Client Conference 2023

- What trends will shape returns going forward?
- Considerations for institutional investors

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What trends will shape returns going forward?

Before we start – a poll!

- Will interest rates:
  - Keep rising
  - Stay flat
  - Go back down

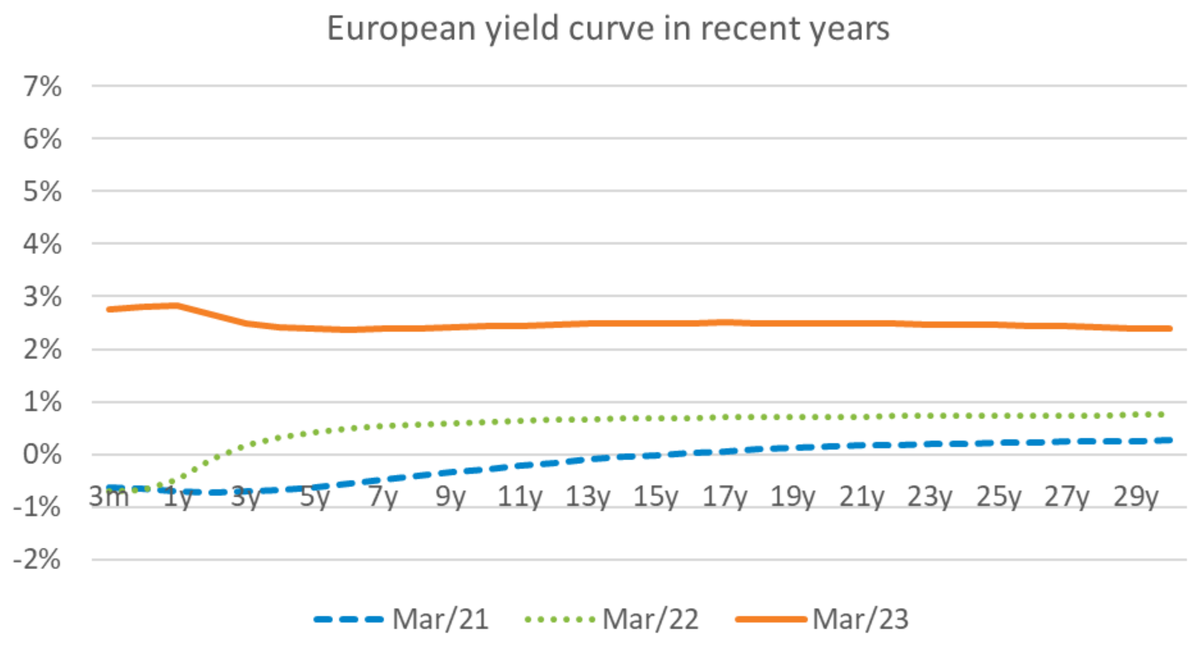
- Would you rather choose:
  - Risk on
  - Stay put
  - Risk off

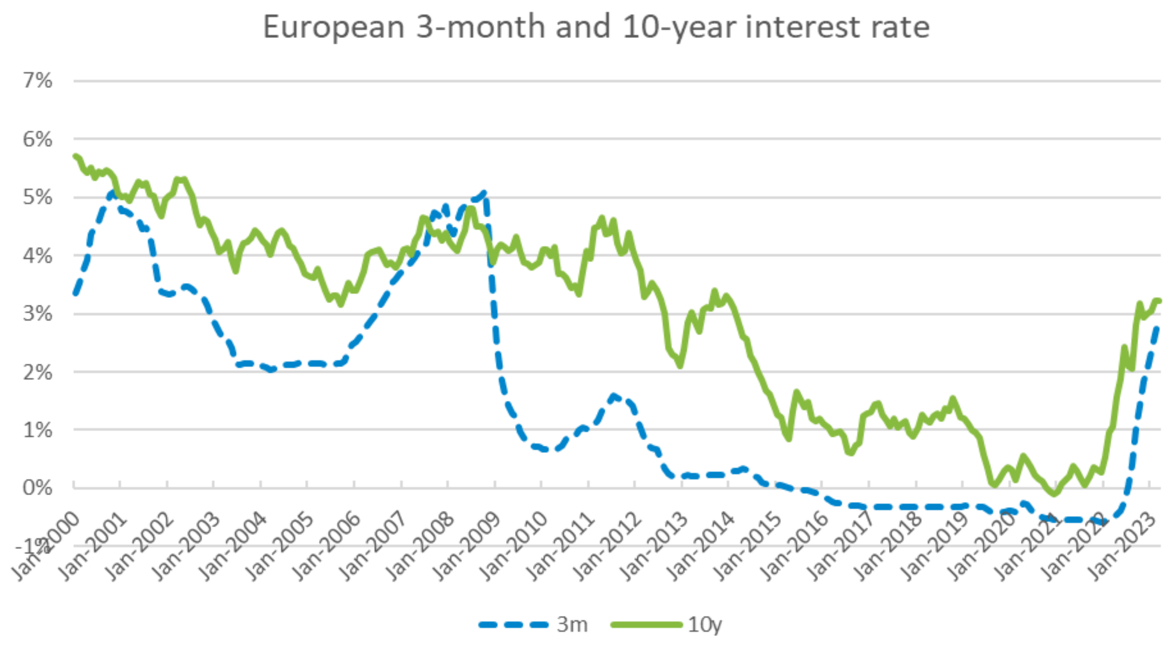
- What is your main concern about the economic environment?

Scenario projections in a changing world

- Decline in energy prices cooled headline inflation in the US and Europe, core inflation remained elevated
- Equity returns, growth and labor markets still strong
- Substantial stress in the banking sector, illustrated by the fall of SVB and Credit Suisse
- In March 2023, complete U-turn in market expectations of central banks' policy rate
- Exhaustion of excess household savings
- Credit retrenchment and lagged impact of monetary tightening

How did we get here?





- In 2000 the 3-month European interest rate reached 5.0%.
- After the 2008 GFC, 3-month rate steadily in negative territory from May 2015 until June 2022.
- Ukraine war and inflation driven by energy price shock led to aggressive hiking.

“Heard on the street”

- 2015 and before
  - “Rates cannot go below zero. Economic theory doesn’t allow it.”
- 2019 and 2020:
  - “We’re in a Japan scenario. Secular stagnation. Rates will remain low forever. Search for yield.”
- 2021:
  - “Will inflation start rising through monetary and fiscal stimulus?”
- 2022:
  - “Inflation! Rates will be very high from this point forward.”
- 2023:
  - “Fixed income now attractive compared to risk assets?!”

What's next?

- In recent years, real rates have been low, even negative. What is next?

- Larry Summers and Nouriel Roubini:
  - Secular stagflation / Great Stagflation
  - Rates and inflation will remain high
  - Negative supply shocks, geopolitical uncertainty, deglobalization, climate change

- Olivier Blanchard and Willem Buiter:
  - Secular stagnation
  - Rates and inflation will remain low
  - Aging populations, deglobalization, safe-asset demand, climate change, and excessive debt

- Is there a way out?
  - New sources of productivity growth (artificial intelligence, green transition, ...)?

What happened to secular stagnation?

