UPDATE: 5-Year Capital Market Assumptions

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Maintaining long-term forecasts for major asset classes provides helpful context for responding to short-term swings in markets.

When it comes to making asset allocation decisions, we find great value in maintaining a long-term outlook for major asset classes. Twice a year, we conduct an extensive update of our five-year return forecasts for major asset classes. The purpose of this exercise is two-fold. First, taking a longer term perspective helps us set strategic asset allocations and design portfolios for diverse investment goals. Second, and equally important, we find that maintaining long-term forecasts provides helpful context for responding thoughtfully to daily swings in market prices.

How we arrive at our capital market assumptions

Our capital market assumptions begin with our economic and interest-rate outlook. Since the specific timing and duration of economic expansion is difficult to forecast, we develop a central thesis along with two alternative scenarios. Typically, these alternative scenarios consider a stronger economic scenario and a weaker one. For this update, we developed a slightly more nuanced framework for alternative scenarios. We note that in today's financial markets, investment outcomes suggest an unusually high influence from global monetary policy. Specifically, the process of asset price inflation through ultra-low policy rates combined with quantitative easing (that is, asset purchases by central banks) has been ongoing since the global financial crisis of 2008. With this intervention now so long lived, we articulate our alternative scenarios going forward as specific variations of how this policy-driven period might resolve.

Our central case and two alternative scenarios

Our central case presumes an extended period of loose monetary policy and ongoing asset price inflation. We can imagine two variations from this central premise. In one case, the loose monetary policy could create a classic money-driven inflation response. In this scenario, one we call "money illusion," we would expect rate-sensitive bonds to fare poorly, while other assets benefit in nominal return terms but lose much of their purchasing power to rising inflation rates. The alternative case, "debt deflation," contemplates the ultimate ineffectiveness of monetary tools in combating deflation. In this scenario, global deflation dynamics gain the upper hand and subdue economic growth while pressuring the global financial system. We consider the debt deflation scenario to be less likely than our money illusion scenario, but we think it is important to think through both scenarios in setting our strategic portfolios with a five-year horizon. Below we explain the key features of our three scenarios:

- **Most likely:** In our central case scenario, we observe that economic data have stabilized enough to push out our expectation of a mild recession into the back half of 2017. The global economy appears to be on better footing than at the beginning of the year but unable to generate a sustained acceleration to higher growth. The Federal Reserve has started down the path of normalizing interest rates, but we expect that will take considerable time. This would keep Treasury yields relatively low and fuel the ongoing search for yield elsewhere. Also, the intensity of the world's monetary policy response to the Brexit vote should help the major economies outside of the U.S. avert an economic contraction in the near term as well.
- **Less likely:** Our money illusion scenario recognizes positive impacts of a recovery in commodity prices feeding back into the global economy, particularly the consumer and energy importers. In this scenario, nominal earnings improve for corporations but valuation multiples contract.
- **Least likely:** Our weaker scenario now calls for a much broader slowdown in global growth due to constrained spending by debt-burdened consumers and governments. This is a deflationary environment.

Our final forecasts represent a weighted average of expected asset class performance across all three scenarios. Below are some observations from our mid-year update:

- Expected returns remain below historical averages for all major asset classes.

- Equities retain an expected return advantage over bonds, as expected returns from fixed-income asset classes continue to be subdued by low current yields. Outside of near-term disruptions, equity prices should benefit from the search for yield.
- Corporate bonds and emerging market debt show the biggest change in expected returns since the beginning of the year; this is due in part to their spectacular performance so far in 2016 and their special sensitivity to our weaker, deflationary scenario.
- Emerging market stocks and commodities show the greatest improvement in expected return compared with our last update, reflecting their unique positive sensitivity to our money illusion scenario. Equity earnings growth is likely to be low.

As a final exercise in the process, we consider for each asset class the likelihood that returns relative to our expected five-year average are likely to be front-loaded, back-loaded or fairly steady. This exercise yielded the following observations during this update:

- **Investors should be mindful of downside risk in the early part of our forecast.** Since even our central case anticipates a mild economic recession sometime in the next two years, the possibility of a notable correction in risk asset prices during the first half of our forecast horizon is noteworthy. Dollar-cost averaging into new investments and keeping some powder dry may help manage risk in a frustrating market. Even without an economic recession, portfolios can be buffeted in this environment where steady gains across assets are intermittently and unpredictably interrupted by market tantrums during which many assets decline concurrently.
- However, **investors should also be mindful of where to deploy capital when downside risks lessen**
- With so many market outcomes hinging upon monetary stimulus, **markets will remain highly sensitive to the macroeconomic news and Federal Reserve policy**.

The bars in the chart below show our updated forecast five-year total average annual returns for several major asset classes.

Updated forecasted five-year total average returns (2016-2020)

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Bar chart results are as of September 1, 2016 and reflect updated forecasted five-year total returns for the time period of January 2016-December 2020. Dotted line results are previously forecasted returns.
Source: Columbia Management Investment Advisers, LLC. Past performance does not guarantee future results.

Equities offer greater expected returns than fixed income

From this chart, we can extract a few of the major implications for strategic asset allocation over the next five years. First, we continue to have very modest expectations for total returns from most fixed-income assets. This is due to the low level of yields offered by major fixed-income asset classes combined with the expectation that U.S interest rate policy will begin to normalize over the next five years. We believe equities, meanwhile, offer returns that are slightly below their long-term averages. We note that equities are likely to struggle during an economic slowdown, resulting in below average expected returns. Equity returns compare favorably to most fixed-income returns on this horizon, as worldwide equity valuations are not extremely expensive.

Opportunities for investors

To summarize, we believe that portfolios designed to rely more on equity risk than fixed-income risk are more likely to succeed, on average, over the next five years. In the near term, we would caution investors to expect hiccups and volatility across risk assets. Our economic scenarios imply that returns may be much lower early in the forecast than later. Risk management will be important during the early years of our forecast, and with bond yields so low, we encourage investors to explore alternative sources of diversification and explicit strategies to stabilize portfolios during market downturns.