LONG-TERM INVESTMENT RETURNS

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Summary and Major Conclusions:

Prospects for investments over the next five years appear extremely challenging. Starting-point valuations for all asset classes are elevated, as most markets have pulled forward returns from future years. Although the current phase of the traditional business cycle is supportive of financial assets, unprecedented policy stimulus suggests that the business expansion could evolve quickly over the next several years. Meanwhile, policymakers are faced with daunting long-term structural challenges that must inevitably be resolved.

- It can be highly beneficial for investors to step back from the short-term outlook and focus instead on investment prospects for the long term. This report provides an update on the longer-term economic outlook along with expected returns for all major asset classes over a five-year time horizon.
- The next five years can be conveniently divided into two distinct phases: The first two years, which incorporate the very early years of a classic business cycle; and the final three years, during which time business cycle forces could be overwhelmed by long-term structural forces that would be disruptive to the economy.
- The early years of a traditional business cycle are the most favorable for financial markets, and are generally referred to as the sweet spot for equity investing. Stock market history reveals that a disproportionate share of cumulative returns earned over a full investment cycle are concentrated in the first two to three years.
- By definition, the traditional business cycle is always in flux, transitioning from phase to phase as economic, financial, and policy conditions unfold. Favorable conditions early in the typical cycle evolve and gradually become less supportive of financial markets as the economic expansion reaches a mature phase.
- Unprecedented government stimulus is expected to persist through all of this year, but is unsustainable. Policymakers will gradually reverse current expansionary policy measures as the economy returns to a firmer footing, culminating in a rising trend in interest rates and higher taxes.
- It is very likely that inflation will drift higher over the next several years as the economy approaches full employment. Currently at 1.4%, core consumer inflation could rise to 3% in 2023, and even higher thereafter.
- A combination of rising inflation, more restrictive monetary conditions, and increased economic confidence should exert upward pressure on long-term interest rates over time. Higher borrowing costs will act as a constraint on business and consumer spending.
- Population trends will continue to deteriorate over the next decade. Labor force growth has slowed as the birth rate has steadily declined, while the dependency rate is in a rising trend, as the baby boom generation reaches retirement age.

- The pandemic caused an immediate shrinkage in the long-term productive capacity of the US economy, a condition that could undermine sustainable economic growth and accentuate inflationary pressures.

- The outlook for investment returns through 2025 is lackluster. Following strong noninflationary growth over the next two years, the US economy is expected to steadily deteriorate through the middle of the decade. Valuation is another obstacle to investment returns, as virtually all asset classes are overvalued.

- Balanced account investors should expect a compound annual total return of less than 3% through 2025. Returns on global equities are unlikely to exceed 5%, while global bond markets could yield negative rates of return.

- The outlook for fixed-income markets is dismal because of two basic factors: The current starting point of market yields is negative, after adjustment for inflation; and the general direction of interest rates should be higher over the next several years.

- The long-term outlook for the equity market is nuanced: Stocks should perform well over the next one to two years but could be severely challenged beyond 2022.

- The equity bull market should continue into 2022 in an environment of solid economic growth, continued low inflation, strong growth in earnings and dividends, significant monetary and fiscal stimulus, and only moderate increases in bond yields.

- The current cyclical bull market could face powerful headwinds beyond the next two years, as economic and profit growth begin to decelerate. Equity valuations could be seriously challenged when monetary policy shifts from stimulus to restraint and bond yields move sharply higher.

- The market leaders of the past several years are likely to become laggards. Cyclical stock groups should become more attractive to investors as business conditions improve and economic confidence rises. Higher inflation and interest rates should also favor value stocks at the expense of growth stocks.

- International equity markets should outperform the S&P 500 over the next several years, assuming a strong rebound in world GDP and world trade and a declining US dollar. Non-US stocks should also benefit from relatively attractive valuations.

This week's *Economic Perspective* looks beyond the customary 12-to-18-month time horizon and explores the potential for investment returns over the next five years. Although this analysis takes into account the classic business cycle – especially in the early years of this decade – the emphasis in this report focuses on long-term structural economic forces and their implications for financial markets.

