Julius Bär

SECULAR OUTLOOK

Economic and investment trends

Marketing Material
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Julius Bär

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The end of the peace dividend

Dear Reader,

In the previous edition of our Secular Outlook update, we highlighted that the world economy and capital markets were at a historic inflection point. One major consequence of the global pandemic has been the transition from a world led by neoliberal principles, which is characterised by fiscal conservatism and falling inflation, to a world of state-sponsored capitalism, where expansive fiscal and monetary policies work together to reduce inequalities, ultimately reflating developed economies. 2022 has shown us just how violent and volatile this kind of shift can be given the many curveballs it has thrown at us: a major war in Europe, a global energy crisis, and record-breaking inflation have been accompanied by a synchronised, brutal monetary-policy tightening campaign by global central banks, which has led to the worst bond market sell-off in centuries and an equity bear market. To add insult to injury, China has suffered a marked slowdown, driven by its Covid-19 zero-tolerance policies and continued issues related to its real estate sector. In such a restless environment, it is more challenging than ever to differentiate transitory from structural trends.

Many of the developments this year could indeed be interpreted as signs of new trends kicking in. The geopolitical crisis has raised concerns about further deglobalisation and the break-up of supply chains, possibly fuelling not only higher energy prices for years to come but also a broad-based commodity super cycle. Financial commentators are not only proclaiming the end of the low-inflation era but also the end of near-zero interest rates and ultra-accommodative policies in general. However, as extreme as these short-term developments are, their usefulness for predicting long-term trends remains limited, which is the key takeaway we would like to highlight this year.

On (de)globalisation, for example, we have been highlighting the strategic confrontation between the US and China for years. As the war in Ukraine unfolded and it became clear that energy supply chains needed to be overhauled, at least in Europe, it seemed that a new iron curtain was about to fall, separating those who side with one global superpower or the other. As we delved deeper into that question, we concluded that the world was most probably not turning 'bipolar' but rather 'multipolar'. In the name of national interest, countries have a tendency to deviate from seemingly strong alliances. Overall, historical precedence and real-world constraints speak against a widespread deglobalisation, and any reshoring efforts would likely be driven by strategic national security reasons and the need for increased resilience rather than a dogmatic dismantling of established, efficient supply chains. That said, geopolitical tensions will likely endure, and going forward, as we have seen in the aftermath of Russia's invasion of Ukraine, trade as well as financial markets will be weaponised in geopolitical conflicts, in our view. This constitutes a continued challenge to economies and markets – what we call the 'end of the peace dividend'. For investors, this means an increased need to evaluate their geographical portfolio allocation, not only based on economic fundamentals but also on geopolitical risk and confiscation risk.

What about the end of financial repression? We certainly did not expect the aggressive monetary-policy tightening campaign of the US Federal Reserve (Fed) this year, just as we underestimated the persistence of the current inflation spike. Frankly, the rapid normalisation of short- and long-term rates surprised us more than anything. The question is whether this new high-rates world represents the new normal. In our view, not quite. At the end of the day, we believe the world is too financialised and global debt is too systemic to allow for a continued rise in interest rates. Beyond 2022, the tail will continue to wag the dog (i.e. given the exponential value of financial assets in relation to global gross domestic product, changes in asset prices still disproportionally influence the real economy), and central banks will only be allowed to act in an unconstrained manner in the absence of systemic risk threats.

Let us now turn to the most watched topic of this year, inflation. Following the geopolitical events of 2022, we have adapted our view on long-term inflation. In the previous year's edition of the Secular Outlook, we saw no structural forces warranting a rapid and persistent rise in inflation. We expected economies to gradually reflate as a result of generous fiscal and monetary policies and decreasing inequalities. While we do not believe, as noted above, that global supply chains will be dismantled rapidly, geopolitical frictions should nonetheless exert enough pressure and increase supply volatility to maintain average inflation in the West somewhat above 3%, on average, as opposed to the below 2% that prevailed in the decades prior. Critically, inflation in the new supply-constrained world is the result of policy choices. This is of the utmost importance for investors, who need to work extra hard to prevent the purchasing power of their capital from eroding. In this environment, real assets (e.g. equities) generally outperform nominal claims, such as bonds. That said, the move towards a higher but contained inflation world will not be smooth. Therefore, in the not-too-distant future, even a deflationary spell may appear, which complicates the role of central banks. We expect both inflation and general macroeconomic volatility (including economic activity as well as financial markets) to be much more pronounced as a result of the new geopolitical environment.

This year, we return to the subject of the energy transition. We still maintain the view that even if the race to net-zero may prove to be inflationary at times in the short term, its long-term impact is to increase efficiency and decrease energy costs. Shorter-term price flare-ups, as those seen in 2022, should be cyclically driven in our base case scenario. Currently, Julius Baer commodity analysts expect fuel prices to drop further in 2023. Accordingly, we do not expect a generalised commodity super cycle to materialise this decade – even if some selected key commodities necessary for the energy transition may see upward price pressure for years to come, as supply struggles to catch up with demand.

Finally, this year is exceptional in the sense that, given the derating across asset classes, it provides investors the rare opportunity to (hopefully) profitably reposition their portfolios for the next cycle. This, naturally, gives rise to conversations about the emergence of a new market leadership. The last decade was all about the US technology platforms, known as the FAANMGs[1]. As the business models of these companies mature, it remains to be seen whether they can maintain their previous above-market profitability. For our part, we surmise that new growth champions could emerge from the group of companies that manage to bring the digital revolution into the physical world. After the internet, this is the next step in digital disruptions. The field is quite large, from robotics and automation to supply-chain optimisation, but our preferred theme remains these disruptions in the life-science space, including digital healthcare and biotechnology.

We hope you will enjoy reading this edition of the Secular Outlook, and that you will find it a useful guide for your investment decisions in these turbulent times.

Yours faithfully,

Yves Bonzon
Group Chief Investment Officer
Member of the Executive Board

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

Key secular trends

Every decade is characterised by a different economic and investment environment in which capital markets are shaped by different trends. This results in some asset classes outperforming while others lag behind, and market leadership usually changes from one decade to the next. In this Secular Outlook, we attempt to identify the key trends for the current decade and to determine which asset classes will profit the most from them by 2030.

Historical secular trends

	1960s	1970s	1980s	1990s	2000s	2010s	2020s*
	Bretton Woods		Neoliberal era (Globalisation, Financialisation, Digitalisation)				State-sponsored capitalism
What happened?	Bretton Woods	Floating exchange rates Oil shock The Great inflation	Falling inflation Plaza currency agreement Deng'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 Unorthodox macroeconomic policies The end of the US-dollar regime alternation Energy transition Life-science disruptions
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 FAANMGs USD	'Store of value' equity markets Selected commodities Global TechCare Digital assets**

Source: Julius Baer
Notes: 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; FAANMGs: 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. These jurisdictions are characterised by solid institutions, sound governance, and efficient capital allocation; TechCare = combination of technology and healthcare; * Julius Baer projection; ** Investments in digital assets are exposed to elevated risk of fraud and loss and to price fluctuations.

Secular trends 2020–2029

Macroeconomic and capital-market trends shaping the decade

Multipolarity and strategic reshoring

Depending on their national interests, many countries will choose to opportunistically deviate from either the China or the US alliance. A redesign of supply chains is likely for goods that are critical to national security but not on a broader scale.

