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Strategic Forecasting

Long Term Return Expectations 2016

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1: Why Strategic Forecasting

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Strategic Forecasting: Why Do We Bother ?

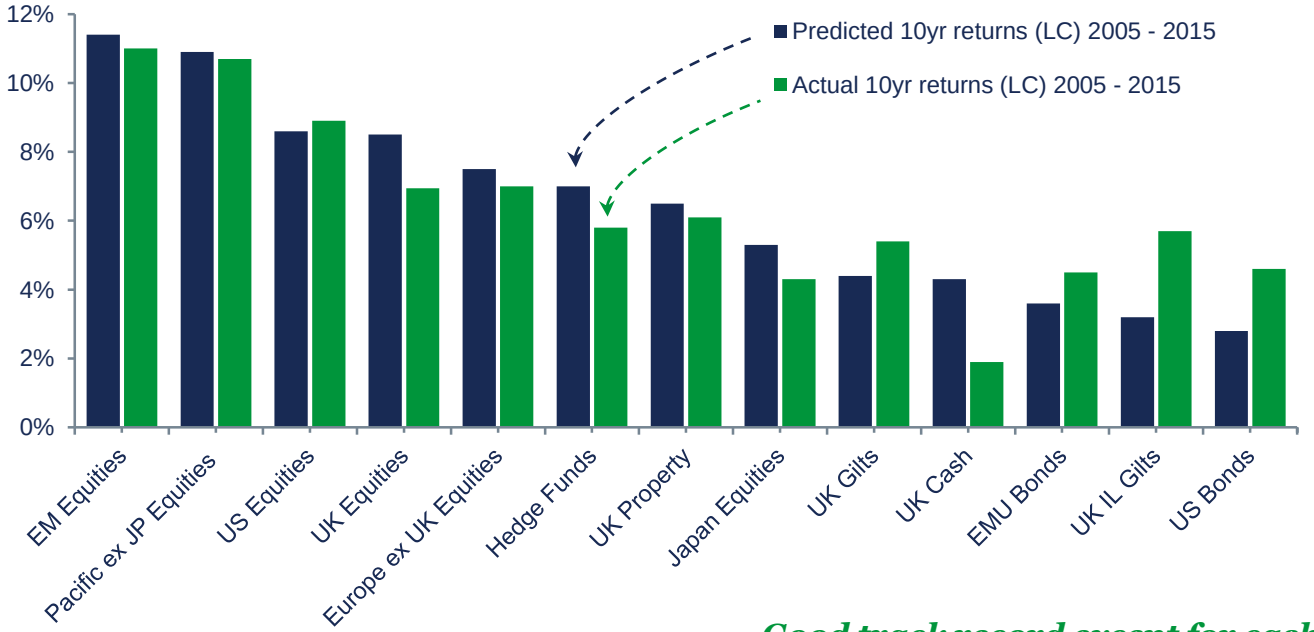
SECULAR ISSUES	VALUATIONS	DIRECTION OF TRAVEL
Allows examination of issues **unrelated** to short term price movements	Valuation is the **key driver** of long terms	Tells us point of arrival, but **not the type of journey**

Very useful to identify long-term themes
Not a portfolio construction tool

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Ten Years After Ten Years: Does It Work ?

Barings forecasts vs. actual outcomes



Good track record except for cash and bonds

Source: Barings, December 2005 predictions against average annual returns during the subsequent 10 years
Please refer to Important Information

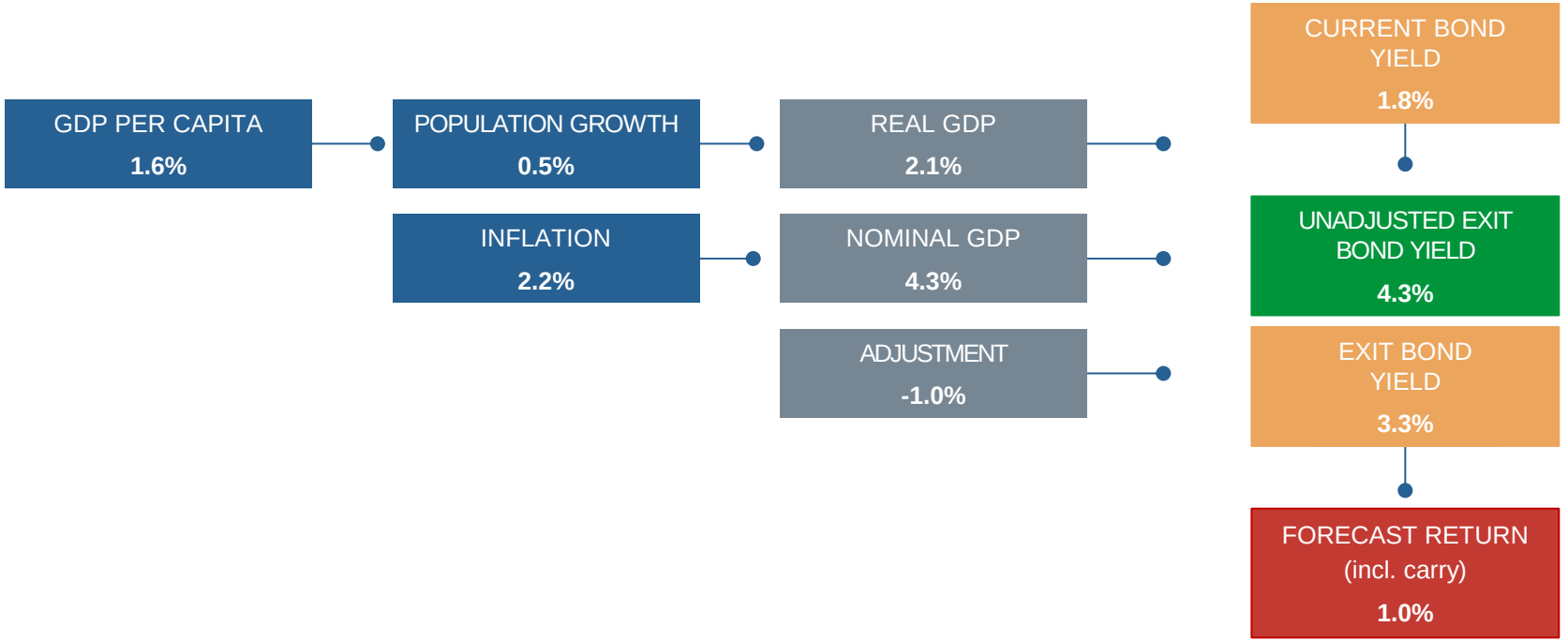
2: Economic Growth & Government Bonds

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From Economic Forecasts … to Government Bonds

