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Notes from the Road: Summer 2024

In this note, we discuss feedback from recent meetings with clients around the world, where common themes emerge: The cyclical vs structural inflation outlook has become more muddled. The sustainability of public debt has come up in the majority of recent meetings, leading to a debate about the possible ways forward. Many investors seem to be looking for an excuse to own EM equities. Allocation to private assets remains a huge topic. We also reflect on some of the recent questions we have fielded about the aggregate impact of artificial intelligence (AI). We discuss how investors are adapting to these topics and what we think they mean for portfolio design.

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When we ask about which of our research notes are read most, one of the consistently popular seems to be feedback from our trips to see clients around the world. Everyone, it seems, wants to know what everyone else is doing. So, we offer another such note here, reflecting on discussions with clients in the US Southwest and Northeast, around Europe and Zoom calls with people anywhere in the world.

Of the key topics that we were repeatedly asked about, inflation topped the list. No surprise there, but with a focus on the distinction between cyclical and structural inflation. There were a significant number of questions about debt sustainability, in part prompted by the policy response to inflation but also relating to observations about the degree of fiscal largesse in the US. Private asset questions come up in nearly every meeting with allocators, specifically: How large should the exposure be? Which private assets should one choose? Is private asset investing a bubble or a structural trend? How would we know?

A significant number of investors seems to be looking for an excuse to buy emerging markets (EM); we discuss some of the tactical and strategic issues that have surfaced in these meetings. Finally, we reflect on some of the more strategic AI-related questions that clients have asked in meetings.

What is equally of interest, it goes without saying, is what people don't ask about. We found very little concern about market valuation (any market!) and very little mention of the US election (there has been more recent interest in the French election from European investors and what this means for the volatility of fixed income). The US faces its most consequential election in decades, but, when en route to the lift at the end of the meeting, we ask why the topic didn't come up. The reasons we hear are one of the following: a) it is too close to call; b) it's too hard to work out the impact; c) despite massive differences in style, the net fiscal difference may be small or; d) the importance of politics for markets is overstated. On the latter reason, we would agree that this is usually the case, but we do worry that, strategically speaking, that view is overly complacent given the scale of the choice on offer. Finally, we note that environmental, social and governance (ESG) considerations remain off the list of topics that people want to ask about.

Inflation: Cyclical vs Structural

Unsurprisingly, inflation comes up in all macro discussions. The flavor of the debate has changed a little, however, with more of a focus now on the way the cyclical near-term inflation outlook has become harder to unstick from longer-term equilibrium inflation. There is less willingness to assume a neat decline in cyclical inflation as distinct from forces that might drive longer-term inflation. The difference between the two has, perhaps, become harder to separate. When we speak to allocators, there is universal agreement that long-run equilibrium inflation will be higher than it was before the pandemic. That much does not appear to be remotely controversial. The disagreement comes on what the level of inflation will be. A majority of investors seem to cluster around the break-even level in their forecasts, but with a non-trivial group forecasting much higher numbers.

One reason we forecast higher structural inflation is deglobalization, which we view as one of the most unambiguously inflationary forces. One client asked us whether this has essentially happened already, in the sense that global supply constraints have already contributed to inflation in recent years. While that is the case, we think there is likely to be an ongoing effect, because supply chains have to be re-wired. There is also an upward force on the volatility of inflation, as the cushioning effect of global supply and global labor pools are attenuated.

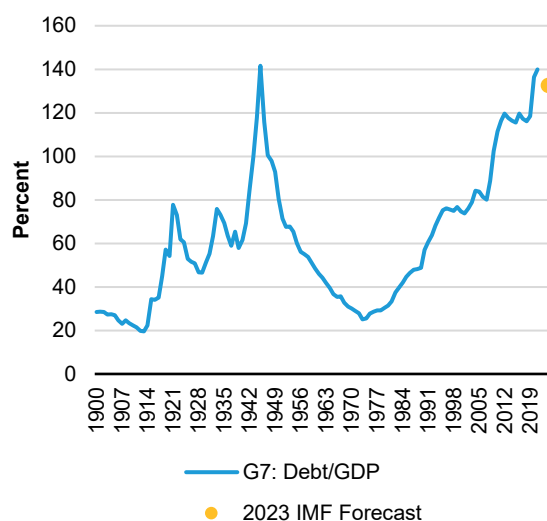
Another client asked about a nearly opposite view, suggesting that deglobalization may be overstated. The thesis: it will cause too much economic pain, so companies won't "let" it happen. We have a clear view on this: in a standoff between governments and corporations, governments will win, despite the pro-corporate environment of recent years. There is also the depressing analogy with 1913 as well, when it was assumed that the global system couldn't come under threat given that it was too interdependent. With deglobalization driven both by US-China rivalry and also by a rejection of globalization in the domestic politics of many advanced economies this is a process that will continue for many years.

