yield curves and short-term deposit rates at attractive levels last seen two decades ago is tempting investors to simply ride out the currently volatile period in cash while earning (virtually) risk-free income. The problem is that today's short-term yield levels may not last forever; thus, associated short-term investments carry significant reinvestment risk.

With bonds no longer priced for confiscation, we expect to see a revival in income investing, and for good reason. Income investing is not limited to fixed income, but the currently depressed situation in the bond market strengthens the investment case for this specific asset class. Bond yields are very attractive by historical standards. This remains the case even when taking expected inflation into account. Real bond yields have moved well into positive territory this year, allowing investors to secure high-quality income while protecting their purchasing power. In equity markets, dividends have historically made a significant contribution to total returns when reinvested due to the compounding effect. At the same time, such investments maintain the potential for capital appreciation. Overall, a steady income stream is even more valuable in times of macroeconomic uncertainty. With investors able to find attractive income from both bonds and dividend-paying equities, we expect this investment style to regain popularity this decade.

A steady income stream is even more valuable in times of macroeconomic uncertainty.

‘Store of value’ equity markets

With the return of geopolitical conflicts in a multipolar world, the investment opportunity set has shrunk. Investors should continue to favour real assets over nominal claims in jurisdictions where they are comfortable with the relevant political risk. The desired quality of investments should be found predominantly in ‘store of value’ equity markets, such as the US, Sweden, and Switzerland.

In times when globalisation expands and geopolitical tensions between the world’s largest economies are subdued, investors benefit from not having to pay much attention to international diplomatic disputes when making investment decisions. In such scenarios, the primacy of profit maximisation means that conflicts can reliably be set aside to preserve business interests. However, in a multipolar world characterised by opportunistic manoeuvring on the geopolitical stage, which keeps macroeconomic and financial market volatility high, it is better for investors to focus on capital markets where the playing field is familiar and where the rules of the game are stable.

In this sense, even though we do not see a full-blown deglobalisation with unconditional reshoring and friend-shoring activities coming into play, we reiterate our view that investors should focus on ‘store of value’ equity markets. We use this as an umbrella term for markets in countries where shareholder value is well protected and where there is a strong institutional framework, sound governance, and efficient allocation of capital. Our preferred examples are the US, Sweden, and Switzerland, all of which have an exceptional track record of shareholder value creation. Their respective flagship stock indices have outperformed both global equities and gold, not only over the last 40 years of neoliberalism but also consistently before that, including in the more inflationary and geopolitically intense decades, such as the 1970s and 1980s.

