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Weekly Investment Commentary

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Long-term return prospects

The capital markets landscape is set to change markedly over the next decade, with the huge gap in recent performance between stocks and bonds set to narrow or even reverse. Moreover, the benefits that investors have enjoyed in the past four decades from the persistent reflationary policies of the U.S. and other major economies will inevitably lose momentum, with inherent inflation risks and bloated public debts eventually constraining returns.

EQUITY MARKETS (INDEX TOTAL RETURN %)	LAST WEEK	YEAR-TO-DATE
DJIA	1.44	21.21
S&P 500	1.08	28.07
NASDAQ	1.14	28.86
RUSSELL 1000	0.51	27.42
RUSSELL 1000 GROWTH	1.12	32.27
RUSSELL 1000 VALUE	1.05	22.83
RUSSELL 2000	0.82	21.13

S&P EQUITY SECTORS (INDEX TOTAL RETURN %)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	1.93	35.38
CONSUMER DISCRETIONARY	2.36	27.10
CONSUMER STAPLES	1.58	20.89
ENERGY	-2.00	16.79
FINANCIALS	1.11	38.06
HEALTHCARE	2.15	9.37
INDUSTRIALS	0.90	27.61
INFORMATION TECHNOLOGY	0.25	35.05
MATERIALS	0.76	11.96
REAL ESTATE	1.97	15.12
UTILITIES	1.75	34.07

Investors should temper their overall return expectations over the next 10 years, despite the current risk-on climate. As we regularly note, valuations are rarely a driver of returns on a one- to three-year horizon, but are powerful predictors of long-term returns. Elevated valuations for equities and credit point to pedestrian real returns in the decade ahead. The same likely looms for other recent high-fliers, such as private equity and credit as well as gold and cryptocurrencies.

Equity markets are very expensive by historical standards, which undermines their return prospects in the future. Forecasting the day of reckoning for U.S. stocks is challenging, but it stretches credulity to believe it will be beyond our 10-year projection horizon. We expect U.S. stocks to deliver mediocre real returns in the next decade.

A threatening geopolitical environment casts a potential cloud over the economic outlook, given tensions in Asia, the Middle East, and Ukraine, and between the U.S. and China. Incoming President Trump's promise to implement stiff trade tariffs could amplify geopolitical stresses, including among U.S. allies.

Our outlook should not be interpreted as bearish. We expect the global economy to expand at a decent pace over the next 10 years, with scope for upside if AI delivers even a fraction of what its advocates promise. After a grim past three years, bonds should deliver positive real returns over our forecast period, given the current starting point of yields.

The economic outlook

The global economy struggled through much of the 2010s as the U.S. and euro area household sectors deleveraged and China downshifted from the supercharged growth of the prior two decades. The pandemic provided a pronounced disruption, albeit with variable impacts across regions depending on health and fiscal policies.

Underlying growth momentum has improved in the U.S., with the economy expanding at a strong pace since the pandemic. After the lackluster performance in the 2010s, labor productivity growth is also trending higher, which we believe is sustainable. Supported by moderate population growth, we expect U.S. real GDP to expand by 2-2.5% annually over the next decade.

Global GDP growth is projected to average 2.5-3% annually over the next decade, with DM economies growing 1.5-2% annually, and EM growing 3.5-4% per year. A key feature of our outlook is the projection that DM inflation will average around 2.5-3% over the next 10 years (above the central bank target in each of the main economies). In the U.S., we expect higher underlying goods' price inflation as past tailwinds from globalization fade and the flat prices of the 2000-20 era give way to moderate but steady increases, while service price inflation remains sticky. Moreover, with high and rising fiscal deficits and debts in many DM economies, we believe central banks will accept moderately higher inflation to support economic growth.

Continued technological advances, whether from AI or elsewhere, represent the most obvious potential source of upside global growth surprises. U.S. labor productivity growth accelerated materially in the 1990s and early 2000s as computing power increased and the internet was adopted, and ongoing improvements suggest another boost is possible.

Fixed income

While yields have risen materially since early 2022, the G7 real 10-year government bond yield remains historically low and has only nudged into positive territory in the past year.

Bonds should deliver moderately positive real returns over the next decade, reversing the losses over the past 10 years. Credit should continue to outperform government bonds, but with starting spreads tight, outperformance will be modest.

Equities

The outlook for global equities hinges importantly on the U.S., since the U.S. now accounts for about 65% of total market capitalization, the highest in five decades. At the same time, global equity market capitalization relative to global GDP is also at a historic high. The latter is consistent with a conclusion that global equities are expensive by historical standards, although that implies little about equity performance in the immediate future.

Equities have re-rated significantly over the past decade, accounting for a big chunk of the real total return during the period. The elevated level of corporate profitability or return on equity (ROE) is a constraint on global equity returns in the next decade.

A key aspect of our equity return projections is that a major shift in relative performance between the U.S. and the rest of the world looms after nearly two decades of consistent U.S. outperformance. Such an outcome defies current market sentiment and perceived U.S. exceptionalism. It relies on an eventual pickup in economic growth outside the U.S., which many investors remain leery of front-running. Yet both the U.S. relative P/E ratio and ROE are stretched, with each expected to partially unwind in the next 10 years toward historical norms.

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN %)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	0.50	19.75
MSCI ACWI EX U.S.	0.58	7.22
MSCI EAFE	1.24	5.62
MSCI EM	-0.69	7.76

FIXED INCOME MARKETS (INDEX TOTAL RETURN %)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	1.03	2.57
BLOOMBERG U.S. CORP HIGH YIELD	0.27	8.47
BLOOMBERG U.S. GOV/CREDIT	1.05	2.50
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.05	4.86

ALTERNATIVES (INDEX TOTAL RETURN %)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	2.23	14.26
COMMODITIES (DJ)	-0.64	4.44
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	0.73	23.11
CURRENCIES (DB CURRENCY FUTURE HARVEST)	-0.70	11.56

Conclusion

Investors should expect the next decade to result in lower real returns for global equities, higher real returns for G7 government bonds, and slightly lower real returns for a 60/40 equity/bond portfolio than during the past 10 years. This outlook largely reflects the unusual starting point. As noted earlier, global equities have delivered strong real returns over the past decade that are unsustainable given current valuations and corporate profitability, especially in the U.S. Conversely, bond losses in real terms over the past 10 years are poised to improve, since real yields are again positive (and based on a buy-and-hold forecast at current yields).

There will still be plenty of money to be made in the next decade, but real returns will be more modest and more difficult to sustain than has generally been the case since the early 1980s. Buy-and-hold was generally a winning strategy over the past four decades, but more tactical allocation will likely be necessary to generate historically good returns in the next 10 years.

Sources: MRB, BCA, Goldman Sachs

Data from Bloomberg as of Nov. 29, 2024