Debt Sustainability, the Dollar, Central Bank Independence and Gold

Debt sustainability is a topic that has come up frequently, predicated partly on the observation that the ratio of public debt to gross domestic product (GDP) for the US, and for OECD nations more broadly, has climbed back to its level at the end of WWII (*Display 1*). The Congressional Budget Office (CBO) projects that the servicing cost on debt will overtake Social Security expenditure in the US by 2050. The US is delivering a degree of fiscal support that is unprecedented outside wartime, and this seems likely to persist beyond the election (albeit by different routes depending on who wins—either tax cuts or spending). Several clients voiced concern that this level of fiscal support is “reckless”, that it might have to be counteracted by monetary

policy, and that the US economy is really weaker than it appears. Nevertheless, the political narrative implies that this state of affairs will continue, which is likely a significant part of the reason for the strong showing of US earnings growth and the continuation of high margins (*Display 2*).

DISPLAY 1: G7 DEBT / GDP RATIO

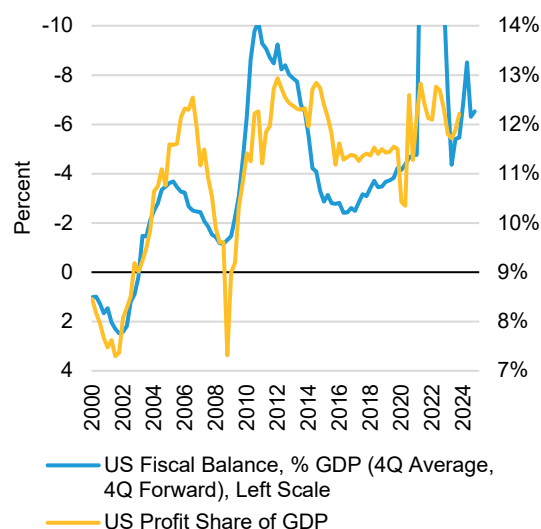


Current analysis and forecasts do not guarantee future results.

The chart shows government debt/GDP for G7 countries, weighted by nominal GDP denominated in USD. Data from 1900–2021 is from Global Financial Data. 2023 forecast is from International Monetary Fund (IMF).

Source: CBO, FRED, Global Financial Data, IMF and AB

DISPLAY 2: US FISCAL BALANCE AND PROFIT MARGINS



Historical analysis does not guarantee future results. As of May 8, 2024

Source: Thomson Reuters Datastream and AB

The worry about US debt sustainability seems somewhat ironic. Yes, the degree of fiscal support implies that US debt levels will rise relative to other nations, but the US is also better placed to weather it, given the “exorbitant privilege” of the US dollar being the world’s reserve currency. We are asked about threats to the dollar’s status, too—China and other nations would like to find an alternative, an effort that has been behind the rapid uptick in central bank gold purchases. However, despite the wish for dollar alternatives, we see no prospect of a viable one emerging in the near to medium term. A client in New York also recently expressed the view that if the dollar’s status is not under threat, then the US can issue as much debt as it likes. Maybe. The experience of the UK under the brief Truss administration revealed potential limits to this approach in an environment when rates are no longer at zero. The UK is more exposed, given the size of domestic pension holdings relative to the size of the supposedly risk-free domestic government asset. Nevertheless, it demonstrates that sovereign risk can be priced. The surprise election in France has likewise had a significant impact on spreads amongst European bonds and raised fixed income volatility, this is linked to questions of fiscal sustainability. Whatever the specifics of a given election the larger point is that high debt levels and the return to non-zero rates implies this topic is not going to go away and we think it will remain a feature of markets for years.

