Economic & Investment Perspectives

Figure 1: 1/31/2021 Returns (source: Yahoo! Finance)
Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Jan	1YR	Max Draw Down	Current vs. 52-wk High	Current vs. 52-wk Low
US Aggregate Fixed Income	AGG	-0.7%	4.6%	-11.5%	-2.0%	11.1%
U.S. Treasury Bonds	GOVT	-0.5%	4.2%	-6.2%	-5.0%	3.1%
Investment Grade Corp Bonds	LQD	-1.8%	6.3%	-26.9%	-2.7%	29.2%
Muni Bonds	MUB	0.3%	3.8%	-15.3%	-0.5%	17.6%
High Yield	HYG	-0.4%	4.6%	-23.7%	-1.7%	28.8%
Non-US Fixed Income	BNDX	-0.6%	2.1%	-9.1%	-1.0%	8.0%
Emerging Markets Bond	EMB	-1.8%	2.3%	-27.5%	-2.9%	33.9%
Global Equity						
ACWI Global Equity	ACWI	-0.3%	17.7%	-34.8%	-4.2%	69.6%
United States	VTI	-0.3%	20.7%	-36.5%	-4.1%	77.2%
International Developed	EFA	-0.8%	9.9%	-35.1%	-4.4%	58.3%
Emerging Markets	EEM	3.2%	28.6%	-35.0%	-5.7%	77.1%
Global Equity by Region						
United States	VTI	-0.3%	20.7%	-36.5%	-4.1%	77.2%
Europe	IEUR	-1.0%	7.6%	-38.5%	-5.0%	64.3%
Asia ex-Japan	AAXJ	4.4%	37.4%	-30.7%	-6.1%	76.6%
China	MCHI	8.1%	47.3%	-26.3%	-6.9%	75.0%
Japan	EWJ	-0.8%	17.4%	-31.5%	-4.5%	61.0%
Latin America	ILF	-7.5%	-11.3%	-56.0%	-17.3%	74.8%
US Equity						
US S&P 500	IVV	-1.0%	17.2%	-35.3%	-4.0%	68.7%
NASDAQ 100 QQQ	QQQ	0.3%	44.4%	-30.5%	-4.8%	90.7%
US Large Growth	IWF	-0.8%	34.1%	-33.5%	-4.6%	86.6%
US Large Value	IWD	-0.9%	4.0%	-39.4%	-5.1%	61.0%
US Eqwt S&P 500	RSP	-0.8%	13.4%	-40.7%	-4.9%	79.3%
US Mid Cap	IJH	1.5%	18.4%	-44.1%	-5.8%	97.9%
US Small Cap	VTWO	4.9%	30.3%	-43.8%	-5.6%	115.8%

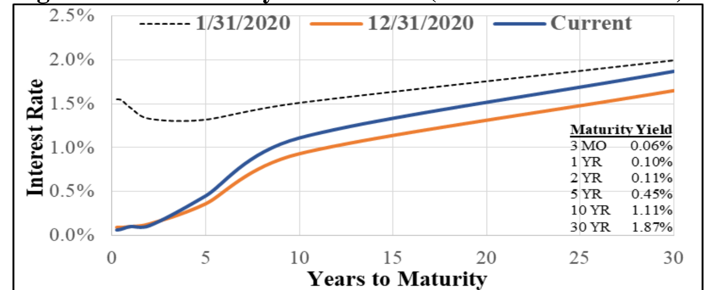
Equity markets rallied through most of January before selling off sharply in the last days of the month. In addition to the usual suspects (virus/vaccine concerns, corporate earnings), the selloff was exacerbated by the mania surrounding heavily shorted stocks like GameStop (GME), which rose from $19 to $325 as massive online buying sparked a rally and subsequent short squeeze (read more here). In the grand scheme of things, this is a temporary anomaly that will likely not end well, but it drew attention to concerns over volatility and frothy equity valuations. Performance highlights for the month and quarter include the following:

- Global equity (ACWI): -0.3% in January.
- US Equity: The broad market (VTI) lost 0.3% in January, and the S&P 500 (IVV) fell 1.0%. Small-cap stocks (VTWO) posted another strong month, gaining 5.0%. The Russell Value (IWD) and Growth (IWF) indices were both down this month; Value has out-performed recently but trails Growth dramatically over the past 12 months (+4.0% vs, 34.1%) due to the strength of tech and e-commerce stocks over longer periods.
- Non-US Equity: Emerging markets (EEM) out-performed developed markets (EFA) this month (+3.2% vs. -0.8%) and trailing 12 months (+28.6% vs. +9.9%), led by Asian equities.
- Fixed Income: The US Aggregate bond index (AGG) fell 0.7% in January as interest rates rose. Corporate (LQD) and emerging market debt (EMB) lost 1.8%; high yield (HYG) fell 0.4%.

Interest Rates and the Economy

Figure 2 graphs the US yield curve, which plots yields (Y-axis) for various maturities (X-axis) of US Treasuries. Long-term interest rates moved slightly higher during January but remain below year-ago levels. The yield on the 10-year bond rose above 1% for the first time since before the pandemic (now 1.11%), and the 30-year bond inched toward the 2% level (now 1.87%). The Federal Reserve (Fed) has stated that it intends to keep short-term yields near zero for years to come, and the belief that the Fed will "manage" the yield curve through asset purchases and quantitative easing has kept interest rates low across maturities.

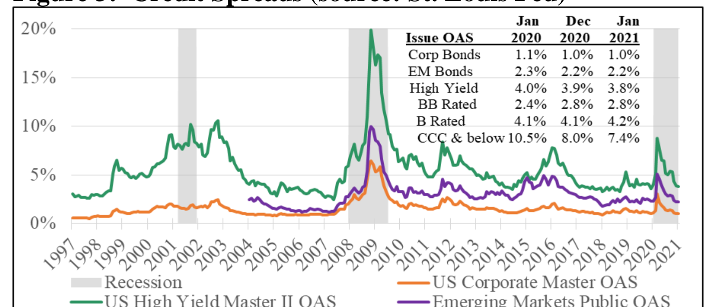
Figure 2: US Treasury Yield Curve (source: St. Louis Fed)



For bonds other than US Treasuries, we focus on the option-adjusted spread (OAS) between various bond yields and comparable US Treasuries. High spreads signal fear; low spreads signal optimism as investors are willing to accept lower returns for riskier assets. As illustrated in Figure 3 below, credit spreads spiked on pandemic fears last March but have tightened steadily since, now resting at or below pre-pandemic levels.

- Investment grade corporate bonds yield 1.0% over Treasuries, unchanged this month and slightly tighter than one year ago.
- Emerging market bonds carry an average yield premium of +2.2% versus +5.1% in March and +2.3% a year ago.
- High yield (non-investment grade) spreads narrowed slightly this month to +3.8% and remain tighter than year-ago levels. The riskiest bonds (rated CCC & below) carry credit spreads well below pre-pandemic levels (+7.4% vs. +10.5% last year).

Figure 3: Credit Spreads (source: St. Louis Fed)



Capital Market Assumptions: Forecasts

Many research-intensive investment firms maintain long-term capital market assumptions (expected asset class returns, volatility and correlations) and publish them annually. We have long followed JP Morgan and Blackrock forecasts, which offer some of the most robust research on the topic, as well as other well-respected firms such as Wells Fargo, Vanguard, Research Affiliates and Grantham Mayo (GMO). Together, this group of firms manages over $18 trillion on behalf of institutional and individual investors. Figure 4 below summarizes their forecasts.

