Allison Nathan: Slowing economic growth, rising inflation, and ongoing market volatility sparked by the Russia-Ukraine war are upending investors' portfolios.

Christian Mueller-Glissman: Does that mean we expect the lost decade? No. Does that mean we expect possibly that a 60/40 portfolio will deliver less than the average real return we've seen in the last 100 years, which is around 5 percent per annum? I think, yes. I think it'll be much more difficult to achieve that 5 percent real return which we had over the long run, and certainly, quite difficult to get anywhere close to where we were in the last cycle.
**Allison Nathan:** I'm Allison Nathan and this is Exchanges at Goldman Sachs.

[MUSIC INTRO]

**Allison Nathan:** For decades, investors have relied on a 60/40 portfolio, a mix of 60 percent stocks and 40 percent bonds, for steady growth and income. But rising [UNINTEL] risks are raising the possibility of a lost decade for investors in these balanced portfolios. Today we'll discuss how investors are rethinking their portfolio strategies in the current market environment. To do that I'm joined by Christian Mueller-Glissman who heads asset allocation research efforts within portfolio strategy in Goldman Sachs Research and Maria Vassalo, Deputy Chief Investment Officer of the multi asset solutions group within our asset management division. Christian, Maria, welcome to the program.

**Christian Mueller-Glissman:** Thanks for having me.

**Maria Vassalo:** Thank you, Allison. Great to be on it.
**Allison Nathan:** Christian, you and your team recently published new research explaining why 60/40 portfolios, again, 60 percent equity, 40 percent bonds, could be at risk of a lost decade. What do you mean by that?

**Christian Mueller-Glissman:** Yeah, it sounds more bearish than it is really supposed to be. I think we were accustomed to this very simple portfolio strategy, 60/40, working really well, delivering attracted real returns because that is what it did in the last 20 - 30 years. Actually, in the last cycle you got 8 percent real return from a 60/40 portfolio. And the long run average is around 5 percent. So, you can see you did really well with such a strategy.

And now we're just thinking that there is a risk that you have prolonged period of low real returns. And I think the lost decade, as you can imagine, is referring to a decade of poor real returns. And that is not necessarily our expectation. I mean, that's a risk scenario. But you will be surprised in such a period, such a long period of poor real returns for such a portfolio is more common than you
think.

We had quite a bit of times in the last 100 years. And one of the periods is, of course, the famous '70s stagflation. But also, World War I and World War II were examples. And the financial bubble period of the 2000s. So, I think we kind of refer to these types of episodes where the buy and hold investor who literally just did this very simple strategy would have had very little real returns generated over that period.

**Allison Nathan:** Just to clarify, what is your mainline view versus this risk scenario of a lost decade?

**Christian Mueller-Glissman:** Yeah. I mean, we feel like the structural goldilocks regime we had in the last cycle, which was essentially anchored inflation, pretty good economic growth, but bad enough for central banks to ease policy because they worried about secular stagnation and deflation, which pushed on [PH] real yields and boosted valuations, coupled with very good profit sector growth. I think that's unlikely to continue.
So, we expect that in the best-case scenario we're dealing with higher inflation, less tailwinds from valuations across assets, less tailwinds from profit margins, lower returns.

So, does that mean we expect the lost decade? No. Does that mean we expect possibly that a 60/40 portfolio will deliver less than the average real return we've seen in the last 100 years, which is around 5 percent per annum? I think, yes. I think it'll be much more difficult to achieve that 5 percent real return which we had over the long run, and certainly, quite difficult to get anywhere close to where we were in the last cycle.

**Allison Nathan:** And so, what are the type of allocation strategies that make sense given that more challenging macro backdrop? Is there anything that can perform well or even outperform?

**Christian Mueller-Glissman:** I think it depends a lot on the interaction of growth and inflation structurally now in the coming years. I think we feel quite convicted [PH] about this idea that you might have a big more inflation. I mean, not as much inflation as we have right now because there
are a lot of cyclical factors. But there are these structural factors like deglobalization, decarbonization, the fight on income inequality. And it just means that at the margin you need to reposition your portfolio for assets that can deal with higher inflation.

