ECONOMIC & INVESTMENT PERSPECTIVES

JANUARY: STRONG START TO 2023

Figure 1: 1/31/2023 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	3.3%	6.3%	-8.3%	-10.5%	7.5%
Investment Grade Corp Bonds	LQD	5.2%	10.4%	-10.5%	-13.6%	12.7%
U.S. Treasury Bonds	GOVT	2.7%	4.7%	-8.7%	-10.3%	5.4%
U.S. 20+ YR Treasuries	TLT	7.6%	12.3%	-23.0%	-25.4%	16.7%
Muni Bonds	MUB	2.5%	7.1%	-2.7%	-5.1%	6.7%
High Yield	HYG	3.7%	5.3%	-5.2%	-10.2%	8.4%
Non-US Corp Bonds	IBND	3.4%	13.0%	-14.2%	-15.2%	18.5%
Emerging Markets Bond LC	EMLC	4.3%	13.2%	-7.0%	-13.5%	12.9%
Global Equity						
ACWI Global Equity	ACWI	7.5%	11.1%	-8.1%	-11.6%	20.5%
United States	VTI	6.9%	5.9%	-8.4%	-12.4%	16.9%
International Developed	EFA	9.0%	21.1%	-3.1%	-8.2%	31.0%
Emerging Markets	EEM	9.1%	22.8%	-13.3%	-17.5%	23.5%
Global Equity by Region						
United States	VTI	6.9%	5.9%	-8.4%	-12.4%	16.9%
Europe	IEUR	9.4%	22.0%	-4.6%	-9.5%	34.9%
Asia ex-Japan	AAXJ	9.4%	29.2%	-11.7%	-15.1%	30.4%
China	MCHI	12.8%	52.8%	-12.6%	-16.6%	53.0%
Japan	BBJP	7.6%	17.6%	-7.1%	-10.5%	21.2%
Latin America	ILF	11.3%	6.4%	12.8%	-18.4%	22.8%
US Equity						
US S&P 500	IVV	6.3%	5.7%	-8.2%	-12.0%	16.8%
NASDAQ 100 QQQ	QQQ	10.6%	6.3%	-18.3%	-20.8%	15.9%
US Large Growth	IWF	8.3%	4.5%	-16.1%	-18.8%	14.9%
US Large Value	IWD	5.1%	7.2%	-0.6%	-6.0%	18.9%
US Eqwt S&P 500	RSP	7.4%	9.2%	-0.7%	-5.9%	21.5%
US Mid Cap	IJH	9.3%	9.4%	2.4%	-4.6%	21.6%
US Small Cap	VTWO	9.8%	4.9%	-3.3%	-9.8%	17.7%

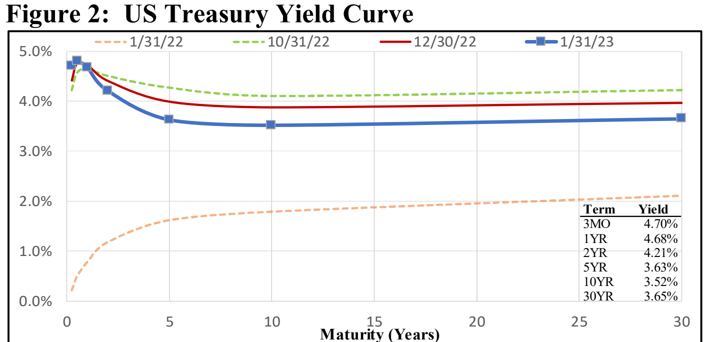
The new year began with strong gains for stocks and bonds in January. Moderating inflation and hope that the Fed is nearing the end of its rate hike cycle drove yields lower and stocks higher. Market highlights for January are summarized below.

- Bonds: US bonds gained in January as interest rates fell. The US Aggregate index (AGG) rose 3.3%; long-term Treasuries (TLT) were up 7.6% but are still down 23.0% over the past year. Corporate bonds (LQD) rose 5.2%, and high yield gained 3.7%. Non-US bonds (IBND) were up just 3.4% despite a weaker dollar, while emerging market debt (EMLC) rose 4.3%.
- Global equity (ACWI): +7.5% in January (-8.1% last 12 mo.).
- US Equity: The broad market (VTI) rose 6.9% this month but is down 8.4% in the last 12 months. The S&P 500 (IVV) gained 6.3%, while small stocks (VTWO) soared 9.8%. Growth stocks and sectors (consumer discretionary, communications, tech) posted solid gains, but defensive sectors (utilities, health care, consumer staples) were actually down in January.
- Non-US Equity: Developed markets (EFA) rose 9.0% this month, and emerging markets (EEM) rose 9.1%. After lagging US stocks for the past several years, non-US equity has begun to out-perform. In the past three months, US stocks are up 5.9%, but European stocks (IEUR) have risen 22.0%, and Japan (BBJP) rose 17.6% as currencies recovered; China (MCHI) is up 52.8% over that period amid easing Covid restrictions.