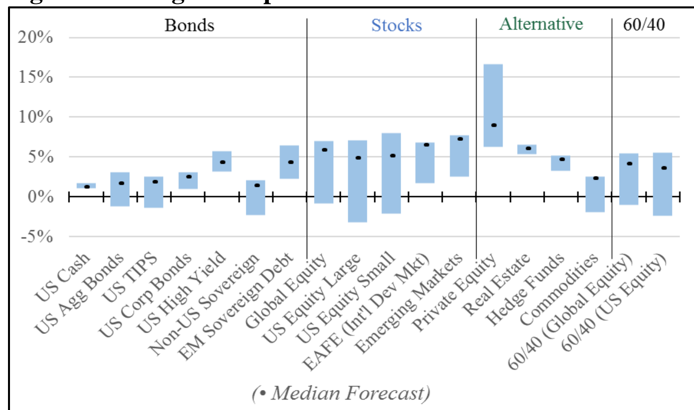
Figure 4: 10-year Return Forecasts (Nominal, Geometric)

Class	Asset	JP Morgan	Black Rock	Wells Fargo	Vanguard	Research Affiliates	GMO	Median E(R)	Change vs. 2020
Inflation	US Inflation	2.0%		2.0%	1.4%	2.2%		**2.0%**	**0.0%**
Cash & Bonds	US Cash	1.1%	1.0%	1.7%	1.1%	1.5%	1.4%	**1.3%**	**-0.7%**
	US Agg Bonds	2.1%	0.8%	3.1%	1.2%	2.1%	-1.2%	**1.6%**	**-0.4%**
	US TIPS	1.5%	2.2%	2.5%	0.9%	2.4%	-1.4%	**1.9%**	**0.2%**
	US Corp Bonds	2.5%	1.0%	3.1%	1.8%	2.5%		**2.5%**	**0.1%**
	US High Yield	4.8%	4.3%	5.7%	3.2%	3.2%		**4.3%**	**-0.2%**
	Non-US Sovereign	1.8%	0.4%	2.1%	1.0%	1.9%	-2.3%	**1.4%**	**-0.3%**
	EM Sovereign Debt	5.2%	3.4%	6.0%	2.8%	6.4%	2.3%	**4.3%**	**0.1%**
Equity	Global Equity	5.1%	5.8%	7.0%	6.1%	5.9%	-0.9%	**5.8%**	**-0.3%**
	US Equity Large	4.1%	5.0%	7.1%	4.6%	5.1%	-3.2%	**4.8%**	**-0.2%**
	US Equity Small	4.6%	5.6%	8.0%	4.7%	5.5%	-2.1%	**5.1%**	**-0.9%**
	EAFE (Int'l Dev Mkt)	6.5%	6.8%	6.4%		6.5%	1.7%	**6.5%**	**0.1%**
	Emerging Markets	7.2%	6.4%	7.7%		7.5%	2.5%	**7.2%**	**-1.4%**
Alt	Private Equity	7.8%	16.6%	10.1%		6.3%		**9.0%**	**0.2%**
	Real Estate	5.9%	6.1%	6.5%		5.3%		**6.0%**	**0.6%**
	Hedge Funds	3.3%	5.1%	5.1%		4.2%		**4.6%**	**0.2%**
	Commodities	2.3%		2.5%		-1.9%		**2.3%**	**-1.4%**
Portfolio	60/40 (Global Equity)	3.9%	3.8%	5.4%	4.1%	4.4%	-1.0%	**4.2%**	**-0.3%**
	60/40 (US Equity)	3.3%	3.3%	5.5%	3.2%	3.9%	-2.4%	**3.5%**	**-0.3%**

**Note: GMO 7-year exp. real return forecasts were converted to nominal by adding the long-term inflation forecast of 2% to all returns.*

Figure 5 below is a graphical summary of the data in Figure 4, illustrating the range of return estimates for each asset class and the median observation for each. We focus on the median rather than a simple average of forecasts to limit the impact of outliers.

Figure 5: Range of Expected Return Forecasts



Expected returns continue to be low for all asset classes, given persistently low interest rates and inflation, the building blocks of asset returns. Observations are summarized below.