We have been asked several times about the strategic setting of monetary policy. Essentially, clients are asking whether central banks are still independent. Our view is that, strategically, they are likely less independent than they were—high public debt levels open the possibility that it might be attractive for governments to let inflation run at a slightly higher level in the long term as one route to managing the real value of debt. One client told us that they thought US yield curve control was a 50% possibility. This is a minority view, but it is interesting it even came up for debate.

These topics sometimes lead to questions about gold, crypto and tokenized assets. It is famously impossible to value gold, but one can value everything else. At current levels, gold does look less attractive in the near term. If there is to be a near-term catalyst higher, it would presumably be central bank purchases. But it is very hard to have an edge in making a call here. For us, the more attractive long-term aspect of gold at this point is the observation that its correlation with equities is invariant to inflation level.

One client wanted to talk about the role of crypto in managing depreciation risk. We sympathize with the sentiment: in such a scenario, zero-duration non-fiat assets would be useful. However, high realized volatility and regulatory uncertainty makes it hard to recommend strategic holdings of crypto at this stage. That may change in time. What is likely to be much more significant is the growth of tokenized real assets. The development of these assets has taken longer than we thought, but we think it will happen, driven by the strategic imperative of investors needing more real assets, but at the same time having elevated fears about liquidity.

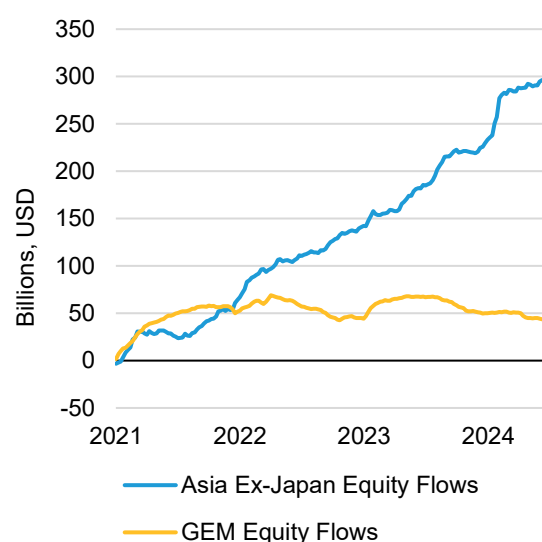
Looking for an Excuse to Overweight EM

In general, we see a lack of enthusiasm for discussing regional calls. This is especially true for US-based clients who see little reason to invest elsewhere (who can blame them!). The one regional call that does elicit interest is EM; our interpretation is that a significant number of clients are looking for an excuse to overweight it. The hook for this urge has been the scale of underperformance over the last two years along with the scale of the asset outflow.

Gauging the sentiment of investors toward EM has become tricky, as there is something of a change in meaning of what EM, in equities at least, actually means. *Displays 3 and 4* show that emerging Europe, the Middle East and Africa (EMEA) and Latin America have become insignificant compared to flows into Asia. Meanwhile, the cumulative flow into Asian EM equity funds in recent years now eclipses that into dedicated global EM (GEM) funds. Moreover, the China component has been bifurcated between inflow from domestic investors and an exiting by overseas investors.

Looking at the recent run rate of flows into GEM funds specifically, the lack of inflow would be enough to suggest that sentiment is overly bearish. However, noting the change in the composition of how investors choose to buy EM exposure, the sum of country and regional flows shows that there has been some net inflow, but still at a very low level and consistent with outperformance over the next 12–24 months (*Display 5*).

DISPLAY 3: ASIA EX JAPAN AND GEM EQUITY FLOWS

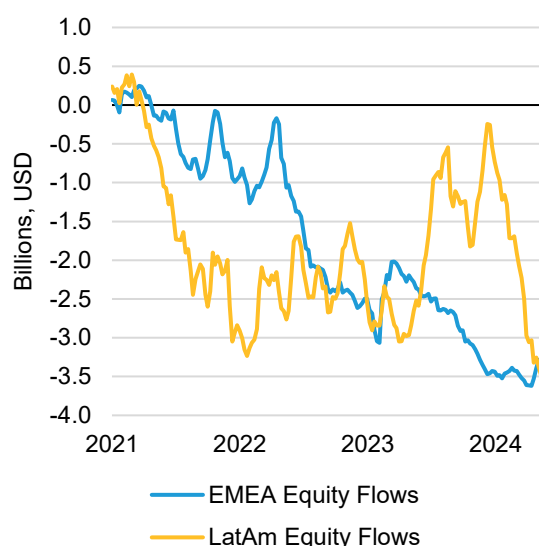


Historical analysis does not guarantee future results.