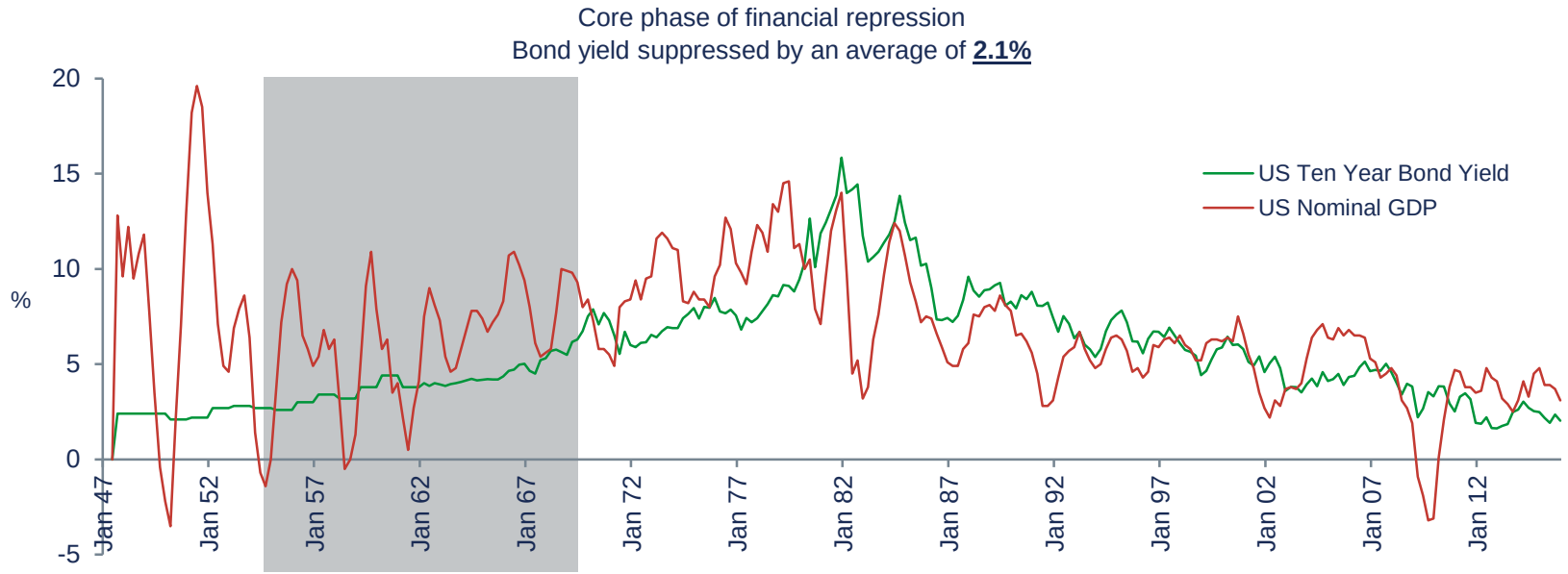
Forecasting the long-term total return (annual) of 10 years US Treasuries



Source: Barings calculations as of 31 March 2016

The Adjustment

Financial repression in history
1955-1969



We assume that Financial Repression will continue

We assume the impact to be half of the one experienced during the 1955-1969 period

Source: Bloomberg and Barclays Capital, as of 31 March 2016

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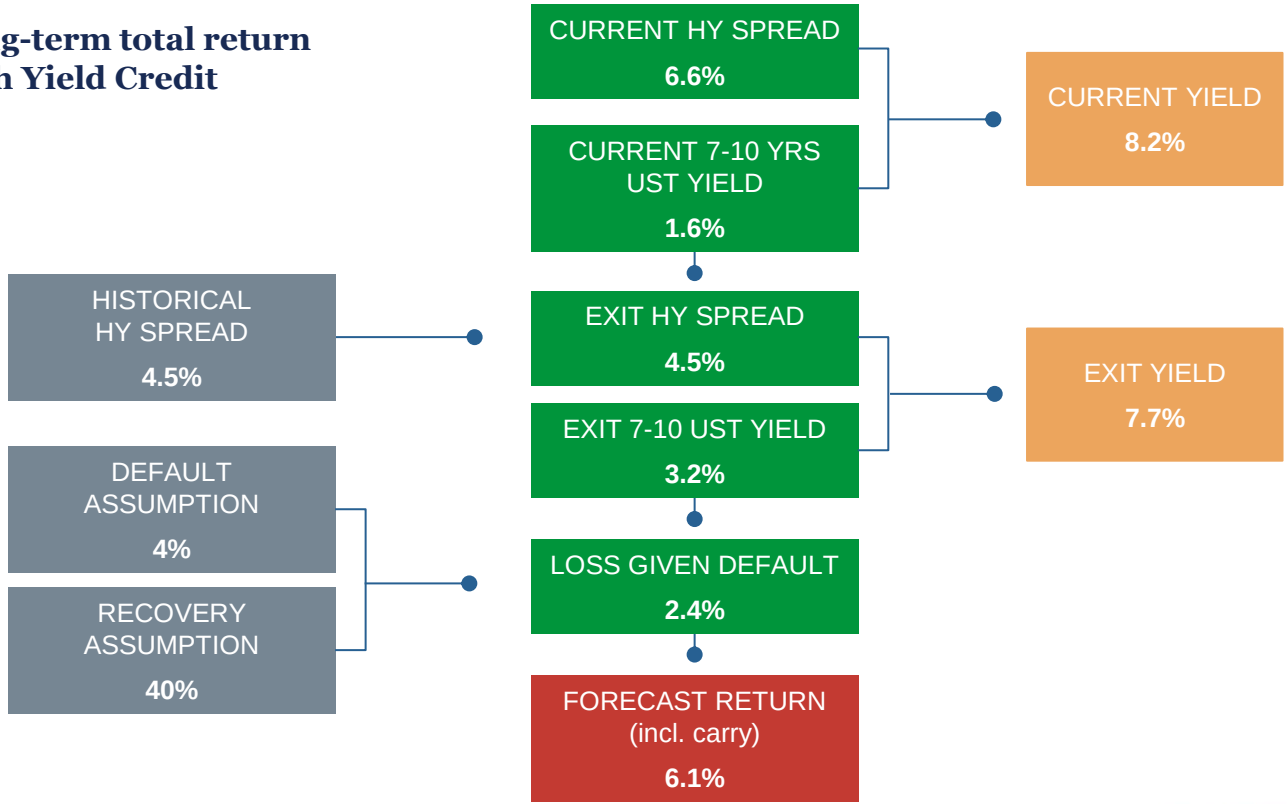
3: High Yield Credit

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Forecasting High Yield Credit

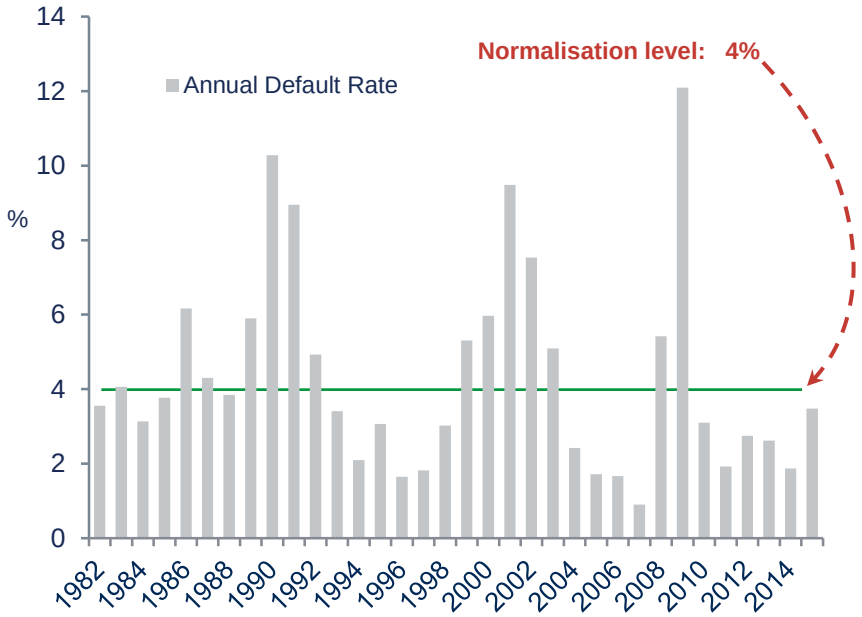
Forecasting the long-term total return (annual) of US High Yield Credit