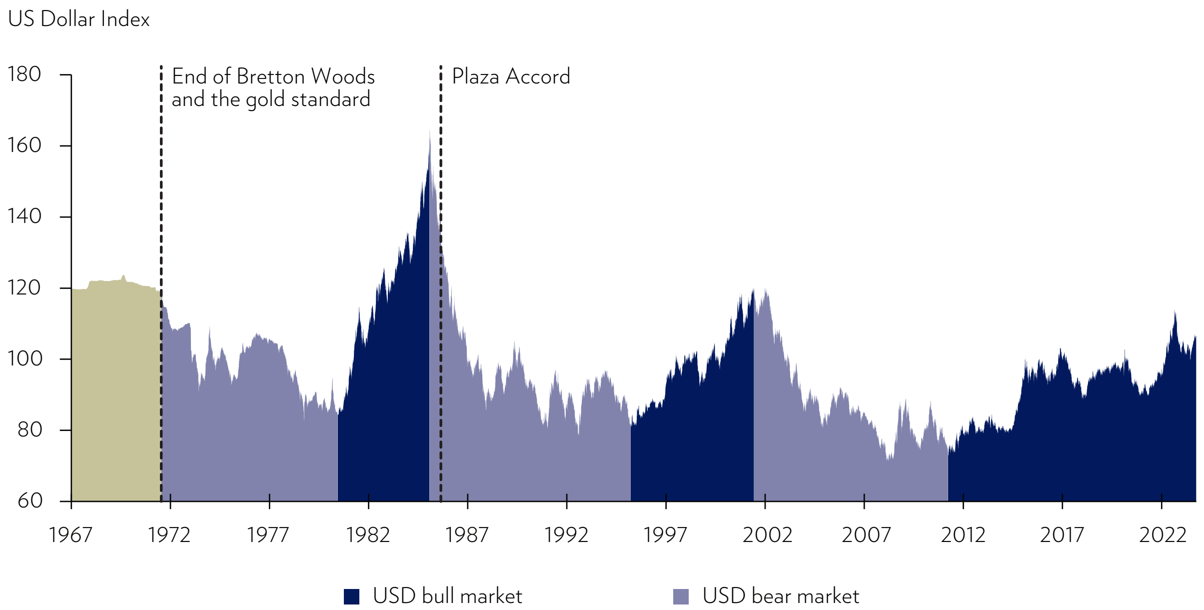
USD capital markets

In the current decade, the typical transition in market leadership from information technology (IT) to commodities – which provides a way to assess whether US assets are to outperform or underperform their global counterparts – is not playing out. The USD bull regime that began in the aftermath of the GFC is still in place, and current evidence points to a continuation of the dominance of USD-denominated assets in global capital markets.

In 1971, President Nixon announced that the US would no longer convert USD into gold or other primary reserve assets, thus ending the Bretton Woods fixed exchange rate system. Since then, we have experienced successive USD secular bear and bull cycles (see chart 7), and it has been particularly important to understand the USD regime and its implications for asset allocation. During USD bull cycles (e.g. 1994–2001 and after the GFC), US assets outperformed rest-of-the-world assets, while during USD bear cycles (e.g. 2002–2008), rest-of-the-world assets outperformed US assets. This sequence has been driven by the unique status enjoyed by the USD as the world's main reserve currency. Most of the global trade in goods and services is conducted in USD, even if to a declining extent. And USD dominance remains pronounced in global foreign exchange markets, where still more than 80% of all transactions are conducted using the greenback.

Following Russia's invasion of Ukraine and the weaponisation of the USD-dependent financial system in retaliation by Western policymakers, the debate has raged over whether the USD could finally lose its status as the world's reserve currency. Such shifts have happened before, and it was in fact only after World War II that the USD achieved its current

Chart 7: The USD regime alternance might be over



Source: Bank of America, J.P. Morgan, Bloomberg Finance L.P., Julius Baer
Note: The US Dollar Index is weighted by trade in USD. Data as at 31.10.2023. Past performance and performance forecasts are not reliable indicators of future results. The return may increase or decrease as a result of currency fluctuations.

status, replacing the British pound. Non-Western governments, particularly China, have recently stepped up their efforts to reduce their vulnerability to the threats posed by the further weaponisation of the global financial system and to break away from it by establishing their own currencies as trade and reserve alternatives. Does such activity signal the end of the USD as the world's dominant currency, heralding a secular USD bear market and the need to diversify away from US assets?

There is little evidence that Western sanctions have had an impact on central banks' reserve currency portfolios. Although the share of the USD has fallen by around 10% since the turn of the century, recent data does not show a significant acceleration in the currency diversification of central bank reserve holdings in response to the weaponisation of finance but rather a stabilisation in the composition. In fact, most of the shift away from the USD in the recent past has been to non-traditional reserve currencies such as the South Korean won, the Norwegian krone, the Canadian dollar, the Australian dollar, and the Singapore dollar, which have offered relatively attractive risk/return profiles – an advantage that is fading as traditional reserve currencies return to positive yields. Beyond attractive return prospects, the US Treasury market remains the go-to place to invest foreign exchange reserves. There is no viable competition in terms of offering the highest-quality, most-liquid debt in large volumes, coupled with a stable regulatory framework and no capital controls. The latter is also applicable to the US equity markets, which are clearly among the default destinations for Western investors looking to deploy capital at scale. Market action points in the same direction. In the current decade, the typical transition from technology to commodity market leadership – another way of looking at USD bull and bear cycles and assessing whether US assets outperform or underperform their rest-of-the-world counterparts – is not playing out, despite the new geopolitical reality since the start of the war in Ukraine. However, the war in Ukraine still carries an important message for global investors, namely that the era of politically risk-free cross-border capital flows came to an end on 24 February 2022.

In the current decade, the typical transition from technology to commodity market leadership is not playing out.

Nasdaq+

The presence of an innovation super cycle has important implications for asset allocation. Historically, accelerated innovation has always led to significant shareholder value creation among leading companies. The big question is where this new market leadership will emerge. Looking at historical precedents, the answer is quick to find: within the US IT sector.

