Julius Bär

SECULAR OUTLOOK 2020–2029

Economic and investment trends

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CIO EDITORIAL

Dear Reader,

This year, senior experts from our asset management and research departments gathered on the heights around Lake Lucerne to reassess secular economic, financial and social trends around the world. The timing of this edition is particularly interesting as the decade 2010-2019 draws to a close. The decade began on the ruins of the worst financial crisis since the 1920s at the end of the last one. Its beginnings were marked by the crisis of the European currency and the austerity imposed by force on the peripheral countries of the eurozone. While no one could imagine it only ten years after the dot.com bubble and crash, the secular rise of the greenback has once again favoured the Nasdaq and its current epicentre, the famous FAANMG stocks (Facebook, Amazon, Apple, Netflix, Microsoft and Google), which in and of themselves constitute an asset class with a market capitalisation of more than 4 trillion! We have characterised **this decade as a US technology-led bull market,** similar, in some respects, to the booming 1990s.

THE ONLY CONSTANT IS THE CHANGE FROM ONE DECADE TO THE NEXT!

We consider the identification of secular forces to be a **key step in Julius Baer's asset allocation process.** On the one hand, markets are fundamentally less uncertain in the long term than in the short term, but above all, **a clear view of the direction of gravity in the financial system is crucial** to navigate it in the shorter term, by distinguishing noise from information. However, the exercise remains highly difficult, as the future is by definition uncertain... and remaining aware of the limits of our predictive ability is essential to managing money. While taking this into account, however, a first observation can be made when reading the secular trends of the last six decades: **the only constant is the change from one decade to the next!** In other words, the asset classes that perform best in one decade generally do not work in the next, especially when it comes to equities and the dollar. At the index level, equities therefore seem to have mean reversion properties. The Deutsche Mark-US dollar exchange rate, turned Euro-US dollar exchange rate twenty years ago, also seems to have a tendency to reverse to trend.

TRANSITIONS DO NOT HAPPEN OVERNIGHT

Each edition of the Secular Outlook is interesting, but this one is especially important as the decade draws to a close. In this issue, **we present for the first time the catalysts and trends we are forecasting for the 2020 decade.** It should be noted that, at the time of writing, **the trends that have been in place since 2010 are still in force.** However, they will gradually give way to new ones. Humans tend to extrapolate the recent past. Thus, in 2010, it was difficult to foresee the return of leadership from American technology stocks after their disastrous performance in the 2000s. In 2000, however, the future seemed bright and certain for them and the Asian crisis of the late 1990s did not suggest the emerging economy bull market of the 2000s! Similarly, today the FAANMGs seem invincible. **The transition from one investment regime to the next does not happen overnight. It takes place in a protracted process involving successive milestones.** Trends will have been strong for several years, as the FAANMGs are now, before investors realise it.

MONETARY POLICY HAS REACHED ITS LIMITS

Let us now take a look at a few of the main trends we envisage for the coming decade. First, monetary policy has reached its limits working in isolation in developed economies. The urgent need to stimulate nominal GDP growth in the developed world should gradually lead to **the adoption of unorthodox macroeconomic policies.** Fiscal stimulus should eventually be coupled with monetary stimulus, for example through direct liquidity injections to households rather than indirectly through the financial system. This could take an almost unprecedented form, **negative taxes.** A tax credit for all residents of a region such as the Eurozone could facilitate the redistribution of purchasing power to the lowest income groups. The idea may seem utopian, but it is an integral part of the macroeconomic levers in Modern Monetary Theory's (known as **'MMT'**) arsenal. To a pre-defined extent and on a temporary and discretionary basis, such injections would be able to reflate the system and extract us from the paradox of negative rates.

PRIVATE MARKETS' ILLIQUIDITY PREMIUM IS ERODING

Second, the past decade has seen private equity become a mainstream asset class. One of the consequences of investors' enthusiasm for unlisted assets is that **the historical illiquidity premium they offered has probably been significantly reduced or even completely eliminated.** As a result, returns on listed equities will seriously challenge returns on unlisted assets in the coming years.

A BIPOLAR WORLD IS IN THE MAKING

Finally, the strategic confrontation between Beijing and Washington will lead us to **a bipolar world.** Investors will have a choice between assets dominated by the US cycle and its technology ecosystem and assets dominated by the Chinese cycle and its own technology ecosystem. These two capital markets of the two largest economies in the world will therefore be fundamentally uncorrelated. As a result, the **merits of international diversification will be revived** after thirty years of increasing correlations due to globalisation.