- In 2013, Larry Summers declared at an IMF conference that advanced economies were in a state of secular stagnation

- Alvin Hansen, observing the Great Depression, characterized secular stagnation in 1938 as a situation with structurally low private demand, driven by:
  - Slowdown in population growth
  - Lower productivity growth

- Both lead to insufficient investment opportunities and therefore saving

- Needs natural real rate (r*) lower than growth to discourage saving and therefore sustain demand

- Evsey Domar noted in 1944 that a public debt burden would arise if government spending used to fill the investment gap

Stagflation and financial repression

- Stagflation (Iain Macleod, 1965) is characterized by low growth, high inflation, and high unemployment, potentially driven by
  - Supply shock: the 1970s oil price shock (e.g. Ukraine war).
  - Monetary policy too accommodative.
  - Output gap mismeasurement (Taylor rule).

- Keynesian response to 1970s stagflation: low rates, fiscal stimulus
  - “Fed's credibility as an inflation fighter was lost” (Bernanke)
  - After this, Volcker recession through massive rate hikes

- Financial repression (Shaw and McKinnon, 1973)
  - Interest rates below the inflation rate
  - Effectively a wealth transfer from private to public since savers harmed while public debt is reduced
  - May harm growth through inefficient allocation of capital
  - At low cost of debt, firms that would otherwise fail may survive

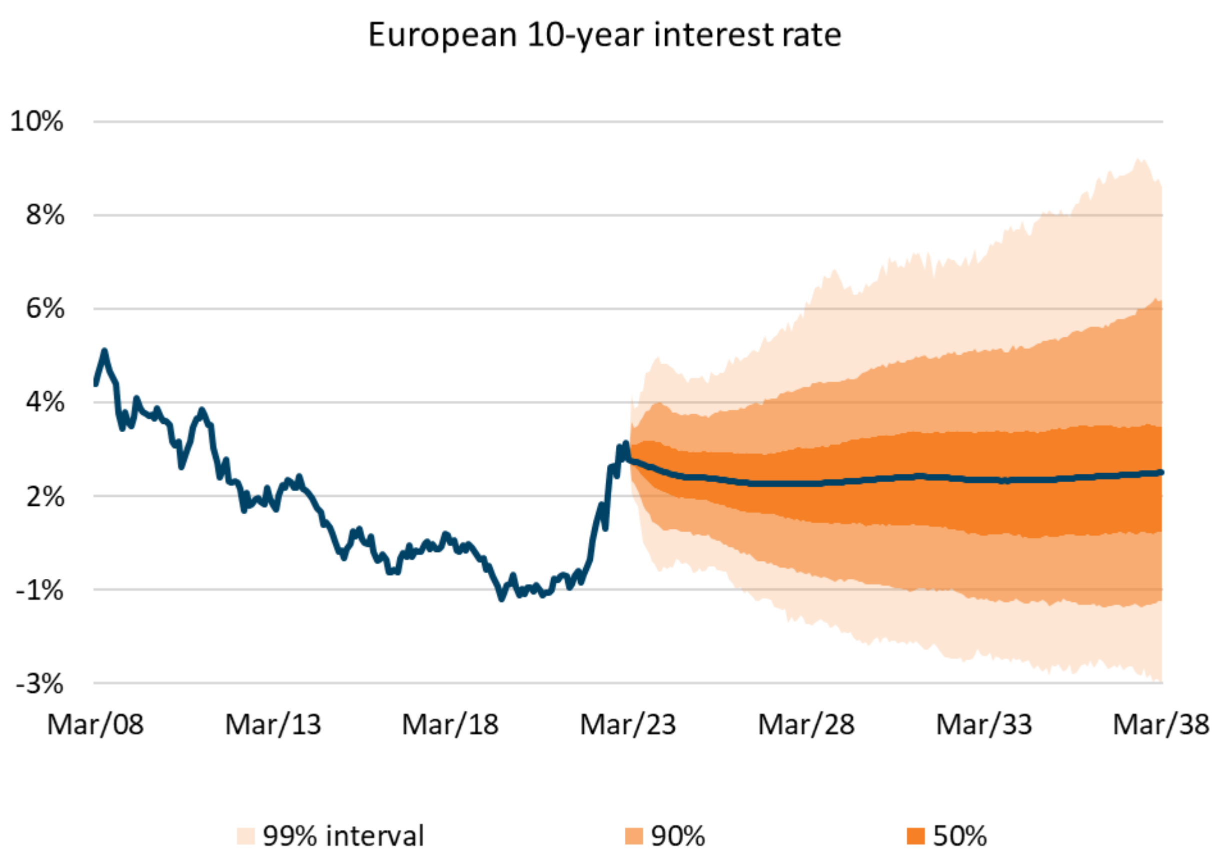
Interest rate expectations

- Before 2020 our long-term expected European 10-year nominal interest rate was 3.25%

- Per December 2020, we updated this to 2.25%
  - Demographic change
  - Lower productivity growth
  - New monetary policy tools

- Since December 2021, also incorporate information from forwards in interest rate expectations for first years of projection
  - Reflects news about monetary policy

- Interest rate expected to stabilize or decline in coming years, in line with business cycle



Going forward – the short to medium term

- Cautious outlook for risk assets
- Negative short term equity outlook surrounded by elevated downside risk
- Fixed income attractive due to high initial yields
- Short-term interest rate expected to decline in coming years
- Long rates are expected to stabilize around current levels or decline, in line with business cycle

