2021 risk management white paper:
Summary of asset allocation strategy

Post-coronavirus investment world: a new script for portfolios?

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The world of investing after coronavirus will be markedly different from the one before it. This white paper explores the shifts in macroeconomic trends, analyses the implications for investment and presents recommendations for action.

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1 Introduction

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Coronavirus has dramatically changed people's private and professional lives. Not all of these changes will be permanent, but some do look set to last. And there is much to suggest that the pandemic will leave an indelible mark on the capital markets.

The world of investing after coronavirus will be markedly different from the one before it, particularly when compared to the period following the financial crisis of 2008/2009. Long-term macroeconomic trends have begun to shift. Most important of all, the pandemic could even be the catalyst that helps the global economy to break free of an environment of weak growth and disinflation. The focus here will be on the transition to a green and digital economy. This was already under way before coronavirus, but the pace of change is now much more rapid.

The shifting sands at the macro level will have important long-term implications for investors. It is not just the outlook for asset classes, investment styles and regions that will alter, but also the way in which multi-asset portfolios are diversified. The US will be setting the tone once again; this is where the clearest signs of change are emerging. And although Europe's structural transformation will not be as rapid or extensive as America's, the shifts will be evident to European investors as well when they look to the international capital markets.

Which specific long-term macroeconomic trends will change? What will the implications of this be for the capital markets and how should investors be adjusting their portfolios in response? These are the questions that the summary presented in this white paper will address.

The most important macroeconomic trends that investors are likely to encounter in this context, in addition to an increase in nominal economic growth, are accelerated technological progress, more support for investment, greater productivity, higher government spending and a slightly higher level of US interest rates.

In the following chapters, we describe the key implications of the post-coronavirus world for investing, both within the individual asset classes and in a multi-asset context. We provide analysis and recommendations of how investors should rewrite the script for their portfolios. The focus is on a traditional portfolio of equities and bonds that we will adjust to the new environment through allocation and selection.

The key points of the white paper are summarised below. Union Investment has made the full version of the white paper available at www.die-risikomanager.de.

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2 Pre-coronavirus investment world

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In order to make sense of the changes that the coronavirus pandemic has set in motion in the economy and the financial markets, we should first take a look in the rear-view mirror.

The capital market environment in the period between the global financial crisis of 2008/2009 and the collapse triggered by the outbreak of the pandemic in spring 2020 was in many respects a one-off. The world of investment was shaped by various overarching trends that were often interrelated and mutually reinforcing:

- The financial markets outperformed the real economy.
- Bond yields fell, in some cases well into negative territory.
- Tech stocks dominated.
- Growth investing clearly and consistently outperformed value investing and high-quality defensive stocks also outperformed the market.
- The US equity market significantly outperformed all other developed regions.
- There was a negative correlation between equity and bond prices.

Wall Street beats Main Street

'Secular stagnation', in which low economic growth is coupled with persistently low inflation, has been one of the primary narratives in the capital markets since the financial crisis.

The phenomenon was particularly pronounced in Europe, where the euro crisis precipitated by the financial crisis depressed growth to an even greater extent than in the US. It was a similar story for inflation, which fell below its pre-crisis level and remained stubbornly low.

Economists have spent a long time debating the causes of secular stagnation over recent years. The most plausible explanation for us is that the combination of a relatively weak propensity to invest combined with a significant global rise in the savings ratio put a sustained dampener on economic growth.

Our view is that this marked weakness in demand explains a number of macroeconomic features of the past decade and, to some extent, also the post-millennial, pre-financial crisis period, namely low interest rates, low inflation, low productivity growth and asset price inflation.

So, how did this environment affect prices in the financial markets and in the real economy? Well, as yields on bonds continued to fall in line with key interest rates, the price of assets in other financial markets surged. By contrast, prices in the real economy, for example for goods and labour, increased only modestly, and many commodities actually decreased in price. In a sense, Wall Street and Main Street had become detached. The financial markets had left the real economy behind.

Technology and the US dominate

For many stocks, however, particularly in the eurozone, the stellar performance was not always attributable to stellar corporate profits. The tailwind for prices was actually provided by the ever lower interest rates and bond yields. Eurozone stocks soared by 93 per cent between 2009 and 2020. Dividends accounted for 40 per cent of this growth, and profits were actually down by 14 per cent. This means that more than half of the uplift was due to higher valuations (67 per cent).

The picture looked a little different in the US, where higher profits were in fact the biggest factor by far in the performance of equities. But that tells only half the story. The strong profitability of the tech sector and the large share it occupies of the US market hid the fact that many US corporates delivered only lacklustre growth. Tech company profits swelled by 143 per cent between 2009 and the end of 2020 due to the structural trend towards digitalisation, the often easily scalable business models and growing market power.