Unorthodox macroeconomic policies

In a highly financialised world, unorthodox macroeconomic policies will continue to dominate, including financial repression and fiscal policy inspired by Modern Monetary Theory.

The end of the US-dollar regime alternation

Since the end of the Bretton Woods monetary system and the start of floating exchange rates, we have experienced five decades of successive US-dollar secular bear and bull cycles. This is changing due to the end of neoliberalism and due to geopolitics.

Energy transition

The energy transition, which aims for a shift towards net-zero carbon emissions, is in full swing. However, legacy energy sources will remain important for some time to provide energy security during the transition period.

Life-science disruptions

Reinforced by the digitalisation of healthcare and the rise of data, life science innovations will deeply impact lifestyles and the investment landscape.

Multipolarity and strategic reshoring

Depending on their national interests, many countries will choose to opportunistically deviate from either the China or the US alliance. A redesign of supply chains is likely for goods that are critical to national security, but not on a broader scale.

From the trends that arose out of the embrace of neoliberal policies in the West, the most prominent one is globalisation. The surge in global trade that was first incited by the end of the Cold War, and later boosted by China's accession to the World Trade Organization in 2001, had a tangible impact on most of the global population. While lifting many people out of poverty in developing countries and allowing for huge efficiency gains and cost reductions for corporations, many cite it as the prime reason for growing inequalities and rising populism within the advanced economies. It is thus not a surprise that as the foundations of the neoliberal doctrine begin to crumble, globalisation is the first element that many suggest should be thrown out the window.

While traditional measures of trade openness have been stagnating since the Global Financial Crisis, it was the US's trade war with China, which was initiated in 2018 by former US President Donald Trump, that really propelled the idea of deglobalisation into the mainstream. The thesis of a decoupling bipolar US-China world severing major global trade ties was reinforced as it became clear that the US stance was not going to change with the Biden administration. If anything, the animosity between the two countries has further increased since then. The Democratic administration has not only extended bans on investment in Chinese companies but has also introduced a ban on the exportation of cutting-edge semiconductors and various key technologies to China.

With Russia's invasion of Ukraine, the threat of deglobalisation has never seemed more real. The ongoing war gives us a glimpse of what a dismantling of well-established trade relations could look like. Soaring energy prices have exacerbated the global inflation spike, especially in Europe, where the fear of shortages in the winter continues to grab headlines. While we see ample evidence that these fears are overblown, as of now Europe's energy security has been upended, and it is forced to rethink its whole energy supply chain.

Thus, on its surface, the picture seems pretty dire. Every significant geopolitical event in recent years tells us that we are on a no-return path to the inevitable restructuring of supply chains that were built in the past three decades. Yet we continue to believe that even if global trade is stagnating and geopolitical tensions will likely also continue to send tremors through economies and markets, a full-fledged deglobalisation and decoupling remains unlikely.

There are two reasons for this. First, we believe that despite the two countries' rhetoric and strategic ambitions, the US and China are simply too economically interlinked to allow for an abrupt and broad break in their trade relations. Reading between the lines, we see plenty of signs that neither nation sees this kind of outcome as desirable. The war in Ukraine has presented plenty of opportunities for diplomatic mishaps, yet overall disagreements between the US and China have mostly been focused on trade and economic competition issues, which has allowed them to mainly express their disagreements on the subject in words, not actions.

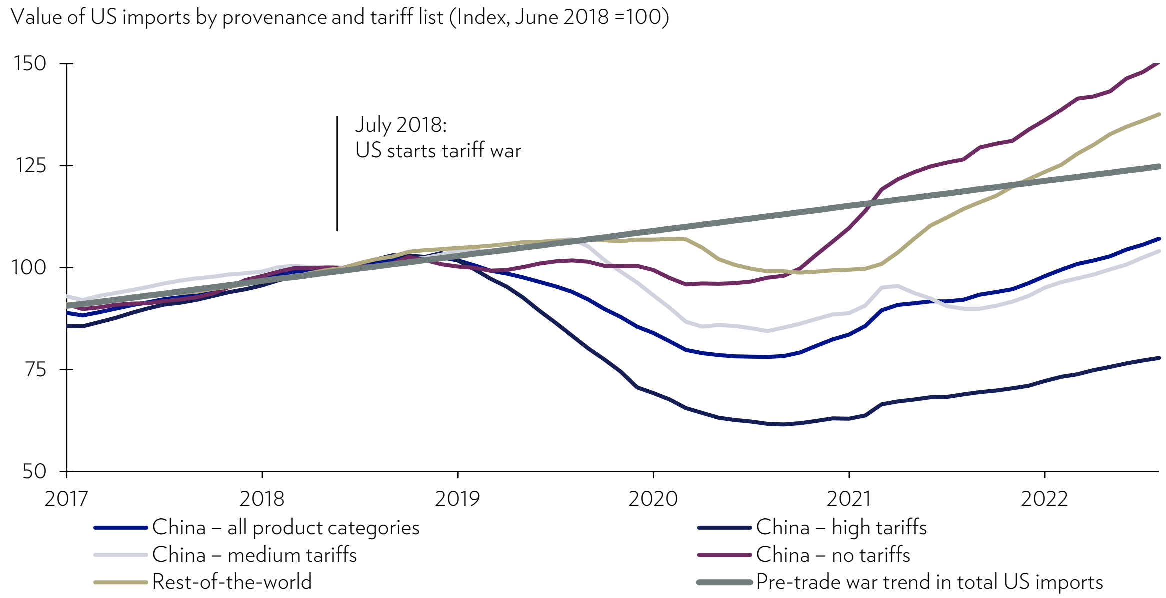
Although the US, as the threatened, reigning global superpower, seems much more resolved to contain China, outside of sanctions and ban lists, its bilateral trade with the country continues to grow, albeit at a slower pace. A recent study by the Peterson Institute for International Economics shows that, in the four years since the start of the trade war, the

Chinese goods hit by high US tariffs have indeed seen a significant decline in terms of US imports. However, those goods that have not been subject to levies have actually surged, increasing by 50% (as compared to US imports from the rest of the world, which increased by only 38%; see chart 1). These include such goods as laptops, smartphones, and video-game consoles. Meanwhile, even imports of some products that were hit with medium-sized tariffs have increased. For example, the import of lithium batteries used in electric vehicles has shot up due to high demand and the absence of a viable (affordable) alternative.

Overall, with international supply chains as intertwined, complex, and mutually profitable as they are today, we believe there is no strong case for China and the US to fully decouple, nor, more generally, for countries to fully reshore (or friend-shore) 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 'the other side's' efforts to succeed. However, goods that are of lesser strategic importance, as well as those where competitive suppliers are scarce, are unlikely to be reshored.