And what assets those are depends a bit on the interaction with growth. If you have good growth, to some extent, that might just mean that you want to own a bit more equity, a bit less fixed income. And if you have good growth with that inflation, it means, essentially, that equities can beat inflation. And the interesting thing is in the last cycle, the optimal portfolio mix in hindsight, if you do like a [UNINTEL] optimization, was actually 40/60. 40 percent equity, 60 percent bonds. So, actually, in the last cycle it was better to have more bonds. And we feel that in the coming cycle it's actually better to have maybe a bit more equity.

But that, obviously, as a precondition requires growth. And if you don't have a particularly good growth backdrop, then I think we feel there's much more case for real asset allocation. Maybe some defensive real asset allocation. Like
essentially assets that can do well even if the growth backdrop isn't that great, but that have some type of ability to generate real cash flow growth, or they retain real value. And I think that's certainly been a key focus area in the last few months because I think the growth backdrop is increasingly getting more uncertain. But I think the inflation has been very sticky.

**Allison Nathan:** So, what assets in particular, then, might perform better if we see growth lower and potentially disappointing as you outlined that risk?

**Christian Mueller-Glissman:** Year to date, I think, and pretty much since the beginning of the COVID recovery, commodities have been the big stellar outperformer here. They have been decoupling, especially this year. The collation of equities and commodities has turned quite a bit less positive. And there you would see some real diversification benefit.

And there are some micro factors here at play, obviously related to geopolitics, multiple years of underinvestment in productive capacity, and I think these types of things can
linger. So, I think here you have a real asset, which obviously, there is a lot of similarity with the '70s stagflation in that regard. So, commodities, I think, are on that list. Gold can be quite interesting as well as a kind of long-term store of value, especially if you're worried about debasement risk over the long run.

But I think we also like assets like real estate and infrastructure. They have issues. Like real estate can be levered. So, with rising rates it can be a bit more risky. But it's also quite an early cycle asset. So, it does quite well early in the cycle. And you could argue already it has done really, really well.

So, I think at the margin we're leaning a bit more to infrastructure currently. I mean, a lot of those infrastructure assets have contractually defined inflation protection. And that's very valuable right now. And much in contrast to an index-linked bond which is the ultimate inflation protected secretary, the yields on a lot of infrastructure assets are positive. So, I think it's really these areas where we currently see a lot of opportunity.
Allison Nathan: And when you say infrastructure assets, what specifically is that?

Christian Mueller-Glissman: It's a very broadly defined asset class. I mean, there are some really hot areas: warehouses, data centers, these types of areas which are not easy to access actually in public markets. We've seen a lot of investors utilize private equity and private infrastructure type vehicles to access those. Or you go to traditional stuff like utilities, toll roads, airports, [UNINTEL]. These types of areas, they have an angle. And I think what we actually found is to some extent a very broad exposure, especially if you're a macro investor, might actually really do a good job. So, we've been looking at the broad infrastructure indices. And they've been doing really well year to date in line with what we would have expected.

Allison Nathan: Maria, let's bring you into the conversation. You talk to institutional investors and CIOs everyday about their investment strategies. What are you seeing and hearing from them? And the key question is, are they actually making any changes given the risks to the macro backdrop that we are concerned about?
Maria Vassalo: Allison, certainly, this conversation about 60/40, whether that's the right allocation or not, is something that comes up a lot in our discussions. And the question is, it's not really for us whether you should be 60 percent in equities, 40 percent in bonds. But really what is the mix that you have to have in your portfolio so that you have some part of your portfolio providing growth and returns, but also part of the portfolio being more defensive and trying to hedge you in a downturn, protect you against negative scenarios and so on?

So, one of the things that we're seeing now given the rise of inflation and the Fed [UNINTEL] much more aggressive interest rate policy, clearly the bonds have not been a good hedge against equity selloffs. But that does not mean that you don't need other assets or other strategies, if you like, in your portfolio to protect your downside.

So, perhaps going forward then, as long as inflation remains a concern, what you need to include in the 40 percent, if we say that the right percentage is 40 percent, and taking Christian's point that sometimes it may be
higher, sometimes it may be lower. But the important thing is that you would need some protection against risky assets. That protection may be coming from other strategies. It could be coming from strategies that are more geared to pay off in negative scenarios. They may come from relative value strategies. They may come from alternative strategies that basically, synthetically, create the risk [UNINTEL].

