THE NEXT FIVE YEARS: AN ERA OF LOW RETURNS

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Summary and Major Conclusions:

In the short term, the equity market should benefit from a revival in US and world economic growth. However, expected investment returns beyond 2020 are not encouraging. Investors should expect low-to-mid single-digit annual rates of return in most asset classes over the next five years. Common stocks will generally outperform fixed-income securities, primarily because bonds are massively overvalued at a time when interest rates will be in a rising trend. Annualized equity market returns are unlikely to exceed 5%, while returns in the fixed-income market could be close to zero.

- Compound annual returns on large-cap US equities and long-term US Treasury bonds have been 10.5% and 7% over the past 50 years, respectively. For the most recent ten-year period, the annual returns on common stocks and government bonds have been 13.5% and 3.3%, respectively.

- Investment returns over the next five years are predicated upon assumptions pertaining to basic economic, financial, and policy factors: GDP growth, inflation, monetary and fiscal policies, productivity, and corporate earnings.

- The central long-term theme in the outlook is that the US and world economies are entering a new era that could differ radically from that of previous decades, with profound implications for prospective rates of return.

- Economic growth could be slower, corporate profitability ratios under increased pressure, and world trade much less dynamic. There is also an uncomfortably high likelihood that government policies will be less friendly to businesses and investors, as populist and anti-capitalist sentiment spreads.

- The domestic equity market will face numerous headwinds that should dampen returns. Of greatest relevance is the current elevated starting point for both valuations and profit margins: Each is likely to end the five-year period at a somewhat lower level, thereby dragging down actual equity market returns over this period.

- The strategic focus of domestic equity investors should be on economic sector selection. A major rotation in leadership is likely in future years, with defensive sectors — such as utilities and consumer staples — lagging economically sensitive groups — such as industrials, materials, transports, and financial services.

- A shift in equity investment style is also likely. Value stocks have lagged growth and momentum stocks for an unprecedented 12 years, and should outperform over the next five years. Small- and mid-cap value managers are likely to post the best absolute rates of return within the domestic equity market.

- Many foreign equity markets are positioned to outperform the S&P 500 in coming years. Non-US equities should benefit from attractive valuations along with an extended period of profit growth and monetary ease relative to that of the US.

- Government and high-quality corporate bonds are extremely overvalued and overbought. Non-US government bonds should be the worst-performing asset class over the next five years.

- Financial assets in developing countries are likely to provide the best returns for global investors over the next five years. Emerging market (EM) equities appear cheap and should benefit from rapid economic growth and rising living standards, while EM sovereign debt provides competitive market yields.

- The US property market is at risk to overbuilding in retail, office, and apartment markets; rising borrowing costs; slowing leasing activity; and softening rents. Valuations are also stretched with cap (capitalization) rates at exceptionally low levels. Total rates of return on commercial property are unlikely to exceed 5% over the next five years.

- There are a number of significant wild cards in the outlook, primarily in the realm of politics and geopolitics. A major shift in political sentiment and economic policy away from capitalism and toward populism would be another headwind to both economic growth and investment returns.

- Other wild cards include a further shift away from globalization and toward protectionism; a potential military conflict between Iran and Saudi Arabia; rising debt levels worldwide; unfavorable demographic trends; a surging federal government deficit; and continued sluggish growth in productivity.

- Slower long-term GDP growth in China will deprive the world economy of the powerful growth engine of the past two decades. Growing antagonism between China and the US would undermine certain mutually beneficial economic linkages built over the past several decades, to the detriment of the world economy.

This week's *Economic Perspective* looks ahead to the next five years and explores the underlying economic, geopolitical, and policy factors that are likely to drive world financial markets. These assumptions serve as a foundation for gauging relative rates of return among the major asset classes. One of my central themes is that the US and world economies are entering a new era that could differ radically from previous decades, with profound implications for long-term investment returns.

