NORTHERN TRUST

10-YEAR MARKET OUTLOOK: STEERING PUBLIC FUND PLANS THROUGH OPPORTUNITY AND RISK IN THE DECADE AHEAD

Every year, Northern Trust's Capital Market Assumptions Working Group develops forward-looking, historically aware forecasts on global economic activity and financial market returns. We analyze historical relationships between asset classes and drivers of asset class returns, and we develop forward-looking investment themes to inform how those relationships and return drivers may change in the future.

Of the six themes contained in our 2024 Capital Market Assumptions 10-Year Outlook, three stand out as potentially affecting the long-term strategies of public pension fund plans: **Growth Restraints, Inflation Adaptation,** and **Private Matters.**

Growth Restraints, Inflation Adaptation, and **Private Matters** are the three strategic themes impacting public pension plan sponsors over the next 10 years.

GROWTH RESTRAINTS

Necessary, but heavy, spending to mitigate emerging global political threats and climate change may handcuff economic growth and weigh on the investment outlook. High yield bonds may be a suitable alternative for public pension plans as growth restraints continue.

INFLATION ADAPTATION

While global economic growth has backtracked, inflation persists with tight labor markets, regionalization of economies, and higher commodity prices. Public pension plans must prepare for a new era of structurally higher inflation.

PRIVATE MATTERS

An improving investment infrastructure in private markets likely will support more liquidity and asset growth, providing access to opportunities that public markets can't or won't. We expect private investments to spread wider and larger in public pension plans.

Keeping these three themes at the forefront, this paper examines each theme in detail and highlights key points that are relevant to public pension plans.

GROWTH RESTRAINTS

In the next decade, we expect to see a shift from recent economic disruptions — the pandemic, the war in Ukraine, and the possible ramifications of the rapidly evolving war in Israel — to longer-term structural restraints on growth.

Regionalization (countries rerouting supplies of key goods and technologies closer to home) is gaining strength, and the associated costs are significant. This type of long-term restraint will likely hinder economic growth and impact investment returns that are already restrained by high government debt and aging populations.

We expect long-term factors will continue to put upward pressure on inflation, possibly causing most central banks to allow inflation to go slightly above their target of 2%. If this happens, markets and economies will be forced to adapt as prices on most everything will likely continue to rise. Notably, even if the economy struggles due to higher inflation, central banks may be reluctant to step in and help.

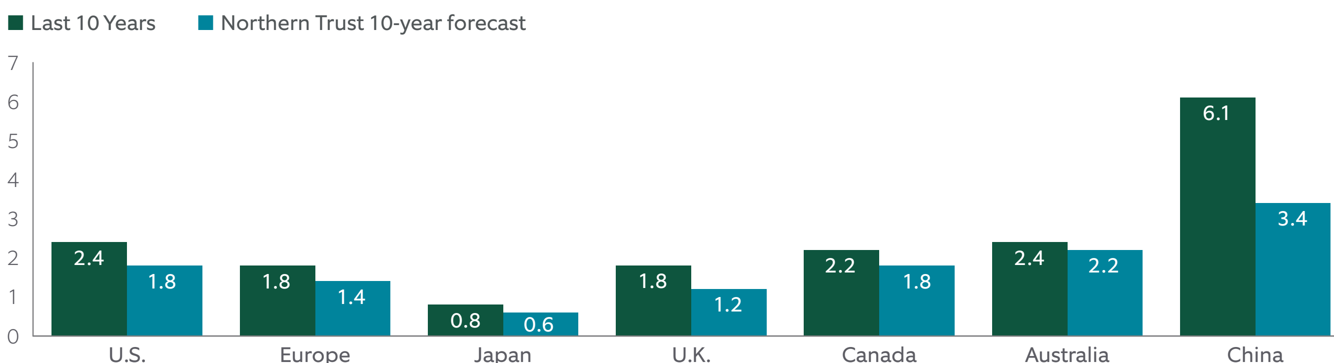
Additionally, a rise in the inflation rate means an increase in the cost of borrowing money for governments, businesses, and individuals. If a person or an entity already has high debt, they'll be forced to refinance or roll over that debt at higher rates.

