Long-Term Forecasts

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The Good (Vanguard), the Bad (Research Affiliates) and the Ugly (GMO)

Opinions about the outlook for financial market returns vary widely. As we enter 2022, it may be useful to compare the long-term forecasts of three highly regarded investment firms that publish their forecasts for public viewing. Vanguard and Research Affiliates publish a 10-year forecast, while GMO has a 7-year forecast. All of the figures in the table below are annualized. In the right-hand column, I show the forecasted volatilities of the expected returns from Research Affiliates, which are not materially different from those of Vanguard. The volatility estimate represents one standard deviation (plus or minus) for a single year from the forecasted average return. One standard deviation represents 68.3% of the distribution of potential returns.

The three investment firms sometimes use different asset class descriptions for a different mix of assets, so there may not be a direct comparison available for some asset classes.

Inflation

The inflation forecasts, 2.5% from Research Affiliates and 2.0% from Vanguard, are below recent rates of price inflation published by the Bureau of Labor Statistics of 6.8% (CPI for consumers) and 9.6% (PPI for producers). This reflects the belief that inflation is transitory, and the Federal Reserve will take actions to reduce inflation expectations.

Equities

Return expectations are modest for US stocks. The range of forecasted nominal annualized returns of US large capitalization stocks (S&P 500) is from +3.2% for Vanguard to -4.2% for GMO. While the negative return of -4.2% doesn't sounds so bad for one year, it represents a compounded return for a cumulative -26% over a 7-year span. GMO and Research Affiliates have slightly better expectations for US small cap stocks (Russell 2000). The low expectations for US stocks reflect a combination of low dividend yields, modest earnings growth, and lower valuations due to mean reversion from historically high levels.

Asset Class	Vanguard 10 Year	GMO 7 Year	Research Affiliates 10 Year	
	Nominal Expected Return			Volatility
Inflation				
Consumer Price Index	2.0%		2.5%	
Equities				
US Large Cap (S&P 500)	3.2%	-4.2%	1.6%	15.4%
US Small Cap (Russell 2000)	3.2%	-3.7%	3.5%	20.8%
MSCI EAFE (Europe, AustralAsia, Far East)			6.6%	17.4%
Global ex-US Equities	6.2%			
International Large Cap		0.6%		
International Small Cap		1.9%		
Emerging Markets		4.4%	9.0%	21.2%
Emerging Value		8.2%		
Real Estate				
FTSE NAREIT (US)	2.9%		2.9%	22.3%
US Commercial Real Estate			4.1%	12.7%
Fixed Income				
Barclays US Aggregate	1.9%	-1.4%	2.0%	3.2%
US Corporate Intermediate			2.9%	4.5%
US High Yield	2.7%		3.9%	9.6%
US Treasury Long Index			-5.7%	11.7%
US Inflation Linked Bonds	1.5%	-1.1%	2.7%	5.3%
International Bonds Hedged (to US$)		-2.3%		
Emerging Debt	2.8%	1.4%	7.6%	13.1%
Commodities				
Bloomberg Commodity Index			1.5%	16.8%
Cash				
US Money Market	1.7%	1.4%	1.1%	0.3%
Emerging Markets Cash			5.3%	7.6%

Source: websites for Vanguard, Research Affiliates, and GMO.

Note: GMO publishes real returns (after inflation). Their forecasted real returns were adjusted by adding 2.5% inflation to make them comparable to the nominal returns of Research Affiliates.

All three firms have higher and more consistent expectations for international stocks. The expected returns reflect higher dividend yields, earnings growth, and small changes from current valuation levels. Expectations are higher for emerging markets than developed markets.

Many emerging market stock funds have a heavy weighting in China, Taiwan, and Korea. In 2021, the SEC took issue with many Chinese companies. The SEC halted approval of any new Chinese IPOs and was specifically concerned about variable interest entities which often lease, but do not own, the assets of a company in China. The SEC also now requires Chinese companies to disclose their ownership and provide evidence of their audit inspections. According to Reuters, there are potentially 200 Chinese companies that may be kicked off US stock exchanges. We also have the geopolitical threat of China claiming and invading Taiwan, which I believe is not factored into the forecasts. Despite the higher expected returns, I would prefer to avoid emerging market funds with Asian stocks for now. The recent purchase of the Franklin FTSE Latin American ETF is a viable alternative, with a weighted average forward P/E ratio of 8.5.

