



AEGON ASSET MANAGEMENT'S BASELINE ECONOMIC SCENARIO: ASSET ALLOCATION FOR A LOW GROWTH ENVIRONMENT

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The European debt crisis is steadily worsening. Although the problem initially appeared to have been contained within a number of smaller peripheral countries, the markets have recently turned their attention to the larger European economies, most notably Italy and Spain. Now it appears that the Belgian and even the French bond markets are no longer seen as a safe investment. The outcome of the debt crisis appears to be largely dependent upon the actions taken by Europe's politicians and the European Central Bank.¹

Although it is clearly impossible to predict what politicians will do, AEGON Asset Management in the Netherlands has instead analysed a range of possible scenarios for the coming years in order to highlight some trends visible today that, from an investment perspective, may be valuable in deciding upon asset allocation. In this article, AEGON Asset Management in the Netherlands provides a summary of most probable or 'baseline' scenario for the coming four years.²

How did we get here? A quick re-cap

Building-up debt

The 2008 US housing market collapse triggered the worldwide credit crunch and financial crisis. The 2008 crisis exposed the fact that a large part of the western world's economic prosperity was being driven by a flywheel of borrowed money. In order to prevent a run on the banks, western governments stepped in to provide guarantees to deposit holders or provide capital injections to banks. Although these actions were effective in the short term, the debt mountain was not reduced. It simply changed ownership, from financial providers and consumers to governments.

The US housing market bubble was, for a large part, caused by unrealistically low credit spreads, resulting in excessive (and reckless) lending, until the bubble burst. In some ways, this is comparable to Greece, where low interest rates caused a lending splurge. With Greece, however, it was primarily the government that lived beyond its means. The result was a rapid rise in government debt (see Figure 1).

¹ This has been described in more detail in a previous edition of AEGON Global Pensions View, <http://www.aegonglobalpensions.com/en/Home/Publications/News-archive/News/Pensions-and-the-European-debt-crisis/>

² This article describes AEGON Asset Management's 'baseline' scenario (60% probability). In the full paper **Beleggingsvisie November 2011** (available in Dutch only) a negative scenario (25% probability) and positive scenario (15% probability) are also described. The negative scenario includes fragmentation of the Eurozone and the positive scenario includes growth supported by high levels of growth in the emerging markets.

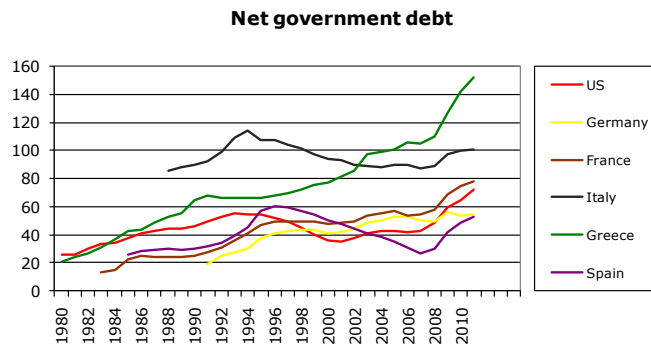


Figure 1: Net government debt

An abnormal recovery

Following a severe recession, recovery typically follows a fixed pattern. Directly after the recession, growth tends to be high, as restocking of inventories and business investments boost economic growth. After this period of higher growth, the economy then enters a more stable state with growth around its long term trend.

Initially, the post-2008 recovery looked like the economy had reached a stable state. Unemployment declined modestly, while demand from emerging markets for capital goods also declined. However, the 'recovery' is threatened by excessive levels of debt. Governments are being forced to reduce deficits and consumers are once again starting to postpone consumption due to uncertainty surrounding jobs and property markets. Together, these two factors are reducing growth.

