ECONOMIC & INVESTMENT PERSPECTIVES

February 1, 2024

JANUARY: A MIXED START TO THE NEW YEAR

LONG-TERM CAPITAL MARKET RETURN FORECASTS

Figure 1: 1/31/2024 Returns (source: Bloomberg, AJO)

Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	YTD	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	-0.2%	-0.2%	2.1%	-2.0%	8.2%
Investment Grade Corp Bonds	LQD	-0.4%	-0.4%	3.6%	-2.1%	12.1%
U.S. Treasury Bonds	GOVT	-0.2%	-0.2%	1.3%	-2.8%	6.5%
U.S. 20+ YR Treasuries	TLT	-2.2%	-2.2%	-6.7%	-11.6%	17.3%
Muni Bonds	MUB	0.0%	0.0%	3.1%	-0.3%	7.6%
US High Yield	HYG	0.1%	0.1%	7.7%	-0.8%	8.1%
Non-US Corp Bonds	IBND	-2.4%	-2.4%	4.2%	-3.7%	9.4%
Emerging Markets Bond LC	EMLC	-1.5%	-1.5%	5.0%	-4.4%	8.0%
Global Equity						
ACWI Global Equity	ACWI	0.3%	0.3%	14.1%	-1.5%	20.1%
ACWI Global Equity ex US	ACWX	-1.7%	-1.7%	4.4%	-2.2%	11.7%
International Developed	EFA	-0.5%	-0.5%	8.1%	-1.3%	14.2%
Emerging Markets	EEM	-4.5%	-4.5%	-4.6%	-8.7%	5.5%
Global Equity by Region						
United States	VTI	1.1%	1.1%	19.2%	-1.8%	26.1%
Europe	IEUR	-1.0%	-1.0%	8.3%	-1.6%	15.7%
Asia ex-Japan	AAXJ	-5.3%	-5.3%	-9.0%	-12.5%	3.5%
China	MCHI	-10.3%	-10.3%	-29.4%	-33.3%	2.7%
Japan	BBJP	3.2%	3.2%	15.7%	-1.0%	20.4%
Latin America	ILF	-4.2%	-4.2%	14.6%	-6.7%	25.7%
US Equity						
US S&P 500	IVV	1.6%	1.6%	20.7%	-1.8%	26.9%
NASDAQ 100 QQQ	QQQ	1.8%	1.8%	42.5%	-3.0%	46.3%
US Large Growth	IWF	2.4%	2.4%	34.8%	-2.6%	40.2%
US Large Value	IWD	0.1%	0.1%	6.0%	-1.2%	15.4%
US Eqwt S&P 500	RSP	-0.8%	-0.8%	4.9%	-1.5%	17.3%
US Mid Cap	IJH	-1.7%	-1.7%	4.7%	-3.0%	17.6%
US Small Cap	VTWO	-3.9%	-3.9%	2.4%	-6.1%	19.1%

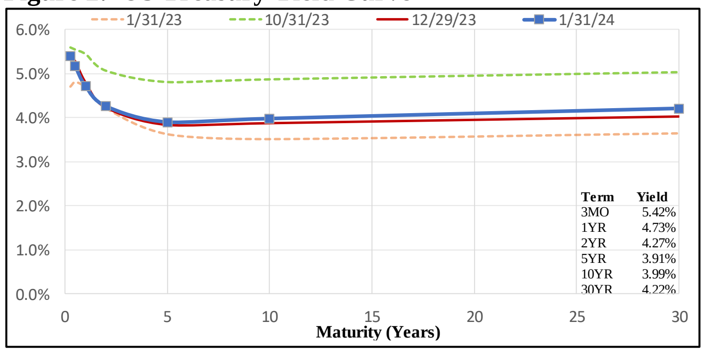
Stock and bond returns were mixed in January. Rising interest rates led to modestly negative bond returns. Stocks were more volatile as investors digested a mixed bag of fourth-quarter earnings reports and forecasts along with interest rate uncertainty. Performance highlights for the month are summarized below.

- Bonds: The US Aggregate index (AGG) fell 0.2% in January as interest rates increased. (Note: Bond prices fall as interest rates rise.) Long-term Treasuries (TLT) are highly sensitive to interest rates, falling 2.2% during the month. Investment grade corporate bonds (LQD) lost 0.4%, while high yield bonds (HYG) eked out a gain of 0.1%. Non-US bonds under-performed this month (IBND -2.4%, EMLC -1.5%) as the US dollar strengthened but have out-performed over the past year.
- Global equity (ACWI): +0.3% in January.
- US Equity: The broad market (VTI) rose 1.1% this month. The S&P 500 (IVV) gained 1.6%, but small (VTWO) and mid-cap stocks lost value after a very strong Q4. Gains at the sector level include communications, financials, health care and tech (all up 2.7-4.4%); weaker sectors include real estate, consumer discretionary, materials and utility stocks (all down 3.0-4.8%).
- Non-US Equity: Developed market stocks (EFA) fell 0.5%, led lower by marginal losses in Europe (IEUR -1.0%) while Japanese stocks (BBJP) rose 3.2%. Emerging markets (EEM) fell 4.5% with broad-based weakness across Latin American markets (ILF -4.2%) and especially China (MCHI -10.3%) as confidence in their economic recovery continues to deteriorate.