HISTORICAL RETURNS

Rates of return on most asset classes have been relatively consistent when measured over very long periods. Compound annual returns on large-cap US equities and long-term government bonds over the past 50 years have been 10.5% and 7%, respectively. For the most recent ten-year period, the annual returns on common stocks and government bonds have been 13.5% and 3.3%, respectively, while returns over the past five years have been 10.5% and 2.5%, respectively.

KEY CAPITAL MARKET ASSUMPTIONS

Expectations for investment returns over the next five years are based upon assumptions pertaining to basic economic, financial, and policy factors. *US and global economic trends are likely to be less supportive of financial markets over the next five years: Growth should be slower, corporate profitability will be less robust, world trade will be much less vibrant, and monetary policy will become increasingly restrictive as the five-year period unfolds*.

Elevated Starting Points: The process also considers *starting-point market valuations* and projections for valuations at the end of year five. In combination, these evolving trends should result in a more challenging environment for investors. *Total rates of return for all asset classes are likely to trail their long-term historical averages over the next five years*, in some instances by a wide margin. What follows are my assumptions regarding factors most relevant for long-term investment returns:

1. **US Economic Growth**: Average annual US real GDP growth is unlikely to exceed 2% over the next five years. *There is a high probability that the US economy will experience an outright recession during this upcoming five-year period*, although more likely later rather than sooner. A projected growth rate of 2% compares with a growth rate of 2.5% both over the past five years and since 1995. *The short-term outlook will benefit from a cyclical rebound in US economic growth in 2020, as the US emerges from the current mid-cycle economic slowdown*.

2. **World GDP Growth**: My forecast assumes world GDP growth over the next five years will be 2.75%, which compares with 3.75% since 1995. Growth should be led by emerging market economies, which comprise more than 40% of global GDP. Chinese GDP growth will likely slow from its current 6% rate to less than 5% in 2024.

3. **Consumer Inflation**: Inflation is expected to be a neutral factor over the next five years. My forecast assumes an average inflation rate of 2% through 2024, with wages increasing at a 3% annual rate. These growth rates are below the averages of the past 50 years but are *consistent with the experience of the past two decades*.

4. **Corporate Earnings**: Growth in company earnings over the next five years will almost certainly fall short of recent historical experience, and therefore detract from equity returns. There are two reasons for slower growth in business profits:

    - *The starting point* of company profit margins is elevated and not far from record highs, suggesting that the path of least resistance for margins will be lower.

    - The odds of a *recession* during the next five years are above 50%, which implies a meaningful decline in business profits consistent with a slump in GDP. My forecast assumes annual after-tax profit growth of only 3% through 2024, well below the long-term average of 6.5%.

5. **Monetary Policy**: The direction of central bank policy is expected to shift as the next five years play out. *The Federal Reserve will lead all other central banks in shifting from monetary accommodation to restraint*. The Fed has not abandoned its long-term strategy of *interest rate normalization*, which should resume in 2021. From an expected low of 1.75% in 2020, the federal funds rate is projected to rise to a neutral 2.5% in 2024, roughly half its 5.2% average of the past 50 years.

6. **Long-Term Interest Rates**: Long-term interest rates are likely to enter a rising trend as 2020 unfolds, for two reasons: (1) Market anticipation of an end to the Federal Reserve's rate-cutting cycle; and (2) An expected rise in inflationary expectations, as market fears of deflation gradually fade. My estimate of an equilibrium market yield for ten-year US Treasury securities in 2024 is 3.5%.

7. **Valuation Headwinds**: Future returns will also be disadvantaged by current lofty valuations in both the equity and fixed-income markets. Equity valuations are not unreasonable, but the current 12-month forward price-to-earnings (P/E) ratio of nearly 18x is near the high end of the normal historical range. Much more extreme are current valuations on both government and corporate bonds. Current valuations in the commercial real estate market are also excessive.