ANALYTICAL FRAMEWORK: BUILDING BLOCKS

The analytical process used for projecting long-term investment returns must carefully consider several critical independent variables.

- **Government Policy:** The conduct of monetary, fiscal, and regulatory policies is a major contributor to economic growth, inflation, and interest rates, each of which drives investment returns.

- **Economic Growth:** The potential for sustained growth in aggregate spending and output is a critical aspect of the forecast, most notably for equity assets.

- **Corporate Profitability:** The ability of the business sector to effectively translate economic growth into a consistently rising level of earnings, dividends, and cash flow is a key driver of equity returns.

- **Inflation:** Long-term investment returns are critically dependent upon the underlying rate of inflation, which in turn determines the thrust of monetary policy and the level of long-term interest rates.

- **Government Bond Yields:** In textbook theory, the US Treasury market represents the starting point in valuing for all other asset classes, each of which is priced based upon risk premiums relative to Treasury securities.

- **Asset Class Valuations:** Arguably the most significant variable in the long-term investment outlook is the starting point of market valuations. If a projection of future returns begins at a point of significant overvaluation, such as occurred in 1999, prospective returns over the next five years will be penalized. Similarly, when valuations are at depressed levels, as in 2009, future long-term returns benefit.

Table One
Key Long-Term Economic Assumptions
Independent Economic Variables
Next Five Years: 2020-2025
Source: Veritas Economic Analysis LLC
February 2021

Economic Variable	Forecast Next Five Years 2020-2025 (%)	Actual Average Previous 30 Years 1990-2020(%)
US Real GDP	3.5	2.3
World GDP	4.5	3.3
World Trade	4.0	5.0
Emerging Markets (Real GDP)	5.0	5.5
US Consumer Inflation	2.5	2.3
US Corporate Earnings	12.5	6.0
Dividends Per Share	8.0	5.0
World Oil Prices ($ per barrel)	60	48
Federal Funds Rate (Period End)	3.0	2.7
Treasury Bond Yield (Period End)	4.0	4.2

FIVE-YEAR OUTLOOK: TWO DISTINCT PHASES

The next five years can be conveniently divided into two distinct phases: (1) The first two years, which incorporate the very early years of a classic business cycle; and (2) The final three years, during which time business cycle forces will gradually fade and be overwhelmed by increasingly challenging long-term structural forces.

Next Two Years: As I have discussed, the early years of a traditional business cycle are the most favorable for financial markets, and are generally referred to as the ***sweet spot*** for equity investing. *A study of stock market history reveals that a* ***disproportionate share*** *of cumulative returns earned over a full investment cycle is concentrated in the first two to three years*. This basic principle is based upon the fact that economic fundamentals are optimal during this phase. *My favorable forecast for 2021 and 2022 is based upon the following key assumptions*:

- GDP growth is rapid as the economy rebounds strongly from the previous recession and lockdown from the coronavirus pandemic

- *Public health conditions* will return to normal later this year as herd immunity is finally achieved following a sharp increase in vaccine distribution

- Growth in labor productivity reaches a peak as business output surges at a time when companies are slow to hire

- Company earnings surge because of a strong rebound in revenues and rapid growth in labor productivity

- As a quintessential lagging indicator, inflation remains low until the economy begins to approach full employment in 2023

- A combination of high unemployment and low inflation causes the Federal Reserve to maintain an accommodative monetary policy for longer than normal

- Long-term interest rates are held in check until the bond market perceives that a cyclical rise in inflation and a new rate-tightening cycle are imminent

This confluence of fundamental forces is consistent with favorable financial market conditions through much of 2022, suggesting positive returns in world equity markets. The opposite is true for global bonds: Because bond yields are likely to rise as economic confidence improves, rates of return in the fixed-income market are likely to be negative.

LONG-TERM STRUCTURAL FORCES

How long can this benign economic climate persist? By definition, the traditional business cycle is always in a state of flux, transitioning from phase to phase as economic, financial, and policy conditions unfold. In general, favorable conditions early in the typical cycle evolve and gradually become less supportive of financial markets as the economic cycle matures.