As of June 12, 2024

Source: EPFR Global and AB

DISPLAY 4: EMEA AND LATAM EQUITY FLOWS

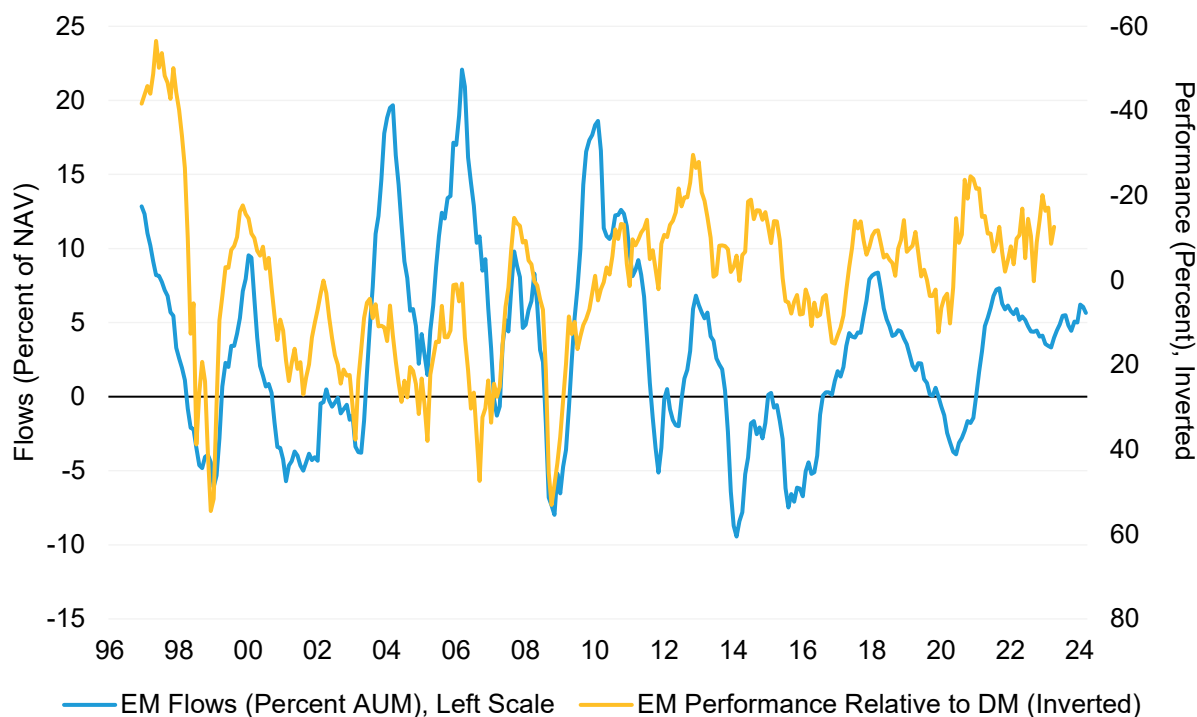


Historical analysis does not guarantee future results.

As of June 12, 2024

Source: EPFR Global and AB

DISPLAY 5: SUM OF EM COUNTRY NET EQUITY FLOW AND FORWARD RELATIVE PERFORMANCE



Historical analysis does not guarantee future results.

The EM flow series is the cumulative value of net inflows into all EM equity funds as a percentage of aggregate net asset value for EM equity funds.

Through April 30, 2024

Source: EPFR Global and AB

Just as many EM questions from clients have been strategic in nature, though. There are challenges in constructing a strategic cross-asset portfolio that seeks to eke out enough return. These include the prospect of lower growth as a result of smaller working-age populations in developed markets plus China, and the impact of deglobalization and the higher costs and drag on growth from the ongoing US-China rivalry. Thus, in this context, India is occasionally mentioned by clients as the great hope. Whereas the working-age population of China is already contracting, the working-age population of India is not set to peak until the late 2040s. We are somewhat wary of the comparison—not only is India tactically crowded in terms of investor positioning, but strategically the country seems unlikely to fulfill the same role in the global economy as China did in recent decades, at least not without huge policy changes.