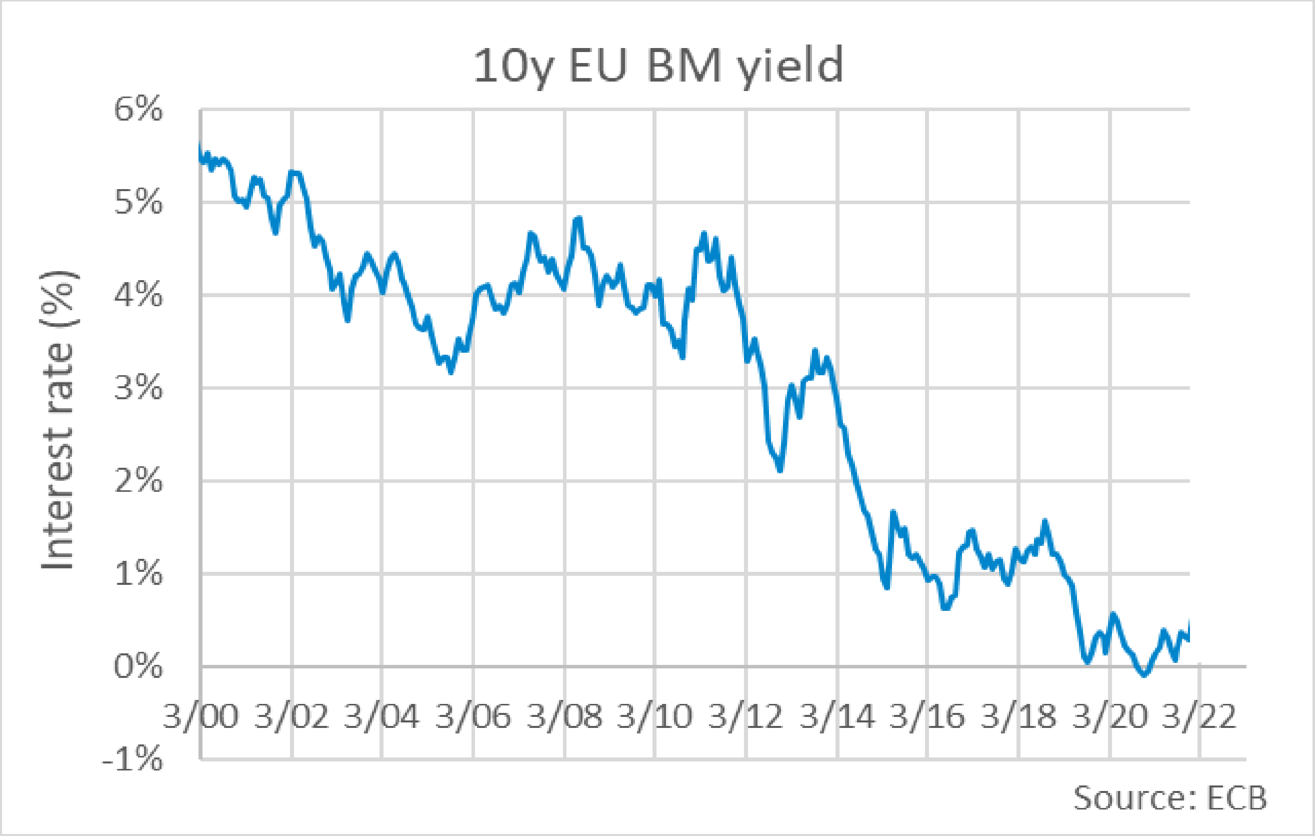
Beyond the business cycle

- Pre-existing trend of declining interest rates since 1980 is reverting upwards
- Yet interest rates are expected to stabilize around current or lower trend levels reflecting:
  - Moderate growth prospects
  - Sluggish structural economic drivers such as weak productivity growth
  - Demographic headwinds.
- Inflation uncertainty will remain elevated:
  - Geopolitical uncertainty
  - Climate transition
  - Fiscal and monetary challenges

Considerations for institutional investors

Two decades of declining interest rates

How have investors responded to low yields?

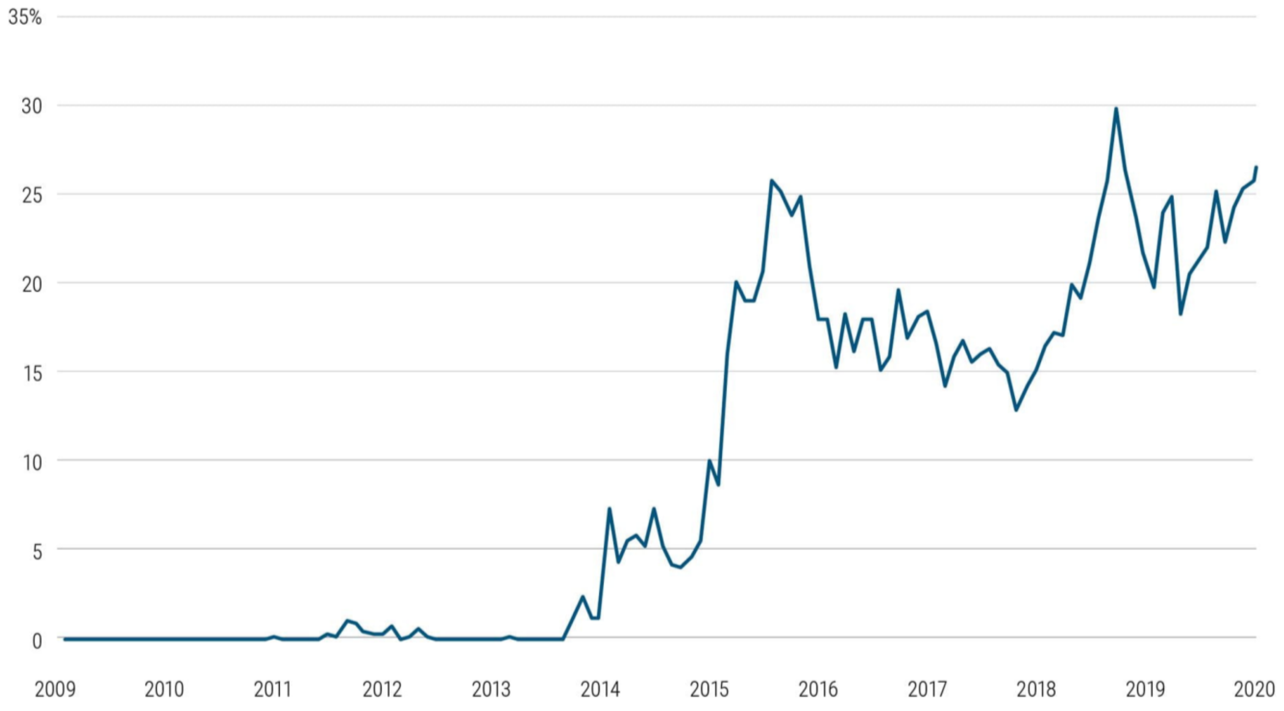


Two decades of declining interest rates

How have investors responded to low yields?

- Accepting lower returns

Global Fixed Income Securities with negative yield as % of MV



Source: Bloomberg

Two decades of declining interest rates

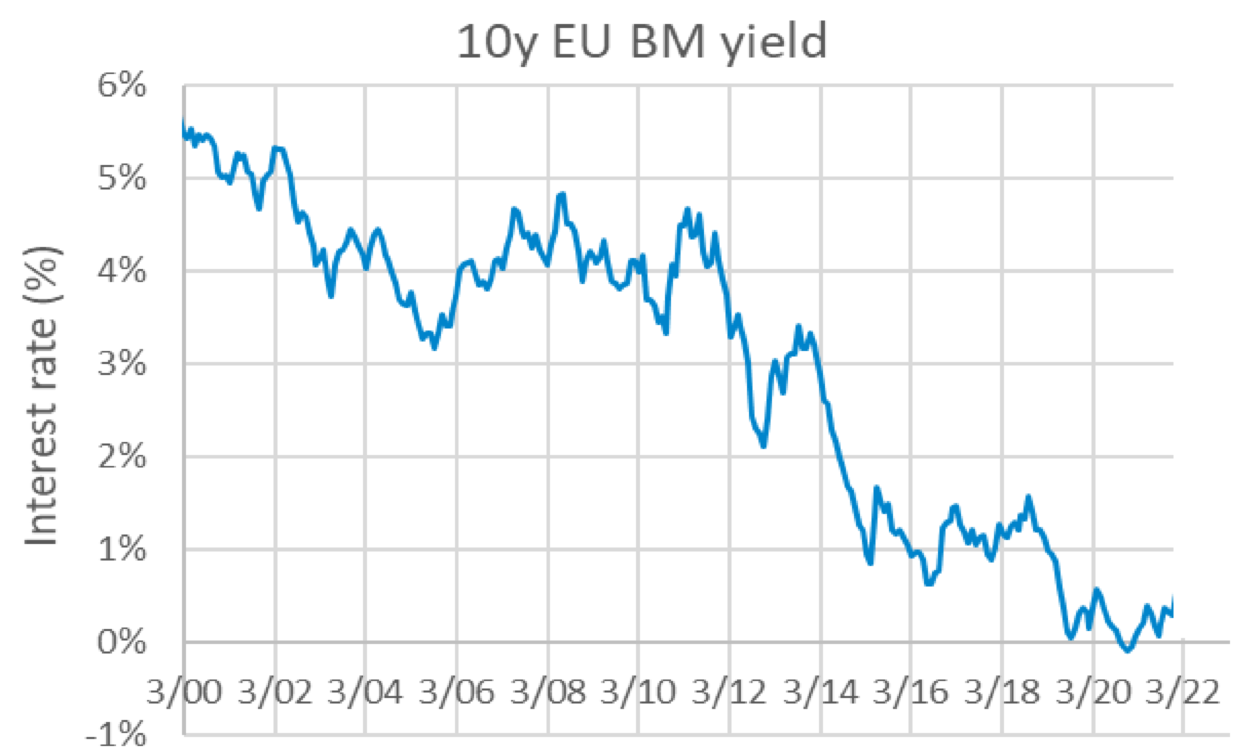
How have investors responded to low yields?