- **Countercyclical Policy**: Unprecedented government stimulus is expected to persist through all of this year, but is unsustainable. Policymakers will be compelled to gradually reverse current expansionary policy measures as the economy returns to a firmer footing, and implies higher interest rates, higher taxes, and a sharp reduction in fiscal policy stimulus.

- **Big Government**: The public health and economic crises could result in a greater involvement of government in the economy over time, accompanied by increased regulation. There are numerous historical examples in support of this view, most notably the New Deal response to the Great Depression. While a ***society*** can benefit broadly from greater government intervention, the implications for ***businesses*** and the ***equity market*** are typically negative.

- **Rising Inflation**: It is highly likely that inflation will drift higher over the next several years as the economy approaches full employment. Currently at 1.4%, core consumer inflation could rise to 3% in 2023, and even higher thereafter.

- **Higher Interest Rates**: A combination of rising inflation, more restrictive monetary conditions, and increased economic confidence should exert upward pressure on long-term interest rates over time. The market yield on the ten-year US Treasury bond could rise from its current 1.1% rate to a range of 3.5% to 4% within the next three years. Higher borrowing costs will act as a constraint on business and consumer spending.

- **Rising Debt Burdens**: US nonfinancial debt is near an all-time high as a percentage share of GDP and will increase steadily over the next five years. Debt burdens will worsen as borrowing costs trend higher, thereby undermining aggregate spending.

- **Demographics**: Population trends will continue to deteriorate over the next decade. Labor force growth has slowed as the birth rate has steadily declined, while the ***dependency rate*** — the ratio of retired workers to the total workforce — is in a rising trend as the baby boom generation ages. Spending on health care will absorb an increasing portion of national income over the next five years.

- **Production Constraints**: The pandemic caused an immediate tightening in long-term productive capacity, which could constrain long-term economic growth and add to inflationary pressures. Damage to the supply side of the economy includes failures of tens of thousands of businesses; a permanent shrinkage in the labor force; and disruptions to global supply chains.

- **Immigration**: Another supply-side constraint on the economy involves the deliberate cutbacks to immigration imposed by the Trump administration. The number of immigrants entering the US annually declined from one million under President Obama to only 500 thousand in 2020. Immigration has always been beneficial to the labor force in particular and economic growth in general. A reversal in immigration policy would be a positive for financial markets.

Table Two
Expected Long-Term Rates of Return
Major Asset Classes
Next Five Years: 2020-2025
Source: Veritas Economic Analysis LLC
February 2021

Asset Class	Next Five Years 2020-2025 (%)	Previous 30 Years 1990-2020 (%)
International Equities	6.5	6.2
US Large-Cap Equities	3.5	10.6
US Growth-Style Equities	1.5	11.0
US Value-Style Equities	7.5	9.5
US Small-Cap Equities	6.5	10.7
Emerging Market Equities	8.5	7.5
US Government Bonds	(2.5)	5.5
US Corporate Bonds	(1.0)	6.8
US High-Yield Bonds	3.5	8.8
Emerging Market Debt	3.5	7.5
US Commercial Property	3.5	7.5
Global Commodities	5.0	1.8
US Treasury Bills	3.0	2.5
US Consumer Inflation	3.0	2.3

EXPECTED ASSET CLASS RETURNS

The outlook for investment returns over a five-year time horizon appears lackluster, for two reasons: (1) Following excellent performance over the next two years, the US economy is expected to steadily deteriorate through the middle of the decade; and (2) Virtually all asset classes are overvalued to a greater or lesser extent. Investors should expect an annualized total return of less than 3% through 2025 from a balanced portfolio of global stocks and bonds.

FIXED INCOME

In principle, the expected return on bonds is a function of two factors: (1) The current starting point of market yields, adjusted for inflation; and (2) The general direction of interest rates in subsequent years.