We wish you a lot of pleasure in discovering this first edition of the secular trends 2020 and we look forward to discussing them with you.

Yours sincerely,

Yves Bonzon
Chief Investment Officer
Member of the Executive Board

SECULAR OUTLOOK 2020–2029

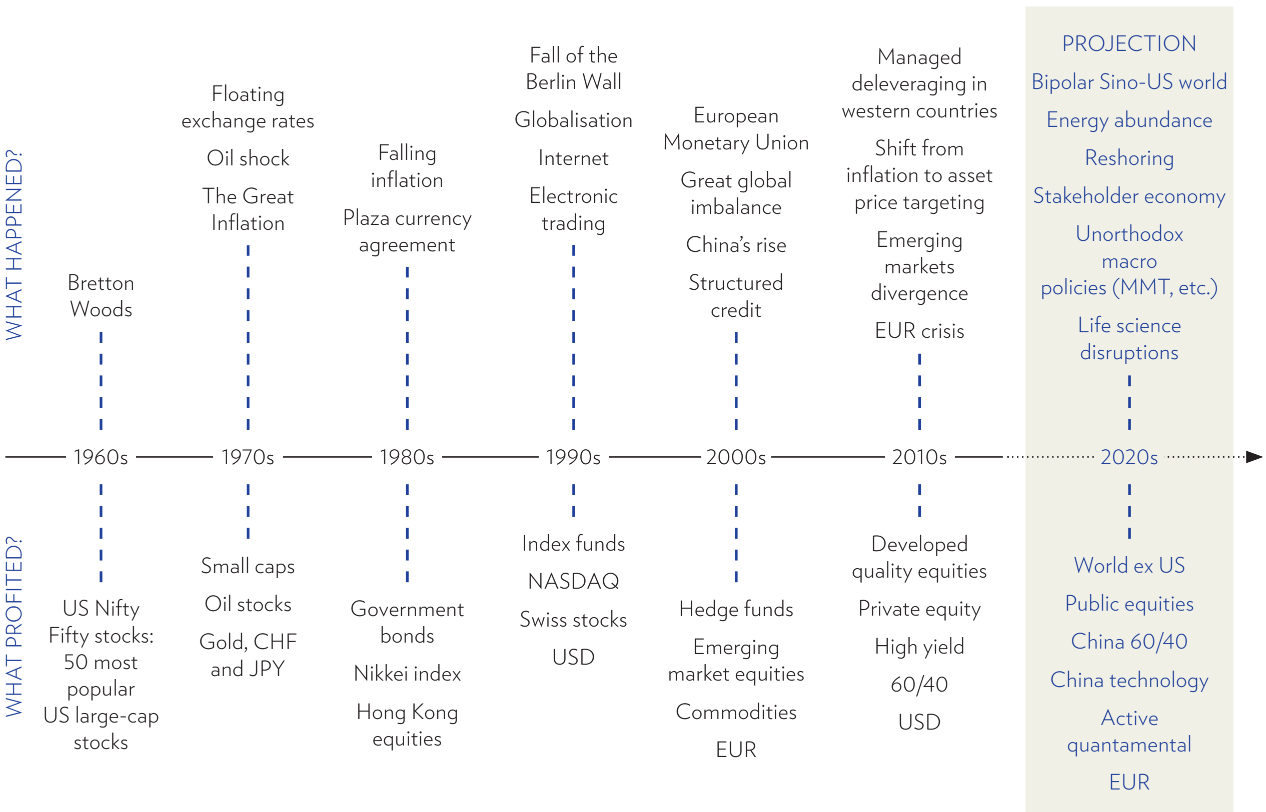
KEY SECULAR TRENDS

MACROECONOMY
- Bipolar Sino-US world
- Energy abundance
- Reshoring
- Stakeholder economy
- Unorthodox macro policies
- Life science disruptions

CAPITAL MARKETS
- Late-stage USD bull market
- China rising to core asset class status
- Rise of political triggers and decline of market signals
- Public equities challenge Private Equity returns

RISK FACTORS
- Dormant systemic risk
- Rise in cyber risk
- Global political risk
- China-US decoupling

CHART 1: EVERY DECADE IS CHARACTERISED BY A DIFFERENT ECONOMIC AND INVESTING ENVIRONMENT



Source: Bank Julius Baer

KEY MACROECONOMIC TRENDS

BIPOLAR SINO-US WORLD

The trade war is a symptom of a broader, long-lasting confrontation between the current world leader, the US, and its aspiring challenger, China. Both countries have initiated an 'arms race' on multiple fronts. Apart from ongoing trade tensions, attempts have been made to restrict financial market access to Chinese companies in the US while also banning Chinese technology companies from doing business with US corporations. The Chinese Belt and Road initiative is ploughing ahead, highlighting the ambition and extent of global Chinese influence. On the ideological front, the two parties continue to stand their ground, as exemplified by US support of Hong Kong protesters. This 21st century Cold War over economic, technological and military supremacy will usher in a new, dual world order, with separate economic and financial cycles and technological ecosystems.