Exhibit 1 shows the effect of these restraints over the next 10 years. We forecast a 2.4% real annualized growth rate for the global economy, an underwhelming expansion relative to the prior decade. Most regions will likely undershoot prior-10-year growth levels as the forces impeding growth are mostly global.

EXHIBIT 1: NEW WORLD RESTRAINTS

We expect several restraints to lead to below-trend real economic growth levels.

Annualized Real Gross Domestic Product Growth (%)



Sources: Northern Trust Asset Management, Bloomberg. Data from March 31, 2013 to March 31, 2023. Historical trends are not predictive of future results.

Key Considerations for Public Pension Plans

The anticipated low-growth environment through the upcoming decade presents both challenges and opportunities for public pension plans. Traditional assets, such as investment grade bonds, may restrain returns due to low growth and high interest rates, which, in turn, will likely affect the portfolio's ability to meet long-term goals.

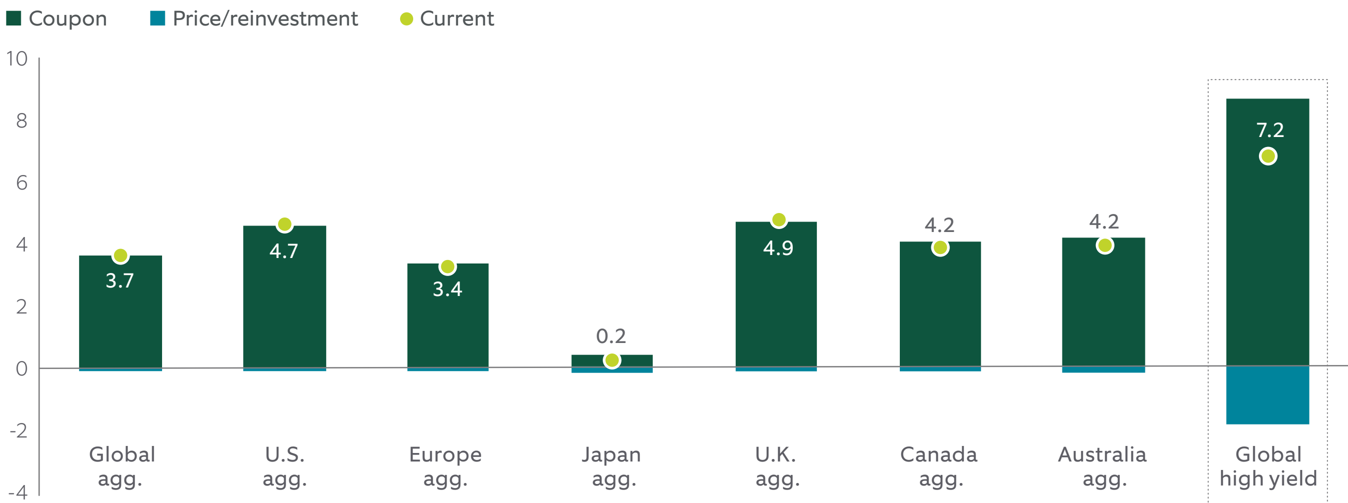
One option for plans to consider in this low-growth environment is high yield bonds. While high yield bonds have historically underperformed their starting yields by 2% over a 10-year period, current market conditions indicate a potential shift toward a lower default risk and the likelihood of more sufficient returns. The improved index quality suggests a healthier, more dependable pool of bond issuers. In addition, recent nominal economic growth, particularly in commodity-related sectors, further alleviates some of the concerns tied to credit risk. Even if some companies encounter higher refinancing fees, we expect the above-mentioned considerations will help mitigate the impact.

Looking at Exhibit 2 below, we see that a 2% cut to the June 30 yield of 9.2% resulted in a global high yield forecast of 7.2%. This makes high yield bonds a noteworthy asset for public pension plans striving to navigate a low-growth landscape while meeting capital growth targets and balancing long-term plan performance.

EXHIBIT 2: ABUNDANT YIELDS

We largely expect returns across fixed income to match yield to maturities.