High level of diversification

Portfolios containing both equities and bonds were significantly boosted by the negative correlation between the prices of these two asset classes, i.e. losses on equity investments were mitigated by gains on bonds. For many years, multi-asset portfolios benefited twice over, from the high returns generated by these two asset classes and from a high level of diversification. This made the portfolios both robust and profitable.

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3 The global economy during the pandemic

3 The global economy during the pandemic: the beginnings of a shift in long-term trends

At the core of our white paper is the proposition that coronavirus will lead to a new growth dynamic. Why? Because the supply side is set to be boosted by the acceleration of technological progress while the demand side will benefit from an increase in state economic activity.

However, it is not just the growth dynamic that will change but also international economic relations. The key questions are what impact will this set of circumstances have on growth and interest rates and what will happen with inflation given these conditions?

The end of weak demand

Just as in many crises that came before it, the coronavirus pandemic increased the speed at which new technologies were adopted. Social distancing, in particular, has dramatically accelerated the digital transformation in numerous sectors. The result has been higher productivity growth. This is particularly evident in e-commerce and telemedicine. But in manufacturing too, the crisis is likely to speed up the adoption of automation technology. Even under normal circumstances, businesses tend to use the recovery phase after a recession to invest in new, labour-saving technologies. The recovery from the current pandemic appears to be following the same pattern, but writ large.

The effect will probably be stronger in the US than in Europe. The US labour markets are more flexible than in Europe, which also tends to be slower to adopt new digital technologies. On the positive side, there is an increasing recognition that Europe's economies and governments have a lot of catching up to do on the digital front, and this deficit is now being addressed from a number of angles, including via the EU's recovery fund.

But there is simply no comparison with the pace being set by the US, which switched on the afterburners in March 2021 by passing the American Recovery Act. The aim being to put its economy back on its pre-pandemic growth trajectory as quickly as possible. Far less support will be provided for the recovery in the EU once its programmes designed merely to stabilise the economy have been wound up.

So, there is much to suggest that the US will break free from its stunted growth trajectory. The direction in which Europe is heading is not as clear. This is mainly because of the less pro-

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nounced effect of digitalisation on productivity growth, the absence of any short-term overheating of the economy and a fiscal policy stance that remains more cautious than across the Atlantic.

A reordering of global economic relations

We also expect the coronavirus pandemic to bring about lasting changes to international economic relations. Numerous trends had already begun to emerge before the pandemic began. The crisis has accelerated these trends, and in some cases escalated them to a whole new level.

The trend towards deglobalisation[1] can be traced back to the aftermath of the financial crisis. One of the key drivers behind this trend was the emergence of China as an economic force. Within China itself, this was reflected in rising wages and, as a consequence, higher wage costs. But it also contributed to the growing shift from investment to consumption in China's economic model. This led to weaker growth in the demand for imports in China, particularly for commodities.

In addition, the past decade has shown us how susceptible highly efficient global supply chains are to shocks from natural disasters such as the earthquake that triggered the Fukushima nuclear disaster in 2011. In many cases, companies had already taken action in an attempt to reduce risks. But COVID-19 proved to be the worst-case scenario for global supply chains. It is thus likely the pandemic will further accelerate the restructuring of supply networks.

Political trends

The pandemic's impact on the dispute between China and the US is not to be underestimated. The two nations were already embroiled in a strategic tussle before coronavirus, and the pandemic has significantly intensified the conflict.

If forced to choose, the US will put the interests of national security ahead of the interests of business. Specifically, this means that it will seek to decouple from China in strategically important economic sectors in order to ensure security of supply. This will mainly affect the supply chains of key products and industries. Right at the top of this list will be semiconductors, critical minerals (such as rare-earth elements), batteries and pharmaceutical products. The primary objective for the US is to establish the supply chains for the technologies of the future and to do so within its own borders wherever possible.

[1] A trend in which global trade grows at a slower rate than global economic output.

The future of inflation

The new growth dynamic that we are anticipating for the US will have a bearing on inflation too. An end to structural underutilisation of capacity should bring the disinflationary tendencies of recent decades to a halt and result in more 'normal' levels of price increases on the other side of the Atlantic. Inflation rates that persist at a level far below the US central bank's inflation target of 2 per cent a year would likely be a thing of the past. The new normal for inflation will instead probably be a level that is slightly above this target.

We are less optimistic with regard to the eurozone. Although there are certain structural drivers to suggest that inflation may edge up in the future (see figure 1), the eradication of structural weakness in demand, which we consider to be the most important precondition for structurally higher inflation, is likely to be less pronounced in the eurozone.