ENERGY ABUNDANCE

The global energy market is in the midst of a structural shift away from fossil fuels to clean energy. The transition to renewables is accelerating thanks to affordability, scalability and almost infinite resources. Electric cars, air conditioning and heat pumps mark the next phase of electrification, underpinning the energy carriers' future dominance. Traditional utilities are losing their customer base as clean energy and new business models break market barriers. From power trading to infrastructure finance, new players are altering the playing field. With clean energy installations set to plateau going forward and as politics mind the transition's fallout and cap its speed, growth will stem from the power producer sector, not solar- or wind-equipment makers. As energy democratises, we will see shifts from resources to technology, from trade to self-reliance, and from big to small. Electric cars and clean energy are self-reinforcing technologies, translating to peak oil demand, likely to cause tectonic power shifts and geopolitical tremors. Over time, productivity should benefit.

RESHORING

Any way you look at it, various measures of economic openness have either flattened or decreased in the last decade. Globalisation has become a bad word in many areas of the world, with 'America First' and Brexit being prominent examples of this movement. These ideological changes and other forces in the geopolitical landscape will lead to a phenomenon we call 'reshoring', or a shift of value chains 'offshored' in the past 30 years, from global to local.

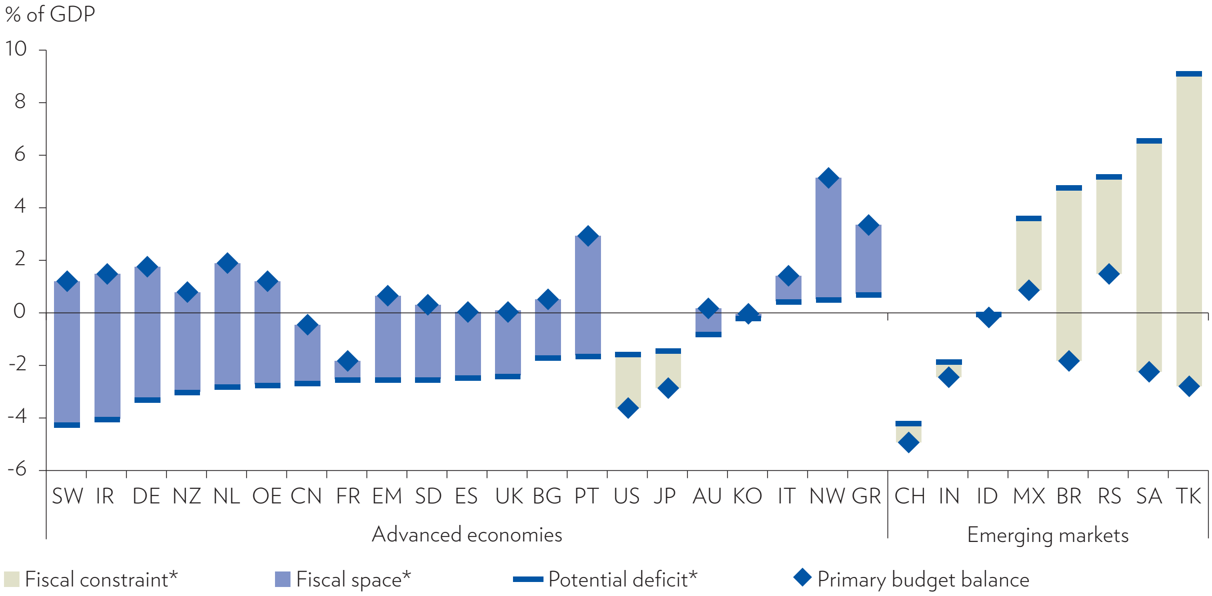
STAKEHOLDER ECONOMY

The benefits of extreme financialisation and globalisation have not been equally distributed across all social and economic groups. Worker compensation has lagged while profit margins have soared, increasing both wealth and income inequality to levels not seen since the 1930s. Meanwhile, climate change and social equality issues have taken centre stage, especially in the eyes of younger generations. These pressure points are pushing the corporate sector to rethink their role, as evidenced by the statement produced by the latest American Business Roundtable, which stressed that corporations should take into consideration not just shareholder value but also their impact on all stakeholders, including workers and society at large.