The severity of the current debt crisis differs for each country. Purely based on overall debt and deficit figures, one would expect that the US and the UK would be experiencing a more severe debt crisis than the Euro zone. However, the major difference between these regions is that the Euro zone is a mixture of very different economies without a strong unifying political structure. The stronger economies in the Euro zone are unwilling to guarantee the debt of weaker economies, without a firm commitment to reform their economies. By contrast, the UK and the US are strong fiscal unions and are backed by central banks that are able and willing to buy large quantities of government debt. The risk of these countries defaulting is therefore small. However, from a bondholder perspective the real value of these bonds could be eroded by higher inflation caused by monetary stimulus.

There are some signs that debt is being reduced. The US consumer has received some relief from lower interest rates, and, since the credit crunch, debt payments as a percentage of income have steadily declined. In addition, US consumers have put a hold on their expenditure due to uncertainty surrounding their assets and pensions. However, reducing debt levels significantly will still take many years. Although some progress has been made, much still needs to be done, particularly in Europe.

Consequences of the mountains of debt

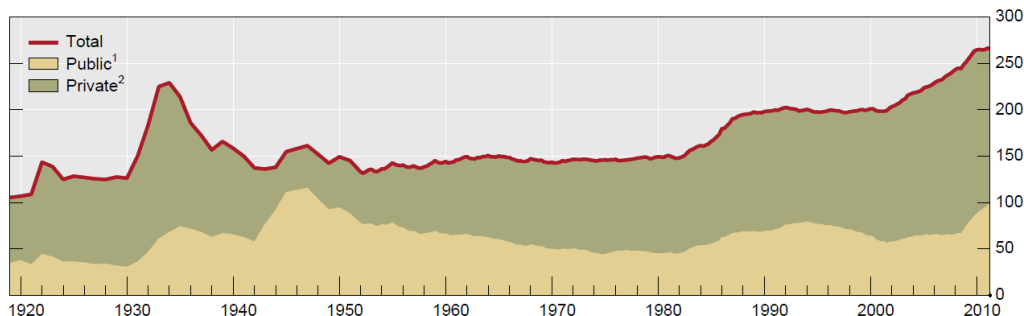
Credit generally plays a positive role in economies, as it allows investments to be made in productive projects, finances trade and enables consumers to buy property. However, a large part of the credit increase over the past twenty years has been used to finance consumption, which is not productive. By using credit to fund consumption, GDP growth in the western world has simply been moved

forward, which will now lead to lower growth as the debt is repaid. An additional drag on growth is the decrease in the working age population in several western economies.

A recent study from the BIS clearly demonstrates how excessive credit destabilises economies and increases the chance of a financial crisis.¹ Figure 2 shows the total non-financial debt in the US, which has steadily increased since the 1980s.

Outstanding debt of US non-financial borrowers

As a percentage of GDP



¹ Sum of federal government and state and local governments. ² Sum of household and non-financial business.

Sources: Board of Governors of the Federal Reserve System; Friedman (1981).

Figure 2: Debt of US non-financial borrowers

The BIS article found an empirical relation between debt and economic growth, with debt affecting economic growth negatively. The effect of debt differs according to the sector of the economy. For the government, the turning point is between 80% and 100% of GDP, for companies, it is 90% and for consumers, 85%.

Economic expectations

In AEGON Asset Management’s baseline scenario, we expect low economic growth and moderate inflation. Table 1 shows our growth expectations for the US and Euro zone.

| | US | Euro zone |
|------|-----|-----------|
| 2012 | 2.0 | 0.7 |
| 2013 | 1.7 | 1.0 |
| 2014 | 1.8 | 1.1 |
| 2015 | 2.7 | 1.7 |

Table 1: Growth rates US and Euro zone

United States

In the election year of 2012, we expect growth in the US to be above 2%, which will then decline afterwards. This decline will be the result of lower government expenditure after the elections. The trend growth rate declines towards 2%. Figure3 shows the different components of US GDP growth.

Consumption in the US has been consistently below expectations. However, the labour market has stabilised and American consumers have increased their net asset position. These two factors will cause a slight increase in consumption. Nevertheless, the increase is significantly lower when compared with previous decades.