The second reason why we believe that deglobalisation will ultimately be limited is that the world is multipolar, as opposed to bipolar. Until recently, we also subscribed to the bipolar view, but developments this year have made us change our minds. What these developments show is that the unquestioned leadership that was, for instance, exhibited by the US and the Soviet Union during the Cold War is not present today. Today, some countries clearly prioritise their own objectives in favour of habitually adhering to one block or another. The most prominent example this year is India's purchase of discounted Russian oil despite being a usual ally of the West, especially when it comes to opposing China. Contrary to what some people might have expected, the West not only neglected to condemn the country for its self-serving practice, but it even confirmed the legitimacy of its decision. In a similar manner, Saudi Arabia has defied US opposition by agreeing with Russia to support oil prices. It could be argued that these countries are not in the US's core alliance against China – after all, they are not part of

Chart 1: US imports from China diverge depending on trade tariffs



Source: Peterson Institute for International Economics, Julius Baer
Note: Data as at July 2022. The grey trendline is the pre-trade war trend based on US imports from the world – August 2016 to June 2018 (trend based on linear regression).

'the West'. However, even the European Union (EU) has shown a willingness to carve its own path; given its profitable trade ties with China, it is reluctant to take steps similar to those undertaken by the US. While its approach to China is likely to become more cautious, we do not expect the EU to back the US one-to-one on their rivalry with China, especially as the US itself is prioritising its own economy (e.g. by subsidising their green energy industry, to the dismay of European colleagues).

A multipolar world order is fertile ground for geopolitical mishaps, as the higher the number of actors there are with their own national interests, the harder it is to predict other players' moves. This lies at the basis of our view that overall geopolitical risk will rise. However, this is also an environment where beneficial diplomatic and trade relations are harder to stamp out and one that speaks for a slowdown in global trade, rather than its outright decline.

Investment implications of the 'end of the peace dividend'

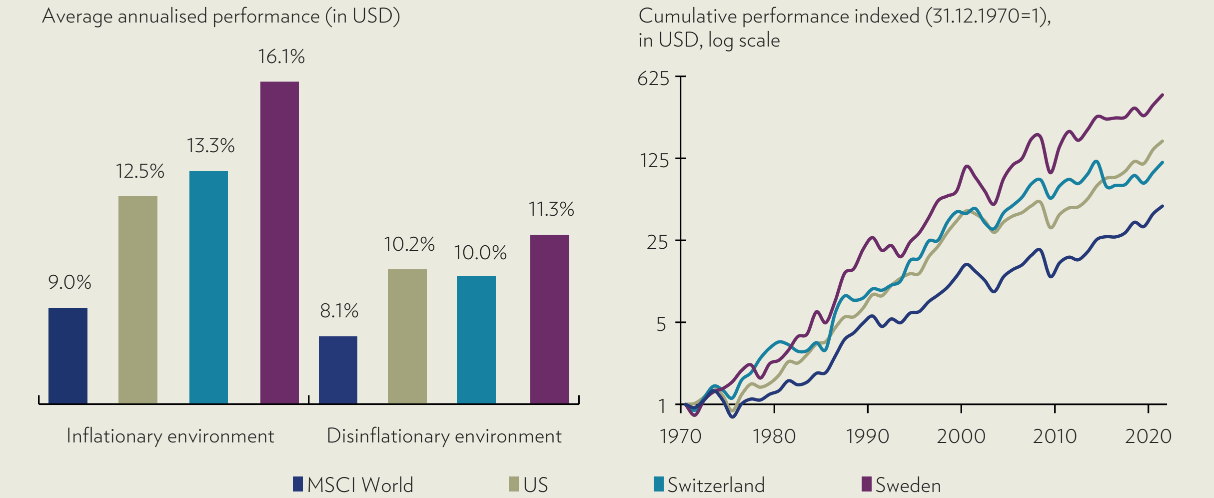
When globalisation is expanding and geopolitical tensions among the world's largest economies are subdued, investors benefit from not having to devote much attention to international diplomatic spats when making investment decisions. In such a scenario, the primacy of profit maximisation means that conflicts can reliably be put aside in order to preserve business interests. However, in the current environment, as the weight of geopolitical and economic priorities gets recalibrated, this tailwind is decreasing.

China's shift to 'common prosperity' and its crackdown on digital platforms, especially those vulnerable to US regulations, have permanently impaired the value of some of the country's market leaders. More recently, the sanctions imposed on Russia have exposed the risk that investors face by investing in markets that may be subject to financial warfare. These developments prompted us to reverse our decision to promote China to core-asset-class status.

Similarly, investors who could previously invest globally without much concern for international regulatory and confiscation risk will need to think harder about the consequences of geographical exposure. Depending on their preferences and risk tolerance, they might be exposed to the risk that their investment could essentially be marked down to zero if the wrong geopolitical elements collide.

More broadly, we believe the increase of these risks makes a strong case in the years to come for what we call 'store-of-value' equity markets. These are located in jurisdictions where property rights and shareholder value are well protected and are characterised by solid institutions, sound governance, and efficient capital allocation. Our preferred examples are the US, Sweden, and Switzerland. Their respective equity markets have actually outperformed global equities in the past five decades, both in more inflationary and geopolitically charged times, as well as in periods of low inflation.

Chart 2: 'Store-of-value' equities have outperformed global markets



Source: Bloomberg Finance L.P., Thomson Reuters Datastream, O. Jordà, M. Schularick, and A.M. Taylor (2017). Macrofinancial History and the New Business Cycle Facts. In NBER Macroeconomics Annual 2016, volume 31. O. Jordà, K. Knoll, D. Kuvshinov, M. Schularick, and A.M. Taylor (2019). The Rate of Return on Everything, 1870–2015. In Quarterly Journal of Economics, volume 134.
Notes: Based on annual data. The inflationary environment comprises the period 1970–1990. The disinflationary environment comprises the period 1990–2021. Past performance and forecasts are not reliable indicators of future results. The return may increase or decrease as a result of currency fluctuations.

Unorthodox macroeconomic policies

In a highly financialised world, unorthodox macroeconomic policies will continue to dominate, including financial repression and fiscal policy inspired by Modern Monetary Theory.

Just like us, monetary authorities initially did not expect the 2021–2022 inflation spike to be as strong, and certainly not as persistent, as it turned out to be. On one hand, supply-chain difficulties related to the global pandemic did not dissipate as quickly as expected. China's continued zero-Covid-19 policy contributed to that, while Russia's invasion of Ukraine added fuel to the fire by jacking up energy prices and taking the inflation problem to the next level. On the other hand, in the US, demand turned out to be exceptionally resilient. Once again, Covid-19 and its aftermath are most likely to 'blame' here. The generous US government stimulus meant to compensate for income losses from the lockdowns was most likely more than enough to provide households with a buffer well beyond the reopening of the economy. Additionally, a structural shift in the labour market significantly shrunk the US labour force. A wave of early retirements and a drop in the immigrant workforce coincided with a shortage of workers in the lower-paying industries that were hit by the pandemic, which provided a nice boost in wages for the group.