UNORTHODOX MACRO POLICIES

Since the Global Financial Crisis, major central banks have ventured into unknown waters, engaging in considerable monetary experimentation, including, but not limited to, QE, QT and zero-to-negative interest rate policies. Despite their extent, these measures have failed to reignite inflation, and faced with the task to deal with future economic slowdowns, seem to have little room for manoeuvre and lack effectiveness. At the same time, major developed economies have room for fiscal stimulus (Chart 2), with record low government bond yields, mostly positive budget balances, and quite importantly, a huge private sector saving surplus. The discourse is thus now moving towards the use of a new policy template that just a couple of years ago would have been considered completely unthinkable. The new policy mix will be

CHART 2: FISCAL SPACE AND CONSTRAINT BASED ON INTEREST RATES AND EXPECTED GROWTH



* Distance between actual primary budget balance and the balance which would keep debt/GDP ratio stable based on long-term interest rates and 5-year nominal GDP projections

Source: IMF, Datastream, Julius Baer, Data as at November 2019

much more reliant on fiscal stimulus, which could be packaged into various policy bundles, be it Modern Monetary Theory (MMT), Keynesian policies, or fiscal facilities managed by the central bank[1]. Monetary policy could also eventually consider a much more direct type of policy intervention that bypasses the decommissioned bank-lending channel, such as helicopter money. Thus, negative interest rates will be replaced with 'negative taxation'. The new policy paradigm is slowly emerging and will eventually take over, even though it still encounters some strong opposition, quite notably in Germany. This should lay the ground for very gradual reflation in the developed world.

LIFE SCIENCE DISRUPTIONS

Gene-based therapies are starting to come to market worldwide. The genomics market lies at the intersection of cutting-edge healthcare innovation, Big Data in medicine and unmet medical needs with high return potential. We are entering the 'Genomics 3.0' era, where gene-editing technologies (e.g. CRISPR) are becoming affordable and efficient. Biotech companies that adopt genomics at an early stage might be the greatest beneficiaries. At the same time, healthcare costs are placing a rising burden on consumers all over the world, which is why digital technologies are increasingly adopted across the healthcare industry. These innovations, along with other structural trends pushing life expectancy upward, will fundamentally shift lifestyles, how we manage our money and make investment decisions.

[1] See 'Dealing with the next downturn: From unconventional monetary policy to unprecedented policy coordination', Elga Bartsch, Jean Boivin, Stanley Fischer, Philipp Hildebrand. Black Rock Investment Institute, August 2019.

KEY CAPITAL MARKET TRENDS

LATE-STAGE US DOLLAR BULL MARKET

The US dollar regime is the single most important input for strategic asset allocation, tightly linked to the investment trend dominating markets in each decade. As global growth stagnated and the only refuge turned out to be high US dollar free cash flow technology companies, money chased dollar assets, cementing the leadership of the FAANMG stocks this decade. The US dollar bull trend is still in force, but is extended. However, bull markets do not die of old age.

CHINA RISING TO CORE ASSET ALLOCATION

In the next decade, China will rise to become a standalone strategic asset class, both on the equity and fixed income sides, and there are numerous reasons why. First, China is the ultimate convergence point of the world's two growth engines: emerging markets (EM) and technology. Already its main contributor last decade, China has almost become the unique provider of growth among EM countries in the past years. It is also the only economy which comes close to match (and even surpass in some instances) US technological leadership. No longer the factory of the world, the country is shifting from manufacturing to services, and from exports to a domestic, consumer-led economy. Furthermore, Chinese capital markets are big, but still relatively closed to foreign investors, and thus represent a considerable widening of the investor's opportunity set. They are slowly opening up, with Chinese onshore market shares becoming more accessible through stock market initiatives and inclusion into major global benchmarks. Finally, from a portfolio construction perspective and given the expected decoupling from the US-led economic and financial cycle, Chinese assets will become an increasingly valuable source of global diversification.