- **Current Yield**: As measured by ten-year US Treasury bonds, the current nominal yield is 1.1%, down from an average of 2.5% for the three years ending in 2019. On an inflation-adjusted basis, the current yield is a ***negative 1%***, down from an average of 0.55% during the 2016 to 2019 period and 1.75% over the 25 years ending in 2019.

- **Interest Rate Outlook**: There is a high likelihood that the direction of interest rates will be upward over the next several years, which means that bond prices will be in a steadily declining trend as bond yields rise.

Expected Returns: The combination of negative current real yields and a rising interest rate environment is extremely bearish for long-term government bonds. Assuming the yield on ten-year US Treasury bonds rises to a range of 3.5% to 4% during the next five years, the compound annual total return would be a ***negative 2.5%***. With a current yield of only 1.75%, *investment-grade corporate bonds* should also perform poorly over this same period, registering a return of a ***negative 1%***. Best returns are likely in *high-yield corporate bonds* and *emerging market debt in local currencies*, with expected annual returns of 2.5% in each over the next five years.

DOMESTIC EQUITIES

The long-term outlook for the equity market is nuanced, in two respects: (1) Stocks should perform well over the next two years, but could be severely challenged in the years beyond 2022; and (2) The enormous disparity in valuations among various segments of the equity market suggests that returns among sectors could show considerable divergence.

- **Time Horizon:** Expected equity market performance during the next five years is fully consistent with anticipated economic and policy trends. Over the next two years, common stocks should perform well in an environment of solid economic growth, continued low inflation, significant monetary and fiscal stimulus, and only moderate increases in bond yields.

- **Future Challenges:** The current cyclical bull market could face daunting headwinds beyond the next two years, as economic and profit growth begin to decelerate. Equity valuations could be seriously challenged when economic policy shifts from stimulus to restraint and when long-term structural economic challenges begin to emerge.

- **Economic Sectors:** The market leaders of the past several years — technology and defensive stocks — are likely to become laggards, and vice versa. Economically sensitive stock groups should become more attractive to investors as business conditions improve and economic confidence rises. Higher inflation and interest rates should also favor value stocks at the expense of growth stocks.

- **Expected Returns:** The S&P 500 is expected to generate total returns of less than 4% annually over the next five years. However, *this broad equity market estimate masks considerable variability among economic sectors*.

- **Growth Versus Value:** Whereas growth managers might be limited to total returns of only 1% to 2%, annualized returns for value managers could exceed 8%. And returns on select economic sectors could exceed 10%, including energy, financials, transports, materials, and health care. Small-cap stocks are also likely to outperform the S&P 500, with an average annual return of 6%.

International Equities: World equity market leadership is dependent upon world trade and the strength of the global economy, along with trends in foreign exchange markets. Because the US is widely perceived as a safe haven, assets tend to flow to America during periods of economic stress, uncertainty, and instability. My economic forecast assumes steadily improving global economic conditions over the next two years, which should favor non-US markets. Stocks in emerging Asia, Japan, and Europe should provide the best returns in coming years.

INVESTMENT CONCLUSION

Prospects for investments over the next five years appear extremely challenging. Starting-point valuations for all asset classes are elevated, as *most markets have pulled forward returns from future years*. Although the current phase of the traditional business cycle is supportive of financial assets, unprecedented policy stimulus suggests that the business expansion could evolve quickly over the next several years. Meanwhile, policymakers are faced with daunting long-term structural challenges that must inevitably be resolved.

The outlook for fixed-income investments is extremely poor, such that investors should expect negative rates of return over the next several years. Equity market fundamentals appear favorable through much of 2022, but stocks are vulnerable to a *faster-than-normal unfolding of the business cycle*. A rising trend in interest rates and inflation as the expansion cycle matures could be a problem for equity investors sooner than in a typical cycle.

Asset prices are also vulnerable to a shift to monetary restraint much sooner than currently discounted by financial markets, while rising federal budget deficits will accentuate investment risk. In this economic environment, value stocks and international equity markets should outperform the S&P 500 this year and in 2022 for the first time since 2017. Pulling it all together, total returns on a global balanced portfolio are unlikely to exceed 3% over the next five years ending in 2025.

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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.