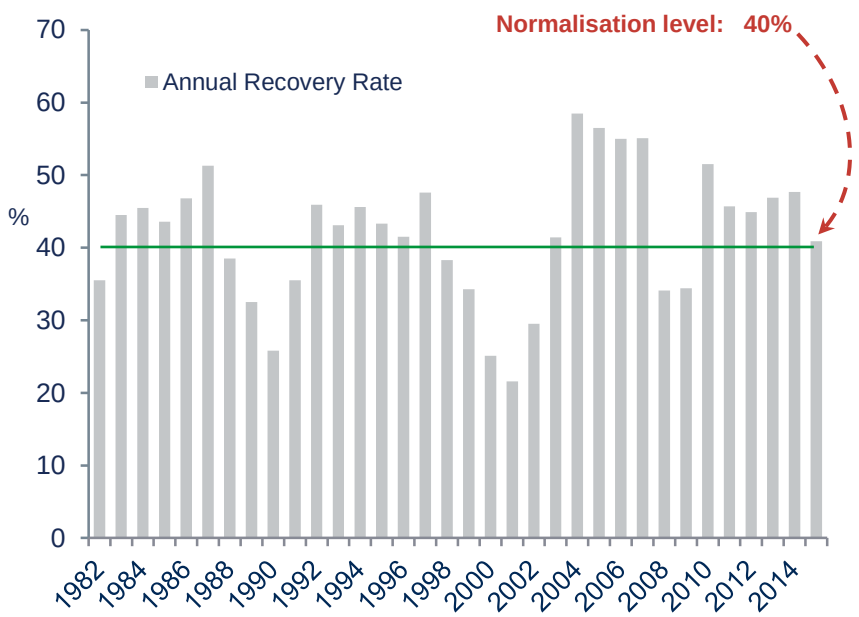
Source: Barings calculations as of 31 March 2016

High Yield Credit: Assumptions for Defaults and Recovery Rates

Corporate Defaults...



... and Recovery Rates



Source: Moody's – Annual Default Study: Corporate Default & Recovery Rates 1920-2015. 29 February 2016

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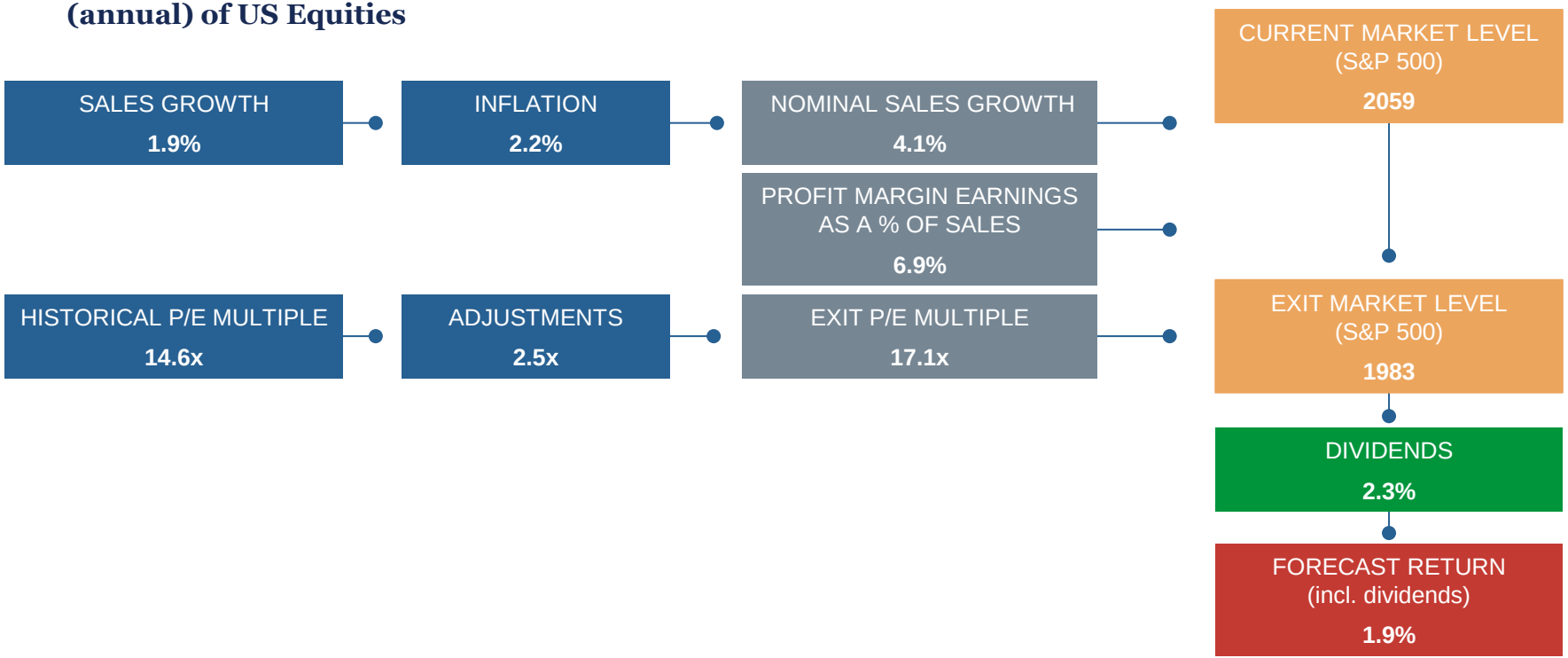
4: Equities

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Forecasting Equities

Forecasting the long-term total return (annual) of US Equities



Source: Bloomberg, Factset, Barings calculations as of 31 March 2016

Margins

DIFFICULTY	DRIVERS	BOTTOM UP APPROACH
Margins are the most difficult input to forecast	Our goal is to understand drivers of changes in margins, to understand how things may evolve going forward	Margin forecast for the whole of the S&P 500, by bottom up aggregation of individual company income statements

Margins: Drivers

ABOVE THE LINE

SG&A (Selling, General & Admin):
No material change
(some increase in wages)

COGS (Cost of Goods Sold):
No material change

BELOW THE LINE

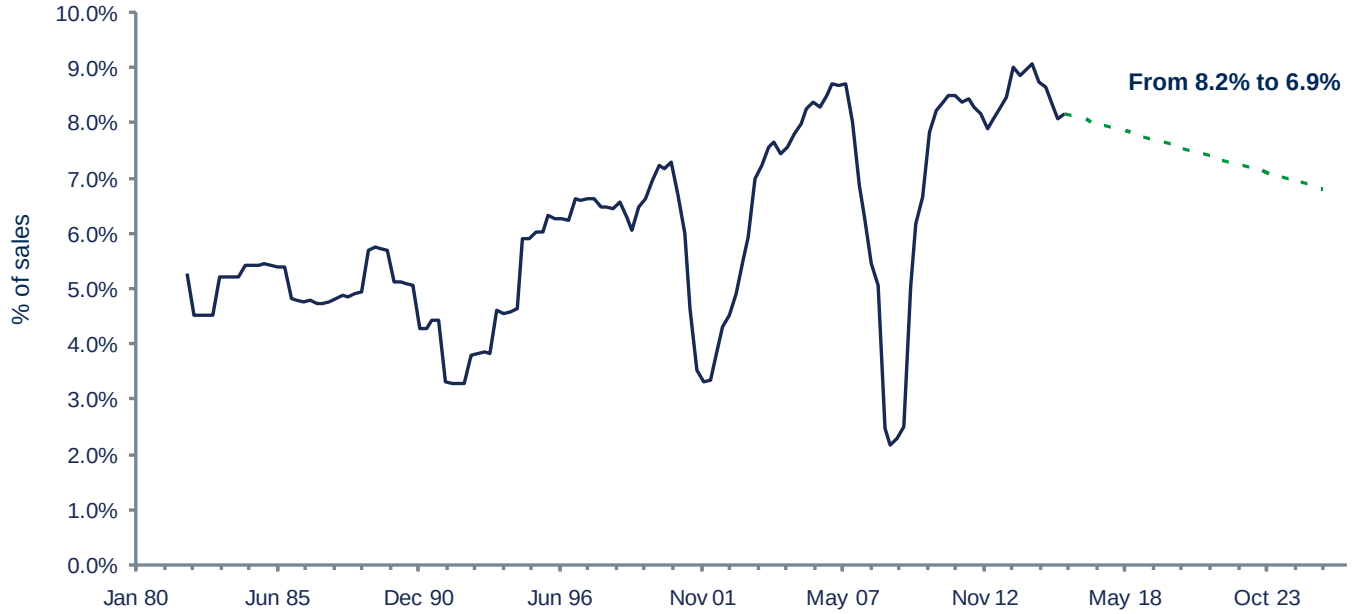
Interest Expense:
Gradual deterioration
(i.e. higher interest expense)