Figure 1 **Impact of macroeconomic drivers on inflation**

Estimated strength and direction of impact

	2009–2020		5 years +	
	US	Europe	US	Europe
Output gap (cycle)	– –*	– –	+	O
Fiscal policy	–	– –	+	O
Green transformation	O	+	+	+
Industrial policy	O	O	+	+
Inequality	– –	–	O / +	O
Competition	+	–	–	O
Monetary policy	O	–	+	O
Digitalisation/technology	–	–	– –	–
Globalisation	O	O	+	+
Demographics	–	–	O / +	O / +

Source: Union Investment; * with the exception of 2018–2019.

4 Investing in the post-coronavirus world

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We anticipate that there will be substantial shifts in asset classes, investment styles and regions – and also in how multi-asset portfolios are diversified.

4.1 Higher US interest rates and less diversification

In recent decades, interest rates have only ever moved in one direction – down. Implicit in our expectation of structurally higher growth, however, are structurally higher interest rates.

Over the next ten years, we expect the neutral US Federal Funds Rate to rise by 0.7 percentage points to around 3.5 per cent. The entire US interest-rate curve will shift upwards with it.

However, there are two factors that will put a brake on rising long-term government bond yields. The first is that higher yields on US bonds should trigger an inflow of international capital that will serve as a natural cap for these increases. The second is that even long-term interest rates will continue to be influenced by monetary policy. After all, it is generally accepted that the Fed will hold the government bonds on its balance sheet through to maturity and not do anything that would unsettle the market.

Less diversification in mixed portfolios

A structurally higher level of inflation above the 2 per cent mark will create a new inflation regime in which a short-term overshooting of the target becomes more likely than deflationary tendencies.

This is particularly relevant in the context of multi-asset portfolios, because the correlation between equities and bonds changes depending on the prevailing inflation regime. Prices of equity and bond investments have been negatively correlated since the late 1990s. The fact that when share prices fell, bond prices rose offered protection to a multi-asset portfolio. Portfolio diversification was at a high level.

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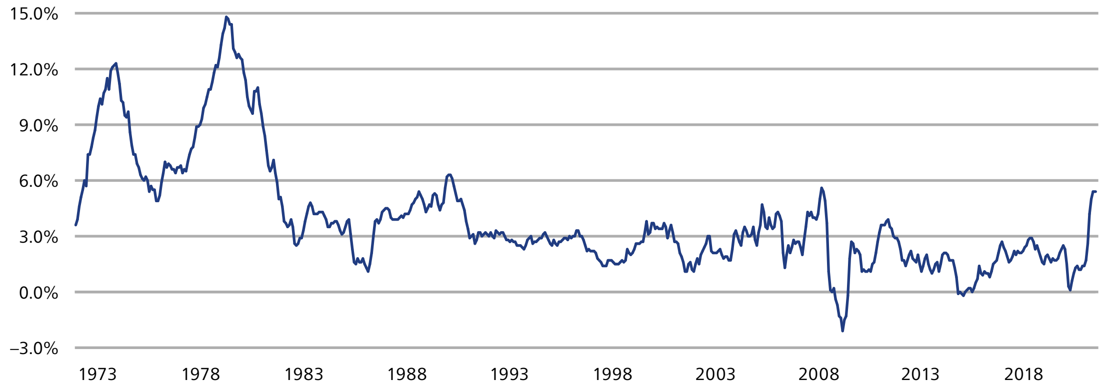
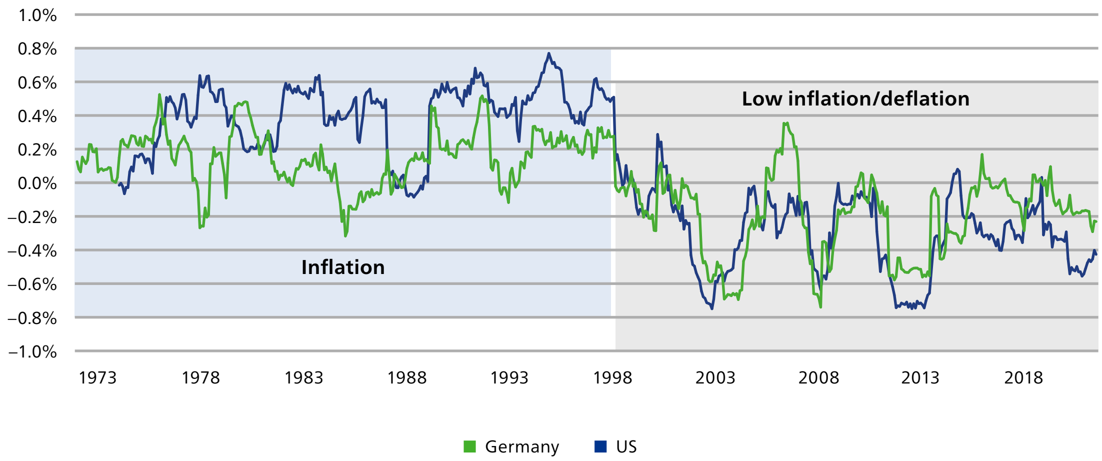
Figure 2 **Asset allocation: high diversification of equities and bonds since the late 1990s, including in Germany**

