ECONOMIC & INVESTMENT PERSPECTIVES

JANUARY: U.S. EQUITY CORRECTION; LONG-TERM CAPITAL MARKET RETURN FORECASTS

Figure 1: 1/31/2022 Returns (source: Bloomberg)
Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	3MO	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	-2.0%	-2.1%	-3.0%	-4.7%	0.4%
Investment Grade Corp Bonds	LQD	-3.6%	-3.7%	-3.6%	-6.6%	0.7%
U.S. Treasury Bonds	GOVT	-2.6%	-1.7%	-3.3%	-4.2%	0.6%
20+ Year Treasury Bonds	TLT	-3.9%	-3.2%	-4.9%	-8.2%	6.9%
Muni Bonds	MUB	-2.4%	-1.7%	-1.8%	-3.9%	0.1%
High Yield	HYG	-2.7%	-1.6%	1.4%	-3.9%	0.9%
Non-US Corp Bonds	IBND	-3.0%	-4.4%	-9.9%	-12.8%	0.6%
Emerging Markets Bond LC	EMLC	0.3%	-1.3%	-7.7%	-13.3%	1.8%
Global Equity						
ACWI Global Equity	ACWI	-4.5%	-3.1%	13.6%	-6.0%	11.3%
United States	VTI	-6.1%	-3.9%	18.5%	-7.1%	16.8%
International Developed	EFA	-3.6%	-3.9%	8.3%	-7.9%	4.0%
Emerging Markets	EEM	0.0%	-2.6%	-6.6%	-16.2%	4.7%
Global Equity by Region						
United States	VTI	-6.1%	-3.9%	18.5%	-7.1%	16.8%
Europe	IEUR	-3.5%	-3.3%	13.8%	-6.6%	9.6%
Asia ex-Japan	AAXJ	-1.3%	-3.6%	-10.8%	-20.3%	4.9%
China	MCHI	-0.3%	-8.9%	-27.8%	-35.8%	6.6%
Japan	BBJP	-4.1%	-5.0%	-2.1%	-14.7%	3.7%
Latin America	ILF	8.6%	8.6%	1.5%	-21.7%	12.8%
US Equity						
US S&P 500	IVV	-5.3%	-1.7%	23.2%	-6.3%	21.2%
NASDAQ 100 QQQ	QQQ	-8.7%	-5.9%	16.0%	-11.2%	22.1%
US Large Growth	IWF	-8.7%	-6.2%	17.3%	-10.5%	23.1%
US Large Value	IWD	-2.4%	0.1%	23.1%	-4.4%	20.9%
US Eqwt S&P 500	RSP	-4.4%	-1.1%	24.8%	-5.6%	22.8%
US Mid Cap	IJH	-7.3%	-5.4%	14.0%	-10.1%	12.3%
US Small Cap	VTWO	-9.8%	-11.6%	-1.2%	-18.0%	6.8%

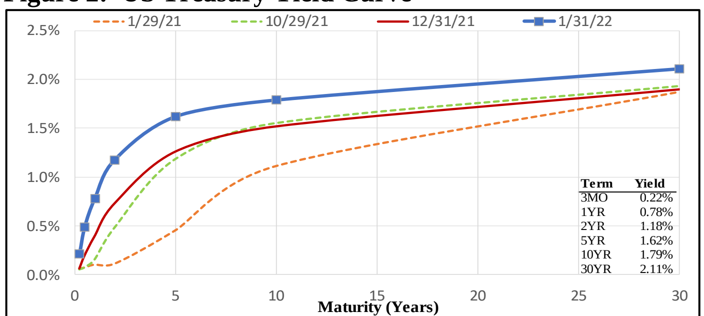
Stocks sold off aggressively in January in anticipation of higher interest rates as the Fed reiterated its pledge to fight stubbornly high inflation. Most U.S. equity indices fell more than 10% before rebounding in the final trading days of the month. Performance highlights (lowlights?) for January are summarized below.

- Bonds: The U.S. Aggregate index (AGG) fell 2.0% in January as interest rates rose across the board. Long-term Treasuries (TLT) lost 3.9%. Corporate bonds (LQD) were down 3.6% and high yield bonds (HYG) fell 2.7% as credit spreads widened. Emerging market credit (EMLC) rose 0.3% for the month.
- Global equity (ACWI): -4.5% in January.
- U.S. Equity: Stocks had fallen roughly 12% before rallying in the last two days to cut their losses. The broad market (VTI) ended January down 6.1%, while the S&P 500 (IVV) lost 5.3%. Poor performance of large, growth-oriented stocks (QQQ and IWF -8.7%) makes sense amid rising interest rates, but the small cap weakness (VTWO -9.8%) signals broader economic growth concerns. Energy stocks (XLE) bucked the trend, rising 18.8% with spiking oil prices (Russia-Ukraine crisis).
- Non-U.S. Equity: Developed markets (EFA) fell 3.6% in January; European stocks (IEUR) lost 3.5% while Japanese equities (BBJP) lost 4.1% on average. Emerging markets (EEM) were flat with strong gains in Latin America (ILF +8.6%).