We have to remember that since the financial crisis, we've seen destruction of safe assets in the world. And so, trying to create strategies that play the role of safe assets or protect against the downside is really important. So, these are some of the discussions that we have. And of course, how you achieve that for any given portfolio depends very much on the objectives of the institutional investor, the type of targets they have, and many other considerations.

**Allison Nathan:** Right. But you're actually seeing the inclusion of more hedging strategies. Are you actually seeing some of these different investors shifting their allocations on the margin compared to other periods in the past? How much are investors focused on tweaking their
portfolios given the macro risks?

**Maria Vassalo:** Yeah. There is an interesting rotation, both within the equity space and the fixed income space. For instance, in the fixed income space, people are more interested in taking exposure through floating rate instruments. In equities, they could be shifting towards more value stocks or trying to capitalize on dislocations that exist in the markets.

We've seen also a migration to private equity and private assets that may be hedging against some of the volatility that we've seen in the markets. But also exploiting some of the opportunities that Christian highlighted in infrastructure or real estate or life sciences that may be not readily accessible through public markets.

Another thing that is important to note is that increasingly the segment of the real economy captured by public markets tend to be more different than the segment of the real economy captured by private markets. So, increasingly, when we approach an investor's portfolio, we approach it from a more holistic perspective and trying to
think how we can achieve a broader diversification, how we can access more investment opportunities, and how we can better protect the downside. And that means increasing the combination of private and public assets. And really going to private markets to the extent that we cannot access the same investment opportunities through the public markets. But also use the two parts of the markets in a complimentary way.

**Allison Nathan:** Both of you have really emphasized the role of private markets here in providing some diversification. Christian, what about geographic diversification? Is there some benefit to be gained by thinking more broadly across geographies in this type of environment?

**Christian Mueller-Glissman:** In the last cycle, the best thing you could have done is not to diversify and just stick with the US, both in equities and in fixed income. And I think to some extent, there are some structural reasons for that. I think the US economy and the US equity market just offers incredibly attractive growth and is very friendly to investors and is a stable backdrop to [UNINTEL] risk
premium. And it's deep in terms of liquidity. I could go on forever.

And I think, nevertheless here, we feel that at the margin, diversification across regions while disappointing in the last 20 - 30 years and in particular in the last cycle, could come back a bit. And that's both for equities and for fixed income.

So, I think a good multi asset portfolio has stocks with growth that are cheap and bonds with yield after inflation. And you find some of that stuff also outside of the US. So, for example, in China, the Chinese government bonds, they offer you a positive real yield right now. And they can diversify certain risks you might be facing in a portfolio related to the Chinese economy and possibly global growth. And also in equities, there have been selective opportunities which are maybe not related only to their domicile, but for example, UK equities year to date have been a very interesting asset due to the sector exposure to energy, to banks, to healthcare. Its value has high dividend yield. It's been under positioned and cheap. It also is in a very stable domicile, which is not necessarily affected by
energy crises or the Russia-Ukraine war.

So, I think at the margin there are opportunities that are popping up on the regional basis. But I admit this is potentially a multi-year process where some of those opportunities emerge and it's a slow process because deliquidity is with the US equity market. And a lot of large companies there are attractive.

The last thing I would say is, as I mentioned, we have a bit of a regime shift here with regards to inflation. And I think part of the outperformance of US equities in the last cycle was linked to very low and anchored inflation, falling real yields, and this boost in profit margins of the tech sector. And we feel that at the margin, some of those tailwinds are becoming headwinds from here. And that just, over time, should manifest itself in lower outperformance. I don't think underperformance of US equities versus the rest as a base case. But lower outperformance.

And against that you need to consider the correlation [PH] structure. So, if you look in the last year, actually value and growth stocks in the US have actually been close to
zero correlated. And if you then look at Europe versus the US, that correlation was a bit higher, but it started to tick down a bit in functional of the larger value exposure in Europe in equities as well. And then I think the Russia-Ukraine crisis happens.

So, at the beginning of the year, actually, Europe managed to outperform the US up until that crisis happened, which clearly is a bad tail event which is not really fundamental. So, my sense is the opportunities will come. But as of now, early stages. And they're not that visible. Very specific.

