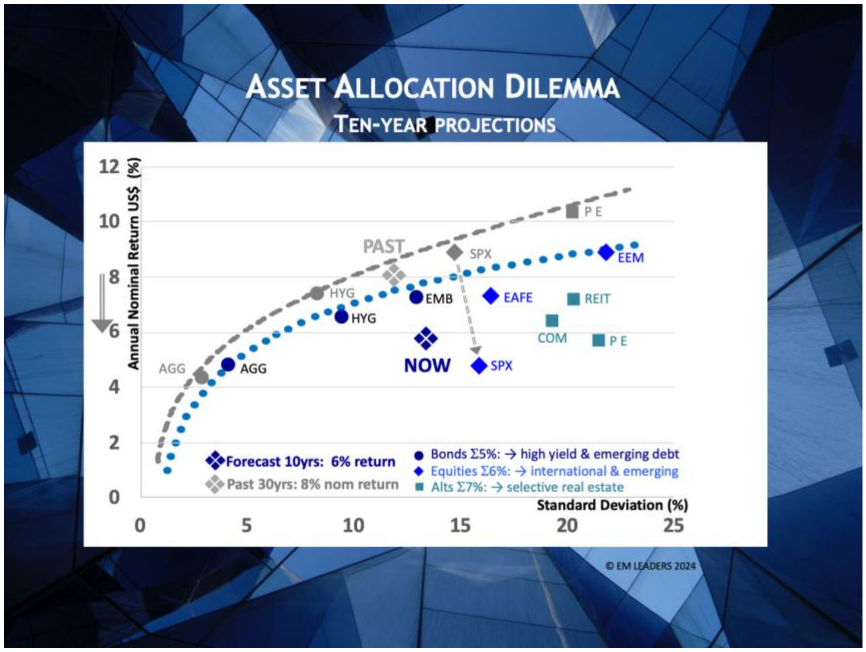


Solving the Asset Allocation Dilemma

Asset allocation may require some difficult choices this year: US technology stocks and leveraged alternative investments have delivered outstanding double-digit returns over the past decade, but their valuations have reached the sky and the strong dollar cycle has been extended into its 14th year. Investors need to analyze carefully what forward-looking returns are realistic, to what extent risks are likely to be rewarded, and how portfolio construction can be more differentiated.

We address two questions in this article: First, what are realistic return assumptions for the next decade, given that extreme valuations will partially revert to their mean. Second, what return deltas are projected when three missing assumptions are being fully priced in the markets: long-term interest rates are not declining, energy prices are no longer docile, and US equities and the US dollar are no longer dominant.

We find that investors can benefit from a more differentiated portfolio construction but still face nominal portfolio returns declining from 8% to 6%, with more attractive returns from bonds and international equities, but much lower expected returns from US equities and alternatives. Deltas from correcting for three areas of market myopia reveal a full percentage decline in US equity returns, albeit with higher fixed income returns, while most risks are currently underpriced ahead of a structural realignment.

Part 1: The current dilemma in asset allocation is that higher interest rates are starting to bite both equities and alternatives. Higher costs of financing reduce the current value of future earnings of listed companies and especially of highly leveraged private companies. What are the solutions if interest rates stay high for longer and don't go back towards zero: more niches, more credit, more risk, or lower returns? Our conclusion points to a combination of these strategies plus more search for alpha.

<1a> The easy choice in asset allocation for the past 14 years was to overweight public **US equities**, especially in technology. The SPX and QQQ annual returns exceeded 12% and 18% over ten years, and average very-long-term US equity returns reached 9% in nominal terms. Currently, even under most optimistic assumptions, those US equity returns are projected to be at best 4.5% over the next ten years, before inflation, and at best 2% in real terms. Those projections are based on the sum of dividend yields (about 1.5%) plus earnings growth (6% at best) minus multiple compression (about 3%) assuming that average market CAPE ratios decline from 33 to 25 (ten-year average). Uncertainty for US CAPE is relatively high (stdev of 8) as it declined to 12 in 2009, which would then require twice the annual multiple compression and dramatic losses.

While US equities are currently priced in the 97th percentile, the valuations are much more reasonable for international equities (EAFE at 43rd percentile) and for emerging markets equities (EEM at 35th percentile) and for Chinese equities (at 2nd percentile). Those markets can benefit from modest multiple expansion, from higher dividends (above 3%), and solid earnings growth (3% in developed vs. 5% in emerging markets). That would imply projected equity returns of 7% in international and 9% in emerging markets over the next decade, albeit with large differentiation across countries. Latin America, Eastern Europe, and most of East Asia could even see double-digit returns.