Interest Rates and the Economy

The yield curve (Figure 2) plots the interest rates (vertical axis) for various U.S. Treasury maturities (horizontal axis). Yields rose slightly in January amid uncertainty regarding the timing and magnitude of potential Federal Reserve (Fed) interest rate cuts. In their meeting this week, the Fed again held interest rates steady (Fed Funds target range: 5.25-5.50%) and attempted to tamp down expectations for near term cuts. The inverted yield curve (short-term > long-term yields) continues to signal economic slowdown or recession. The 10-year US Treasury yields 3.99%.

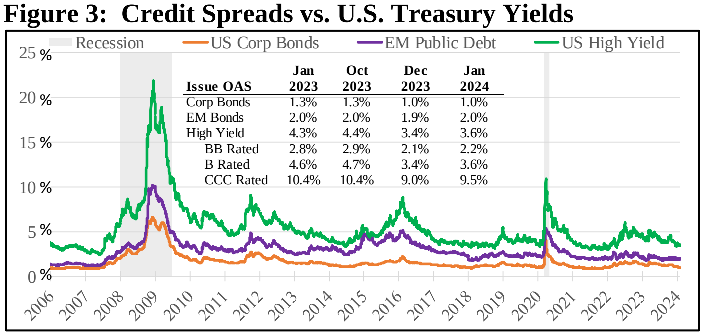
Figure 2: US Treasury Yield Curve



For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between their yields and Treasuries of comparable maturities (Figure 3). Low or narrowing spreads signal optimism, while high or widening spreads signal fear. Spreads widened in January but remain below historically average levels.

- Investment grade corporate bond spreads were stable at +1.0% this month and are well below year-ago spreads of +1.3%.
- High yield (non-investment grade) spreads widened to +3.6% but are down from +4.3% a year ago. The riskiest bonds (rated CCC & below) rose to +9.5% over Treasuries but are still down significantly from +10.4% spreads one year ago.
- Emerging market spreads rose slightly to +2.0% but have been very stable over the past year. Emerging market credit has out-performed US bonds due to higher yields and stable currencies.

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



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, Invesco, 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.

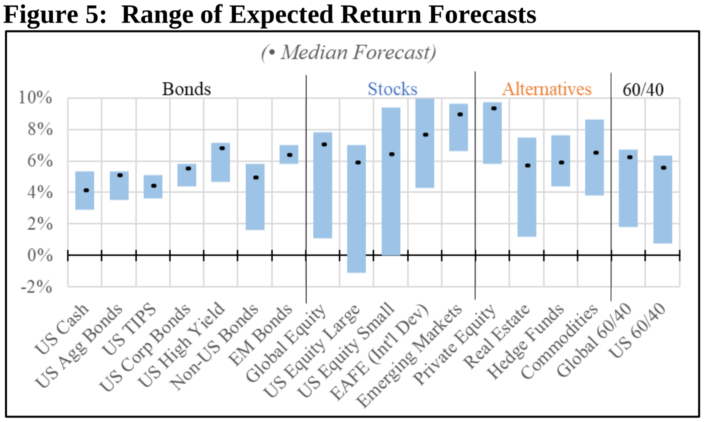
Figure 4: 10-year Return Forecasts (Nominal, Geometric)