**Maria Vassalo:** I wanted to add two points to what Christian said. The one is related to this partial, at least, reversal globalization. So, as we are moving towards less globalized world, that also creates segmentation in the goods markets, or partial segmentations in the goods and capital markets. That actually should increase the diversification benefits because correlations across different regions could go down. So, we may suddenly have an additional reason to look outside the US as a result of this trend.
The other thing is that as we've seen, one of the big themes and sources of inflation that we are facing this year is related to commodities. And so, as we get into an environment where access to commodities will drive a lot of the growth, the ability to be a producer of commodities puts you in a preferential position relative to someone with an [UNINTEL] of commodities. Rather than thinking in terms of emerging markets versus developed markets, or US versus Europe or Asia, maybe another way to look at it is thinking in terms of commodity importers versus commodity exporters. And really try to capture some investment opportunities that exist at different parts of the world depending on the particular makeup of those regions.

**Christian Mueller-Glissman:** I would actually add something on that on top. I think it's a great point. And I think there's another one as well. The sources of inflation differ quite materially between Europe and the US currently. In the US you have a wage inflation problem, you could say. In Europe, you have an energy inflation problem. And with that, you can obviously diversify your type of inflation risk you're exposed to as well. And I think
that also triggers policy divergence.

I think we are entering a period here of much higher inflation volatility. And inflation [UNINTEL] local. And that creates then policy divergence potential, coupled with fiscal policy divergence potential. And I think that can also lower correlations on the regional basis, both in equities and in bonds.

**Allison Nathan:** So, Christian, you mentioned China bonds. Are there any other assets you'd highlight given all the factors that you and Maria have discussed? And Maria, as well, do you have thoughts then about what places, what assets might be best positioned relative to this?

**Maria Vassalo:** Some of the Latin American countries are well positioned as they're trying to stabilize inflation. And they're major energy or commodity exporters. I think China could potentially benefit from access to commodities from Russia, given the geopolitical shifts and alliances that we're seeing. By accessing commodities at preferential prices, those could also boost profitability for Chinese firms.
And I think beyond that, we are going to see a significant push towards greener energy going forward. And so, regions or sectors that are focused on green energy could also see more investment opportunities and more capital flowing into that area as well.

**Allison Nathan:** So, we’ve basically been talking about risk to growth here. But there is a growing concern that we will find ourselves in recession at some point, maybe not tomorrow, but some point in the next year, two years, three years. So, at what point should investors be preparing for that? And what are you advising clients right now?

**Maria Vassalo:** This is certainly a topic of discussion with asset owners, with [UNINTEL] the risk of recession is increasing. It’s not yet at a point where we need to take action in the portfolios. But we are very vigilant about it. We are looking at the various indicators out there in terms of what they signal and, of course, the yield curve is one of the major indicators we look at. Some parts of the yield curve [UNINTEL] have inverted. If we look at the three month to ten year, that’s not inverted yet. And mainly
because the Fed has telegraphed that it will increase interest rates going forward quite significantly.

If we look at the three month to ten year one year forward, that [UNINTEL] significantly [UNINTEL] signals that as time goes by and then the next six to 12 months the probability of recession could actually increase materially. So, investors need to be on the lookout for signals of increased probability of a recession in order to adjust their portfolios accordingly.

**Allison Nathan:** And if we don't find ourselves in recession, but we are just in a much lower growth environment, does that change how investors would think about adjusting their portfolios?

**Maria Vassalo:** Well, it depends. [UNINTEL] trend growth levels. So, if from the current level of growth, which is around 3.8 percent or higher in certain parts of the world you go to growth level that is half a percent, that's a massive decrease in growth. So, I think whether technically it's a recession or not, it may feel as a recession for all purposes.
So, the important thing is to adjust the exposure to risk assets as valuations decrease, as earnings growth decrease. And have the [UNINTEL] hedges in the portfolio to absorb this potential selloff in risky assets.

**Allison Nathan:** Christian, do you have any thoughts about recession risk and how investors, is it too soon for investors to be positioning for it? What are you thinking?

**Christian Mueller-Glissman:** Forecasting recessions is difficult. We all know that. And I think at the margin, timing bear markets around recessions is even more difficult we've found. I think risky assets tend to react very aggressively once you're at the onset of a recession. But they can rally and do quite well into the recession. So, I think being underinvested into recessions is a risk. And that's why you want to be careful about being too aggressive and shifting the portfolios too early.