Table One
Key Long-Term Economic Assumptions
Independent Economic Variables
Next Five Years: 2019-2024
Source: Veritas Economic Analysis LLC
December 2019

Economic Variable	Forecast Next Five Years 2019-2024 (%)	Actual Average Previous 30 Years 1989-2019(%)
US Real GDP	2.0	2.5
World GDP	2.8	3.5
World Trade	2.0	5.3
Emerging Markets (Real GDP)	4.0	6.0
US Consumer Inflation	2.0	2.5
US Corporate Earnings	3.0	6.5
Dividends Per Share	3.5	5.5
World Oil Prices ($ per barrel)	60	48
Federal Funds Rate (Period End)	2.5	3.0
Treasury Bond Yield (Period End)	3.5	4.6

Bottom Line: The period from 2019 through 2024 is likely to differ from most five-year periods during the past 50 years. Economic growth should be weaker, corporate profits will advance at a slow pace, and the rate of inflation should stabilize around 2%. The market yield on long-term Treasuries is likely to drift higher over this period, pushing down bond prices, which move inversely with bond market yields.

US EQUITIES: A CHALLENGING STARTING POINT

The domestic equity market will face numerous headwinds in coming years that will constrain returns. The most important challenge for equity investors is the current ***starting point*** for profit margins, valuations, and the business cycle. These three variables are approaching cyclical peaks and are therefore likely to normalize in coming years. Beginning in 2021, rising interest rates from exceptionally low levels will also act as headwinds for valuations. On balance, my forecast assumes a total return of only 3% on domestic equities over a five-year time horizon.

Growth Versus Value: A potential opportunity for equity investors is an expected revival of value stock investing. Stock market history reveals a clear alternating pattern in market leadership between growth stocks and value stocks. Following extremely weak relative returns over the past decade, *value stocks* appear poised to outperform growth stocks, possibly by a wide margin. *Small- and mid-cap value stocks should perform best with potential annual total returns in excess of 8%.*

Global Equities: World equity markets are likely to outperform those of the US, benefitting from relatively attractive valuations. Most non-US economies are at an earlier stage in their business and monetary policy cycles relative to those of the US, implying a longer window of opportunity. The current P/E ratio for non-US equity markets is 15x, well below the nearly 18x for US equities. The US dividend yield of only 1.9% also lags the 3.5% yield of the rest of the world.

GLOBAL BONDS: A VALUATION PROBLEM

The outlook for domestic bonds remains poor. Market yields in the investment-grade and high-yield sectors are depressed relative to normal and are likely to be in a rising trend in coming years. Higher yields will result from rising inflationary expectations, rising real rates, and widening credit spreads. Real yields will respond to a gradual but steady tightening in monetary conditions by the Federal Reserve beginning in 2021, along with fading pessimism regarding economic stagnation. *Annualized returns on US Treasury securities are unlikely to exceed 1% through 2024*.

US Corporate Bonds: Returns on domestic corporate debt are also likely to disappoint over the next five years. Option-adjusted spreads (OAS) are relatively tight, offering little value to investors. The current modest yield advantage of non-government bonds will be partially offset by rising delinquencies and defaults as credit conditions steadily deteriorate beginning later next year. Expected returns on investment-grade bonds could average only 2% over the next five years while returns in the high-yield sector could average 4%.

Non-US Sovereign Debt: Non-US government bonds should be the worst-performing asset class over the next five years. Starting yields on ten-year government bonds in Germany, France, Sweden, Japan, Switzerland, and the Netherlands are near zero, and are likely to drift steadily higher over the next five years, implying very large capital losses over that time period.