Northern Trust 10-Year Annualized Fixed Income Return Forecast (%)



Sources: Northern Trust Asset Management, Bloomberg. Coupon return calculated as yield to worst on June 30, 2023. Please see important forecast disclosures on page 9.

INFLATION ADAPTATION

While we expect global economic growth to backtrack, inflation will persist. Tighter labor markets, regionalization, and higher commodity prices will likely more than offset technology's disinflationary promise. Investors must prepare for a new era of structurally higher inflation.

Over the next 10 years, we expect the developed-market annualized rate of inflation to settle around 2.4%, necessitating a fundamental reassessment of long-held economic paradigms by investors and central banks. With a moderation from the elevated levels of recent years, this leaves inflation above the 2% level targeted by most central banks. We forecast 2.6% for the U.S., with Europe lower at 2.2%.

We see more downside risk to prices in Europe given more direct exposure to China, where we expect inflation to be softer (2.2%) due to an unconstructive growth outlook overall. See Exhibit 3.

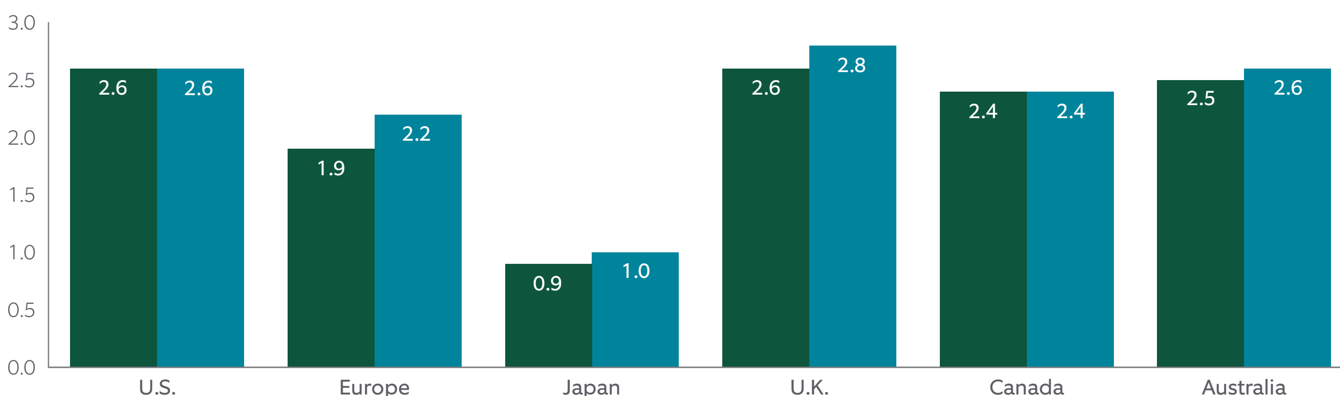
Barring a de-anchoring of inflation expectations, central bank concessions should help offset some of the interest rate pressures, while modestly elevated inflation can support nominal economic growth that feeds into corporate revenues.

EXHIBIT 3: FROM RECALIBRATION TO ADAPTATION

We expect the world will need to adapt to inflation that settles slightly above central bank targets.

Annualized Inflation (%)

■ Last 10 Years ■ Northern Trust 10-year forecast



Sources: Northern Trust Asset Management, Bloomberg. Data from March 31, 2013 to March 31, 2023. All regions use headline Consumer Price Index as the inflation metric. Historical trends are not predictive of future results.

Key Considerations for Public Pension Plans

With an anticipated annualized inflation rate of 2.4% in developed markets for the upcoming decade, pension plans may be required to rethink historical asset allocations. Although real assets have not performed well in recent times when compared to broader equities, the new regime of elevated and uncertain inflation should provide support (Exhibit 4). To help safeguard future commitments, public pension plans may want to explore real assets like natural resources, infrastructure, and real estate.

Natural Resources

We expect a 7.9% return (compares favorably to global equities at 6.3%).