Tax:
Gradual deterioration
(i.e. higher tax expense)

Margins: A Small Margin Headwind

US net income margin

(All companies)



Margins have peaked in the US

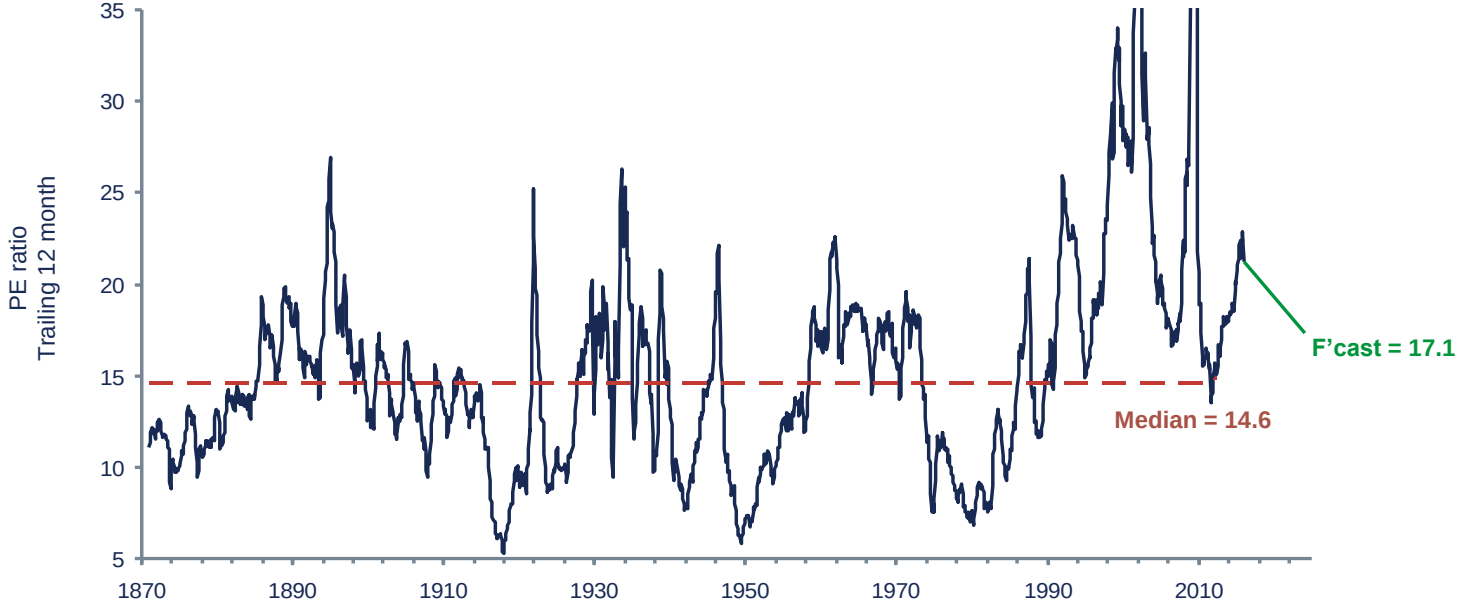
Headwinds from key drivers will gently affect margins, negatively

Source: Factset, Barings calculations as of 31 March 2016

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Valuations: Back to The Historical P/E ?

US price earnings ratio



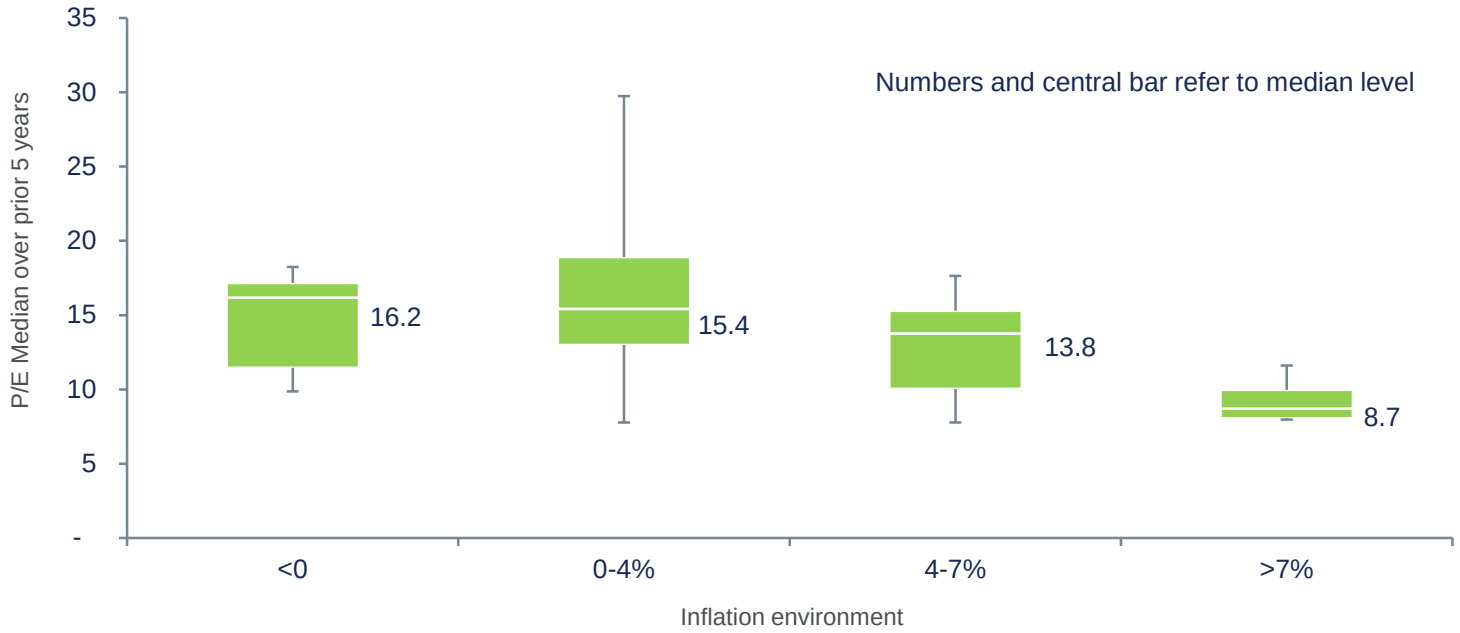
Not going back to the historical median of 14.6x
Valuations will go down but fall will be cushioned by <u>three</u> adjustments

Source: Robert Shiller, Yale, Barings calculations as of 31 March 2016

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Valuation Adjustment (1): P/E Ratios and Inflation

1



The forecasted inflation environment would suggest a P/E premium is warranted (0.8x)