Table Two
Expected Long-Term Rates of Return
Major Asset Classes
Next Five Years: 2019-2024
Source: Veritas Economic Analysis LLC
December 2019

Asset Class	Next Five Years 2019-2024 (%)	Previous 30 Years 1989-2019 (%)
Global Equities	5.5	6.8
US Large-Cap Equities	3.0	9.8
US Growth-Style Equities	1.0	9.5
US Value-Style Equities	6.5	10.0
US Small-Cap Equities	5.5	9.0
Emerging Market Equities	8.5	7.8
US Government Bonds	1.0	5.5
US Corporate Bonds	2.0	6.7
US High-Yield Bonds	4.0	8.2
Emerging Market Debt	6.0	8.5
US Commercial Property	4.5	8.0
Global Commodities	1.0	1.5
US Treasury Bills	2.0	2.8
US Consumer Inflation	2.0	2.5

EMERGING MARKET DEBT AND EQUITY

Developing countries are likely to provide global investors with the best returns over the next five years. Emerging market (EM) equities should benefit from relatively strong economic growth, ongoing improvements in living standards, and more effective company managements. EM bonds should benefit from steadily improving governance and greater financial stability. The EM equity index appears cheap with a forward P/E of 13.5x and a current dividend yield of nearly 3%. My forecast assumes an average annual return of 8.5% on EM equity markets and 6% on EM bonds.

COMMERCIAL PROPERTY: STRONG HEADWINDS

The US commercial real estate market will face numerous headwinds in coming years, including rising borrowing costs; overbuilt retail, apartment, and office markets; slowing leasing activity; and softening rents. Valuations are also stretched with cap (capitalization) rates at unusually depressed levels. Total annualized rates of return on real estate equities are unlikely to exceed 4% over the next five years.

CRITICAL INDEPENDENT VARIABLES

There are a number of significant wild cards in the outlook, primarily in the realms of politics and geopolitics. Actual rates of return over the next five years will be determined by the ultimate direction of the following ten independent variables:

1. **World Debt Ratios**: Growing debt ratios in most regions of the world will constrain GDP growth over the next five years. *Cumulative debt owed by businesses, households, and governments has increased to nearly $250 trillion, an amount equivalent to more than 240% of world GDP*. China and the US have accounted for more than 60% of new borrowing. *International Monetary Fund (IMF) studies conclude that the correlation between debt burdens and economic growth is decidedly negative*.

2. **US Budget Deficit**: The US federal budget deficit is in an accelerating growth trend that will persist for many years. In the short term, ongoing budgets deficits are not an issue — in an environment of economic growth and very depressed interest rates. In the long term, rising trends in the US budget deficit, debt ratios, and net interest payments will become a major headwind to growth as rising *debt burdens absorb an increasingly larger share of national savings that would otherwise be directed to capital formation.*

3. **Geopolitical Issues**: There are an unusually large number of geopolitical issues that could shape economic and investment trends over the next five years. The most important pertain to the eurozone, world trade, and the eventual trade relationship between the UK and the European Union.

    - **Asia and the Middle East**: Other important issues pertain to diplomatic relations between the US and Iran, Syria, Turkey, Russia, North Korea, and China (discussed below). Political and military developments within the Middle East are likely to be an ongoing, long-term source of global instability and potential disruption to world commerce.

4. **World Oil Price Stability**: The recent attack on Saudi Arabia's largest oil facility creates a new risk to the stability of world oil markets. A retaliatory strike by Saudi Arabia on Iranian oil production facilities could culminate in a Saudi-Iran war, resulting in mutual destruction of valuable oil assets, triggering a surge in prices.

5. **Capitalism Versus Populism**: Capitalism has come under pressure in recent years, consistent with a rise in populism within most regions of the world, including the US. This trend has been accentuated by a growing awareness of ***income and wealth inequality***. While it is crucial for governments to actively address social and economic injustices, *adopting extreme populist measures would compromise the proven economic benefits of free-market capitalism, and cause living standards to stagnate*.

   - **Anti-Business Policies**: *The greatest risks involve government policies and mandates that interfere with the smooth functioning of markets and impose excessive costs on businesses*. Higher taxes on capital and increased regulation squeeze profitability ratios in the business sector, thereby reducing incentives for risk-taking, capital formation, new business start-ups, and technological innovation.

6. **World Trade/Globalization**: There is overwhelming evidence that the spread of globalization and world trade since 1970 has enhanced living standards worldwide. Regrettably, *government protectionist policies, currency wars, and isolationism are undermining the foundations of both globalization and free-market capitalism. Some experts believe that globalization is in a long-term peaking process*.