Annual inflation rate in the US (%)



Two-year correlation, equities vs. government bonds*



Sources: Bloomberg, Datastream, Union Investment. *MSCI US and DAX, Bloomberg US Treasury index and REXP.

This negative correlation between equities and bonds tied in with the environment of secular stagnation of recent decades, characterised by weak demand and low inflation. Every time there was hope of breaking free of stagnation, demand for equities rose to the detriment of bond investments – and vice versa.

We expect this negative correlation to weaken as demand strengthens and the economy transitions to a new inflation regime. This means that portfolios containing both equities and bonds will feature less diversification in the years ahead, which will present investors with a new set of challenges.

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4.2 Historical analysis: asset classes in different inflation regimes

So, what is likely to be an optimum allocation of assets in this new playing field? To begin to answer this, we will first look at the historical performance of the individual asset classes since 1973 in various inflation regimes.

The focus here is on inflation because the anticipated end of disinflation in the US represents the biggest break in a trend that has a direct impact on the individual asset classes. The historical patterns provide a good starting point for understanding how these asset classes behave under the influence of rising prices.

We distinguish between five inflation regimes:

- **Below 1 per cent:** low inflation and close to deflation
- **1 to 2 per cent:** lower range of the inflation sweet spot[2]
- **2 to 3 per cent:** upper range of the inflation sweet spot
- **3 to 5 per cent:** inflation at an elevated level
- **over 5 per cent:** inflation overshoot

As a starting point, we compared the prices of US consumer goods with the performance of various asset classes and investment styles (see figure 3).

Fixed income

US government bonds delivered a comparatively high total return in all inflation regimes. By contrast, US Treasury Inflation-Protected Securities (TIPS) proved much more sensitive to price rises. The higher the rate of inflation, the better the TIPS performed – which is, of course, how they are designed. The benefits of corporate bonds mainly came into play in the inflation sweet spot of between 1 and 3 per cent. Performance was markedly poorer when inflation was above or below this level. This was particularly true in the case of high-yield bonds, which in phases of low inflation (below 1 per cent) generated a negative total return.

Equities

From a historical perspective, the performance of equities has been weakest during times of low inflation (below 1 per cent). Low inflation often went hand in hand with a weak economic climate. In the subsequent phase of rising growth and rising prices, however, this asset class enjoyed the best of both worlds.

[2] The capital markets, particularly equity investments, have historically performed the best in this inflation bracket.

Figure 3 **Historical performance of asset classes in various inflation regimes**

Average annual return (US dollars or local currency)
(%)

Asset class	Inflation regime				
	less than 1 per cent	1 to 2 per cent	2 to 3 per cent	3 to 5 per cent	over 5 per cent
US government bonds	5.8	6.6	5.9	9.2	7.5
US Treasury Inflation-Protected Securities (TIPS)	2.3	5.1	5.7	7.1	11.0
US corporate bonds (investment grade)	4.0	8.4	8.8	10.1	5.6
US corporate bonds (high yield)	–1.0	9.5	13.1	10.5	4.4
MSCI USA	–3.9	14.7	16.4	12.6	6.1
MSCI Emerging Markets	–11.8	5.2	19.6	20.2	20.7
Cyclical equities	–5.3	16.2	20.6	13.7	4.9
Defensive equities	–3.7	12.9	13.6	16.3	9.2
Cyclical vs. defensive equities (relative)	–2.0	3.3	6.1	–2.3	–3.8
Infrastructure equities (global)	–8.0	12.2	19.7	18.2	–3.9
Infrastructure equities (global) vs. MSCI ACWI (relative)	0.0	1.2	2.1	6.0	6.8
US real estate investment trusts (REITs)	–7.1	16.5	21.7	16.3	9.6
US real estate investment trusts (REITs) vs. MSCI USA (relative)	–3.2	1.8	5.4	3.7	3.5
Equity investment styles, value vs. growth (relative)	–6.8	–4.7	–0.8	0.0	2.7
Equity investment styles, small vs. large caps (relative)	–1.0	–0.4	1.8	–0.3	5.5
Commodities index	–26.4	–5.2	9.1	14.4	19.8
Energy commodities index	–47.1	–17.1	11.1	27.5	13.3
Industrial metals index	–21.8	–0.1	15.8	25.8	11.0
Precious metals index	1.1	4.6	6.9	5.2	24.7
Gold	4.5	4.9	6.2	5.2	22.4
Cash (US$)	0.4	2.2	3.3	5.8	8.7

Sources: Bloomberg, Datastream, from 31 January 1973, except US investment grade (30 June 1973), high yield (31 January 1980), infrastructure equities (31 January 2002) and value vs. growth (31 December 1974); other assumptions/sources are detailed in the annex.