- Accepting lower returns

- Search for yield by taking more risk
  - Increase credit risk
  - Increase illiquidity
  - Adding complexity
  - Increasing leverage

- Lower ambition or increase contributions

- Fear: yields would be low forever



Source: ECB

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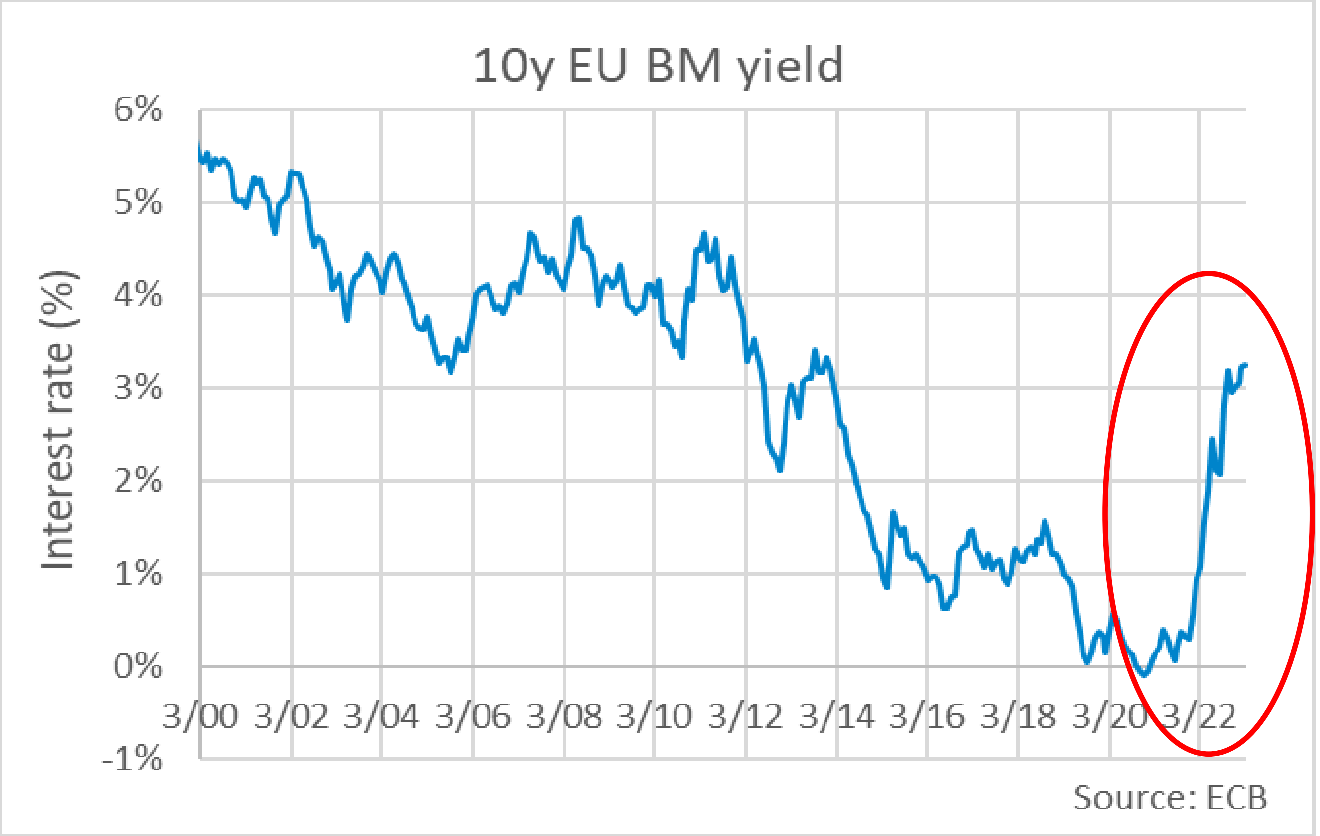
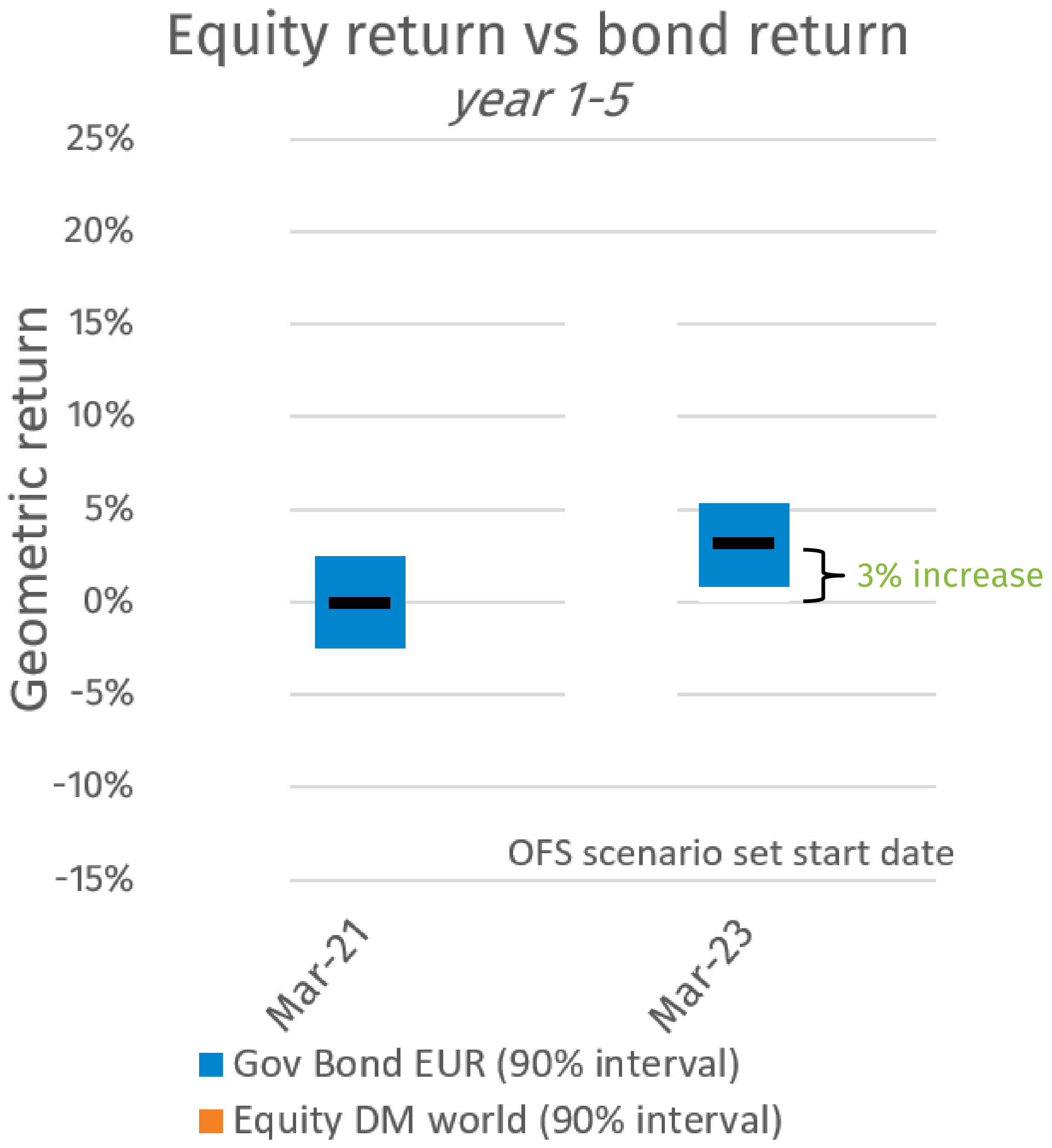
- Time to derisk?