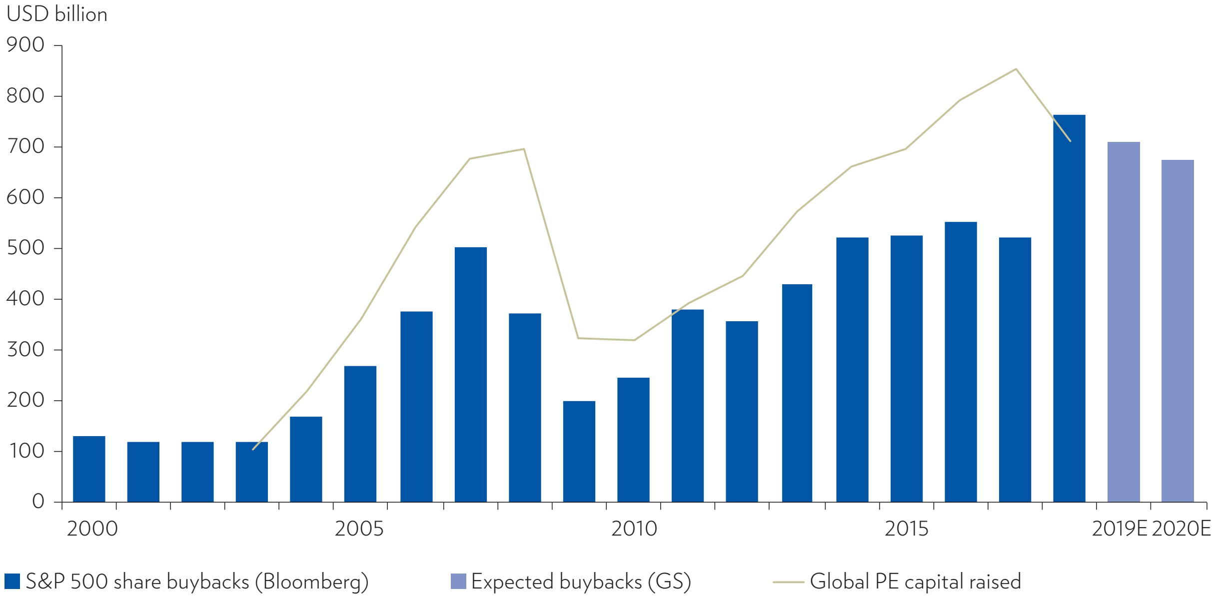
RISE OF POLITICAL TRIGGERS AND DECLINE OF MARKET SIGNALS

Political risk and policy uncertainty have drastically increased, gradually overshadowing traditional market signals, increasing market volatility and noise in the short term. This phenomenon has been reinforced by the increasing prominence of algorithmic and systematic trading. Technical charts become less reliable as a tool, and flash-crashes and overcorrections a normal and more frequent occurrence.

PUBLIC EQUITIES CHALLENGE MEDIAN PRIVATE EQUITY RETURNS

In the US, public markets continue on their de-equitisation trend, with the number of IPOs and listed companies at historical lows and share buybacks at new highs. Though these share repurchase programs are expected to somewhat ease, they remain at elevated levels (Chart 3). Thus, public markets have been transforming from a cash-raising to a cash-returning mechanism. Lagging, European and Japanese markets are slowly moving in the same direction. In the meantime, private equity has experienced a boom, with private market assets more than doubling and reaching 10% of the world public market capitalisation in 2018. Going forward, given the sheer amount of funds flowing into the asset class and increasing scrutiny on the part of investors, the next decade will be much more challenging for private equity firms. Return spreads are shrinking and only top and second quartile private equity managers may manage to beat the public market. Manager selection is even more crucial than before!

CHART 3: THE PUBLIC MARKET IS SHIFTING FROM A CASH-RAISING TO A CASH-RETURNING MECHANISM



Note: PE= Private Equity

Source: Bain and Co, Bloomberg, Goldman Sachs, Julius Baer, Data as at 21.11.2019

KEY RISK FACTORS

DORMANT SYSTEMIC RISK

Indicators of systemic risk are subdued, indicating that the current late cycle environment is different from the one before the Great Financial Crisis.

RISE IN CYBER RISK

In a world where the number of devices connected to the Internet is exploding, a broad-based cyberattack shutting down the net would lead to a dramatic contraction of economic activity.

GLOBAL POLITICAL RISK

The increase in political and economic uncertainty in recent years has promoted the rise of political triggers, constituting an additional source of unpredictable risk and volatility in portfolios.

CHINA-US DECOUPLING

The emergence of a bipolar Sino-US world and the rise of China will probably not be a smooth ride. With every new trade war development and trading ban, the prospects for the economic cycle and financial markets will be challenged.

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