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That is to say no immediate prospect of the economy overheating and therefore no need for any significant tightening of monetary policy. A corridor between 1 and 3 per cent was the inflation sweet spot for equities. When prices rose at a faster rate than this, however, the interest rate hikes initiated by the central banks put pressure on equities from the valuation side. This is why the performance of equities in times of high inflation was, on average, not as strong.

In the sectoral breakdown, cyclical stocks fared better in this sweet spot than defensive ones. This is because cyclically sensitive equities tend to flourish in a growth environment. The analysis also shows that the energy industry has, in the past, proved particularly valuable as a buffer against inflation. By contrast, the performance of the technology sector has been weakest during periods of high inflation. We believe that this is primarily due to the relatively long time horizon for the cash flows generated by tech firms.

Other strong-performing sectors in this context include US real estate investment trusts (REITs) and infrastructure equities. Real estate investments tolerate a slightly higher level of inflation than the broader equity market. A plausible explanation for this is that the sector's cash flows are better protected against inflation. The income generated by infrastructure companies is partially inflation-protected too, which is why global infrastructure stocks also increasingly outperformed the market when inflation rose.

In terms of investment styles, historical data shows that value outperforms growth only when inflation is high. The size factor seems to make little difference, though smaller firms do tend to benefit slightly more from an environment of rising inflation than larger ones.

Commodities

Because rising commodity prices are often a driver of higher inflation rates, there is a risk of the historical analysis painting an exaggerated picture (reverse causality). Nevertheless, we consider commodities to be among the asset classes that are able to provide a certain level of protection against price rises. Looking back, commodities have fallen in price during times of low inflation. Their performance was also slightly negative in the 1 to 2 per cent lower range of the sweet spot, which is commonly reached in the early phase of the economic cycle. The more inflation climbed above this mark, however, the better commodities performed.

4.3 Conclusions in a portfolio context

We have used our analysis of the impact of higher inflation in a multi-asset context to come up with proposals for investors, both in terms of the allocation of the asset classes and the selection of the sub-asset classes. The objective is to improve not just the return generated by the portfolios but also their risk-return ratio.

We have already described how we expect the correlation between equities and bonds to change, so it is now time to look at other examples of correlations. Figure 4, for example, shows that the correlation between equities and commodities decreases as the inflation rate increases. For a multi-asset portfolio, this means that when inflation rates are high, commodities can compensate to a certain extent for the loss of diversification previously provided by equities and bonds.

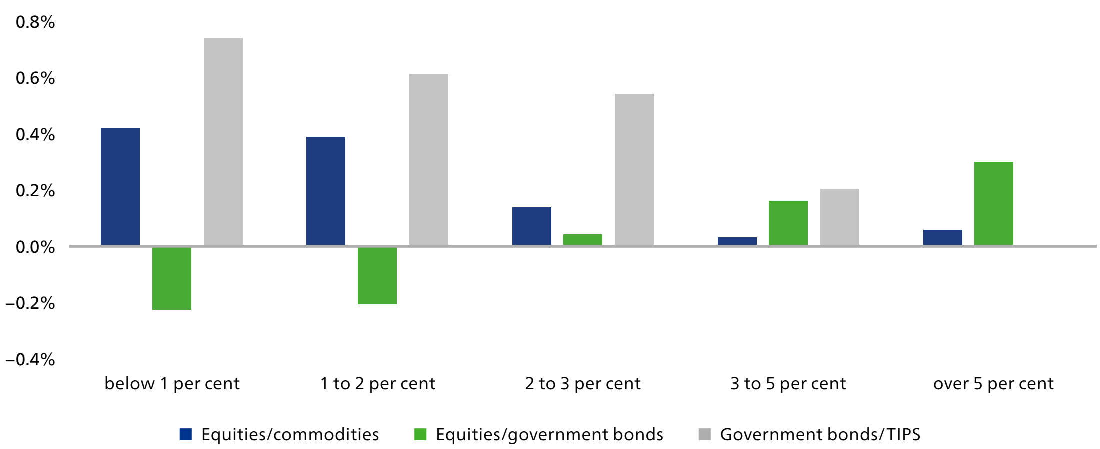
A similar picture emerges with government bonds and US Treasury Inflation-Protected Securities (TIPS). The performance of the latter decouples from that of nominal government bonds the more that inflation increases, meaning that they enhance the level of diversification within the portfolio when prices are rising more rapidly.