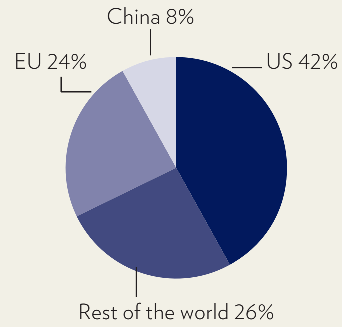
Since the 1980s, every major iteration of technological progress has been driven by US-based companies. Whether it was the proliferation of the personal computer, the dawn of the internet, the advent of the smartphone, the rise of the cloud, or the emergence of generative AI, all technological breakthroughs have been characterised by the dominant or even exclusive leadership of US technology giants. There are good reasons why the US has consistently produced some of the world's most disruptive companies. The country's combination of a strong innovation ecosystem (including top universities and technology hubs), ample access to venture capital, a skilled workforce, a supportive regulatory environment, and a culture of entrepreneurship is hard to match. While the US has, for the fifth year in a row, been among the top three on the Global Innovation Index, it also retains its undisputed lead in research and development spending (31% of global spending in 2020).[2] Admittedly, the competition has caught up over the past two decades, especially China, which has increased its share from 5% to 25%. However, a look at basic research – the bedrock of scientific advances that enable the development of new patents and products – tells a different story. The US dominates with a share of 42%, followed by the European Union (EU) with 24%, while China lags behind with just 8%–9%.

[2] The Global Innovation Index is published by the World Intellectual Property Organization (WIPO), a United Nations agency.

Historically, the Nasdaq has been at the forefront of value creation during major iterations of US-led technological progress. While dominated by the US mega-cap IT names, the stock exchange also attracts growth-oriented, technology-driven companies outside the US. Beyond the Nasdaq, disruptive innovators are selectively also to be found in other domiciles. In China, which we previously believed to be the only market outside the US offering exposure to exponential business models, the domestic leadership has decided to steer its civil society towards the goal of 'common prosperity' and not allow its digital champions to build a dominant competitive position similar to that of the US in recent years.

On that note, in last year's edition of the Secular Outlook brochure, we argued that while the FAANMG[3] have been at the forefront of shareholder value creation over the past decade, it remains to be seen whether the cohort can maintain its previous above-market profitability and hence the supremacy over the US equity market. Stock market performance in 2023 defies the conventional wisdom that the winners of the past decade are unlikely to be the winners of the current decade. In fact, it has been the mega-cap IT companies that have led the S&P 500 higher year to date. Beyond 2023, as alluded to in the previous section, the USD bull regime that began in the aftermath of the GFC is still in place, and current evidence points to a continuation of the bull market in IT. Most of the FAANMG have proven that they are able to successfully transform themselves from growth engines into mature quality companies that can even tap into new growth markets. Those that continue to do so will retain their place in investors' portfolios.

US leads in basic research



Basic research is the bedrock of scientific advances that enable the development of new patents and products.

Source: Organisation for Economic Co-operation and Development, Julius Baer.
Note: Data as at July 2023.

[3] FAANMG: Meta (formerly Facebook), Apple, Amazon, Netflix, Microsoft, and Alphabet (formerly Google).

Key risk factors

The following underlying risk drivers increasingly play a role in investors' portfolios.

Climate risk

The physical risks of climate change are becoming more evident by the day. From rising sea levels to desertification, the consequences are substantial, including the destruction of productive assets, forced migration, and a slowdown in economic growth.

Cyber risk

In an increasingly digitalised and connected world, cybercriminality and ransomware are likely to continue to pose a growing threat to businesses and individuals, as well as to governments and the economy.

Dormant systemic risk

Key systemic risk indicators have to be continuously monitored to assess whether any systemic issues, i.e. ones that threaten the stability of the economic and financial systems, pose a threat to the economic cycle and the overall outlook.

Geopolitical risk

As evidenced by the current wars in Ukraine and the Middle East, geopolitical rivalries have returned with a vengeance in the last few years, extending well beyond a strategic confrontation between the US and China. The new geopolitical landscape is complex and fragile, as countries tend to deviate opportunistically from seemingly strong alliances driven by national interests.

Infrastructure risk

Infrastructure risk lies at the crossroads between climate change and cyber risk. This prompts governments to accelerate their efforts against those threats and pushes infrastructure projects to increase their resilience to them.

Important legal information

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