Investors have wanted to engage in more methodological discussions about the role of EM assets in a portfolio. Our view is that this topic has to be viewed in the context of lower expected real returns on cross-asset portfolios and fewer opportunities for diversification. No single asset class can solve this constraint, so investors will need to pull various risk levers. The properties of EM can help in several specific ways:

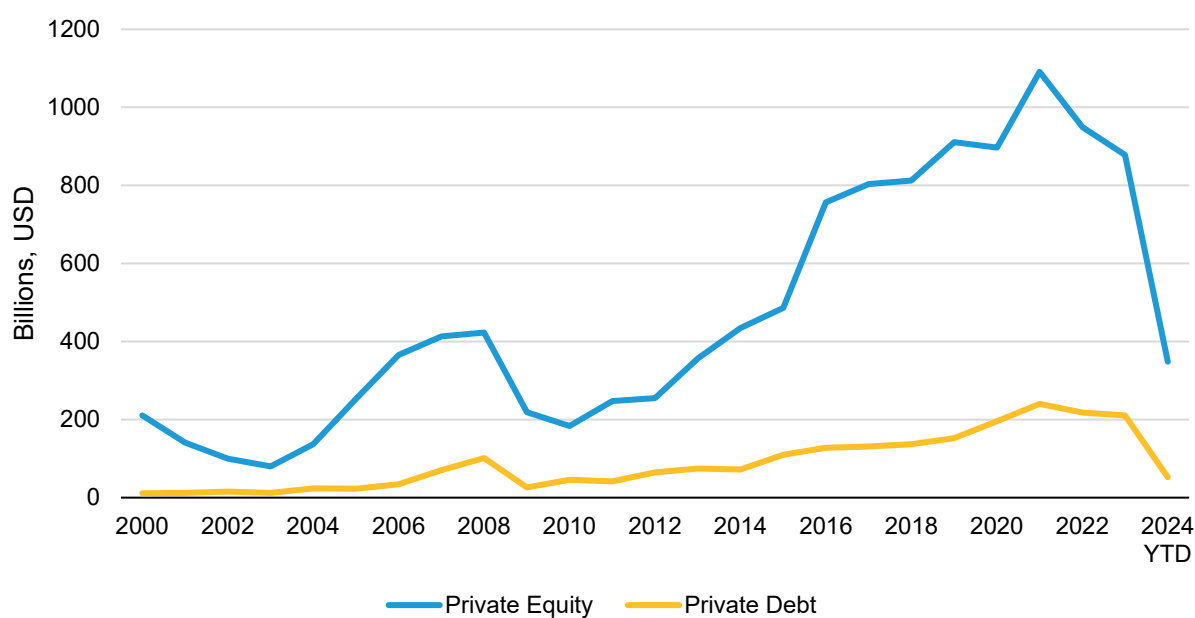
1. The growth premium in EM over developed markets has been falling, but in the context of a lower growth outlook and the need to achieve a given level of real return, even this smaller growth premium is important.
2. About the only upside from deglobalization, from a portfolio design context, is the greater availability of regional and country diversification within asset classes—EM is an important element of that diversification.

3. We see a greater role for idiosyncratic alpha as a contributor to overall portfolio information ratios, and our research has shown active managers are generally better able to generate idiosyncratic alpha in EM than in developed markets. Therefore, there is a case to disproportionately allocate the active risk budget to EM.

Private Assets: How Much? Which Ones? A Bubble or More to Come?

The allocation to private assets remains a topic that occupies a lot of meeting time. We have written about this in recent feedback notes¹, so we won't repeat the same material here. The key questions are whether the overall allocation to private assets should continue to increase and, if so, which subsections within private asset are of most interest. We do encounter much more skepticism now than over the last two years. There has been a slowdown in capital formation for private investing (*Display 6*). Nevertheless, allocations within portfolios are still rising, and we think a case remains for that trend, albeit with caveats about which private assets are being bought.