How can these insights be applied in a portfolio context? Let us examine this using the example of a traditional US portfolio mixing stocks and bonds (60 per cent equities and 40 per cent government bonds). We analyse the inflationary characteristics of this portfolio and demonstrate how investors can adapt their portfolio in readiness for the end of disinflation.

According to our analysis, the traditional 60/40 portfolio achieves the highest return and the best risk-return ratio in the inflation sweet spot of between 1 and 3 per cent. It is also noticeable that volatility increases as inflation does. In the next step, we calculate how investors can optimise their portfolios for an environment of rising inflation.

- If, in the underlying portfolio, we switch 10 of the percentage points allocated to US

Figure 4 **Correlation of various sub-asset classes in different inflation regimes**



Sources: Bloomberg, Union Investment, as at August 2021. Data for equities, government bonds and TIPS based on US indices.

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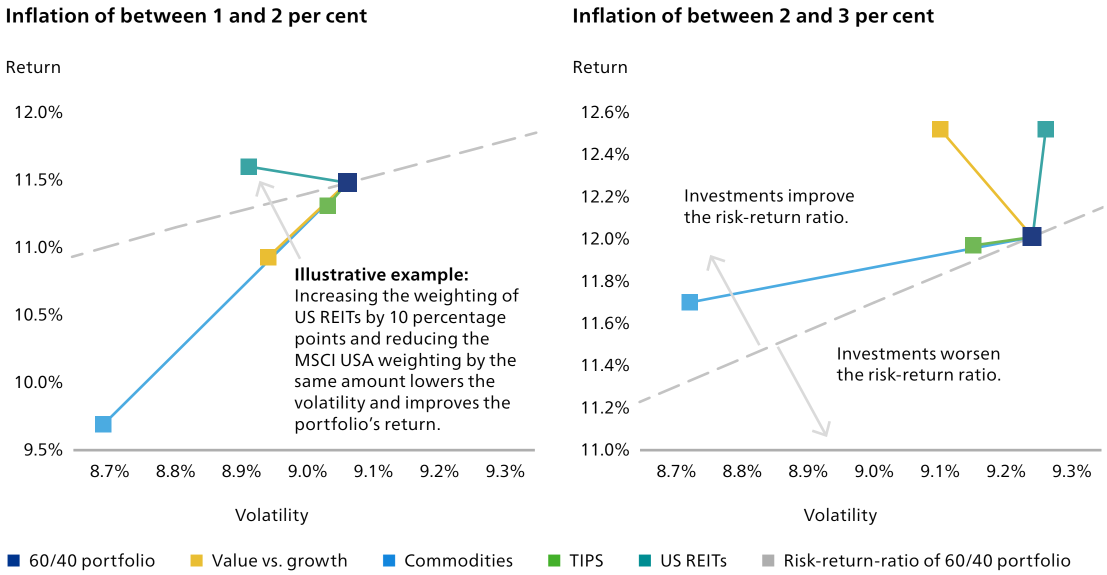
Figure 5 **Selection of strategic portfolio adjustments in various inflation regimes**



Sources: Bloomberg, Union Investment, In each case, either a 10 per cent weighting of US government bonds (TIPS) or equities (US REITs, value vs. growth) or a 5 per cent weighting of government bonds and 5 per cent weighting of equities (commodities) were substituted with one of the other named sub-asset classes for the purposes of diversification.

government bonds over to TIPS, we see – as would be expected – an improvement in the risk-return ratio, particularly when inflation is running at more than 5 per cent. Although in the sweet spot the diversification has almost no impact on the risk-return ratio, it is still to be recommended. This is because the costs of implementing the strategy are low, but the potential benefit in an inflation overshoot scenario is high.

- The addition of other sub-asset classes can also help investors to better protect the portfolio's equity holdings against higher inflation. This is why we reallocated 10 percentage points of the equity position to either US REITs or emerging market securities. We also analyse the effects of changing the weighting of different investment styles. Specifically, in the 60 per cent equity allocation, we increased the weighting of defensive stocks (at the expense of cyclical stocks) and of value (at the expense of growth), in both cases by 10 percentage points.

It turns out that these reallocations improve the return and the risk-return ratio when inflation is at a raised or high level. By tweaking the reallocations, it is even possible to generate a higher rate of return with less risk. The addition of US REITs and the increased weighting of smaller firms have an especially positive impact.