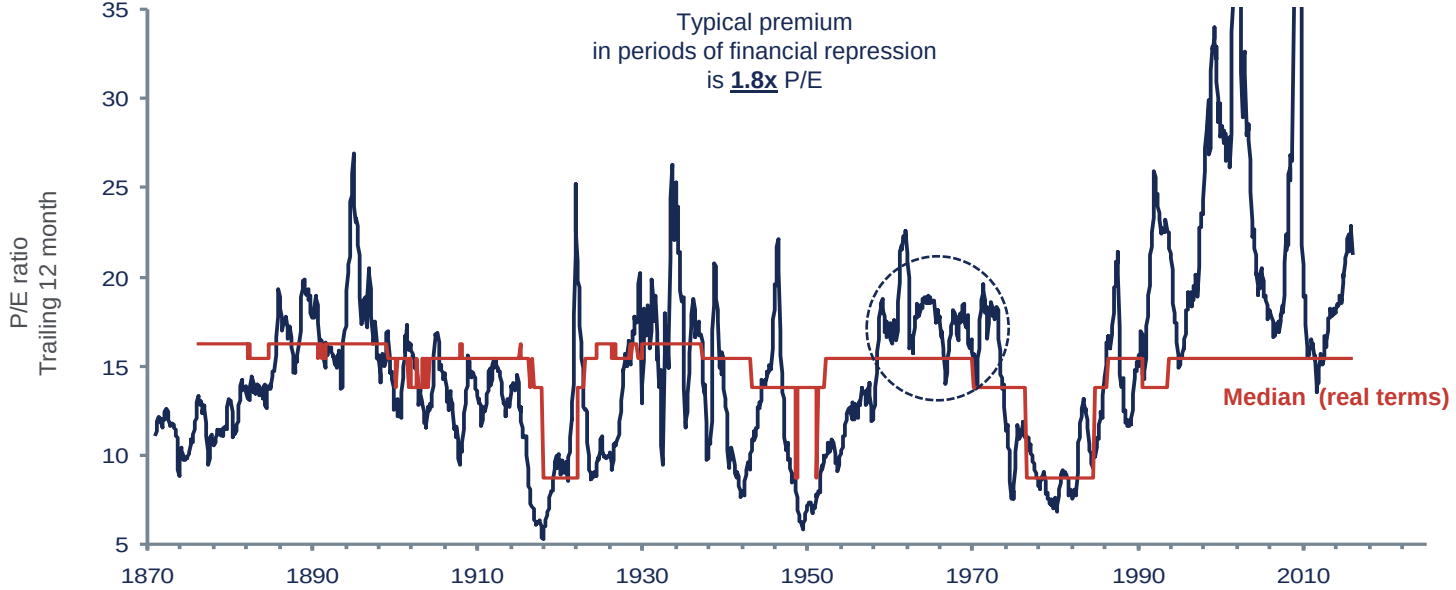
Source: Robert Shiller, Yale, Barings calculations as of 31 March 2016, period considered is (1871-2015)

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Valuation Adjustment (2): P/E Ratios and Financial Repression

2

S&P 500 P/E ratio



More financial repression suggests a P/E premium is warranted (0.9x)
We assume it to be half of the one experienced during the 1955-1969 period

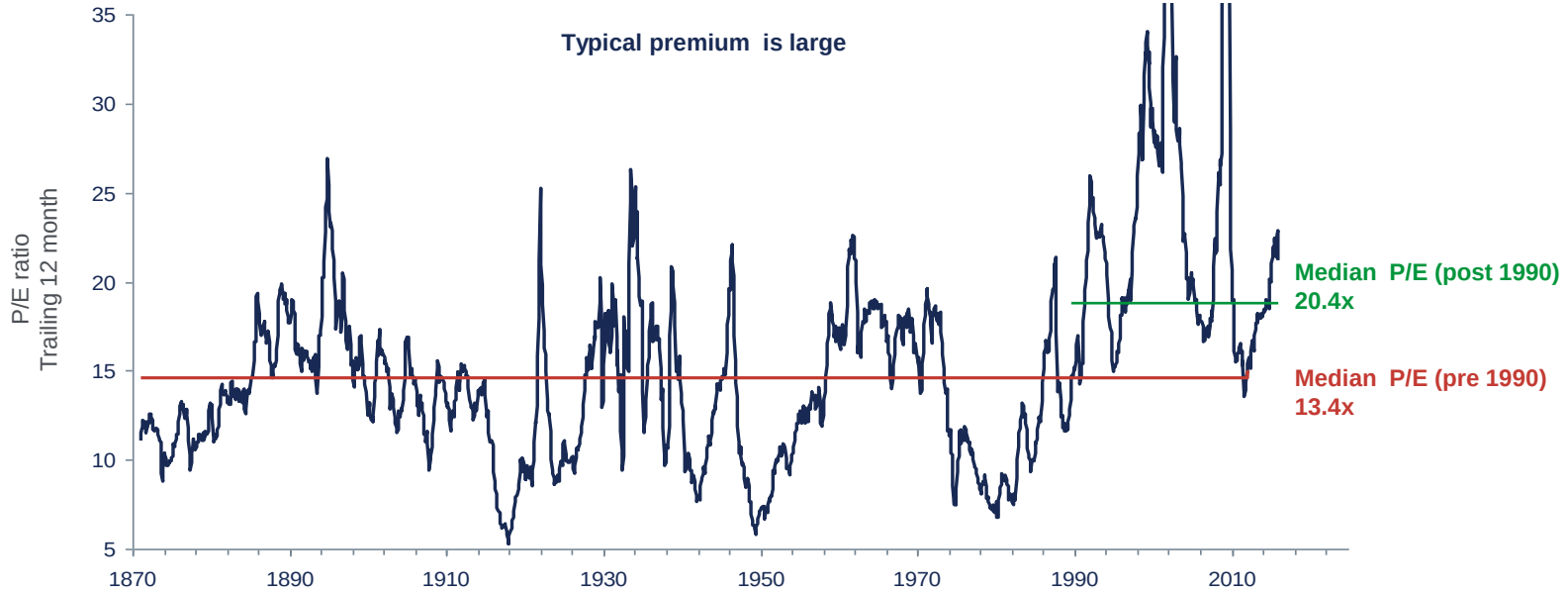
Source: Robert Shiller, Yale, Barings calculations as of 31 March 2016

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Valuation Adjustment (3): P/E Ratio and Globalisation

3

S&P 500 P/E ratio



Globalisation would suggest a P/E premium is warranted (0.8x)
But it is a smaller premium than in the past