DISPLAY 6: AGGREGATE PRIVATE CAPITAL RAISED



Historical analysis does not guarantee future results.

Through May 31, 2024
Source: Preqin and AB

We have gone out of our way in meetings to turn to the slide in our presentation deck that lays out our view on why private equity, in aggregate, seems unlikely to offer an illiquidity premium anymore. Our case is predicated on the view that further multiple expansion seems challenging and that the current cost of debt is higher than it has been for most of private equity's history. Remarkably, we elicit very little pushback on this view. There is a role for private equity in future allocations, but its utility is evolving, stemming more from fund selection and the wide dispersion of outcomes than from an asset class "beta". Put another way, the "easy" beta of applying leverage to cheap assets has run its course—now, the only driver is the harder one of generating alpha from aspects such as operational improvements. Not only is that improvement harder to achieve, it is harder to scale. We find it remarkable that so many investors tell us that they can pick top-quintile funds. Such a statement might sound like parody, but we really hear it a lot.

We are more constructive on private debt, especially if the real limit on private-asset allocation is liquidity. On that basis, the ability to point to cash flows on a three-to-five-year horizon is more attractive than the longer capital tie ups of private equity. There are two specific risks with private debt. One is the macro risk inherent in the transfer of systemic risk from banks to

¹ Inigo Fraser Jenkins and Alla Harmsworth, [A Snapshot of Asset Allocators' Views](#), AllianceBernstein, February 7, 2024 and [Notes from the Road...or the Boarding Gate](#), AllianceBernstein, August 11, 2023

pension plans and insurance companies. We think a case can be made that this trend is a good thing: the longer time horizons of pension funds might at least be a better home for these risks than cyclical banks. It only works, though, if the pension plans really are long term in nature—and that career risk and regulation don't prevent that. For investors, the other risk comes from the relative youth of the private debt industry: there is not sufficient experience with managing default risk. The investors that we speak with have been relatively more positive on private debt. We see this across very different investor types, such as US pension plans, many of which are at or above their target allocation for private equity but have more scope to add private debt. Likewise, for European insurance companies, the allocation to private assets tends to be much lower (sub 10%) but increasing.

We make the case in our research that the allocation to private assets for the industry overall cannot be unstitched from the change in the way capital is raised to fund growth. Public equity and bank credit accounted for the bulk of capital raised in recent decades, but the share that is accounted for by private assets is rising and seems set to continue increasing, given corporate attitudes towards public listing and regulatory constraints on credit creation by banks. While this does not mean all types of private assets have blanket support, it does imply a tailwind for such asset classes.

AI, Productivity and Attempting Strategic Forecasts

The final topic of this note is AI. There is a tactical component of AI in the extraordinary performance of momentum strategies over the past year, but in meetings with allocators, the strategic prospect is the main focus of debate. The challenge is in trying to scale the potential for an aggregate productivity boost from AI. Our approach is to dodge the question, instead reverse engineering the problem by asking what impact AI would need to have on productivity growth to offset the likely decline in growth from the number of workers, climate change and deglobalization. Our best estimate is that AI would have to generate an increase in global productivity growth on the order of 1.5% pa. To put this in perspective, the peak-to-trough amplitude of changes in productivity growth since WWII have been of this scale, so such a change is do-able. It would be, however, at the top end of the historical range, so we would be uncomfortable including that degree of improvement in our core forecast.