Interest Rates and the Economy

The yield curve (Figure 2) plots the yields (Y-axis) for various maturities (X-axis) of US Treasuries. As expected, the Fed raised the Fed Funds target rate by 0.25% today (now 4.50-4.75%). Though near the end of the tightening cycle, the Fed intends to keep rates high for an extended period to tame inflation, but the inverted curve (short-term yields higher than long-term yields) signals that investors believe the weakening economy will lead to rate cuts by mid-2023. The 10-year Treasury now yields 3.52%.

Figure 2: US Treasury Yield Curve

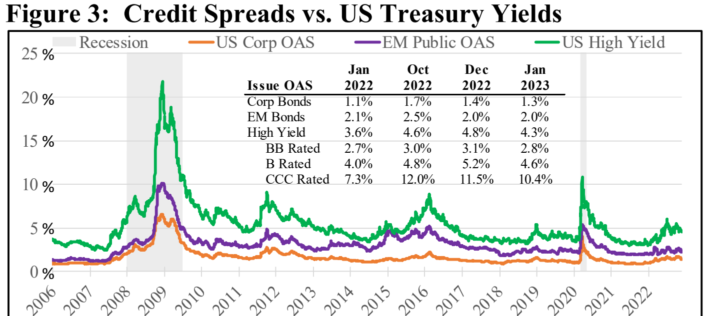


Source: Board of Governers of the Federal Reserve System via St. Louis Fed (FRED)

For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between yields and Treasuries of comparable maturities (Figure 3). Low or narrowing spreads signal optimism, while high or rising spreads signal fear. Spreads narrowed in January as risk assets rallied around the world.

- Investment grade corporate bond spreads have narrowed since October and were down slightly this month to +1.3%.
- High yield (non-investment grade) spreads narrowed to +4.3% this month, still above year-ago spreads of +3.6%. The riskiest bonds (rated CCC & below) now yield +10.4% over Treasuries, narrowing in recent months but still wider than a year ago.
- Emerging market bond spreads have been more stable recently at +2.0% and are below year-ago levels after peaking at +2.8% earlier in 2022. Non-US bond have been strong recently as the dollar weakened while yields and spreads have declined.

Figure 3: Credit Spreads vs. US Treasury Yields



Source: Ice Data Indices, LLC via St. Louis Fed (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 $16 trillion on behalf of institutional and individual investors. Figure 4 summarizes their long-term forecasts.

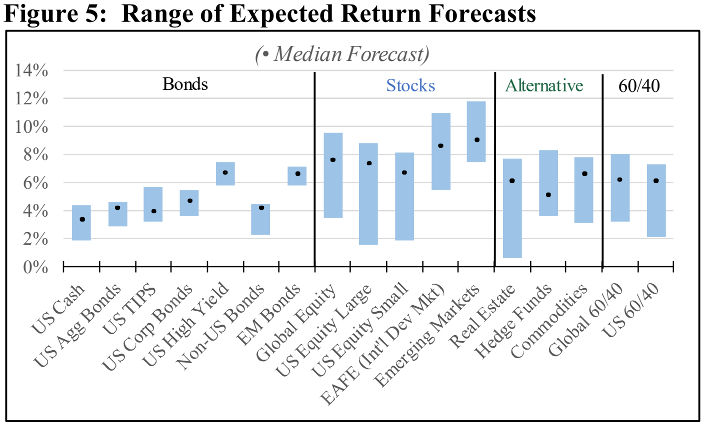
Figure 4: 10-year Return Forecasts (Nominal, Geometric)

Class	Asset	JP Morgan	Black Rock	Wells Fargo	Vanguard	Research Affiliates	GMO	Median E(R)	Change vs. 2022
Inflation	US Inflation	2.6%		2.3%	2.5%	3.5%	2.3%	**2.6%**	**0.4%**
Cash & Bonds	US Cash	2.4%	3.3%	1.9%	3.9%	4.4%	3.5%	**3.4%**	**2.1%**
	US Agg Bonds	4.6%	4.2%	3.6%	4.6%	4.3%	2.9%	**4.3%**	**2.0%**
	US TIPS	4.3%	5.7%	3.7%	3.7%	5.1%	3.2%	**4.0%**	**1.7%**
	US Corp Bonds	5.5%	4.7%	3.6%	5.2%	4.8%		**4.8%**	**2.0%**
	US High Yield	6.8%	7.5%	5.8%	7.1%	5.8%		**6.8%**	**2.9%**
	Non-US Bonds	4.4%	4.3%	2.3%	4.5%	3.6%		**4.3%**	**2.4%**
	EM Bonds	7.1%	5.8%	6.3%	6.9%	7.0%	6.4%	**6.7%**	**1.9%**
Equity	Global Equity	8.5%	9.6%	7.0%	6.8%	8.3%	3.5%	**7.7%**	**2.1%**
	US Equity Large	7.9%	8.8%	7.1%	5.7%	7.8%	1.6%	**7.4%**	**2.9%**
	US Equity Small	8.1%	6.0%	7.7%	6.0%	7.5%	1.9%	**6.8%**	**1.8%**
	EAFE (Int'l Dev Mkt)	9.8%	11.0%	6.4%	8.2%	9.1%	5.5%	**8.6%**	**2.2%**
	Emerging Markets	10.1%	11.8%	7.5%	8.0%	10.7%	7.9%	**9.1%**	**1.7%**
Alt	Real Estate	5.7%	0.7%	7.7%		6.7%		**6.2%**	**0.1%**
	Hedge Funds	5.0%	8.3%	5.3%		3.6%		**5.2%**	**0.4%**
	Commodities	3.1%		6.7%		7.8%		**6.7%**	**4.1%**