Source: Robert Shiller, Yale, Barings calculations as of 31 March 2016

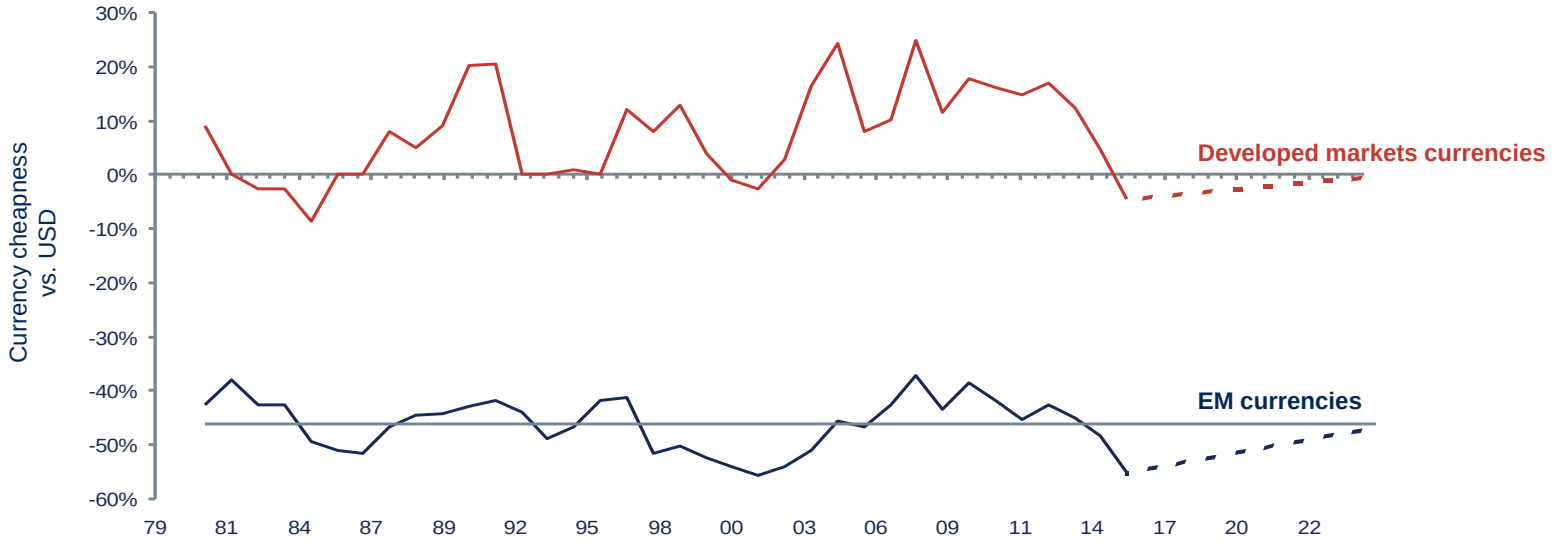
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5: Currencies

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Forecasting Currencies: Reversion to What ?

Cheapness to PPP fair value



Developed: US, UK, Euro, Japan, Australia, Canada

Developed orbitals: Poland, Hungary, Mexico, Singapore, Malaysia, Korea, Russia, Brazil, India, China, Thailand, Taiwan, South Africa, Turkey

We assume FX will fill only 50% of its gap to the historical mean

Source: IMF, Barings calculations as of 31 March 2016

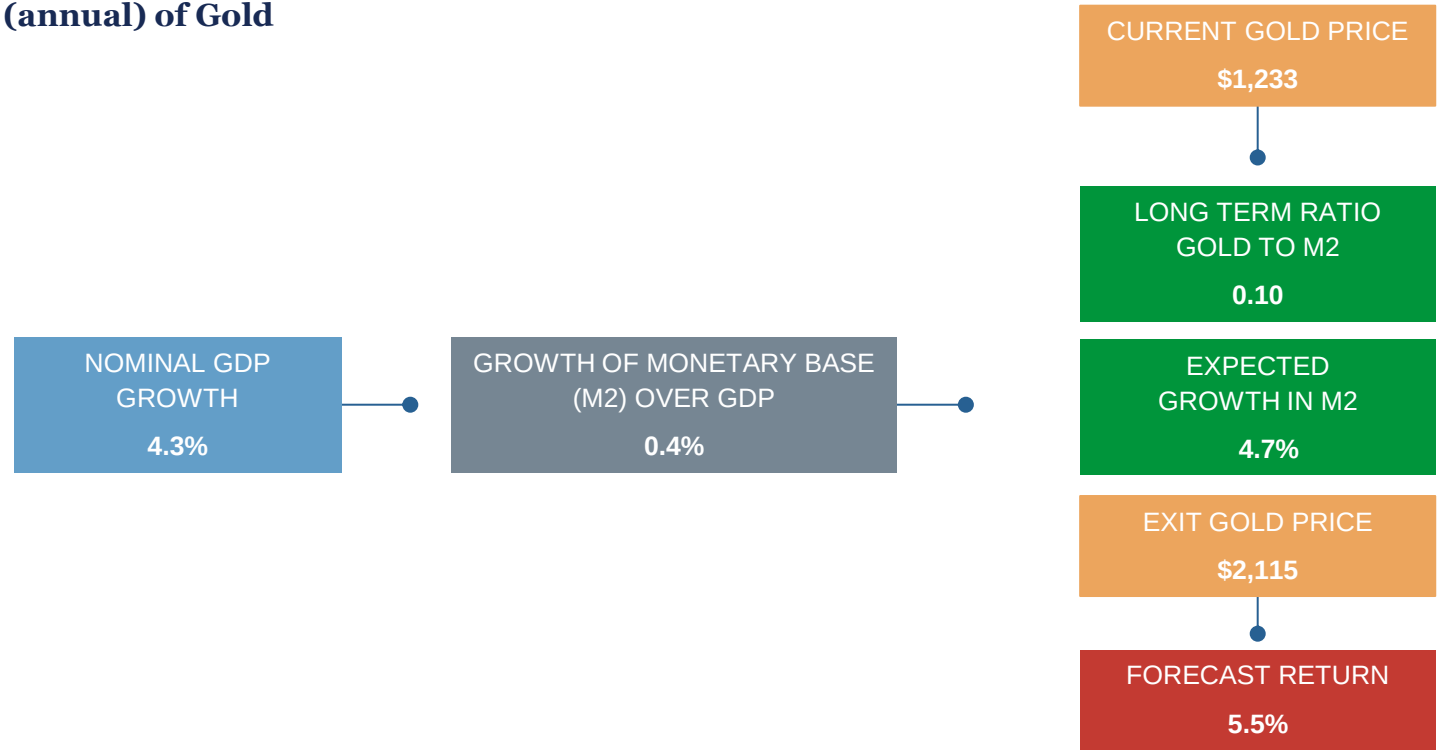
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6: Gold

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Forecasting Gold: Art or Science ?

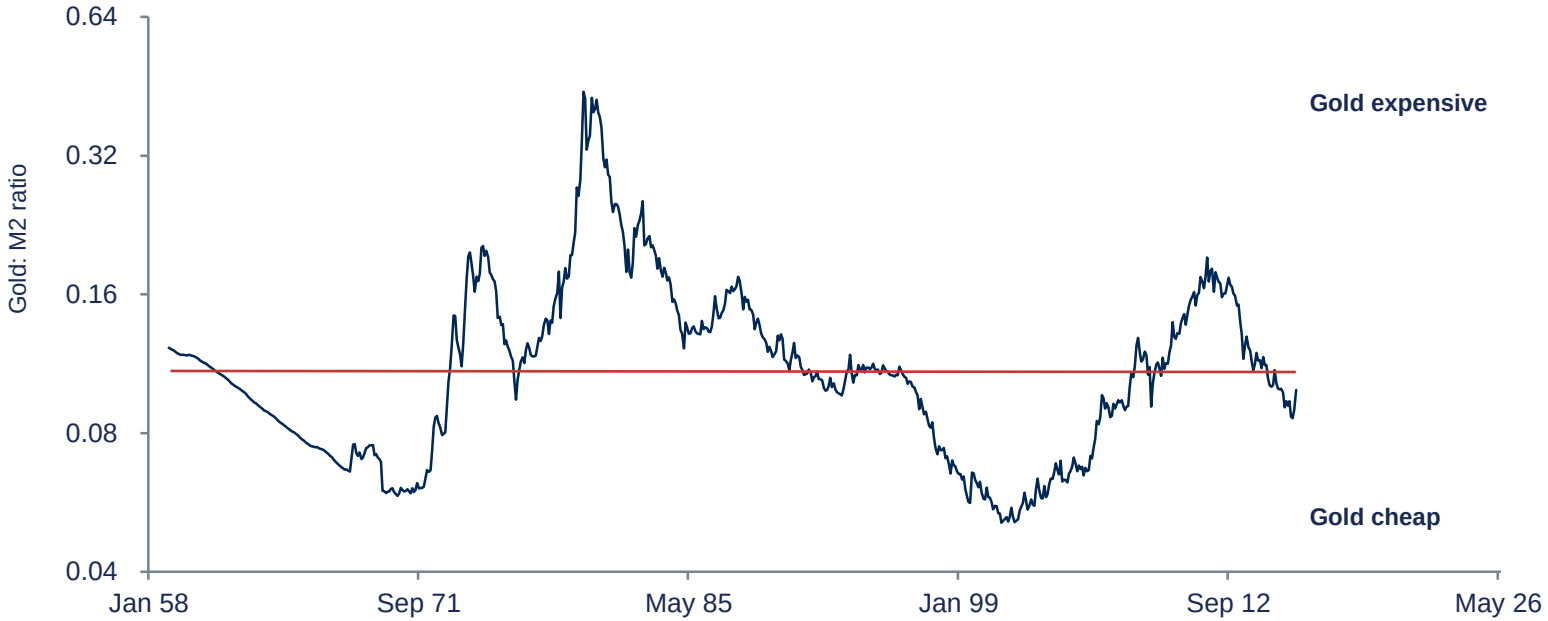
Forecasting the long-term total return (annual) of Gold