On a positive note, there seems to be general agreement that value stocks (low ratios of price/earnings, price/cash flow, or price/book value) will have higher expected returns of about 4% relative to their benchmark. This applies to US, developed, and emerging markets.

Real Estate

Vanguard and Research Affiliates agree on the forecasted return for publicly traded real estate investment trusts (REITs) at 2.9% annualized over 10 years. Research Affiliates shows a higher expected return of 4.1% for US commercial real estate that is not traded on stock exchanges. Several investment companies have created investment products with monthly redemptions for this segment that can be held at TD Ameritrade, but there is a nonstandard asset charge that reduces the distribution yield.

Fixed Income

GMO expects negative nominal returns for US bonds, including inflation-linked bonds. Vanguard expects positive nominal returns in the low single digits for various fixed income categories. Research Affiliates (RA) has a broader range of forecasted returns for fixed income with emerging market debt denominated in local currencies at +7.6% and the US Treasury Long Index at -5.7%. An annualized negative return of -5.7% compounded over 10 years results in a cumulative loss of -41%. We will definitely be avoiding long-term bonds. As interest rates rise among all maturities, the biggest negative price impact will be on long-term bonds. The 30-year US Treasury currently has a yield of only 2.07%.

Commodities

Only Research Affiliates provided a forecast for commodities, using the Bloomberg Commodity Index (BCI) as a proxy. Their nominal expected return of 1.5% is below their forecast of 2.5% for inflation. The BCI is a broadly diversified commodity price index that is weighted as follows: 29.9% energy, 22.2% grains, 17.5% industrial metals, 17.4% precious metals, 7.2% agricultural crops, and 5.8% livestock. The index has increased far more than the government's inflation statistics would indicate. For calendar year 2021, the BCI rose 27.1%.

Two Caveats

I believe there are two significant risks that the forecasts do not reflect: 1) the Fed's ability to maintain monetary order, and 2) the potential decline in the labor force.

Rob Arnott, Founder and Chairman of Research Affiliates, acknowledged the potential for drama in the financial markets during a recent interview with Eric King. King asked about the possibility of a "crack-up boom from money printing," a process described by Austrian economist Ludwig von Mises. Rob Arnott said the following. He considers inflation to also be a type of tax.

> Why do we want to spend money that we don't have?
>
> … Anyway, the simple fact is that it siphons money out of the economy right now, immediately. If you spend money that doesn't exist, you're either taxing current taxpayers or taxing the capital economy by siphoning money away from other worthy borrowers to a less worthy government borrower. So, the crack-up issue is a real one.

The Federal Reserve has been able to maintain low interest rates despite higher inflation, excessive deficit spending, and generous monetary stimulus. The US trade deficit in goods (excluding a surplus for services) increased to a record level of $97.8 billion for the month of November. If less foreign credit is available to finance our trade deficit, the US currency will decline, and the Fed will be pressured to increase interest rates faster than it would like to support the currency.

At the end of November, the US labor force of 162.0 million people remains about 2.5 million lower than it was at the end of December 2019. The BLS also reported that there were 3.7 million more vacant jobs than unemployed workers. If the labor force declines, any GDP growth is reliant on increases in productivity.

Scott Davison is the CEO of OneAmerica, a $100 billion insurance company based in Indianapolis that provides group life and disability insurance. Commenting on results of the third quarter, he said that “death rates (of their customers’ employees) are up 40% over what they were pre-pandemic. Just to give you an idea of how bad that is, a 3-sigma … catastrophe (or 3 standard deviations that would cover 99.7% of a distribution) would be a 10% increase.” He added that “It may not all be (classified as) COVID on their death certificate, but deaths are up just huge, huge numbers.” The company has also seen an increase in disability claims, both short-term and long-term. Costs will be passed on to employers. On the same conference call, Brian Tabor, President of the Indiana Hospital Association, said that hospitals across the state are experiencing more intakes with patients “with many different conditions.”

A return to pre-COVID normalcy seems unlikely in 2022.

If you have any questions or comments, please contact me.

Sincerely,
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