Time to derisk?

Return perspective

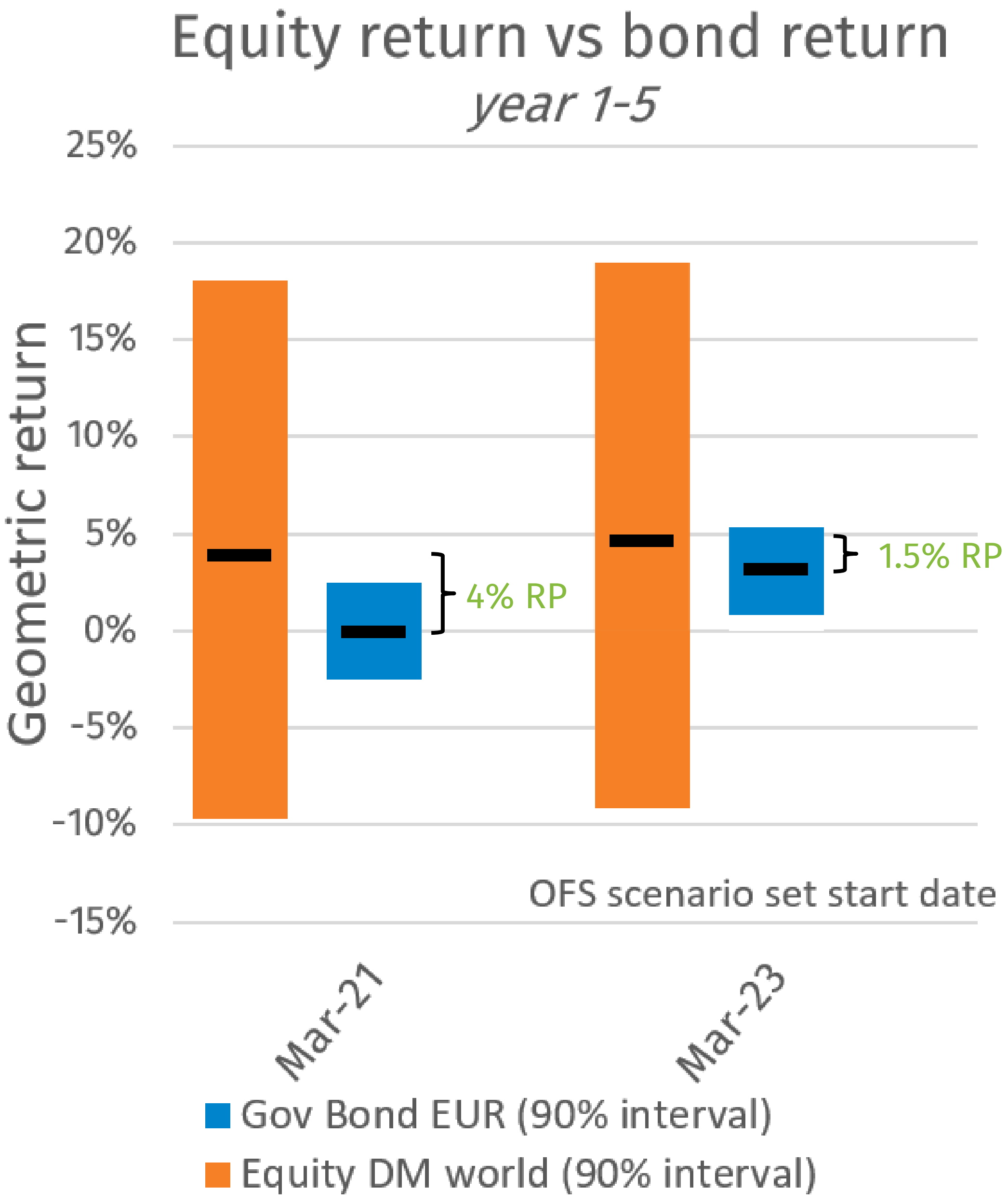
- Expected fixed income return increased by over 3%



Time to derisk?

Return perspective

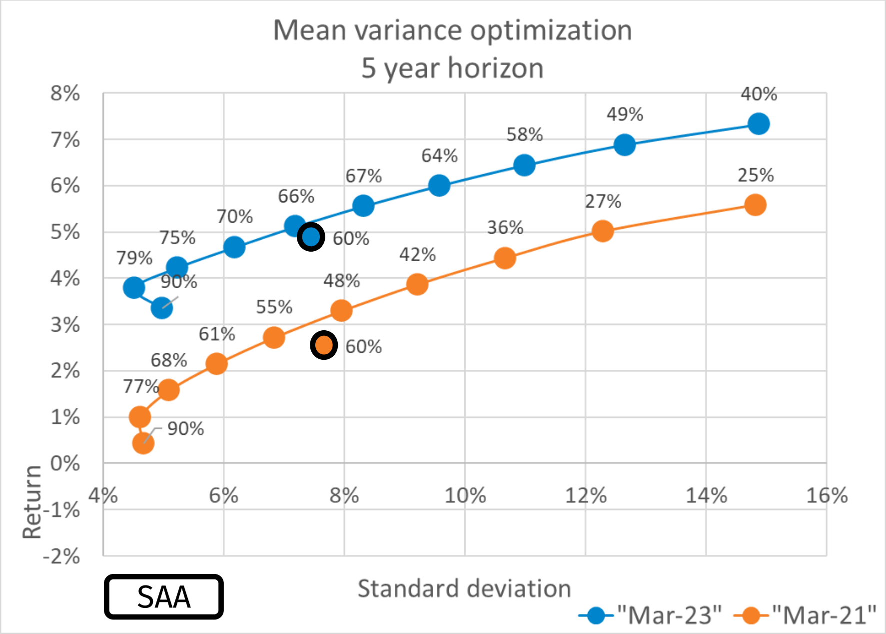
- Expected fixed income return increased by over 3%
- Expected equity return increased slightly but has more risk
- Equity risk premium decreased significantly



Time to derisk?

Portfolio perspective

- Multi asset mean variance optimization EUR investor
  - High yield environment leads to better outcomes for similar risk
  - 20% shift to fixed income assets in efficient portfolios