Source: Bloomberg, Barings calculations as of 31 March 2016

Gold Price Target: Growing in Line with M2

Gold price vs. US monetary base using M2



Source: Bloomberg, Barings calculations as of 31 March 2016

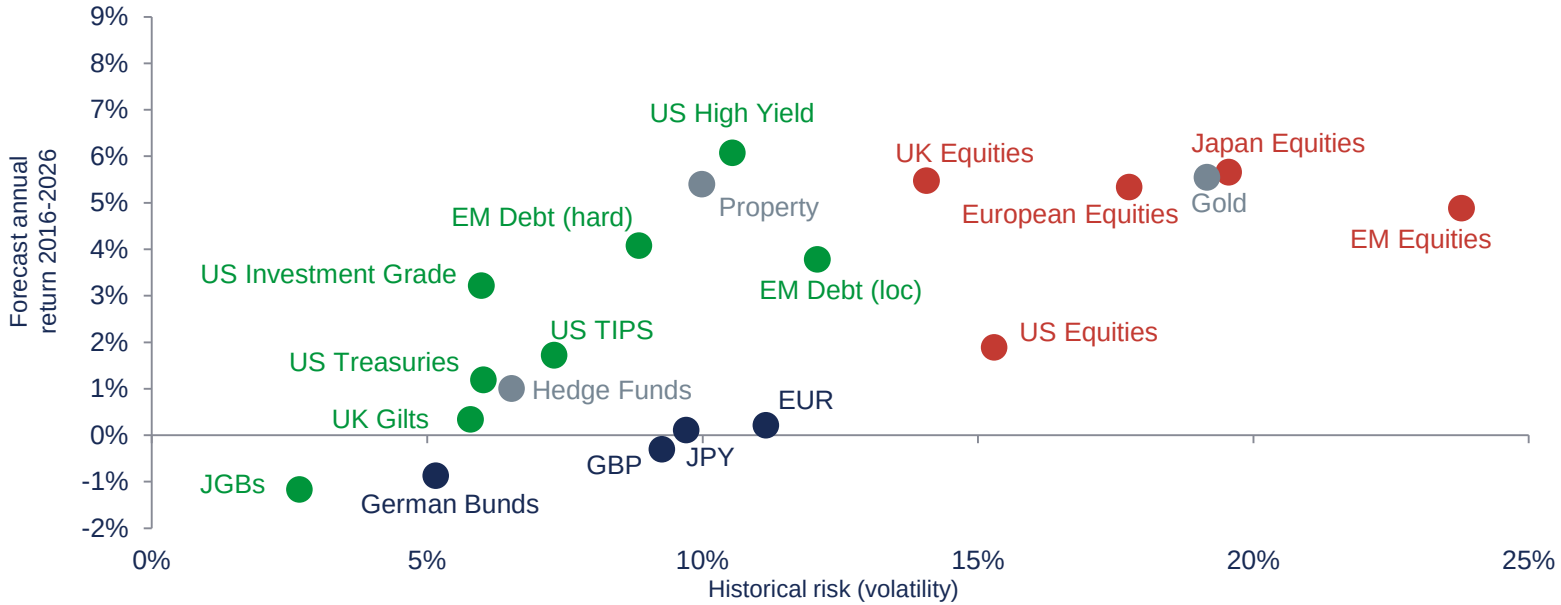
7: 2016-2026 Forecasted Returns

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Strategic Forecasting: Output 2016-2026 Returns

10 Year return forecasts



Local currency returns, except for EM Debt Local and EM Equities which are returns in US$.
EM indices use standard index weights.

Disappointing nominal returns

Source: Barings calculations as of 31 March 2016

Strategic Forecasting: Output 2016-2026 Returns

Effectiveness ratio



ASSET CLASS	RETURN/RISK
US High Yield	0.6
US Investment Grade	0.5
EM Debt (hard)	0.5
Property	0.5
UK Equities	0.4
European Equities	0.3
Japan Equities	0.3
Gold	0.3
EM Debt (loc)	0.3
EM Equities	0.2
US Treasuries	0.2
US TIPS	0.2
Hedge Funds	0.2
US Equities	0.1
UK Gilts	0.1
GBP	0.0
EUR	0.0
JPY	0.0
German Bunds	-0.2
JGBs	-0.4

Source: Barings calculations as at 31 March 2016

Strategic Forecasting: Balanced Strategy

10 Year return forecasts



Poor returns from asset class betas
Additional ingredients required to achieve target objectives

Source: Barings calculations as of 31 March 2016

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The Past and the Future

THE PAST KEY DRIVERS	THE FUTURE
Globalisation	Disappointing returns
Uptrend in profit margins	Correlations might increase
Inflation under control	Volatility might increase
Democratisation of investing through ETFs	Dynamic approach to asset allocation
QE policies supporting asset prices	Equity alpha, more via themes/styles
Diversifiers available	Role of currencies

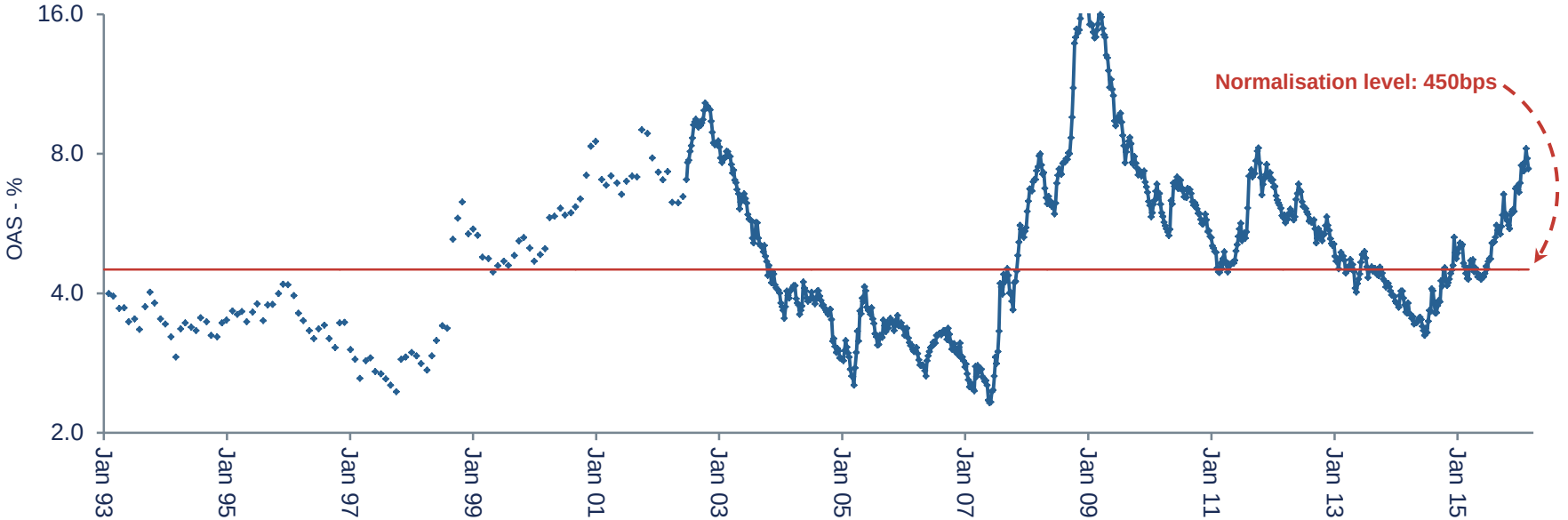
8: Appendix

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High Yield Credit: Which 'Normal' Level For Spreads ?