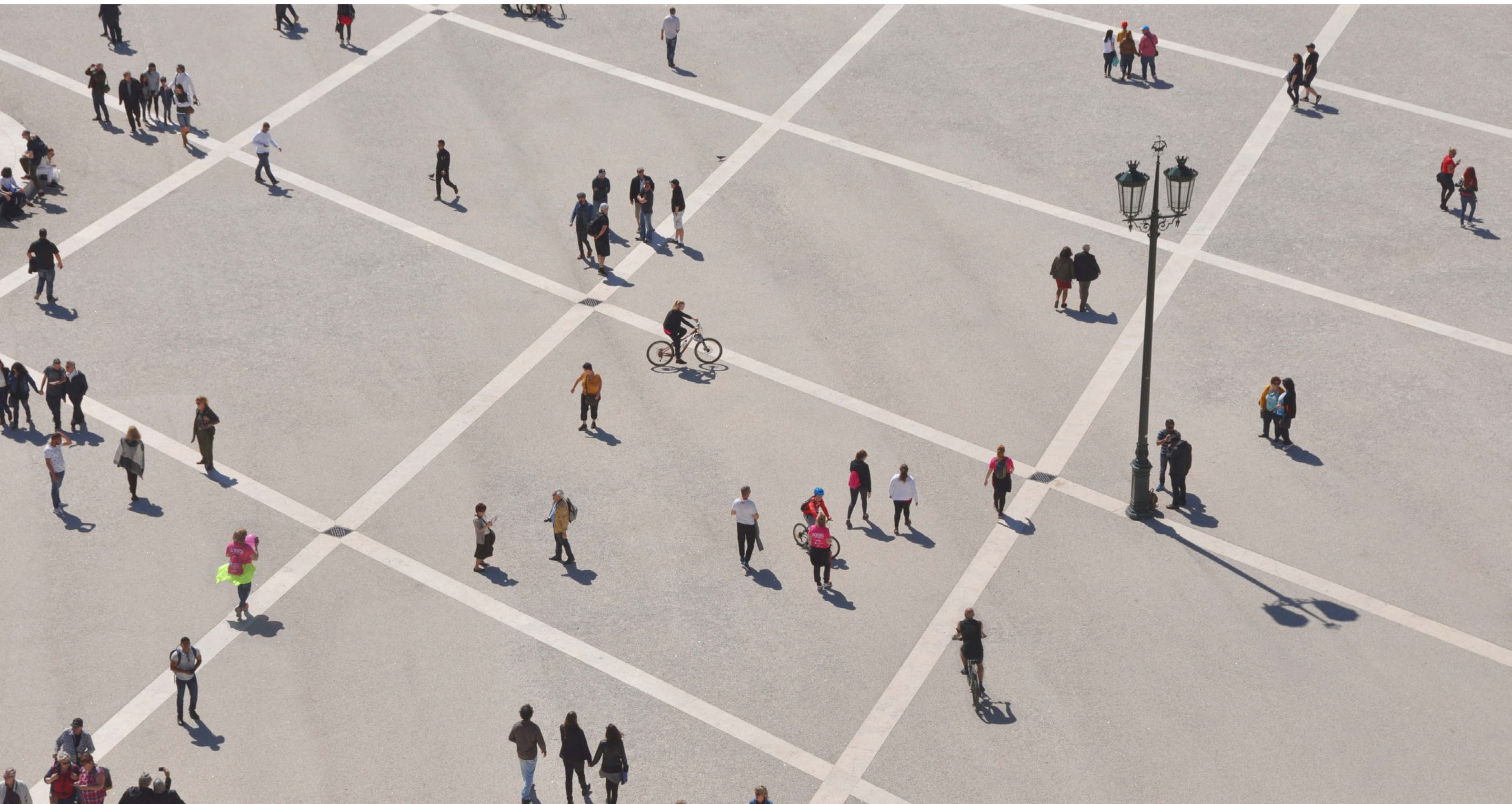
The result of this toxic inflationary mix was the 180-degree pivot from dovish to hawkish by the Fed and the most violent hiking campaign of the federal funds target rate on record. The central bank proceeded with several 50 and 75 basis-point rate hikes, restarted its quantitative tightening experiment, and repositioned itself as an inflation fighter, rather than the 'perma-dove' it had channelled just 12 months prior. At the same time, US fiscal policy, despite making a lot of noise with catchy-sounding bill names (e.g. 'Build Back Better' and 'Inflation Reduction Act'), is expected to be one of the largest drags on gross domestic product in the next couple of years. These programmes are projected to be, at best, fiscally neutral.

This stark shift in the policy landscape is confronting investors with an important question: "Is this the end of unorthodox policies and financial repression?" With the US 10-year Treasury yield having breached the 4% threshold in late September and short-term rates expected at around 5% next spring, it certainly would not be a stretch to say that we are done with zero-to-negative interest rates, quantitative easing, and Modern Monetary Theory (MMT)-inspired policies.

As with other apparent big shifts this year, we prefer to take such predictions with a pinch of salt. Simply stated, many of the trends that led us to declare the new era of state-sponsored capitalism are still well in play. Crucially, we maintain the view that the 'tail is wagging the dog', i.e. given the exponential value of financial assets in relation to global gross domestic product, changes in asset prices still disproportionally influence the real economy. 2022 tried its best to make us believe the opposite – after all, despite the sharpest drop in liquidity supply in decades, the US economy, though predictably slowing, manages to stay remarkably on course thanks to the changes on the labour market described above. At one point, though, if the Fed continues to blindly tighten, something will break, and this breakage will likely constrain its tightening intentions substantially. We saw a similar scenario play out in the UK, as the Bank of England reopened the asset purchase taps in order to rescue the British pension fund market. Since then, the turmoil has calmed down, but one could imagine a situation in which the financial disruption is much greater. Another example lies in the crypto space, where the liquidity crunch did, in fact, cause something of a Lehman-style meltdown in the digital-asset ecosystem. Luckily, this ecosystem is too isolated from the broad market and is small enough to be contained within its own sphere.

Overall, the sheer volume of financial assets and global debt would not allow for a continuous rise in interest rates and yields, as its potential to cause systemic problems is too high. Actually, the best tools for eroding the global debt burden while avoiding a disorderly collapse of debt are low interest rates combined with a healthy (meaning higher, but contained, i.e. between 3% and 4%) dose of inflation.

Looking at the outlook for fiscal policy, advanced economies continue to suffer from record inequalities, ageing demographics, and stagnating economies, and there is still tremendous pressure on governments to alleviate these problems. Moreover, government support is essential for countries to have any hope of reshoring key industries or succeeding in their ambition to achieve net-zero carbon emissions. The fiscal wave might have rolled over for now, but we see this changing throughout the decade, as we get to know the true meaning of 'state-sponsored capitalism'. In five years' time, we might be surprised at just how large the monetary and fiscal policy toolbox has become, as policymakers harness their full potential (including the lessons learned from over a decade of unconventional policymaking) to deal with higher structural inflation and elevated macroeconomic volatility in a highly financialised world (see 'Asset allocation in a 3%+ inflation world' on p. 15).



The end of the US-dollar regime alternation

Since the end of the Bretton Woods monetary system in the early 1970s and the start of floating exchange rates, we have experienced five decades of successive US-dollar secular bear and bull cycles. This is changing due to the end of neoliberalism and shifting geopolitics.

Understanding the implications of the US-dollar regime has actually been the most important asset allocation input, tightly linked to the investment trend dominating markets in each decade. During secular US-dollar bull markets, US assets have outperformed the rest of the world, and during secular bear trends, the rest of the world has outperformed US assets. Since 2011, we have experienced a US-dollar secular bull market again. This sequence has been driven by the unique status enjoyed by the greenback as the world's main reserve currency. Most of the global trade in goods and services has been, and still is to a large but declining extent, conducted in US dollars.