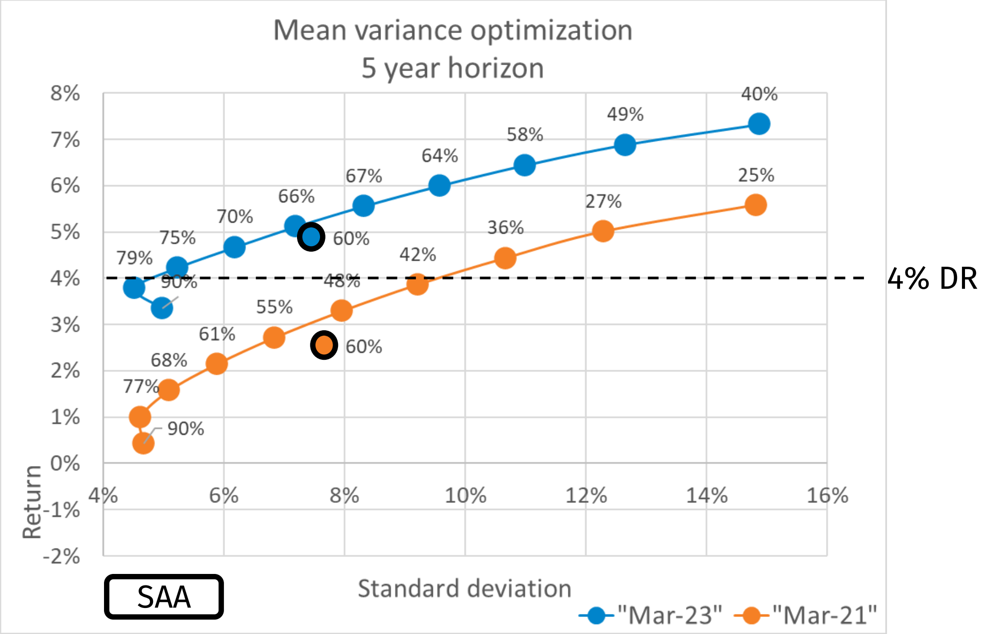


Asset classes	SAA
Equity World	20%
Equity EM	5%
Direct RE	10%
Infra EUR	5%
Private Equity	0%
Index linked bond GER	5%
Sovereign bond EU	30%
Credit	20%
Cash	5%
Matching	60%

Time to derisk?

Portfolio perspective

- Multi asset mean variance optimization EUR investor
  - High yield environment leads to better outcomes for similar risk
  - 20% shift to fixed income assets in efficient portfolios
- 4% required return to outperform liabilities would be achievable while derisking significantly
- Derisking is a relevant option for investors again!



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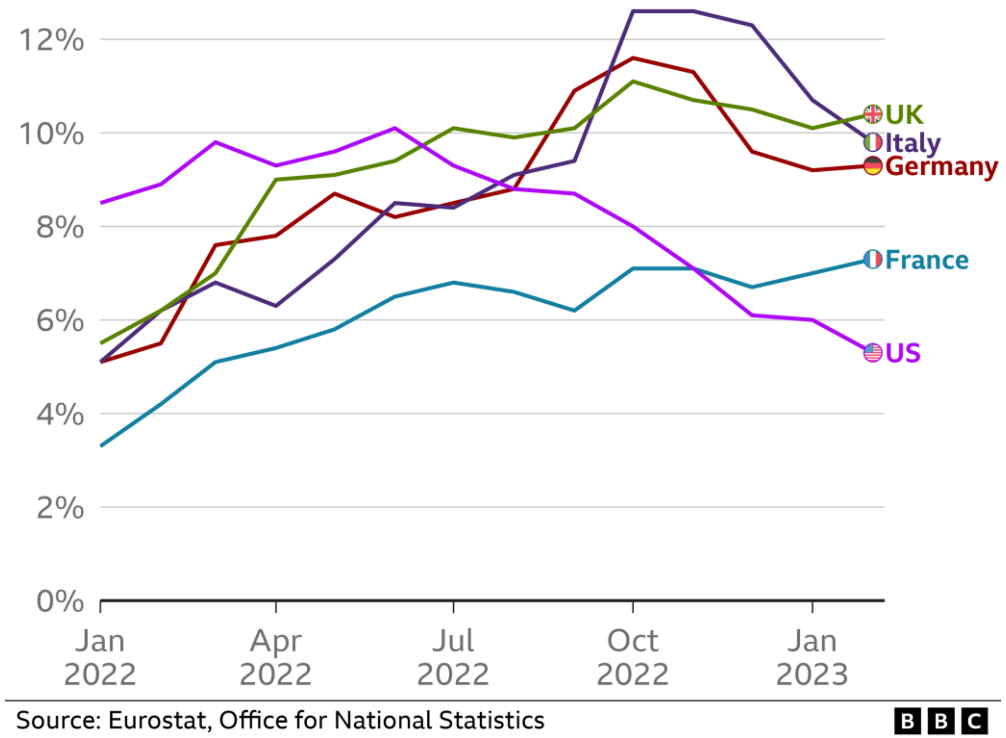
Time to derisk?

- Institutional investors typically have the ambition to offer inflation compensation

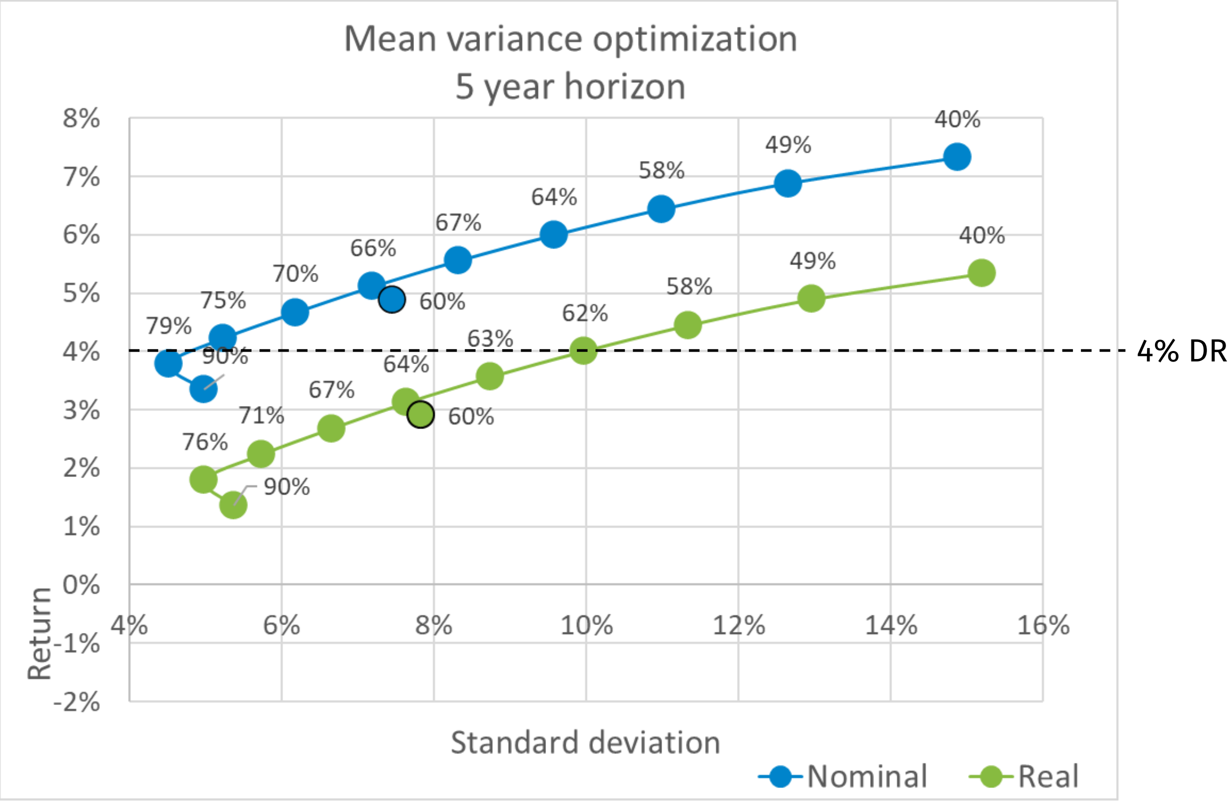


Inflation

- Results show
  - Real returns are over 2% lower
  - Harder to achieve a target in real terms
  - Modestly lower allocation to matching assets