US High Yield Spreads



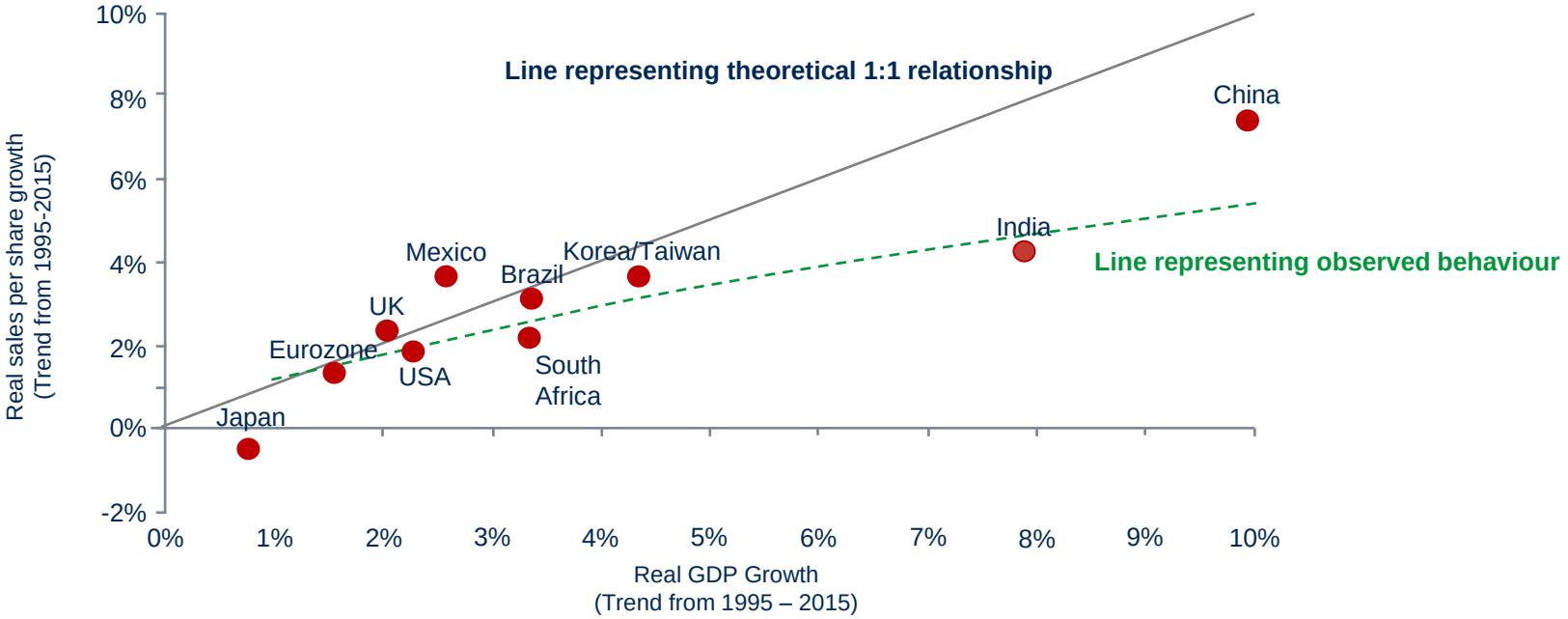
Source: Bloomberg, Barclays, Barings calculations as at 31 March 2016, spread is represented by the OAS on the BarCap US High Yield 2% issuer cap

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A Sales & Margin Approach

STABILITY	COMPARABILITY	CULTURAL
Sales is a stable line item of the P/L account, easier to project than dividends or profits	Sales is consistently defined across geographies, time and inflation regimes	Ease of comparison Unlike dividends, which are biased by differing tax treatment

Sales Growth: How to Forecast It ?

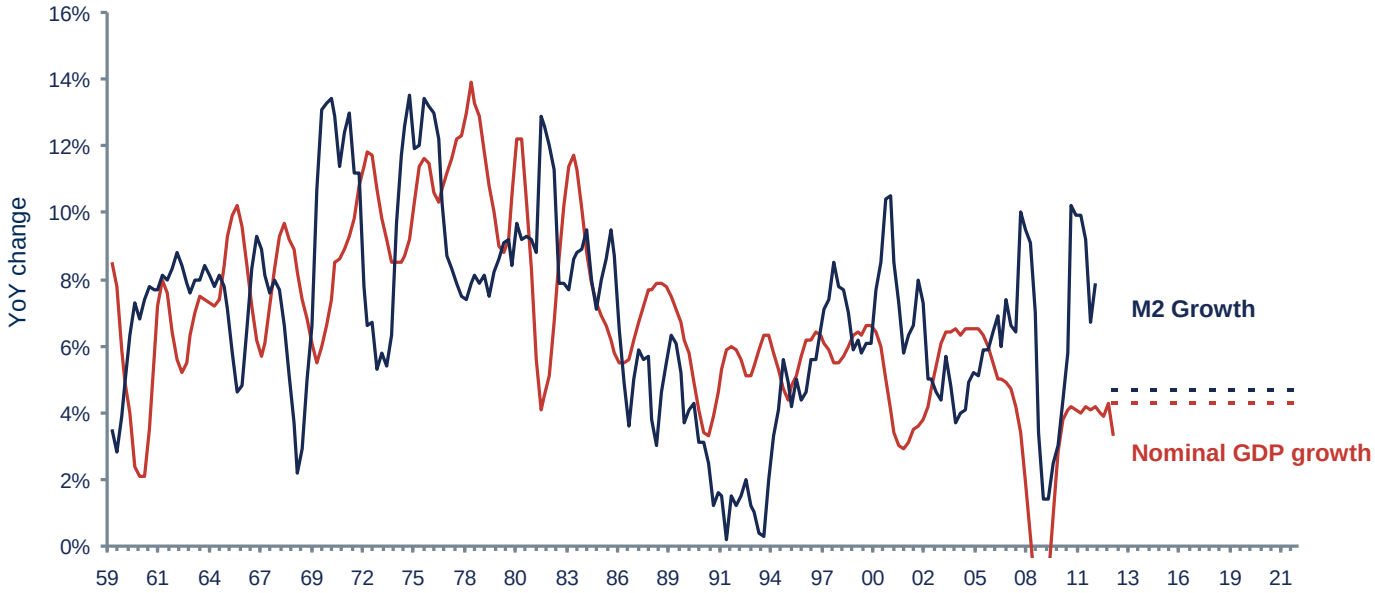


Sales growth never keeps up with GDP growth
Particularly evident in emerging economies

Source: Bloomberg, Barings calculations as of 31 March 2016

Monetary Base: M2 Tends to Follow Nominal GDP

US M2 vs. Nominal GDP



We observe a high correlation between the two series

Source: Bloomberg, Barings calculations as of 31 March 2016

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