Today, the rise of China is changing this dynamic in multiple ways. China is intent on breaking free from the dollar-dominated system and establishing the CNY (or the e-CNY) as a stable global reserve currency. The Russian invasion of Ukraine and Western sanctions imposed on the aggressor will further accelerate this effort. Already today, discount Russian oil bought by China is paid in renminbi. The freezing of Russian companies' assets and the Russian central bank's foreign-exchange reserves, combined with the curtailment of Russian access to the SWIFT payment system, is the first time in history that the global financial system and the US dollar have been weaponised against a major economic power. It would be hard to overstate the geopolitical, economic, and financial ramifications, as this incident is tantamount to the end of the peace dividend that has contributed to the rising prosperity of the global economy over the past three decades. Indeed, financial markets are no longer immune to geopolitical affairs, and financial warfare means that potential international diversification benefits give way to confiscation risk.

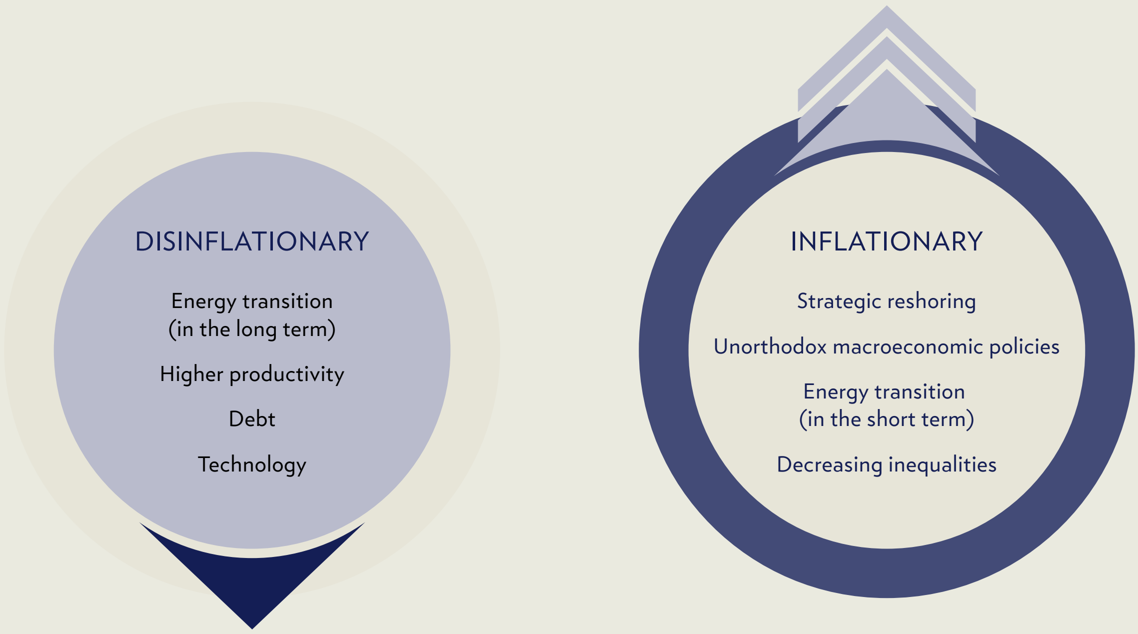
Furthermore, unorthodox macroeconomic policies, including those inspired by MMT, where recurring public deficits are monetised by the central bank, are still very much on the US policy agenda. Yet nowadays, all major advanced economies are doing the exact same thing to various degrees. Accordingly, in a higher inflation world, the US dollar is not expected to debase against other paper currencies but rather against real assets: equities, gold, and real estate, in that order.

Asset allocation in a 3%+ inflation world

In the new geopolitical landscape, we expect structural inflationary pressures to be more balanced. While all of the forces presented in chart 3 below were present well before the breakout of the war in Ukraine in February 2022, it was this conflict that signalled the end of the 'supply-abundance' era. In the four decades of neoliberal orthodoxy, expanding globalisation meant that price pressures from supply shortages were virtually non-existent. Today, supply scarcity is much more likely to occur, creating other inflation incidents like the one we are currently experiencing. This does not mean that inflation will stay nearly as high as it is today, but, on average, we expect long-term US inflation to settle somewhere above 3%, well over the last two decades' high point of 2%. Moreover, the unpredictable nature of supply issues and the increasing importance of political factors is likely to make inflation, and other key macroeconomic variables, much more volatile. Hence, we could be as likely to face inflation spikes in the future as we are to witness deflationary episodes. Moreover, an increase in algorithmic trading would likely only amplify the macroeconomic uncertainty, making rapid and violent price moves much more frequent.

If the primary goal of investing is to preserve wealth, then inflation is a portfolio's worst enemy. How can a portfolio be protected from inflation erosion? The first line of defence is investing in real assets. Usually this refers to physical goods, such as commodities, including gold, as well as real estate. However, it is often forgotten that equities, which give investors ownership of a real-life business, are also real claims. In the long run, and when average inflation is higher but subdued (as expected in our base-case scenario), equities outperform. Commodities are

Chart 3: The structural forces behind inflation



Source: Julius Baer CIO Office

too volatile to form a solid backbone for the typical investment portfolio and work only when inflation is exceptionally high and rising. Purely financial assets, such as bonds, have historically provided limited protection against inflation. They remain a crucial portfolio building block, be it for downside protection or for return-enhancing carry. Following the historical bond market sell-off of 2022, bonds are once more priced for attractive returns in the short-to-medium term.

What is the best way to deal with higher volatility? The short answer is that investors are going to have to learn to live with it. Fighting against volatility by attempting to stamp it out completely would most likely turn out to be counterproductive, as volatility also goes hand in hand with returns. However, there are ways to extract the most from it. First, portfolios could be positioned to be able to profit from both inflationary and deflationary spells. For example, this could be achieved through the right balance of equity styles. Second, investors could take a tactical approach by investing in assets that would profit the most from higher or lower inflation, depending on the market situation. Inflation-linked bonds would work well in an environment where inflation is expected to accelerate. The same goes for equity markets that are exposed to commodities. If expected inflation is on a downward trajectory, US Treasuries and defensive equities should typically outperform.

"What is the best way to deal with higher volatility? The short answer is that investors are going to have to learn to live with it."