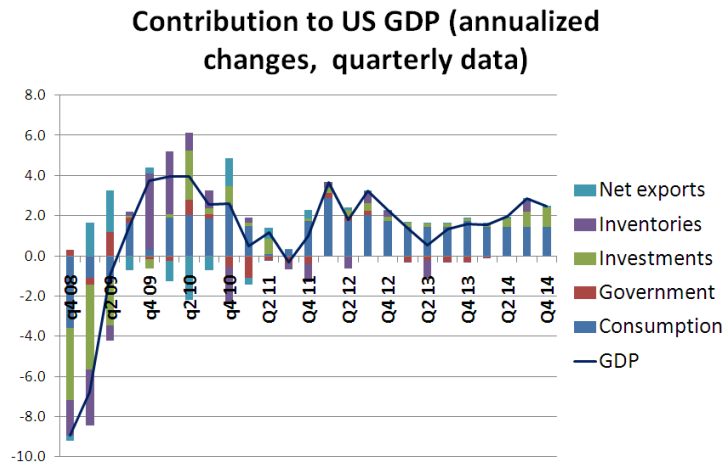


Figure 3: GDP growth US

The corporate sector in the US is healthy. Margins are high and balance sheets are, on average, solid. Corporate investments have contributed significantly to growth in the last couple of quarters. However, we can now expect lower growth in investments as the uncertainty surrounding the economy has caused a decline both in producer and consumer confidence. Companies are likely therefore to postpone or cancel investment.

A number of drivers will determine the contribution of net exports to GDP growth. We expect imports to grow moderately in line with consumption. Exports are presently supported by strong growth in the emerging markets, but are held back by low growth in Europe.

Europe

Cuts in government expenditure across Europe will inevitably have a negative effect on growth. High unemployment rates will prevent significant wage rises, and the European debt crisis will cause uncertainty surrounding jobs, decreasing confidence. We therefore expect consumer expenditure to shrink moderately for a number of quarters after which it will recover slowly. Total GDP growth is estimated at 0.7% which is half the level of the previous 20 years.

The volatility of financial markets will make budget cuts more likely, and these cuts will be more painful than we are used to, as they will take place in a low growth environment. We expect GDP growth to decline by 0.6% due to these cuts, which is in stark contrast to the 1.7% growth over the last 20 years.

We also expect inflation to be below 2% for the next four years. The ECB has bought large quantities of sovereign debt, but has sterilized this by issuing short-term bills. The continuing deleveraging of financial institutions, governments and consumers will also keep a lid on inflation.

Emerging markets

Growth in several emerging markets has been phenomenal over the last couple of years. Emerging markets will soon have a larger share of global GDP than developed countries. For the future, we expect lower, but still high, growth in emerging markets. They will not be immune to a slowdown in Europe and the US, as these are still their main trading partners. Growth will therefore have to come from other sources, like domestic consumption. It is however unlikely that this will fully compensate for slower export and investment growth.

Asset class expectations

Equities

For the next four years, we expect a fairly positive return. This is due to several components. First, equity valuations in the world index, as measured by the Shiller PE (the price-earnings ratio in which the earnings are the average earnings over the last ten years) are slightly below their long run average. A longer term average of earnings is taken instead of last year's earnings to filter out cyclical fluctuations and to get a more stable valuation measure