<1b> The profitable choice in asset allocation during the past decade was to allocate into **alternative assets** where leverage with very low rates created high double-digit returns and active manager selection could have added substantial alpha. Median private equity returns of 10% over the past decade were cut in half since 2020, but average valuations remain very high (around 85th percentile) as higher funding rates are only gradually being priced in. Differentiation was critical, as buyout returns were about 5% last year with strong fundraising, while venture capital volumes declined by half and returns were negative. Looking ahead, expected returns for the average PE fund is projected only around 6% for the next decade, and risks remain elevated.

Real estate funds recorded negative returns in 2023 for the first time in 15 years, as rising financing costs, problems in the office segment, demand uncertainty, and a 30% decline in global fundraising led to net outflows from this asset class. While current valuations have become more reasonable, the growth prospects remain muted, and the average real estate fund is projected to return about 7% over the next decade. For commodities, the average performance over the past decade was poor, around zero for most commodities, as the US dollar strengthened, and supply expanded for most commodities. Looking ahead, a weakening US dollar, growing demand also from the energy transition, and supply hiccups from geopolitical risks bode well for higher expected returns in commodities, which could be around 6.5% for the next decade.

<1c> The problematic choice in asset allocation over the past decade was in longer duration **fixed income** as policy rates increased by 500 basis points just over the past two years. Government bonds returned barely 1% over the past decade but are now valued attractively and are projected to return about 4.5% over the next decade, both in US and international segments. High-yield bond spreads have held up surprisingly well and future returns are projected to remain around their current yields of 6.5%. Emerging markets sovereign debt could even return 7.5% over the next decade.

In a nutshell, our asset allocation model suggests that fixed-income allocations can expand into credit, emerging markets debt, and possibly also into private credit. Expected returns could range around 6%. Public equity returns in the US are likely to disappoint, whereas international equities are projected to remain within their recent range, and emerging markets are expected to outperform, possibly with double-digit returns. Alternative assets will heavily depend on active alpha from manager selection while median returns will decline by half towards a 6% to 7% range for the decade. Portfolio construction will need to consider more niche strategies and incorporate changing correlations, while the search for alpha from active strategies will intensify. As shown in chart 1, we expect that most portfolios will return just 6% nominally.

Part 2: We now look at the delta from three missing assumptions: interest rates remaining persistently higher, energy prices adding to volatility and inflation, and an outperformance of international equity and currency markets. Let us take them in turn: Markets had expected seven cuts in interest rates during 2024, but with solid growth, strong labor markets, bullish equity markets, and easing financial conditions we may only get three cuts in May, June, and July before political breaks are applied. That would imply a new normal for ten-year rates around 4.5%, where the current slope inversion would normalize. The high debt burden and persistently large fiscal deficits (in magnitude comparable to Italy) could create further upward pressure.

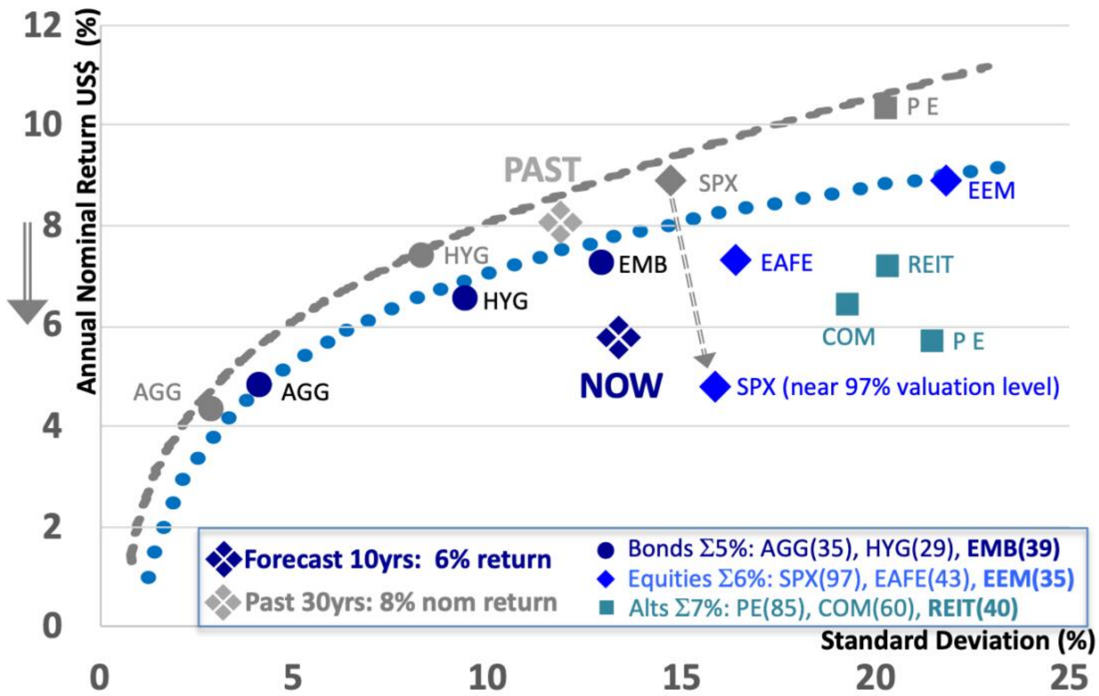
The implication of persistently **higher interest rates** would be better average returns for fixed income, adding 50 to 75 basis points to government debt and over 100 basis points to high-yield debt, although default rates will likely rise somewhat, especially from pressures in real estate and regional banking. On the other hand, equity returns could decline by 100 to 150 basis points, as corporate funding costs take 18 months to adjust from mostly fixed-rate financing, and a higher discount rate depresses returns. Pressure on real estate and private equity could initially even be more severe.