Yves Bonzon
Group Chief Investment Officer

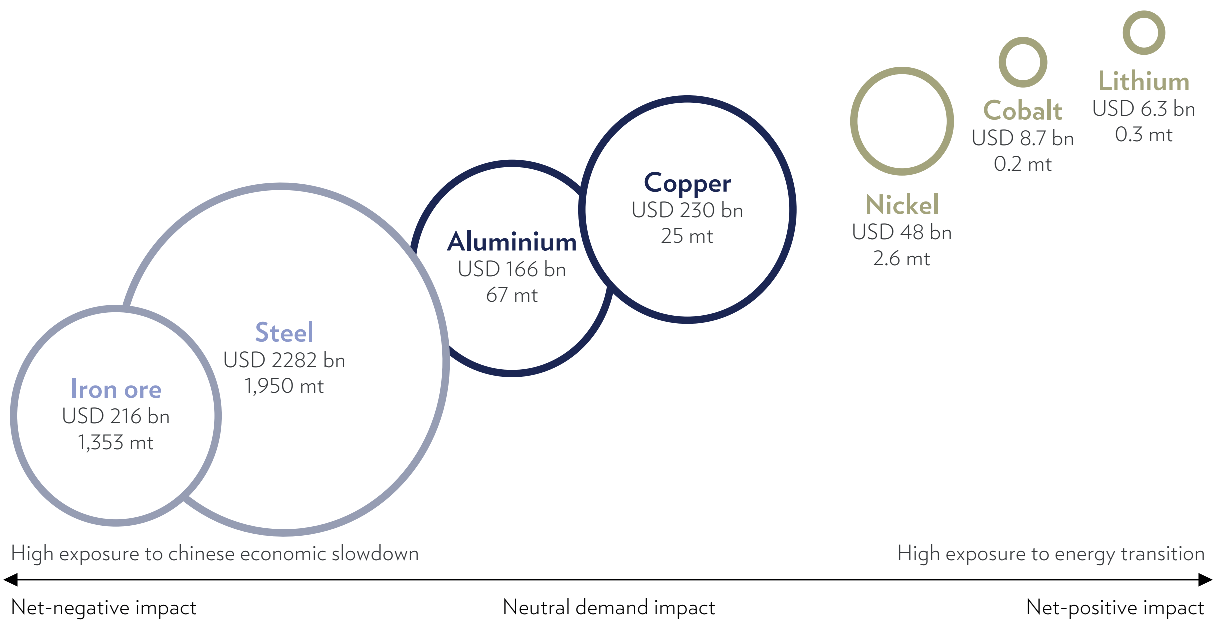
Energy transition

The energy transition, which aims for a shift towards net-zero carbon emissions, is in full swing. However, legacy energy sources will remain important for some time to provide energy security during the transition period.

This year has put global markets to the test, to say the least. Continued global supply-chain disruptions, a war in Ukraine, and an unfortunate maintenance schedule for nuclear power plants in France has unsurprisingly proved to be an explosive mix for global energy prices. Additionally, various media outlets, alongside a great number of financial analysts, did not hold back in predicting a freezing Europe this winter, sending investors into panic mode. Critics of green and renewable energies were quick to find a scapegoat for this accumulation of mishaps: the ongoing energy transition. Is the world's shift towards net-zero carbon emissions and the subsequent decrease in investments into fossil fuels really to blame for this year's energy price rollercoaster? The short answer is no. The longer answer, however, is not as black and white.

One year ago, in the prior edition of this publication, we explicitly stated that the global shift to more sustainable energy sources would not be a smooth journey and that the first bumps in the road were already noticeable. Twelve months later, it has become clear that we might have underestimated the emerging challenges and that some of these bumps in the road have turned out to be potentially car-wrecking potholes. The war in Ukraine has demonstrated how dependent Western Europe still is on imported Russian and nuclear energy. Despite significant

Chart 4: Industrial metals exposure to structural trends



Source: International Aluminium Institute, International Copper Study Group, International Nickel Study Group, United States Geological Survey, Julius Baer

Notes: Bubble sizes show market size; volumes and values based on 2021 production and average annual prices. The vertical position of the bubbles also illustrates the demand impact. A higher position indicates higher demand, a lower position lower demand. Mt = metric tonnes; bn = billions investments into renewable energy sources in the past few years, the system was not yet ready to entirely absorb the shock of being cut off from Russian supplies, which raises concerns about energy security and energy affordability going forward.

This is the first time in history that we are not adding new energy sources but are rather trying to replace existing ones. The challenge here is that the legacy energy-supply machine has to keep running and continue to be maintained while the new system is being built. This has two major implications for the unfolding decade. First, the energy transition will be inflationary in the short term. Transitioning the whole system – from households to transportation to heavy industry – towards net-zero carbon emissions will require massive investments, from the private as well as the public sector. In a decade that will be dominated by the increasing cost of capital, this will inevitably push prices upwards. However, it is important to mention that extreme price flare-ups like the ones we have seen this year are cyclical and will eventually revert towards their mean. In the long term, we still believe that technological advancements in this space will increase productivity enough to provide abundant energy at cheaper prices and thus be disinflationary. Second, we will not become independent of fossil fuels in the 2020s. The legacy energy sources will continue to play a role in the coming years, especially as a shock absorber when clean energy is unable to handle the stress caused by demand outstripping supply in the system.

While the energy transition is in full swing and the adoption of clean-energy sources in society is well underway, it will take significantly longer for heavy industry, for example, to become independent from highly carbon-intensive commodities and be able to rely on clean-energy sources entirely.

Increasing geopolitical uncertainty, short-term inflationary pressures, and continued reliability on fossil fuels could imply that we are entering a new commodity super cycle. Whether or not this is the case is of utmost importance, as, historically, decades have been characterised by the market leadership of either information technology or oil and raw materials. The thesis of a commodity super cycle is tempting in view of the slow dissolution of supply-chain bottlenecks and the ongoing energy transition. However, we believe it is impossible to witness such a

Commodity super cycle explained

With inflation still on top of investors' minds and commodity prices reaching multi-year highs earlier this year, before somewhat retreating again, the debate on whether the global economy will enter a so-called commodity super cycle continues to be held intensively. However, what exactly is a commodity super cycle?

The most common definition states that a commodity super cycle comprises a sustained, multi-year uptick in commodity prices, driven by a sustained structural imbalance in demand and supply. As supply fails to meet demand over a prolonged period of time, commodity prices are allowed to rise significantly above their long-term trends.

Historically, commodity super cycles are a relatively rare phenomenon, as they tend to arise only from radical changes in the global supply-demand balance in commodities. Over the course of the last century, the global economy has been subject to four such cycles. The first emerged after US industrialisation gathered pace shortly before we entered the 20th century. The second started in the 1930s amid the widespread adoption of the motor car and sustained demand for armaments in light of the looming Second World War. The third emerged in the late 1960s and was strongly accelerated in the 1970s amid two consecutive oil shocks. The fourth and most recent one kicked off shortly after the turn of the millennium, when China entered the World Trade Organization (WTO).

broad-scale super cycle without an accompanying oil super cycle. Nonetheless, we do not see a strong case for the latter, as supplies are constrained politically rather than structurally, and as imminent structural demand headwinds will arise, especially from China.

It is important to note that this unlikeliness of a broader commodity super cycle does not mean that certain commodities will not experience a period of elevated prices during this decade. Looking at industrial metals, for example, there are two opposing structural trends at work influencing demand. China's demographics and its economic transition towards slower growth act as a negative price pressure, while the growth of clean technologies has a positive influence. One metal that deserves more attention in that regard is copper. Despite China slowly moving from boosting to breaking copper demand (Chinese copper demand is expected to peak in 2030), the energy transition will be its single strongest driver until the middle of the century, which will lead to a continuously growing global copper consumption. Looking at the supply side, we expect to see a significant slowdown in mine-supply growth from the middle of the decade before an acceleration of scrap supplies due to a faster recycling cycle for electric-vehicle batteries will finally be able to offset this gap. All in all, this temporary imbalance between growing demand and simultaneously declining supply leads to a very strong structural outlook for copper in the coming decade, which should push prices from today's level of around USD 8,350 back to above USD 10,000 per tonne, and potentially beyond in the longer term. Copper thus joins the energy-transition-driven battery-metals super cycle (including nickel, cobalt, and lithium). That said, prices are still susceptible to short- and medium-term swings, reflecting a mix of the market mood and the cyclical economic environment.