Interest Rates and the Economy

The US yield curve (Figure 2) plots the yields (Y-axis) for various maturities (X-axis) of U.S. Treasuries. Yields rose across the board in January with as the Fed reiterated its intent to raise interest rates to combat inflation now that unemployment is back below 4%. The yield curve remains flat at longer maturities, likely signaling longer-term growth concerns as the Fed removes accommodative policy measures. The benchmark 10-year bond yield ended January at 1.79%, very close to pandemic-era highs.

Figure 2: US Treasury Yield Curve

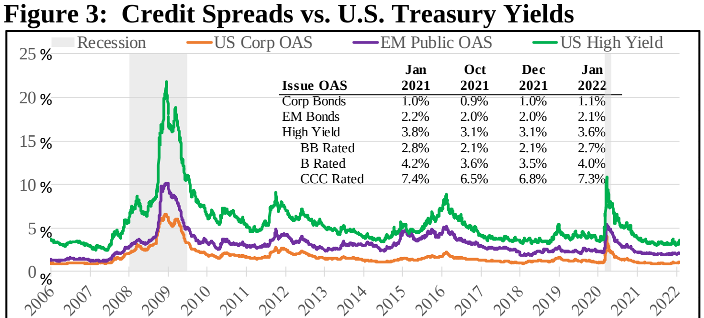


Source: Board of Governers of the Federal Reserve System via FRED

For bonds other than U.S. Treasuries, we track the option-adjusted yield spread (OAS) versus Treasuries of comparable maturities. Low or narrowing spreads signal optimism while high or rising spreads signal fear. Spreads widened this month, reflecting the risk-averse tone of equities, but they remain historically low.

- Investment grade corporate bond spreads were stable throughout 2021 but rose marginally to 1.1% this month.
- High yield (non-investment grade) spreads widened to +3.6%, slightly below year-ago spreads of +3.8%. The riskiest bonds (rated CCC & below) now yield +7.3% over Treasuries, rising last month but still below spreads of +7.4% one year ago.
- Emerging market bond spreads widened slightly to +2.1% and are below year-ago levels. Though these credit spreads have been relatively stable, non-U.S. bonds have under-performed U.S. bonds due to the strength of the dollar in the past year.

Figure 3: Credit Spreads vs. U.S. Treasury Yields



Source: Ice Data Indices, LLC via FRED

Capital Market Assumptions: Forecasts

It is beneficial to seek a longer-term perspective regarding markets and returns, especially in times of stress and volatility. Many research-intensive investment firms maintain long-term capital market assumptions (expected asset class returns, volatility and correlations) and publish them annually, including JP Morgan (some of the most robust research on the topic) and other well-respected firms such as BlackRock, Wells Fargo, Vanguard, Research Affiliates and Grantham Mayo (GMO). Together, these firms manage over $20 trillion on behalf of institutional and individual investors. Figure 4 summarizes their long-term forecasts.

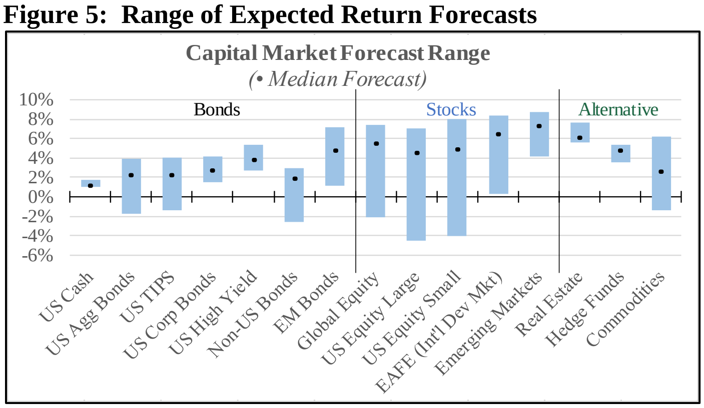
Figure 4: 10-year Return Forecasts (Nominal, Geometric)