   - **Trade Policy**: In particular, the escalation in tariffs from the Trump administration — and retaliation by America's trading partners — is a major wild card in the outlook. ***There appears to be a growing political appetite in most countries for protectionism and isolationism***. *The obvious economic consequences include slower economic growth, reduced corporate profitability, continued weakness in productivity, and higher cost inflation*.

7. **Productivity**: Output per hour worked is a major wild card in the outlook because of its powerful influence on a broad array of economic and financial variables, including *inflation, corporate profit margins, and real wages*. Compared with a long-term average annual growth rate of 2%, labor productivity has slowed sharply to only a 1% rate over the past decade. My forecast for the next five years assumes trendline productivity growth of 1.25%.

8. **Demographic Trends**: Population growth is moderating in both the US and worldwide. US population growth is estimated at 0.5%, down from a pace of roughly 1% earlier this century. Job creation will slow along with a slowing population and become a growing headwind to GDP growth.

    - **Dependency Ratios**: In addition, dependency ratios are rising in all economies, as a result of shifting age groups. The dependency ratio measures the percentage of the nonworking population to total employment and is a gauge of the pressure on the working-age population.

    - **The Graying of America**: An aging population also means steadily rising government social spending to meet the growing needs of the population, most notably on medical care and retirement benefits. *A rise in social spending implies a steadily increasing allocation of scarce resources that would otherwise be available for capital formation, technology development, and infrastructure spending*.

9. **Slowing Growth in China**: The emergence of China as an economic power in recent decades has been a major stimulus to the world economy. With average annual GDP growth of 9% since 2000, China has been a major engine of growth for the global economy.

    - **Reduced Global Impact**: However, its multi-decade industrialization process is slowly coming to an end, with GDP growth likely to expand at only a 5% average annual rate over the next five years. *World economic growth will not receive the same boost from China in future years as it has in recent decades*.

10. **Chimerica:** Coined by economic historian Niall Ferguson in 2006, Chimerica is a term used to describe the symbiotic commercial linkages between China and America. The close economic interrelationship between the two countries has benefitted both economies as well as the world economy, while at the same time boosting global trade.

    - **Impact on the World Economy**: However, the emergence of China as a world economic, political, and military power could undermine the integration of the two economies for geopolitical and national security reasons. Growing antagonism between the two super powers would undermine certain mutually beneficial economic linkages, to the detriment of the world economy.

INVESTMENT CONCLUSIONS

In the short term, the equity market should benefit from a revival in US and world economic growth. However, prospects for investment returns beyond the next 12 to 18 months are not encouraging. Investors should expect low-to-mid single-digit annual rates of return in most asset classes over the next five years. Common stocks will generally outperform fixed-income securities, primarily because bonds are massively overvalued at a time when interest rates will be in a rising trend.

As always, capital market returns will be determined by underlying economic and policy trends along with shifting market valuations. Following a period of expected acceleration in growth during 2020 and early 2021, US economic growth is likely to slow progressively over the following three years, with high odds of a recession prior to 2024. The rate of inflation is likely to remain stable, while corporate profit margins should be in downward trend.

Stretched valuations in most markets will weigh on prospective returns. Especially vulnerable are developed country sovereign debt, with market yields in many countries below zero. Returns on US Treasury securities will struggle to reach positive territory. US equity market valuations are also slightly elevated relative to normal, with many (defensive) sectors extremely overvalued. The best opportunities for relative investment performance reside in non-US equity markets, emerging market debt and equities, and US economically sensitive stock groups.

Within the domestic equity market, value stocks should outperform growth stocks by a wide margin. Small- and mid-cap value stocks should perform best, with the potential for double-digit annual rates of return. Economically sensitive sectors within the S&P 500 — industrials, materials, energy, transports, and financial services — are undervalued and should also generate above-average returns over a five-year time horizon.

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Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.