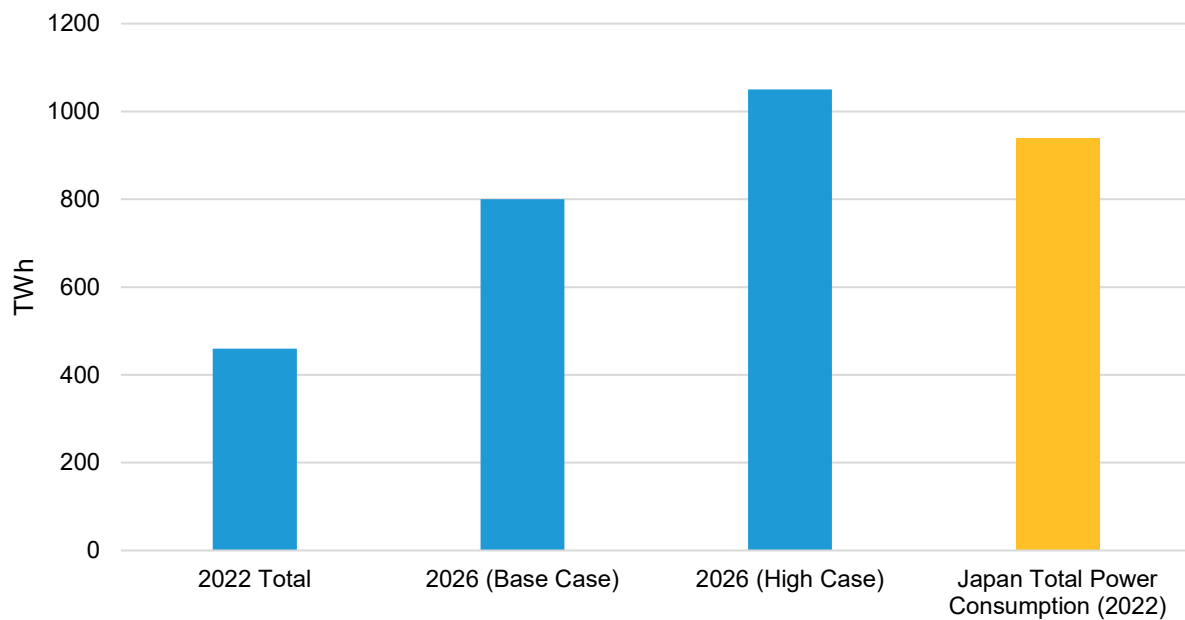
We met exactly one client, and one client only, who was confident that AI would deliver a productivity-growth improvement large enough to raise overall growth rates and reduce the burden of public debt/GDP. At the other end of the range, we would cite the work of Daron Acemoglu², who estimated the potential productivity boost from AI to be no more than 0.66% increase in productivity growth pa over the next 10 years. Lurking in the background of such forecasts is the observation that labor productivity in the US, and in fact in developed economies overall, has stagnated over the last 20 years, despite the buildout of the internet. There is likely large measurement error in this lack of improvement, but AI boosters need to explain why it is different. The lack of productivity improvement in recent decades points to the potential that it is not the technology itself that might be the sufficient condition for change, but also structural issues such as the degree of competition, regulation and social considerations.

One aspect of AI that has suddenly garnered more investor attention is the required infrastructure and power demand. There are several aspects of this demand, one of which is the emergence of a higher capex requirement, something of a switch to tangible rather than intangible assets, and a step up in capital requirements. Another is in the degree to which power demand acts as a potential constraint to the usage of AI. When one adds the power consumption of existing data centers to the power needs of crypto mining and then the potential extra power needs of AI, the result is that data centers in general are on track to require an additional power need equivalent to Japan within a couple of years (*Display 7*).

But this hunger for power is happening at a time when the world is attempting to limit or slow the growth in aggregate power demand. This leads us to the final client question we want to bring up: we were asked which has the larger role in our forecasts, AI or climate change? Your author threw up his hands at this point in the meeting. These are two of the largest unknowns in setting a strategic forecast, and we don't really know how to scale the two. However, the aggregate impact of both on growth, while potentially pointing in opposite directions, might not be the main point. The bigger point might be the distribution of possible future paths for the economy. We argue that both of these forces are likely to act in concert to broaden the range of likely outcomes to 10-year-forward targets. This development would imply the requirement for a new approach to diversification, where the breadth of possible paths is more divergent than recent decades (or centuries?) have implied.

² Daron Acemoglu, "The Simple Macroeconomics of AI" (working paper, National Bureau of Economic Research, 2024).

DISPLAY 7: AI ELECTRICITY DEMAND: GLOBAL ELECTRICITY DEMAND FROM DATA CENTRES, AI AND CRYPTOCURRENCIES



Historical analysis does not guarantee future results.

Forecast is based on IEA (2024), Electricity 2024, IEA, Paris <https://www.iea.org/reports/electricity-2024>

Through May 9, 2024

Source: Enerdata, IEA and AB

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