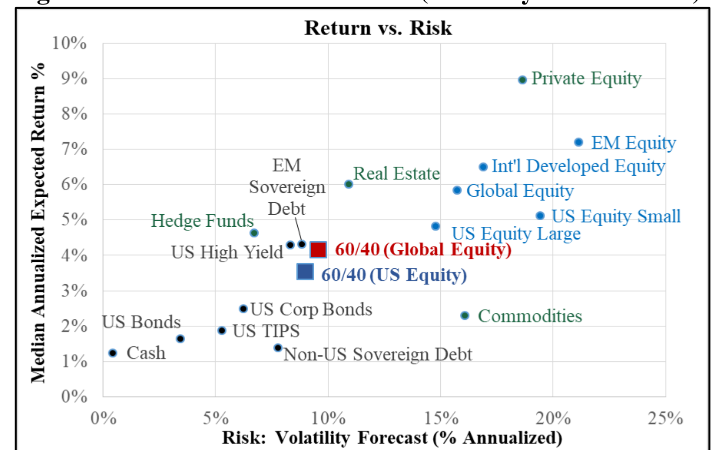
Bonds: In general, expected returns for bonds are at or below forecasts from last year. Cash is expected to earn 1.3% p.a., implying a sizeable increase in short-term yields in the coming years. The median forecast for the US Aggregate Bond index is just 1.6% per annum, down from 2.0% in last year's forecasts. Credit spreads are expected to remain narrow, resulting in lower-than-normal expected returns for investment grade corporate bonds (2.5%), high yield (4.3%) and emerging market debt (4.3%). Non-US sovereign debt is expected to earn a paltry 1.4% over the next ten years, not surprising given the amount of negative yielding government debt currently in Europe and Japan.

Stocks: Given the strong global equity rally in 2020 (especially in the US), forward return expectations have come down versus last year and are well below historical averages. US equities have the widest estimate range due to a very bearish outlook from GMO, who expect US stocks to fall over the forecast horizon. Despite this, the median return estimates are 4.8% annually for large US stocks and 5.1% for small cap US stocks. Developed international markets (EAFE) boast somewhat higher expectations at 6.5% p.a., while emerging market equity forecasts are higher still at 7.2% p.a. Altogether, the median forecast for global equities in this survey is 5.8% annually over the next 10 years, down from a 6.1% forecast in last year's survey.

Alternatives: Private equity boasts the highest return expectations in the survey with a median annualized forecast of 9.0% net of fees. Real Estate should earn 6.0% p.a., while hedge funds are expected to earn 4.6% p.a. Commodities are expected to remain weaker with a 2.3% p.s. expected return. Institutional investors will continue to invest in all of these areas in search of returns (private equity) and diversification (hedge funds, real estate and commodities have a low correlation with stocks and bonds).

Risk: Returns are only part of the investment process. Figure 6 plots the risk/return tradeoff for the various asset classes discussed in this article (median expected return on the Y-axis, and JP Morgan's annualized volatility estimate on the X-axis). Over the long run, higher returns can only be achieved by taking more risk; therefore, it makes sense that less risky assets like cash and bonds fall in the lower left while riskier asset classes like emerging market and private equity lie in the upper right.

Figure 6: Return vs. Risk Forecast (Volatility source: JPM)



Bottom Line

In contrast to the robust performance of risk assets in recent years, forward return expectations are low across asset classes for the next decade. A benchmark 60/40 portfolio (60% stocks and 40% bonds) is only expected to earn about 4% per year over the next decade. These returns are not likely to satisfy the spending needs of individuals and endowments or the actuarial assumptions of pension or retirement plans. To achieve higher returns, investors may choose to take on more risk with higher allocations to equities, specifically small cap, international and especially emerging markets, with less exposure to low or negative yielding fixed income. We feel that a higher-than-average exposure to equity is appropriate as economies emerge from the global recession.

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