Class	Asset	JP Morgan	Black Rock	Invesco	Vanguard	Research Affiliates	GMO	Median E(R)	Change vs. 2023
Inflation	US Inflation	2.5%			2.5%	2.5%	2.3%	**2.5%**	**-0.1%**
Cash & Bonds	US Cash	2.9%	4.1%		4.6%	5.3%	3.6%	**4.1%**	**0.7%**
	US Agg Bonds	5.1%	5.0%	5.3%	5.3%	4.3%	3.5%	**5.1%**	**0.8%**
	US TIPS	4.6%	5.1%	4.8%	4.2%	4.2%	3.6%	**4.4%**	**0.4%**
	US Corp Bonds	5.8%	5.0%	5.5%	5.8%	4.4%		**5.5%**	**0.7%**
	US High Yield	6.5%	6.8%	7.1%	6.9%	4.6%		**6.8%**	**0.0%**
	Non-US Bonds	4.9%	4.5%	5.0%	5.2%	5.8%	1.6%	**4.9%**	**0.7%**
	EM Bonds	6.0%	6.7%	6.9%	7.0%	5.8%	5.8%	**6.4%**	**-0.3%**
Equity	Global Equity	7.8%	6.8%	7.3%	6.1%	7.2%	1.1%	**7.0%**	**-0.6%**
	US Equity Large	7.0%	5.2%	7.0%	5.2%	6.6%	-1.1%	**5.9%**	**-1.5%**
	US Equity Small	7.2%	5.2%	9.4%	5.9%	6.9%	0.0%	**6.4%**	**-0.4%**
	EAFE (Int'l Dev)	9.2%	10.0%	7.3%	8.0%	7.0%	4.3%	**7.6%**	**-1.0%**
	Emerging Markets	8.8%	9.1%	9.6%	7.6%	9.2%	6.6%	**9.0%**	**-0.1%**
Alt	Private Equity	9.7%	9.3%			5.8%		**9.3%**	**-1.2%**
	Real Estate	7.5%	1.2%	6.0%		5.4%		**5.7%**	**-0.5%**
	Hedge Funds	5.0%	7.6%	4.4%		6.8%		**5.9%**	**0.8%**
	Commodities	3.8%		5.6%	7.4%	8.6%		**6.5%**	**-0.2%**

**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 changed measurably since last year's survey reflecting 2023 global stock and bond market advances, 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: 4.1% p.a. (per annum, i.e., annualized next 10 years);
- US Aggregate Bond index: 5.1% p.a., up from 4.3% last year
- Investment grade corporate bonds: increased to 5.5% p.a.;
- High Yield bonds: unchanged at 6.8%, reflecting tight but relatively stable credit spreads going forward.
- Non-US bonds: increased to 4.9% p.a., roughly matching the expected returns for the US Aggregate bond index, but emerging market debt return forecasts are higher at 6.4% p.a.

Stocks: Given strong equity performance in 2023, return expectations for stocks are significantly lower now versus last year's forecasts (having achieved outsized gains last year):

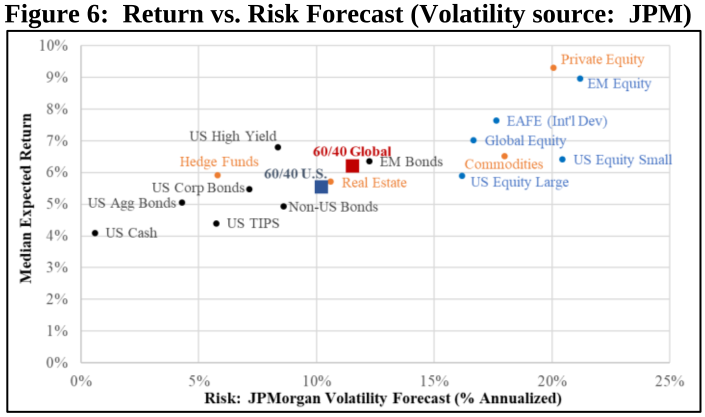
- Global equity: 10-year forecasts decreased to 7.0% p.a.
- US equity: The median return forecast for the next 10 years decreased from 7.4% to 5.9% annually for large US stocks (S&P 500) and 6.4% for small stocks (versus 6.8% last year); forecasts for large caps weakened significantly, reflecting the strong out-performance of this segment realized in 2023.
- Non-US equity: Developed international markets (EAFE) offer higher return forecasts at 7.6% p.a. (down from 8.6% in last year's survey); emerging market equity forecasts are higher still at 9.0% p.a., roughly in-line with last year's forecast.

Alternatives: 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. Return forecasts for alternative assets came down in this year's survey, particularly for private investments as investors factor in high current valuations and borrowing costs associated with debt-financed investing:

- Private Equity: forecasts declined to 9.3% p.a.
- Real Estate: estimates fell to 5.7% p.a.
- Hedge funds: expected to earn 5.9% p.a.
- Commodities: forecasts declined to 6.5% p.a.

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

Strong equity returns in 2023 have resulted in lower expected returns going forward (higher starting point). This is in stark contrast to last year's capital market assumptions survey (weak 2022 returns resulted in rising expectations for the future). A balanced US 60/40 portfolio (60% US stocks, 40% US bonds) is now expected to earn 5.5% p.a. over the next decade on average, while global portfolios offer better returns (6.2% p.a.). To achieve even higher returns, investors must take more risk with higher allocations to alternatives and non-US assets. Diversification remains critical given near-term uncertainties (economic and earnings growth, elections and elevated geopolitical risks).

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