**Note: GMO 7-year exp. real return forecasts were converted to nominal by adding the long-term inflation forecast of 2.3% 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 forecast for each. We focus on the median rather than a simple average of forecasts to limit the impact of outliers. Expected returns have increased measurably since last year's survey reflecting 2022 global stock and bond market declines, higher interest rates and inflation. Observations are summarized below.

Figure 5: Range of Expected Return Forecasts



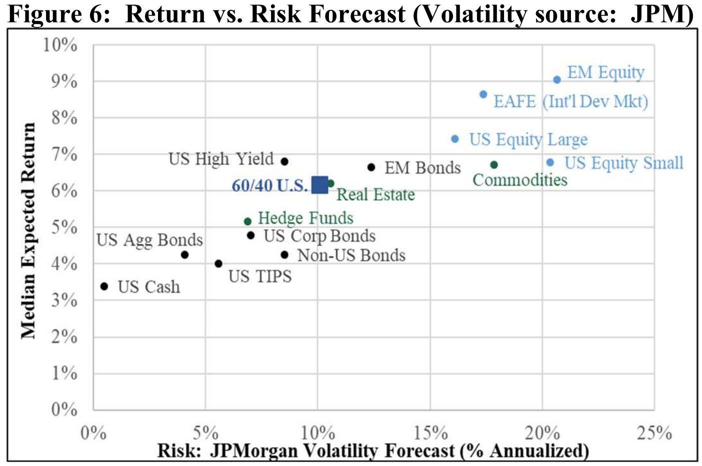
Bonds: The dramatic rise in interest rates in the US and around the world has led to a sizable increase in long-term return forecasts for bonds relative to last year's survey. Cash is expected to earn 3.4% p.a. (per annum, i.e., annualized), and the median forecast for the US Aggregate Bond index is now 4.3% p.a., up from 2.3% in last year's survey. Investment grade corporate bonds are expected to offer solid returns of 4.8% p.a. over the next decade; credit spreads are expected to narrow somewhat, resulting in a 6.8% p.a. expected return for high yield bonds. Non-US developed market debt is expected to earn 4.3% p.a., matching the expected returns for the US Aggregate bond index, but emerging market debt return forecasts are higher at 6.7% p.a.

Stocks: Forward return expectations for stocks are much higher now versus last year's estimates and are closer to historical averages in the wake of the significant global equity selloff in 2022. US 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 7.4% annually for large US stocks and 6.8% for small stocks, both higher than in last year's survey. Developed international markets (EAFE) offer even better return expectations at 8.6% p.a., while emerging market equity forecasts are higher still at 9.1% p.a. Altogether, we estimate that the median forecast for global equities is 7.7% annually over the next 10 years, up from a 5.6% median forecast last year.

Alternatives: Return estimates for alternative assets are modestly higher in this year's survey. Private Real Estate is expected to earn 6.2% p.a., roughly in-line with last year's survey forecast as investors factor in the higher borrowing costs associated with debt-financed investing. Hedge funds are expected to earn 5.2% p.a.., but commodities are expected to return 6.7% p.a., even after very strong 2021-22 returns. Large institutional investors will continue to invest in illiquid assets in search of returns and diversification because hedge funds, real estate and commodity returns have low correlations with stock and bond returns.

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

Every cloud has a silver lining. The painful selloff in global stock and bond markets in 2022 has resulted in higher expected returns going forward (lower starting point). This is in stark contrast to last year's capital market assumptions survey (strong then-current returns resulted in low expectations for the future). A balanced US 60/40 portfolio (60% US stocks, 40% US bonds) is now expected to earn more than 6% per year over the next decade. To achieve higher returns, investors can take on more risk with higher allocations to alternatives and non-US assets. The recent out-performance of non-US equities and bonds is notable, especially in the last three months, after years of under-performance. Diversification remains critical given near-term uncertainties.

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