And I think if you look right now, as was mentioned that the yield curve, the kind of two/tens, the famous indicator, has now inverted. There are a few issues with that. We
know that in high inflation regimes, the yield curve inverts possibly earlier. And generally, already in recent years, there was a pretty big gap between yield curve inversion and the subsequent recession. Like 20 months on average. So, I think the starting point is recession risk is picking up because yield curves have inverted. But it might still be out quite a bit. So, you want to compliment that signal with other signals. So, we look at cyclicals versus defensives. Credit spreads. All kinds of indicators.

And I think the picture is mixed. I think on average, we are looking at the probability for markets, that is probably around 25 percent or so. And what we've found in terms of timing bear markets and equity draw downs around recessions, it's actually around 40 percent. If you get there, that's when you really start to see left tail risk enter in the equity markets. So, we're a bit away from that still. But we're getting to a point where this will definitely be something that will need to be addressed in portfolios probably in the next six to 12 months if the indicators continue to move higher.

**Allison Nathan:** Let's end with your views on the road
ahead. Christian, Maria, we've covered a lot of content here. Christian, what are the couple of key messages you would leave investors with?

**Christian Mueller-Glissman:** I think you need to restructure portfolios a bit relative to the last cycle. And I think where we do feel quite convicted is that we're dealing with a different level of equilibrium inflation, a different level of inflation volatility and risk. And you need to make your portfolio robust to that risk.

So, the inflation component of the stagflation, I think we definitely feel that we have enough evidence here to start to reposition portfolios. So, that means to us more real asset exposure and managing duration risk very carefully, both across and within assets. Don't rely on the bonds as your sole buffer, exactly as Maria said earlier. Look at alternative strategies.

And the other thing which is important is that the stagnation part of stagflation or the recession risk is not necessarily a base case. There are a lot of bullish scenarios for growth. You could see a major capex cycle related to
some of those inflationary drivers I mentioned earlier: deglobalization, decarbonization, the fight on income inequality. How do you fight wage costs? You invest in productivity. No? I think there are a lot of potential scenarios how the coming cycle could deliver a lot of good economic growth.

But as of now, unfortunately, we don't know that. And as of now I think growth risks are still a big skewed to the downside as we are entering this incredibly steep Fed hiking cycle, coupled with the commodities supply issues. So, that tells me that, I mentioned it earlier, it depends a lot on what you expect for growth in the coming cycle and what the solution is to an environment of higher inflation.

I think right now you probably need to run a strategy that is prepared for a bit more growth volatility in the near term. And maybe not, necessarily, increased portfolio risk to beat inflation, but actually try to deal with that and potential higher inflation by allocating maybe to more defensive real asset areas that are not just dependent on growth in the coming years because the buzzword, of course, is recession risk until the end of the year. And we've done a lot of work
on that as well. It's ticking up a bit. It's not at the level where we would argue that it really justifies alarm. But it certainly ticks up. And will probably continue to tick up based on the current trajectory.

**Allison Nathan:** And Maria, any last thoughts from you on key messages for investors right now?

**Maria Vassalo:** I would say that the playbook of investments and portfolio construction of the period since the financial crisis may not be relevant anymore. We have entered a period of higher inflation, higher volatility, more uncertainty. Clearly, we have forces out there that push inflation lower after all these supply chain issues get resolved and the uncertainties with the war [UNINTEL] Ukraine would get settled. So, the underlying forces of inflation are below inflation due to digitalization, automation, and so on. But on the other hand, you have other forces that would push inflation higher. So, deglobalization, assembly inflationary, to some extent. So, there is need to rethink how we construct portfolios.

[UNINTEL] investing will be less relevant going forward. I
think there is a big case to be made for active investments. There is also a much bigger argument for more dynamic portfolio construction. Dynamic asset allocation going forward. And [UNINTEL] prices create opportunities. There will be a [UNINTEL] growth across different parts of the world. And that will also lead to differences in policies, both monetary policy level, but also fiscal policy level. So, all these differences will present opportunities for investors.

So, what is important is to stay invested, stay active, and stay nimble.

**Allison Nathan:** Maria, Christian, thank you both for joining us and sharing your views.

**Maria Vassalo:** Our pleasure. Nice to be with you.

**Christian Mueller-Glissman:** Thanks a lot.

**Allison Nathan:** Thanks so much for listening to another episode of Exchanges at Goldman Sachs. And if you enjoyed this show, we hope you subscribe on Apple Podcasts, Spotify, Stitcher, Google, or wherever you get
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