US Inflation is projected to decline gradually to a range between 2.5% and 3% over the decade, although inflation could spike initially from renewed supply chain problems and higher energy prices. **Market volatility** is currently priced at the lower end (both VIX and MOVE appear at rather complacent levels). When currently suppressed growth in Europe and East Asia returns to full capacity, and when the energy transition adds to commodity demand, we expect that **commodity prices** will increase by about 4% above inflation, albeit with significant volatility that could be triggered by near-term geopolitical risks (both from Russia and the under-the-radar conflict in Venezuela). As a result, commodities could become an important portfolio diversifier and enhance returns (DBC basket, as well as oil and especially gold). However, higher energy prices and higher volatility will likely subtract about 50 basis points from equity returns and may also trigger higher default rates in certain credit markets (new cycle has stared).

Finally, the **myopic US-centered equity view** might evolve into a more differentiated regional and country-specific allocation, where the highest expected returns are likely in the most undervalued markets (China, Korea, Turkey, Europe, and Latin America). Chart 2 reveals that substantial discounts in these markets developed over the past decade, while US and Indian equities became heavily overvalued. Beyond the US, European and East Asian firms also compete as leaders in technology and AI themes.

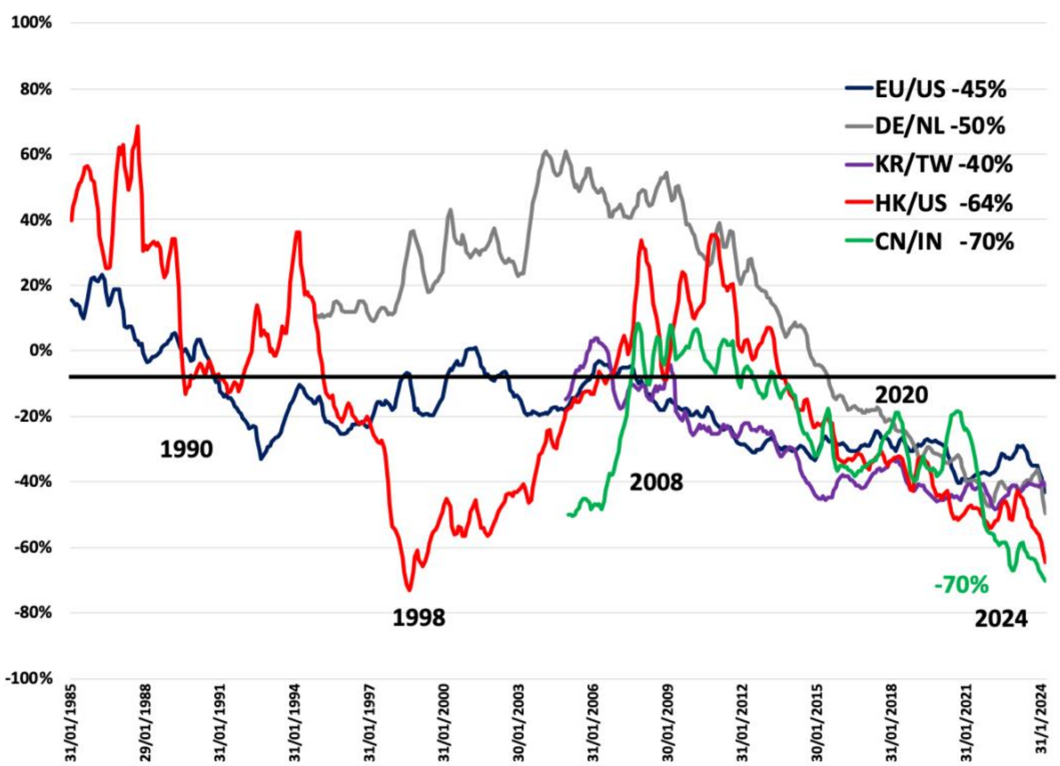
Asset Allocation Framework — Chart 1

2024 Long-Term Return Projections: barely 6% nominal returns



Overvaluation in US and India — Chart 2

CAPE Relative Valuation Pairs (1985-2024)



Sources: Barclays, Bloomberg, Yale (2024)