Natural resources may serve as an effective risk management tool against events that could disrupt energy supply or hamper agriculture production, given that many of the biggest exporters of food commodities are vulnerable to flooding and drought. In addition, the attractive valuations for natural resources relative to their historical medians and global equities could mean that this sector is undervalued, potentially providing a good entry point for public pension plans.

Global Real Estate

We forecast an 8.3% annualized return.

The potential stress in office and retail property sectors due to refinancing needs and rising rates can be worrisome. This means that public pension plans with exposure to these sectors or regional banks with concentration might face potential risks. On the flip side, the broader commercial real estate industry's risks appear manageable due to better lending standards, robust bank capital ratios, and additional liquidity provisions.

Global Listed Infrastructure

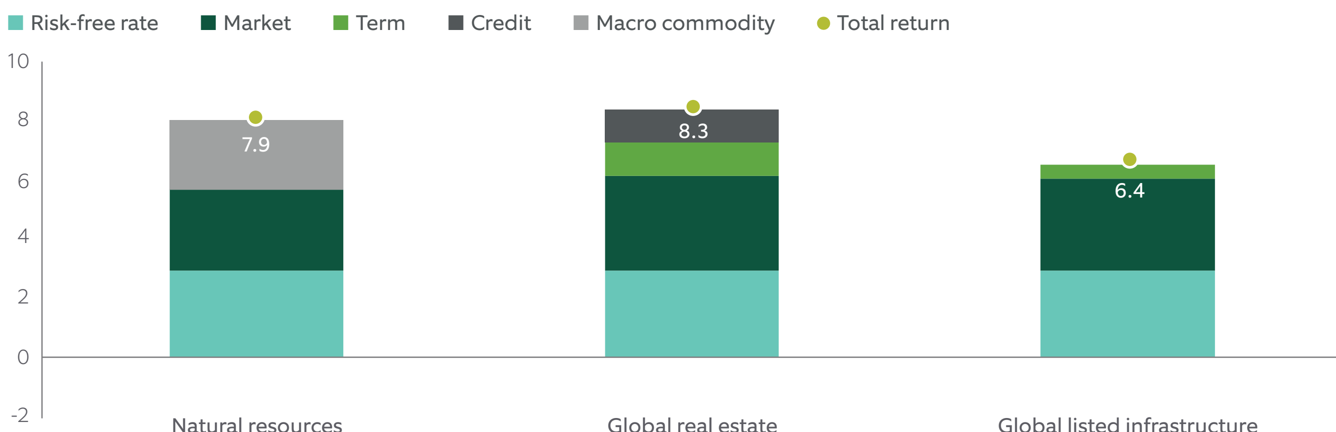
We expect a 6.4% annualized return.

While there may be concerns about higher rates affecting global listed infrastructure, there's optimism as these companies are expected to benefit from capital investment, especially in shifting supply chains and energy resources.

EXHIBIT 4: SUPPORT TOOLS

Real assets should provide welcomed support amid elevated inflation and geopolitical risks.

Northern Trust 10-Year Annualized Real Assets Return Forecast (%)



Sources: Northern Trust Asset Management, Bloomberg. Forecasts are as of June 30, 2023. Please see important forecast disclosures on page 9.

PRIVATE MATTERS

Primed to play an increasingly important role in the economy and investors' portfolios, private equity and private credit provide unique options. While private equity offers access to investment opportunities that public markets cannot or choose not to offer, private credit has emerged as a crucial alternative, particularly for businesses seeking flexible lending solutions outside of traditional banking frameworks.

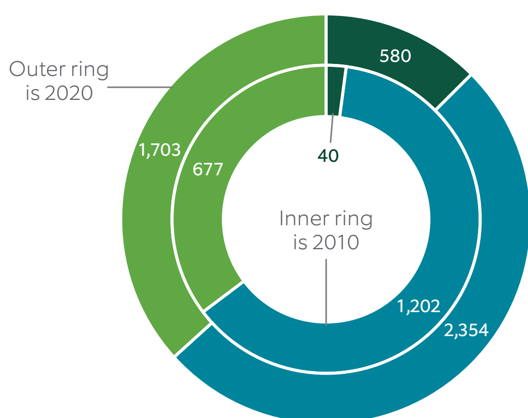
Over the past decade, the growth for both private equity and private credit have been noteworthy. Private equity reached $7.7 trillion at the end of 2022 (up from $2 trillion in 2012), while private credit grew to $1.5 trillion, a significant leap from $0.3 trillion a decade prior.