- Long duration fixed income may lock in low real rates

- Risk of high inflation remains elevated

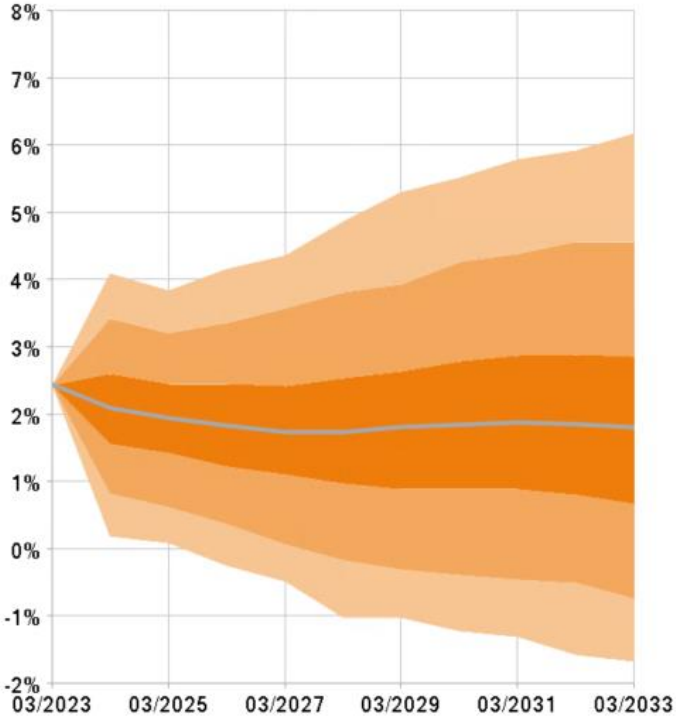


Considerations going forward

Long-term perspective

- There is significant uncertainty as reflected in the outlook

10 year nominal EU AAA yield
March 2023 scenarios



Secular Stagnation

Financial Repression

Stagflation

Considerations going forward

Long-term perspective

- There is significant uncertainty as reflected in the outlook

- Expected outcomes are driven by key assumptions

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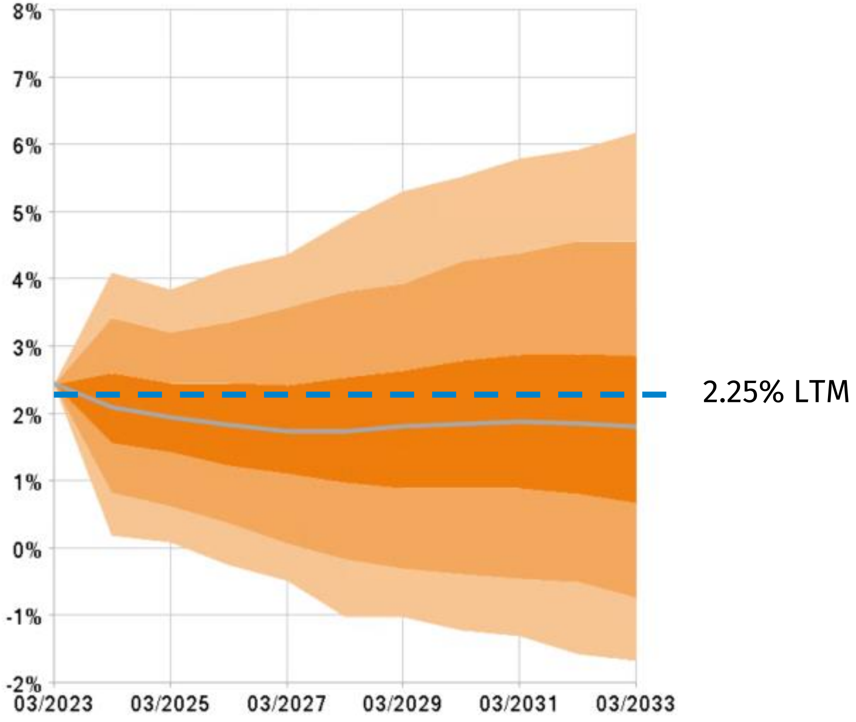

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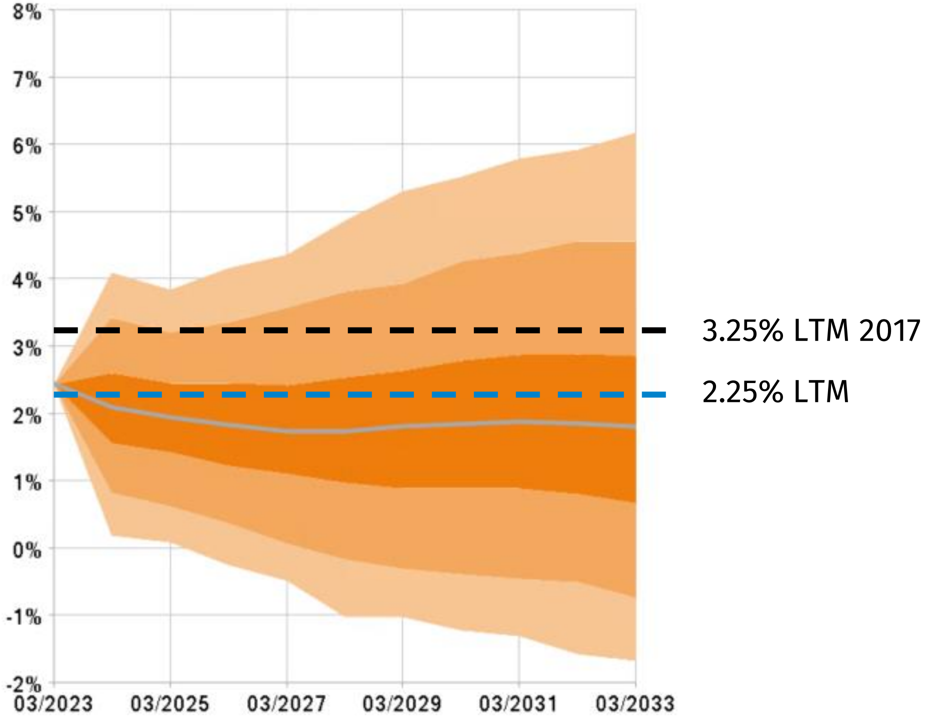