The addition of infrastructure equities brings further improvement. If, in the scenario in which the inflation rate is between 2 and 3 per cent, 10 percentage points of the 60 per cent weighting of US equities are allocated to global infrastructure stocks, both the absolute return and the risk-return ratio are higher. The fact that many infrastructure firms' revenues will increase in line with prices is an obvious benefit here.[3]

Commodities are also ideal for exploiting the opportunities provided by higher inflation while mitigating the risk from an inflation overshoot.

3 Infrastructure equities are omitted from the figure above because the available data covers a much shorter period of time.

4.4 Investment implications of a reordering of global relations

Investment decisions will need to factor in not only the shifting patterns of economic growth and inflation but also the reordering of global economic relations. Although the changes are only now starting to take shape, we believe that investors can already begin capitalising on the new trends that are emerging by constructing their own thematic portfolios.

As professional investors, we provide baskets of individual securities that together can be used to diversify a fund. For example, the pandemic has further accelerated the restructuring of global supply networks. Our investment benefits from this reconfiguration and from the digitalisation and automation of value chains and production processes. An internationally diversified basket of 49 equities provides access to this theme.[4]

4.5 Asset classes: analysis and recommendations

As a response to the expected increases in the level of US interest rates and yields, we recommend reducing the overall proportion of a multi-asset portfolio dedicated to fixed-income investments (government and corporate bonds). In the remaining fixed-income allocation, US government bonds should be preferred to those from core European countries because they pay a higher coupon. The addition of inflation-linked bonds (TIPS) is also advisable as a hedge against an inflation overshoot.

For corporate bonds and other spread investments, the picture is as follows: Rising US interest rates mean that the emergency situation facing investors is likely to ease a little. Demand for spread products such as investment-grade (IG) and high-yield (HY) corporate bonds and emerging market bonds will decrease a little as a result, while equities and commodities should deliver comparatively higher returns. Despite there being less of a tailwind, we assume that the credit asset class will continue to generate an adequate return over the coming years.

With regard to regional allocation, we recommend that credit investors hold on to positions in European corporate bonds for now. Once

[4] The companies selected are in the IT, industrial, healthcare, real estate and basic materials sectors. The investments in the 49 individual securities (long) are balanced out with a short basket that minimises the factor risks arising from the long side. This avoids the actual investment 'theme' being obscured by external influences.

yields on US paper reach a high level, investments should be reallocated to US credit. Focusing more on the high-yield segment is likely to be worthwhile here. In addition to its lower duration, which should mitigate the price falls, high-yield paper has two other key advantages: The first is that it performs better in the inflation sweet spot, and the second is that its default rates are lower in an environment of strong economic growth.

Recommendation 1: **Less fixed income in the multi-asset portfolio. Progressively more US duration and credit. High yield before investment grade.**

Equities

In the new macroeconomic environment, the equities asset class will benefit from the structural shift to higher economic growth in nominal terms. This should more than make up for a certain degree of headwind from rising bond yields.

This stronger economic growth will boost the earnings power of companies, whose (nominal) profits will increase. In the years before the coronavirus pandemic, performance was largely driven by improved valuations, particularly in Europe. But in the coming years, we expect this to switch, with profits taking over as the main driver of performance. Businesses will also have more opportunities for capital investment. For investors, this could mean that dividends will be lower, and share repurchases less common, than in the time before coronavirus.

There also appears to be a gradual shift in the direction of some other long-term trends too. For example, we expect the growth investing style to stop delivering superior performance. In an environment of structurally higher nominal growth, more and more companies will be able to grow at an adequate rate. 'Growth' will become less rare as a factor, which will make a premium for it less justified. Value and the equity markets outside the US will gain in appeal, at least from a relative perspective.

Recommendation 2: **Greater balance of styles and regions**

At sector level, equities of infrastructure companies provide a suitable means of participating in the structural transition to a green and more digital economy. Government infrastructure programmes in many countries will provide an additional tailwind, as will this sub-asset class's properties as an inflation hedge – because of how its cash flows are tied to the rate of inflation.

Recommendation 3: **Greater weighting for infrastructure in equity investments**

Commodities

The commodities asset class is likely to be among the big winners over the coming years. This will mainly be due to the increase in capital spending triggered by more rapid digitalisation, the green transformation, and the US and China establishing separate economic spheres.

All these factors are likely to lead to regular supply shortages of individual commodities. Then there is the fact that decarbonisation will entail a huge amount of capital spending. The required 'incentive prices' for the additional supply suggest that there will be new super

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cycles for individual commodities – as is already proving to be the case right now with copper.