Class	Asset	JP Morgan	Black Rock	Wells Fargo	Vanguard	Research Affiliates	GMO	Median E(R)	Change vs. 2021
Inflation	US Inflation	2.3%		2.0%	2.0%	2.5%	2.2%	**2.2%**	**0.2%**
Cash & Bonds	US Cash	1.3%	1.2%	1.5%	1.7%	1.1%	1.1%	**1.3%**	**0.0%**
	US Agg Bonds	2.6%	1.6%	3.1%	1.9%	4.0%	-1.7%	**2.3%**	**0.6%**
	US TIPS	2.1%	2.7%	2.5%	1.5%	4.0%	-1.4%	**2.3%**	**0.4%**
	US Corp Bonds	2.8%	1.5%	3.1%	2.1%	4.1%		**2.8%**	**0.3%**
	US High Yield	3.9%	3.4%	5.4%	2.7%	4.9%		**3.9%**	**-0.4%**
	Non-US Bonds	2.4%	1.3%	2.0%	1.8%	2.9%	-2.6%	**1.9%**	**0.5%**
	EM Bonds	5.9%	3.7%	5.9%	2.8%	7.2%	1.1%	**4.8%**	**0.5%**
Equity	Global Equity	5.0%	7.4%	7.1%	4.5%	6.0%	-2.1%	**5.5%**	**-0.3%**
	US Equity Large	4.1%	6.7%	7.1%	3.2%	5.0%	-4.5%	**4.6%**	**-0.3%**
	US Equity Small	4.4%	6.2%	8.0%	3.2%	5.6%	-4.0%	**5.0%**	**-0.1%**
	EAFE (Int'l Dev Mkt)	6.5%	8.3%	6.4%	6.3%	6.8%	0.3%	**6.5%**	**-0.1%**
	Emerging Markets	6.9%	8.7%	7.9%	5.2%	8.3%	4.1%	**7.4%**	**0.2%**
Alt	Real Estate	5.8%	6.4%	7.7%		5.6%		**6.1%**	**0.1%**
	Hedge Funds	3.6%	5.3%	5.2%		4.4%		**4.8%**	**0.2%**
	Commodities	2.6%		6.2%		-1.4%		**2.6%**	**0.3%**

**Note: GMO 7-year exp. real return forecasts were converted to nominal by adding the long-term inflation forecast of 2.2% 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. Expected returns continue to be low for all liquid asset classes, given persistently low interest rates and inflation, the building blocks of asset returns. Observations are summarized below.

Figure 5: Range of Expected Return Forecasts



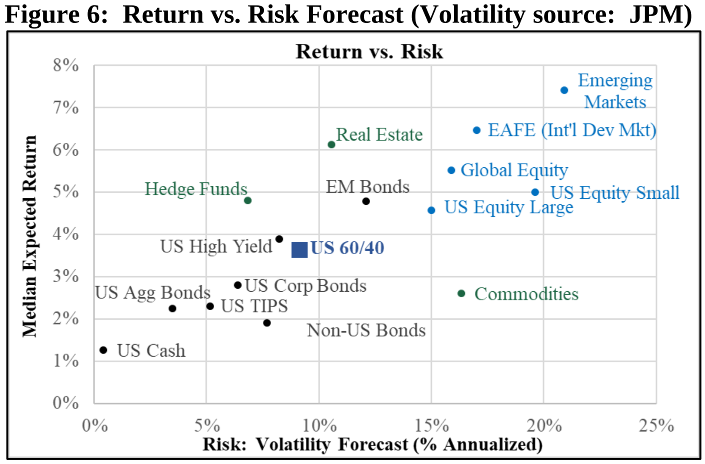
Bonds: Long-term return forecasts for bonds have increased versus last year's survey with expectations of rising interest rates. Cash is expected to earn 1.3% per annum, and the median forecast for the U.S. Aggregate Bond index is now 2.3% p.a., up from 1.6% in last year's forecasts. Investment grade corporate bonds are expected to offer modest returns of 2.8% p.a. over the next decade; credit spreads are expected to widen somewhat, reducing expectations for high yield bonds (3.9% p.a.). Non-U.S. developed market debt is expected to earn 1.9% p.a., underperforming U.S. bonds, which is not surprising given the amount of negative yielding government debt currently in Europe and Japan. Emerging market debt is forecast to earn stronger returns (4.8% p.a.).

Stocks: Given the strong global equity rally in the past two years (especially in the U.S.), forward return expectations have generally declined versus last year's estimates and are below historical averages. U.S. equities have a wide range of estimates due to a very bearish outlook from GMO. Despite this, the median return estimates for the next 10 years are 4.6% annually for large U.S. stocks and 5.0% for small caps, both down versus last year's survey. Developed international markets (EAFE) offer higher return expectations at 6.5% p.a., while emerging market equity forecasts are higher still at 7.4% p.a. Altogether, the median forecast for global equities in this survey is 5.5% annually over the next 10 years, down from a 5.8% median forecast last year.

Alternatives: Return estimates for alternative assets increased marginally in this year's survey. Private Real Estate is expected to earn 6.1% p.a., while hedge funds are forecast to earn 4.8% p.a. After a very strong 2021, commodities are expected to lag going forward with expected return annual returns of just 2.6% p.a. Large institutional investors will continue to invest in illiquid assets for returns 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 small cap U.S. equity are farther out to the right.

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



Bottom Line

Even with the recent stock market correction, equity returns have been stunningly high in recent years. By contrast, forward return expectations are low. A standard U.S. 60/40 portfolio (60% stocks, 40% bonds) is expected to earn less than 4% per year over the next decade, which would not satisfy the spending needs of individuals and endowments or the actuarial assumptions of pension or retirement plans. To achieve higher returns, investors must take on more risk with higher allocations to equities, especially in international and emerging markets, with less exposure to low or negative yielding fixed income. Diversification is critical, especially as investors seek higher returns in an environment marked by elevated volatility, inflation and rising interest rates.

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