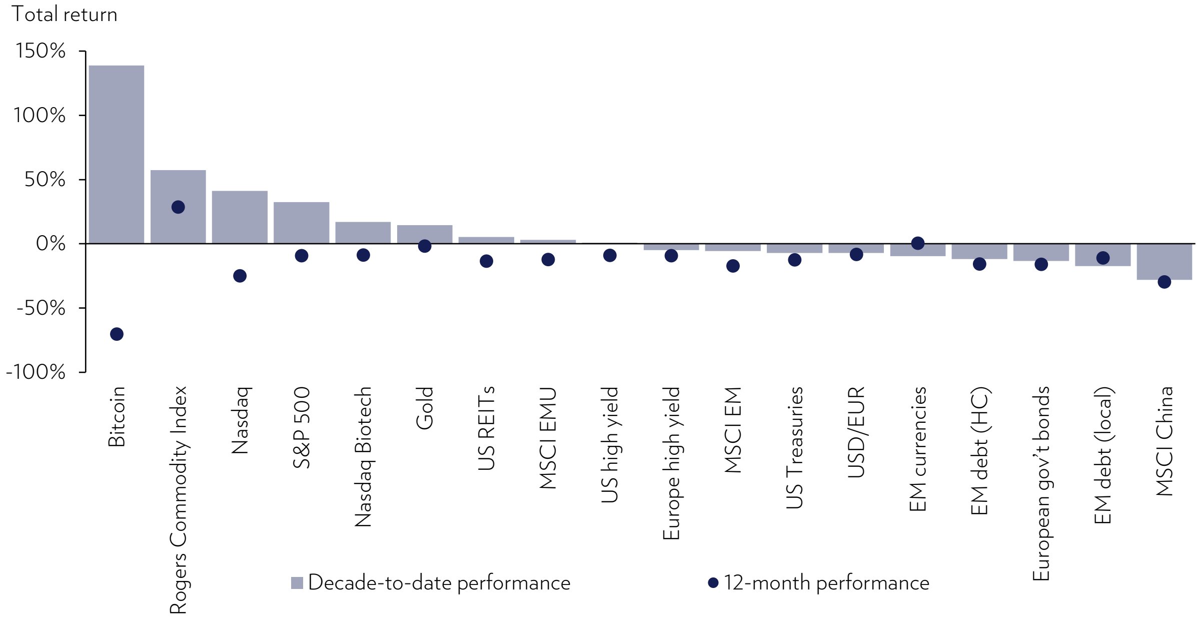
Life-science disruptions

Reinforced by the digitalisation of healthcare and the rise of data, life-science innovations will deeply impact lifestyles and the investment landscape.

Apart from defining the prevailing macroeconomic trends, our yearly Secular Outlook also seeks to identify the market leaders of the unfolding decade. If historical evidence is anything to go by, the winners of the past decade are unlikely to be the winners of the current decade. While the FAANMGs have been at the forefront of shareholder value creation over the past years of secular disinflation, we are starting to see a gradual shift, which marks the end of the FAANMG supremacy over the US equity market. This raises two major questions. What role will the FAANMGs play in investors' portfolios going forward, and what companies will take over the market leadership?

The business models of some of these companies are under serious pressure and raise questions about their future viability as we enter the next phase of the information age. The FAANMGs urgently need to focus on spiralling costs in order to maintain their relevance as building blocks in portfolios. While some members of the group are unlikely to be able to reverse the current negative profitability trend, others will probably succeed in transforming themselves from growth engines into mature quality companies. Those that successfully manage this transition will continue to have their place in investors' portfolios.

Chart 5: The Secular Outlook asset class scorecard



Source: Bloomberg Finance L.P., Julius Baer
Notes: Data as at 30.11.2022. The chart shows data from January 2020 to November 2022 to highlight relevant events. EMU = European Monetary and Economic Union; REITs = real estate investment trusts; EM = emerging markets; HC = hard currency. Government (gov't) bonds – performances are given in USD; US Treasuries exclude Treasury bills; EM debt (HC) includes both sovereign and corporate bonds; EM debt (local) includes only sovereign bonds; EM currency returns include carry returns from a buy and hold carry (equal weight) trade position in eight emerging market currencies fully funded with short positions in US dollars. Past performance and performance forecasts are not reliable indicators of future results. The return may increase or decrease as a result of currency fluctuations.

In the past decade, breakthrough innovations have revolved around the digital world and the manipulation of digits therein, paving the way for the rise of highly competitive companies that have business models centred around e-commerce, social media, online streaming, and cloud computing. We believe that the innovation focus will now move from the digital to the physical world. This will result in a broad spectrum of emerging investment themes, including the shrinkage of factories and the atrophy of supply chains, the spread of robotics and automation, alternative energy and transport platforms, disintermediation facilitated by the blockchain technology, disruptions in the life-science space as technology and healthcare merge, as well as applications to improve energy and resource efficiency. Granted, 2022 was a tough year for equity investments in emerging growth themes. However, we believe that while growth prospects have been reassessed and repriced accordingly, the underlying long-term trends remain firmly in place.

One area that we specifically like and consider to be ripe for disruptive innovation is life sciences. We have been advocating this for several years now, since we see life sciences as a major driving force underpinning the future of healthcare. Specifically, the surge in health data constitutes a key aspect of the transformation in the life-science space. With the desire to keep costs low, reduce inefficiencies, improve access, and make medicine more personalised for each and every patient, healthcare professionals and governments around the world are increasingly turning to technology as a means of addressing some of the 21st-century challenges facing the industry. As far as the experience of patients and consumers is concerned, digital-health technologies have proven their worth in terms of convenience and affordability during the Covid-19 crisis. The pandemic has not only accelerated the digital transformation of the healthcare industry but has also further reinforced the growing acceptance of digital technologies among care providers and their recipients. The heightened interest in digital technologies can be evidenced by the growing volume of fund inflows into the sector in recent years. In particular, 2021 was the year when digital-health funding activity unquestionably took off in the world, especially across the United States. While we expect funding to ebb in the short term in light of stellar performance in 2021 and due to the current market environment, digital-health technologies should still garner attention over the longer term due to their vast potential to enhance the delivery of care to individuals.

Going beyond digital healthcare, life sciences as a growing field of study will become ever more important in tackling some of the major health challenges facing humankind. As a case in point: cancer immunotherapy is emerging as one of the most promising treatments against the illness, potentially paving the way towards the availability of a more precise, personalised treatment for the nearly 20 million people worldwide who are diagnosed with the medical condition every year. The greater adoption of digital-health technologies and other innovative solutions, such as gene-based therapies, could strengthen our resistance to present as well as future health threats and ease the pressure on current healthcare systems.

Digital asset check-in

Talking about disrupting technologies and potentially outperforming asset classes, we should take the opportunity for a short update on blockchain technology and digital assets[1] at this point. Granted, this year the word outperformance and digital assets were hardly ever heard in the same sentence. Nonetheless, we continue to take a constructive but cautious approach to the crypto space. Constructive because the innovation potential of blockchain (and decentralised ledger technology) is considerable. Cautious because we are aware that these assets are ultra-sensitive to liquidity, as the downturn in the first half of 2022 impressively demonstrated. After the recent turmoil, the industry is set to evolve towards greater regulation and convergence with the centralised financial system, in which many business models will have to adapt to the digitalisation of assets.