The private investment infrastructure buildout will continue to facilitate greater liquidity in this historically illiquid asset class. Additionally, a rapidly growing secondaries market (Exhibit 5) provides investors with more exit options, while technology — blockchain, tokenization, etc. — offers the promise of less market friction. Broader participation and more liquidity raise interesting questions as to the appropriate portfolio allocation (we believe larger) and the required asset class return (we expect lower).

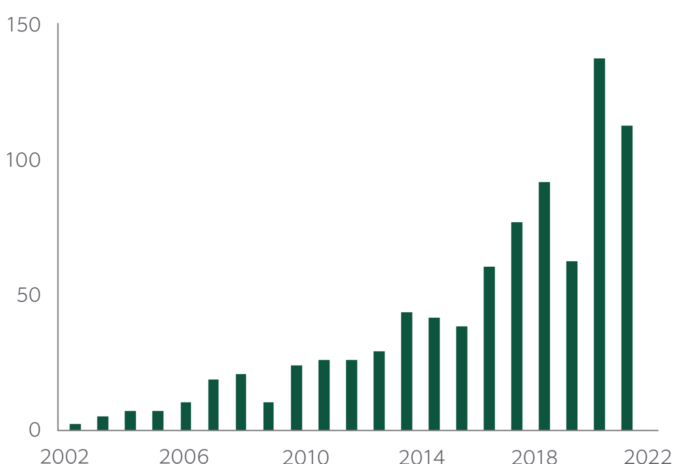
EXHIBIT 5: A THRIVING PRIVATE ECOSYSTEM

Over the past decade, direct lending and private market liquidity have both increased substantially.

Global Leveraged Finance Market Size ($, billions)



Secondary Market Annual Transaction Volume ($, billions)



Sources: Northern Trust Asset Management, Apollo Global Management, Preqin, McKinsey Global Private Markets Review 2021, Jefferies 2022 Secondary Market Update. Left chart: from Apollo using Preqin data as of March 2022. Right chart: transaction volume from 2002 through 2022. All data is the most recent available.

Key Considerations for Public Pension Plans

Significant losses in public markets in 2022 left some investors over-allocated to private equity. Simultaneous with these losses, stock and bond allocations shrunk while private equity allocations rose. To reduce their allocations, many investors are choosing to sell their stakes in private equity in the secondary market, which is creating an imbalance of too many sellers and not enough buyers. This asymmetry has created potentially attractive price discounts for buyers and a fertile opportunity for pension funds (Exhibit 6). While buying at a discount is good, particularly during times when these discounts are substantial, the performance of the fund after purchase is even more critical when determining the ultimate return on investment.

As more investors become aware of the opportunities in the secondary market, the volume of transactions will likely increase. With increased activity, there will be a broader range of asset quality available on the market — both good and bad.