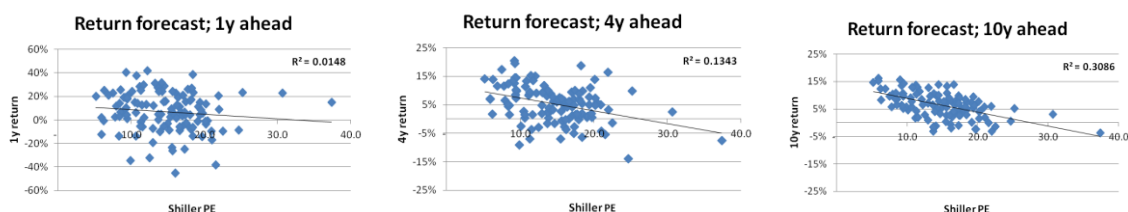


Figure 4: Explanatory power for different time horizons

The Shiller PE mainly tends to work on longer term horizons, as the relations between this variable and equity returns is stronger for longer horizons. This can be seen in Figure. However, this measure differs significantly between regions. In the US, equities are more expensive than their long run average (see Figure 5), while Europe and several emerging markets are more attractive. Secondly, we expect slow but positive growth in the world economy, which is positive for returns. See Table 2 for our equity return expectations.

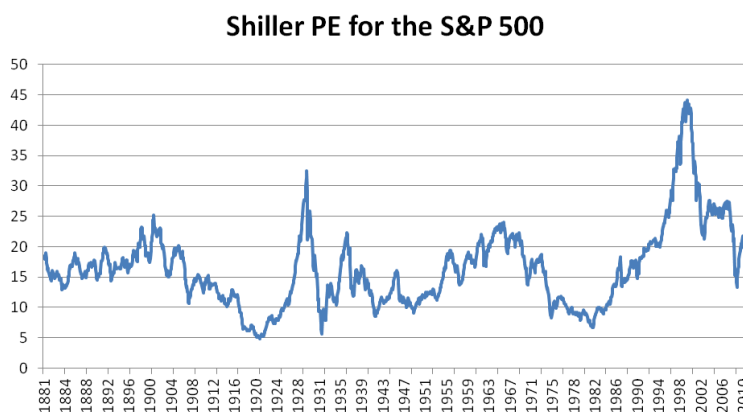


Figure 3: Shiller PE for the S&P 500

| | Ann. 4y return |
|------------------|----------------|
| World | 7% |
| US | 5% |
| EU | 9% |
| Emerging markets | 9% |

Table 2: Expected equity returns

Government bonds

The credit crunch was a wake-up call for many investors; government debt is certainly not risk-free. Greece is clearly not able to repay all its debts, while other countries also needed support from the EFSF and the ECB. The crisis has caused interest rates in these countries to rise rapidly, while

interest rates in Northern European countries initially declined as investors fled to these safe havens. However, we have recently seen indications that contagion is spreading through the Euro zone, as interest rates are rising even on 'safe haven' bonds like Australian and Dutch bonds.

Longer term interest rates are determined by expected inflation, expected economic growth and a credit spread. In our baseline scenario, we expect US long term interest rates to rise, as shown in Figure 4. The rise is due to higher economic growth and inflation, which is consistently higher than 2%. A long term interest rate around 2% is therefore unsustainable in our view.



Figure 4: US 10y interest rates

We also expect rising interest rates in Germany and the Netherlands, as nominal GDP growth will be higher than the current yields. An additional effect will be that the safe haven flows will partly reverse as uncertainty surrounding the debt crisis dissipates.

| | Ann. 4y return |
|------------------|----------------|
| EU AAA sovereign | -1% |
| US sovereign | -1% |

Table 3: Expected government bond returns

Corporate Credits

The credit spread has increased significantly. This is partly justified as the probability of defaults due to the deteriorating economic situation has increased. However, the defaults which are currently priced in indicate a severe economic recession. In Figure 5, the historical and expected defaults are shown for High Yield credits.