[1] Investments in digital assets are exposed to elevated risk of fraud and loss and to price fluctuations.

Key risk factors

Underlying risk drivers that increasingly play a role in investors' portfolios

Climate change

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.

Rise in cyber risk

In an increasingly digitalised and connected world, cybercriminality and ransomware will continue to pose an increasing threat to businesses and individuals, as well as governments and the economy.

Infrastructure risk

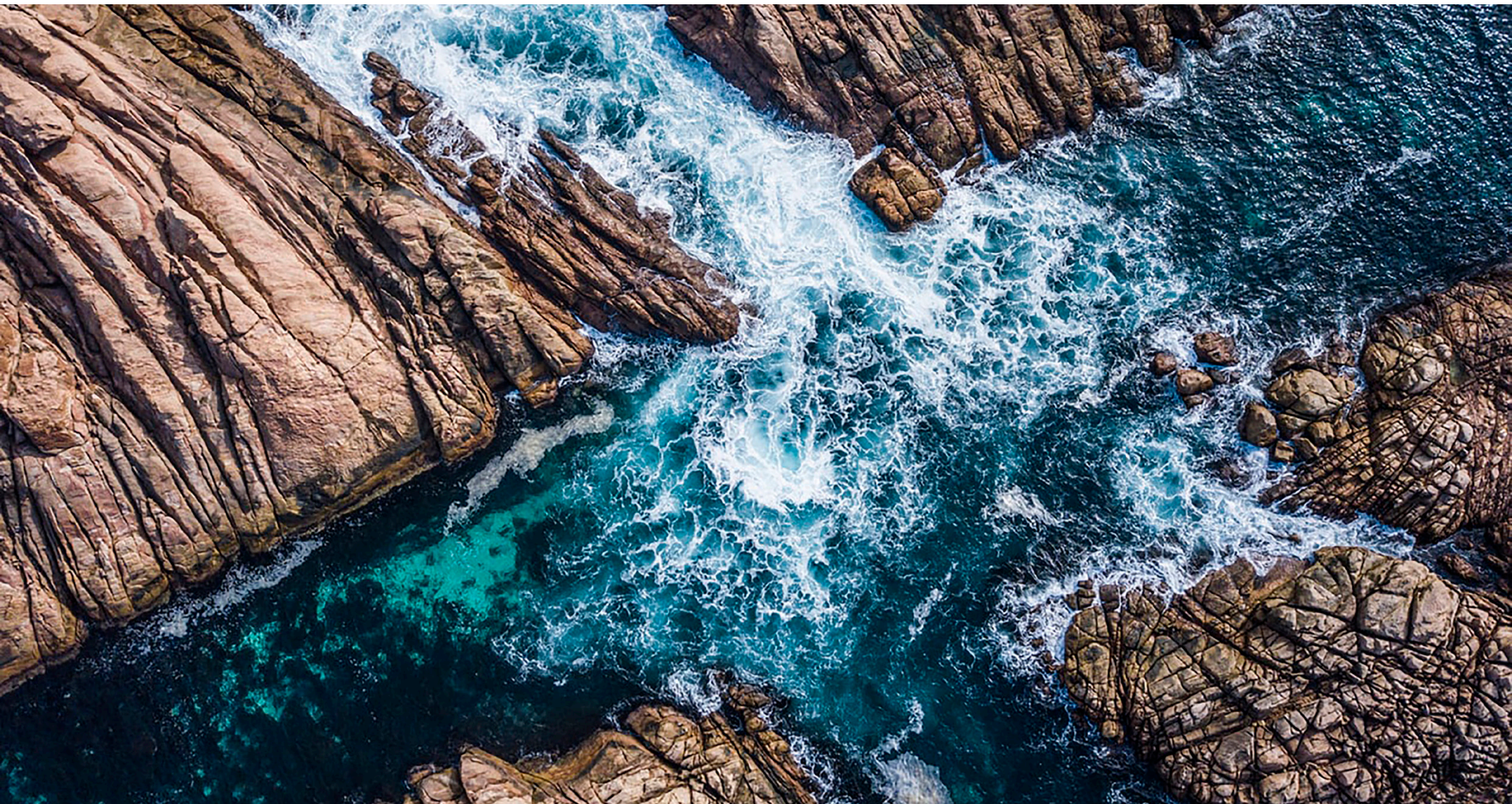
Infrastructure risk lies at the crossroads between climate change and cyber risk. This prompts governments to accelerate their efforts against those threats and also pushes infrastructure projects to become resilient to them.

Sino-US decoupling

The strategic confrontation between the US and China continues. With every new trade-war development and diplomatic escalation, the prospects for the economic cycle and financial markets will be challenged.

Dormant systemic risk

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



Appendix

Table 1: Performance over the last five years

Asset class	YTD	2021	2020	2019	2018
Bitcoin	-63.1%	59.8%	305.1%	94.8%	-73.8%
Nasdaq	-25.7%	27.5%	48.9%	39.5%	0.0%
S&P 500	-13.1%	28.7%	18.4%	31.5%	-4.4%
Rogers Commodity Index	20.7%	41.1%	-7.7%	11.9%	-9.2%
Gold	-4.5%	-3.5%	24.4%	18.9%	-2.1%
Nasdaq Biotech	-7.4%	0.0%	26.4%	25.1%	-8.9%
US REITs	-20.4%	43.1%	-7.5%	25.9%	-4.5%
US high yield	-10.6%	5.3%	7.1%	14.3%	-2.1%
MSCI EMU	-17.1%	14.3%	8.7%	24.4%	-16.2%
European high yield	-10.0%	3.4%	2.3%	11.3%	-3.8%
US Treasuries	-12.0%	-2.3%	8.0%	6.9%	0.9%
MSCI Emerging Markets	-18.7%	-2.3%	18.8%	18.8%	-14.3%
EM debt (hard currencies)	-16.1%	-1.8%	6.9%	13.5%	-2.2%
European government bonds	-14.5%	-3.5%	5.0%	6.8%	1.0%
EM currencies	-2.0%	-5.0%	-2.8%	3.4%	-6.4%
USD/EUR	-8.5%	-6.9%	8.9%	-2.2%	-4.5%
EM debt (local currencies)	-12.0%	-9.2%	3.5%	10.1%	-6.9%
MSCI China	-27.1%	-22.6%	27.6%	21.3%	-20.2%

Source: Bloomberg Finance L.P., Julius Baer
Notes: Data as at 30.11.2022. EMU = European Monetary and Economic Union; REITs = real estate investment trusts; EM = emerging markets; HC = hard currency. Government (gov't) bonds – performances are given in USD; US Treasuries exclude Treasury bills; EM debt (HC) includes both sovereign and corporate bonds; EM debt (local) includes only sovereign bonds; EM currency returns include carry returns from a buy and hold carry (equal weight) trade position in eight emerging market currencies fully funded with short positions in US dollars. Past performance and performance forecasts are not reliable indicators of future results. The return may increase or decrease as a result of currency fluctuations.

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