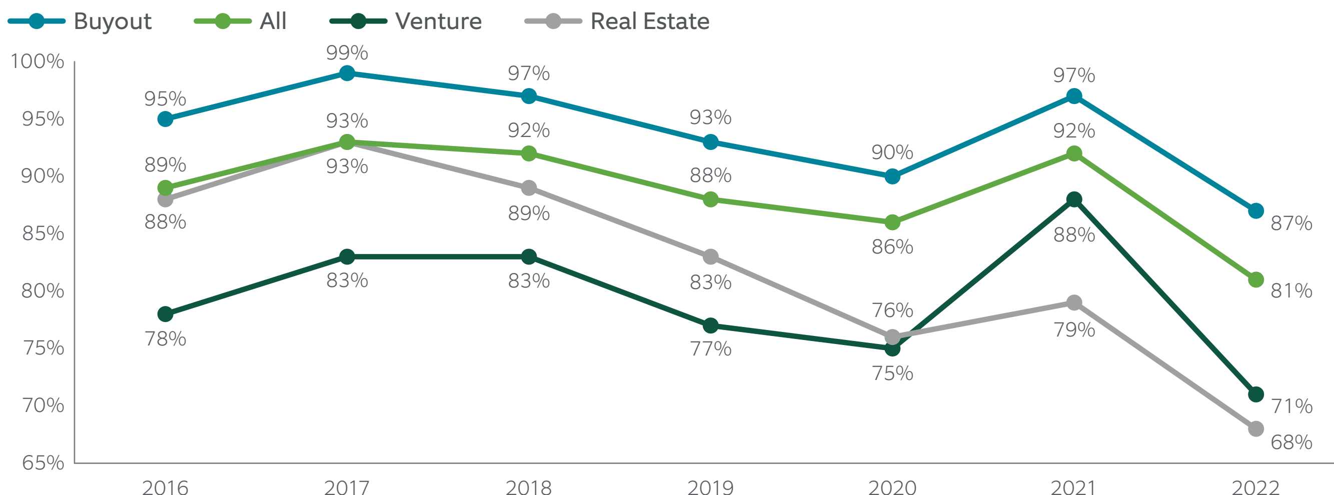
Before investing in a secondary-market private equity fund, we urge public pension plans to:

- Maintain a robust process when evaluating potential managers
- Look to develop or strengthen meaningful relationships within the private equity marketplace to ensure access during periods of market stress
- Establish clear governance structures for monitoring and evaluating private investments

EXHIBIT 6: STEEP DISCOUNTS MAY CREATE OPPORTUNITY

Private equity investors, some who are over-allocated in their portfolios to private investments, are selling their shares into the secondary market at steep discounts to net asset value. This creates a potential opportunity for buyers.

LP portfolio pricing (% of NAV)



Source: Jeffries, "Global Secondary Market Review," January 2023.

FINAL THOUGHTS: NEXT STEPS FOR PUBLIC PENSION PLANS

Over the next 10 years, we expect modest global economic growth, elevated interest rates, and higher inflation, which will make it challenging for public pension plans to meet their long-term obligations. In addition, the increasing role of private equity and credit markets offer both an opportunity and a complexity that managers must navigate skillfully. We expect that high yield bonds, secondaries, and real assets have the potential to help bolster pension plan returns in the upcoming decade.

Asset classes to explore in the decade ahead:

High Yield

High yield bonds typically offer significantly higher interest rates than investment grade bonds, which can help investors keep pace with, or potentially exceed, inflation rates, thereby preserving capital in real terms.

Secondaries

Secondaries allow investors to step into existing commitments, which may potentially lead to quicker returns compared to starting fresh in new ventures. They are typically available at more favorable prices, as well.

Real Assets

Real assets like real estate, commodities, and infrastructure naturally adjust to increasing costs, which means they can offer a hedge against inflation while also offering the diversification needed in volatile financial markets.

By taking a proactive, diversified, and finely tuned approach to portfolio management, public pension plans will be well-positioned to manage their fund's long-term financial objectives in the ongoing inflationary environment.

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Northern Trust is a preeminent global financial institution that provides asset servicing, investment management and wealth management services for institutions, high-net-worth individuals and families. For more than 130 years, our success has been anchored in one purpose: to serve as our clients' most trusted financial partner, guarding and growing their assets as though they are our own. Today, we are more than 23,000 employees strong around the globe and manage $1.4 trillion in assets (as of June 30, 2023) for our clients.

We earn their trust by staying true to our steadfast fiduciary heritage and providing differentiated, exceptional service tailored to each client's specific needs. Our market-leading technological capabilities — spanning from artificial intelligence for currency management, blockchain for fund administration and cloud-based solutions to deliver personalized wealth management services — allow us to deliver the highest level of service to our clients with speed and precision.

Explore Our Full 10-Year Outlook

Explore our long-term asset class return expectations and forecasts at **capitalmarketassumptions.com.** Visit today to:

- Gain valuable insights from our investment experts
- Get exclusive access to our full research paper
- Explore our detailed return/risk and correlation matrix

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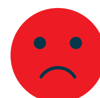
How helpful was this paper?



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