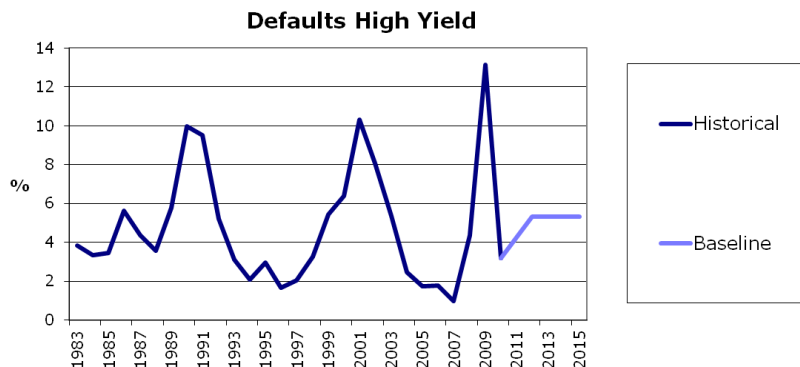


Figure 5: Defaults high yield credits

If a severe recession does not materialise, as in our baseline scenario, the returns on credits will be positive. We also expect spreads to contract. This effect is offset, however, by rising interest rates. See table 4 for our return expectations for credits.

| | Ann. 4y return |
|---------------------|----------------|
| EU Investment Grade | 3% |
| EU High Yield | 7% |
| US Investment grade | 1% |
| US High Yield | 3% |

Table 4: Expected corporate credit returns

European Asset Backed Securities (ABS)

Asset Backed Securities form an interesting asset class. This asset class consists mainly of mortgages loans. This is therefore an interesting diversifier in a portfolio as it exposes the portfolio to consumers rather than corporates and governments. Returns on ABS are expected to be relatively high as spreads are still elevated. This can be partly explained by financial institutions that are deleveraging and the reluctance of investors to enter the asset class after the credit crunch.

| | Ann. 4y return |
|-------------------------------|----------------|
| Asset Backed Securities (EUR) | 8% |

Table 5: Expected ABS returns

Indirect real estate

Real estate has been an asset class under pressure, due to declines in several large property markets, most notably the US, but also Europe. Returns on this asset class have therefore been disappointing.

The current prospects for this asset classes are brighter. Dividend yields are high and we expect a small rebound in property values in several markets. This will lead to high returns in the next couple of years.

| | Ann. 4y return |
|----------------------|----------------|
| Indirect real estate | 9% |

Table 6: Expected real estate returns

Commodities

Demand for commodities has been rising due to strong emerging market growth. China in particular uses a large proportion of worldwide supply, which has the potential to lift commodity prices. However, it is not straightforward to profit from this trend. Investors normally do not own commodities themselves, but invest in future contracts and price rises can already be priced into these contracts. An investor might not profit, therefore, from a rise in commodity prices. This occurred in 2010, when oil prices rose rapidly but the return on oil futures was close to zero. Due to this and also to low economic growth, we expect a low but still positive return on commodity investments.

| | Ann. 4y return |
|--------------------------|----------------|
| Commodities (GSCI index) | 3% |

Table 7: Expected commodity returns

Conclusion

The resolution of the European debt crisis will depend on the actions of politicians and central bankers, and their actions are highly unpredictable. This makes the current economic forecasts even more uncertain than in a normal economic cycle. An unexpected political move may easily derail any well designed recovery plan. This uncertainty therefore warrants a careful stance in asset allocation decisions.

Nevertheless, our baseline assumption is that the crisis will not massively escalate, but that it will result in low economic growth due to continued deleveraging. This scenario is fairly positive for risky asset classes, although the probability of a more negative scenario remains significant.ⁱⁱ

The baseline scenario forms a good starting point for asset allocation decisions. This year, AEGON Asset Management is overweight in credits and asset backed securities in several funds, as the current spreads provides a decent buffer for defaults in various scenarios. We are underweight in high rated government bonds, as any resolution of the European debt crisis will result in higher yields. For pension funds, asset allocation decisions not only depend on the expected returns, but also on the risk of these asset classes and the liability structure of the particular pension fund. For a customized asset allocation recommendation, therefore, these have to be taken into account.

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ⁱ *The real effects of debt, BIS Sep 2011, S.G.Cecchetti, M.S.Mohanty, F. Zampolli*

ⁱⁱ Scenarios for the European debt crisis have been published in a previous edition of AEGON Global Pensions View, <http://www.aegonglobalpensions.com/en/Home/Publications/News-archive/News/Pensions-and-the-European-debt-crisis/>