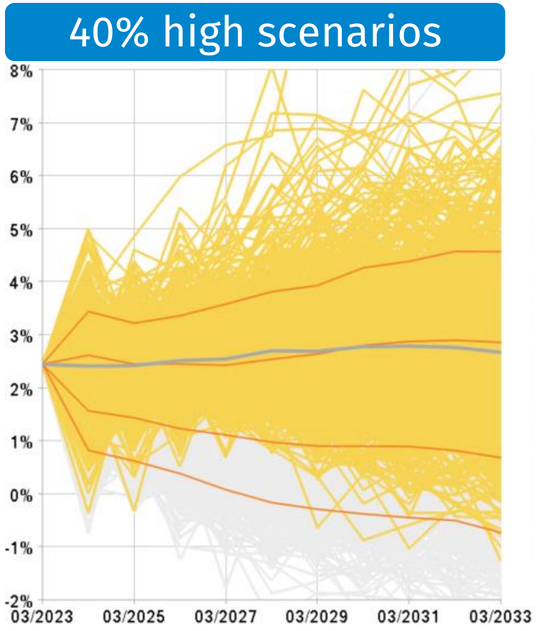
Considerations going forward

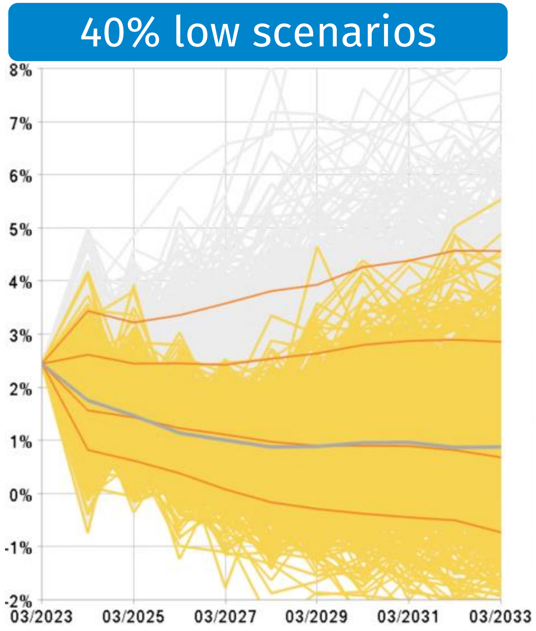
Long-term perspective

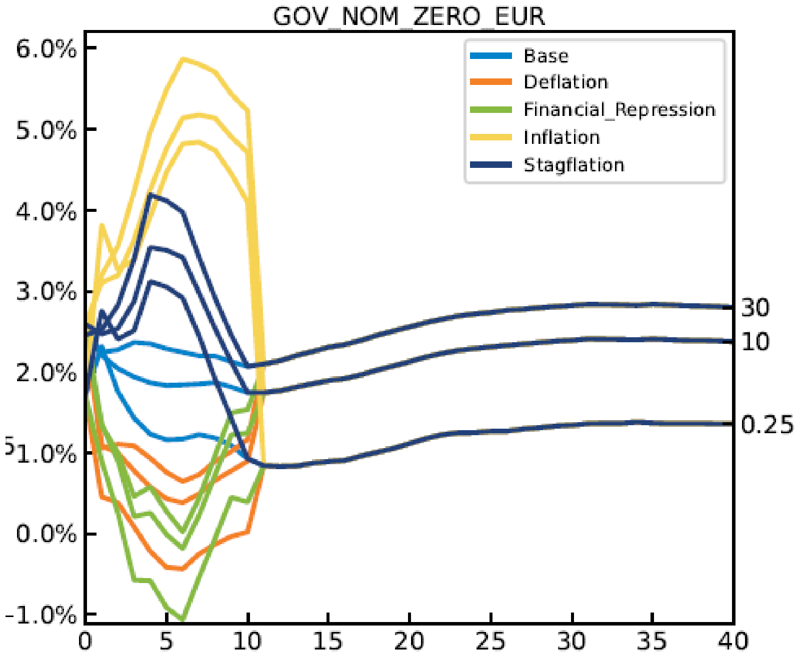
- There is significant uncertainty as reflected in the outlook

- Expected outcomes are driven by key assumptions

- Sensitivity analysis and stress testing are important







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Concluding remarks

How to navigate this uncertain environment?

- Investors gained the option to derisk
  - Higher funding levels
  - Improved fixed income outlook
  - If derisking is on the table make sure to prepare
  - Risk profile can also be adjusted by dialing down leverage/complexity/credit risk

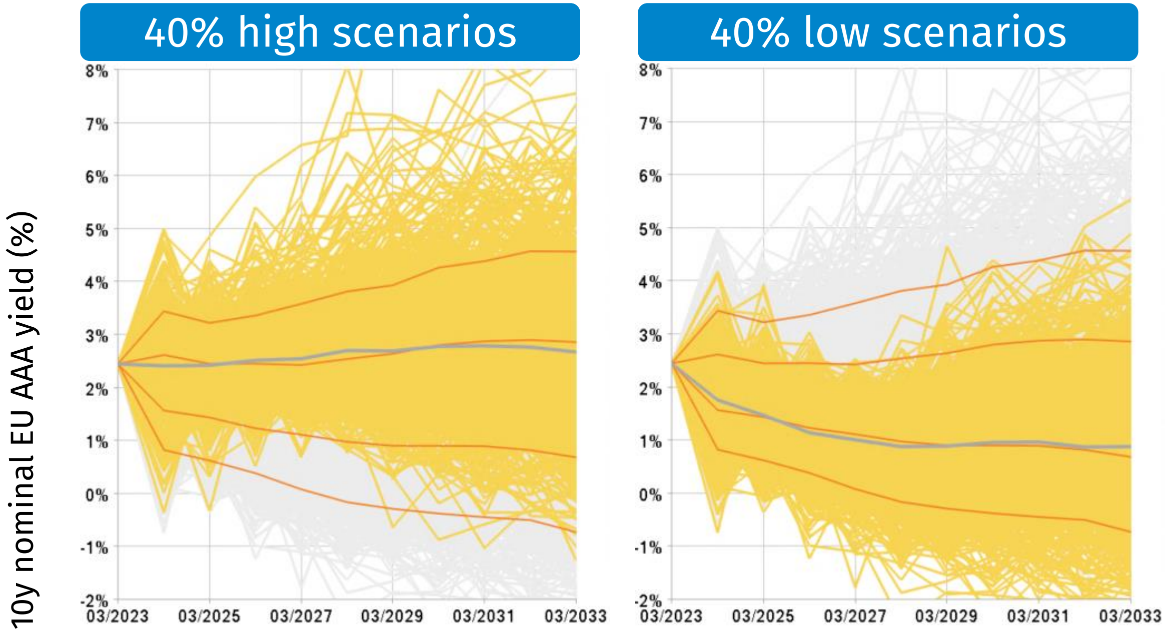
- Increasing fixed income allocation or hedging may seem attractive but …
  - Returns in real terms can still be low or even negative
  - Fund objectives, risk appetite and investment horizon need to be considered

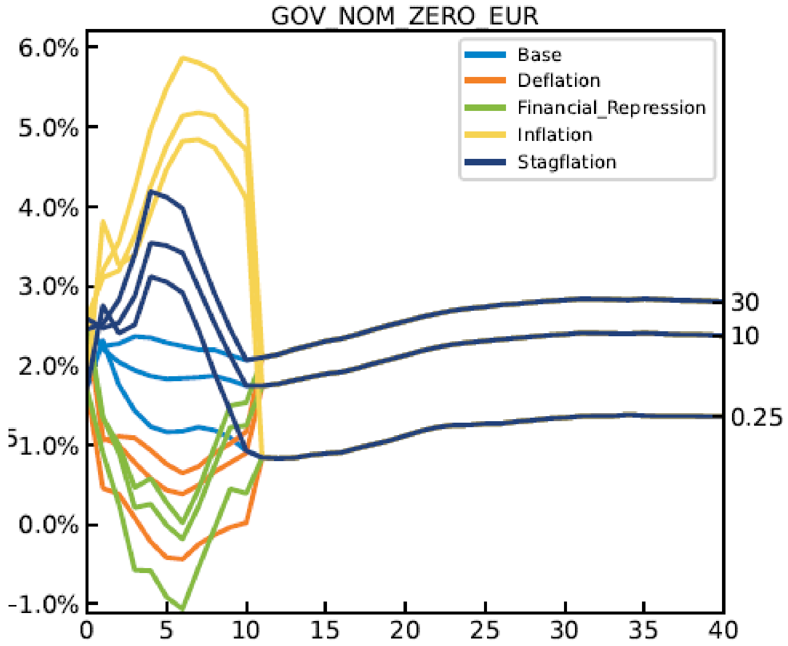
Concluding remarks

How to navigate this uncertain environment?

- Scenario modelling is an essential tool to evaluate the potential outcomes for your specific situation

- Elevated uncertainty calls for sensitivity analysis and stress testing





Thank you!

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