What will be the commodities of the future? Energy remains a critical factor. Global energy consumption is growing all the time. However, the world is on the cusp of a wholesale energy transition in which fossil fuels will increasingly take a back seat. The energy commodities of the future will be those that are essential for sustainable power generation, where decarbonisation will result in a boom in electrification. The requirement to add new capacities in the generation, transport and storage of electricity will drive demand for metals such as copper, aluminium, nickel and lithium.

Recommendation 4: **Increased weighting of commodities**

The focus should be on the winners of the green transformation. In the economic environment that we are expecting, we see not only the prospect of healthy returns but also the benefits of portfolio diversification.

5 Conclusion

5 Conclusion

When it is time to look back, coronavirus is likely to be seen as the spark that initiated the acceleration or reversal of macroeconomic trends, resulting in fundamental shifts in the capital markets.

The return of growth and slightly higher inflation – at least in the US – will consign the secular stagnation that has dominated since the financial crisis to the past. This will be due to digitalisation and the green transformation of national economies but also to the strong stimulus provided by fiscal policy. Particularly in the US, a new economic philosophy is taking hold that gives government a more central role in the economy: transfer payments, public investment and an interventionist industrial policy are set to drive nominal growth and raise productivity while also putting the US ahead of China in the rivalry between the superpowers.

As our analysis shows, these reversals and shifts in trends have long-term implications for investors' actions: A new strategy is needed for the allocation and selection of asset classes, investment styles and regions. As the diversification

Figure 6 **Post-coronavirus: emergence of a new capital market environment**

	Pre-coronavirus	Post-coronavirus (2020s)
Macro trends	Neoliberalism	Strong state/industrial policy
	Monetarism	Keynesianism
	Austerity	Deficits
	'Fed put'	'Fiscal put'
	Tax cuts	Tax increases
	Disinflation	End of disinflation
	Globalisation	US-China rivalry
	Just in Time	Just in Case
	Wall Street	Main Street
Capital market trends	Bonds	Sustainable commodities
	MSCI World	Global infrastructure equities
	Equity rerating	Profit growth
	Carry factor in fixed income	TIPS, US money market
	Diversification	Positive correlation
	Long-duration assets	Short-duration assets
	Growth	Value & growth
	Technology	Technology and infrastructure, materials, banks
	Gold	Copper, nickel (industrial metals)

Sources: World Bank, BofA Global Research.

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provided by mixed equity and bond portfolios weakens, previously successful strategies are now having to be rethought.

In the white paper for the 2020 risk management conference[5], we had highlighted the long-term structural benefits of an internationalised portfolio and of a portfolio diversified with commodities, thematic investments and alternatives such as real estate. These last three elements remain unreservedly beneficial and the outlook for the post-coronavirus world only serves to underline their benefits.

Commodities have already performed well historically in times of rising growth and inflation. They also deliver the kind of portfolio diversification that, in the projected environment, would somewhat fall by the wayside with portfolios consisting of equities and bonds. Commodities that will be in demand because of the transformation to a green economy – for example in the manufacturing of electric vehicles and batteries – will receive additional tailwind. We therefore recommend increasing the proportion of these commodities in the portfolio.

Alternatives can either be invested in directly, of course, but also via equities. Infrastructure companies, for example, stand to gain from the structural transition to a green and digital economy and also protect against inflation. It is a similar story for US REITs. Our recommendation here is to reallocate core equity investments in the direction of these themes. Finally, investors can participate in the reconfiguration of value chains by buying baskets of equities focused on specific themes.

The strategy of internationalisation recommended last year still applies when taking a longer-term view across economic cycles.
On the fixed income front, the post-coronavirus world provides clear reasons for continuing to favour US paper over euro bonds. Interest rates are rising faster in the US, and so its bonds offer a higher current return. High-yield corporate bonds have fared better in an environment of higher nominal growth than investment-grade paper. We therefore recommend allocating a higher weighting to the US high-yield segment.

Structurally, the theme of internationalisation also still applies to equity investments. However, the anticipated end of outperformance by growth stocks is the main reason why a more balanced weighting of regions and investment styles would appear prudent.

We are aware that, due to regulatory restrictions, not all investors will be able to follow every recommendation in this white paper. Either way, a rethink is called for. The strategies that have served investors well up to now may cost them return in the post-coronavirus era or unbalance the portfolio's risk-return ratio.

5 See our white paper for the 2020 risk management conference:
Overcoming home bias: Which strategies really strengthen a portfolio?

When it is time to look back, coronavirus is likely to be seen as the spark that initiated the acceleration or reversal of macro-economic trends, resulting in fundamental shifts in the capital markets. The old strategies may cost return in the new world or unbalance the portfolio’s risk-return ratio.

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