CROSSMARK
GLOBAL INVESTMENTS

FUTURE RETURNS MEDIOCRE — ACCEPTING AVERAGE II

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Introduction

In 1Q 2022, we wrote a white paper ("Accepting Average") where we argued that traditional assets (stocks and bonds) would likely have subpar returns. With stocks and bonds down noticeably since then, prospective returns have improved somewhat, but are still likely to be subpar. The purpose of this white paper is to update that study and prospective return prospects.

Total returns on balanced portfolios of publicly-listed assets over the next ten years will be below the norms of recent decades given elevated current valuations and what we expect to be moderate global economic growth and higher inflation. There are many sources of uncertainty about the economic outlook, but one thing is certain for prospective returns: the tailwind of falling inflation and interest rates that prevailed for most of the past 40 years has ended. That tailwind boosted valuations for virtually all assets and allowed central banks to cut policy rates in response to economic or capital market weakness. Thus, the past is not prologue. Global equities and bonds are expensive by historical standards, tempering potential returns in the years ahead. Forces that subdued inflation in recent decades have faded or in some cases reversed, to the detriment of real returns on fixed-income assets and balanced portfolios.

The Current Situation

We are broadly constructive about the economic outlook, with the three pillars of the U.S., China and the euro area, all expected to post decent growth over the next ten years. Last decade's subdued growth in the U.S. and euro area largely reflected private-sector deleveraging that has run its course, rather than the secular stagnation narrative that some argued. China's economic growth will continue to slow over a ten-year forecast horizon, but it will remain the largest contributor to global growth because of the huge size of its economy. Less positively, we expect inflation to be above central bank targets in the next decade. We caution against the assumption that inflation will fall to the 2% central bank target. Indeed, we expect major central banks to err on the side of too much, rather than too little, inflation to support economic growth.

Slower global potential growth, led by weaker population growth (a subject for a future white paper) will prevail over the next ten+ years and beyond. (That's down from 3.6% in the decade preceding the 2008 financial crisis.) Global population growth has halved over the past 50 years, from 2% per year to less than 1%, and is expected to fall to close to zero by 2075.

There is considerable uncertainty about the long-term economic outlook. Productivity growth in the developed market economies has been chronically disappointing, China has downshifted more rapidly than expected onto a much slower underlying growth path, public sector debts have ballooned since the start of the pandemic and several developed economies have excessive household leverage. Households, businesses and governments face a much higher cost of debt than they became accustomed to in recent decades. The challenges of climate change and an intensifying geopolitical contest between the U.S. and China add to the economic uncertainty. Is it possible that AI can offset these headwinds? We are hopeful, but it is too early to tell.

The bigger challenge for capital markets and investors is that the era of declining/low interest rates significantly inflated asset prices, ranging from stocks to bonds, to real estate, art, and nearly everything else. The hit to asset prices last year was painful, but at the macro level it is difficult to assert that things are cheap. More positively, the economic outlook over the next decade is likely to be sufficient to generate decent real returns for realistic investors. Intense deleveraging pressure rather than secular

The Current Situation (cont'd)

stagnation was the primary cause of subpar growth in the U.S. and euro area last decade, which has now passed. And the rise in yields means that bonds should contribute positively to multi-asset portfolio real returns over the next decade, which was frequently not the case for much of the past ten years.

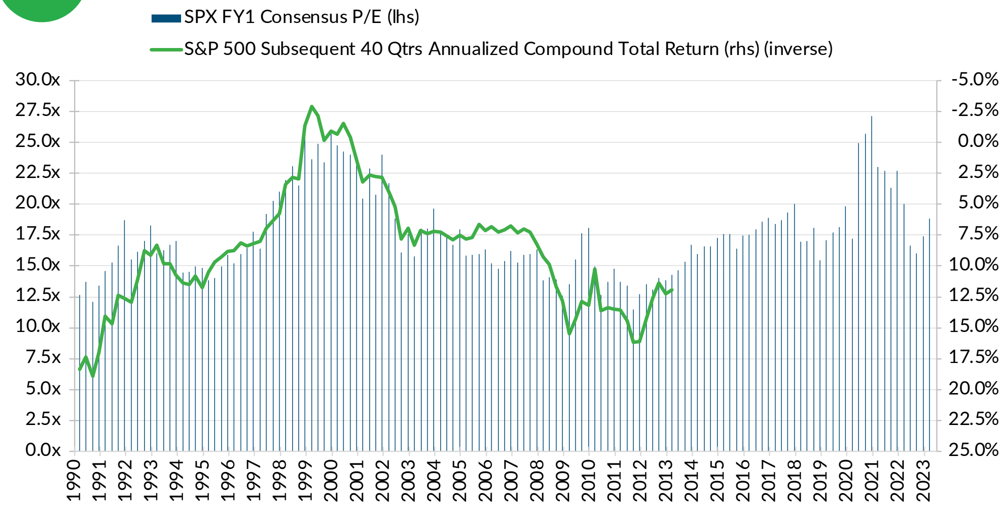
The long-term outlook for a balanced portfolio has improved somewhat following last year's price declines, but setting realistic return expectations for the next decade is tougher because capital will no longer be cheap, liquidity no longer assured, and a central bank "put" no longer reliable. Past returns will no longer be a good guide for prospective returns, even over the longer term.

- The U.S. and euro area economies are projected to grow at a faster pace over the next decade than in the last, which was subdued by chronic deleveraging pressures after the Global Financial Crisis. A rebound in labor productivity growth should somewhat offset slowing population growth. Growth is likely to be slower over the next year or two, but we expect U.S. real GDP growth to average 2-2½% over the next decade versus 2% in the last, while the euro area should see growth pick up to around 1.5% from less than 1% from 2011-2021.
- In China, we expect real GDP to expand at a less than 4% annual pace compared with 6.7% over the past ten years to a significant extent that reflects demographic changes. The population is forecast to be flat over the next ten years, but declining in later years, with risks to the downside as evident from the contraction in 2021/2022. More importantly, the employment-population ratio is declining as society ages, with fewer workers supporting retirees. Thus, economic growth will be driven by labor productivity growth, which is also moderating, albeit still high by global standards. Economic growth will also be restrained as the reliance on leverage diminishes. Geopolitics imply that China may have less access to foreign markets and technologies, but it will continue to move up the value-added chain.
- Despite slowing growth in China, emerging market economies' share of global GDP will continue to rise over the next ten years, aided by a weakening U.S. dollar. That said, EM's contribution to real global growth will diminish marginally, reflecting a slight narrowing of the growth gap versus the developed market economies.

Central banks may verbalize a return to a 2% inflation target, but we do not expect them to succeed. The surge in inflation over the past two years represents a clear break with the past four decades, when globalization and other forces kept consistent downward pressure on goods prices. Goods price inflation will generally be higher as companies build greater buffers into supply-chains and selectively re-shore manufacturing. We expect the recent acceleration in wage costs to be sticky compared with recent decades, in part reflecting aging populations. Central banks may not formally abandon their current inflation targets, but they will not sacrifice growth to achieve them. We expect inflation in the U.S. to average approximately 3% in the next decade.

Historical Observations

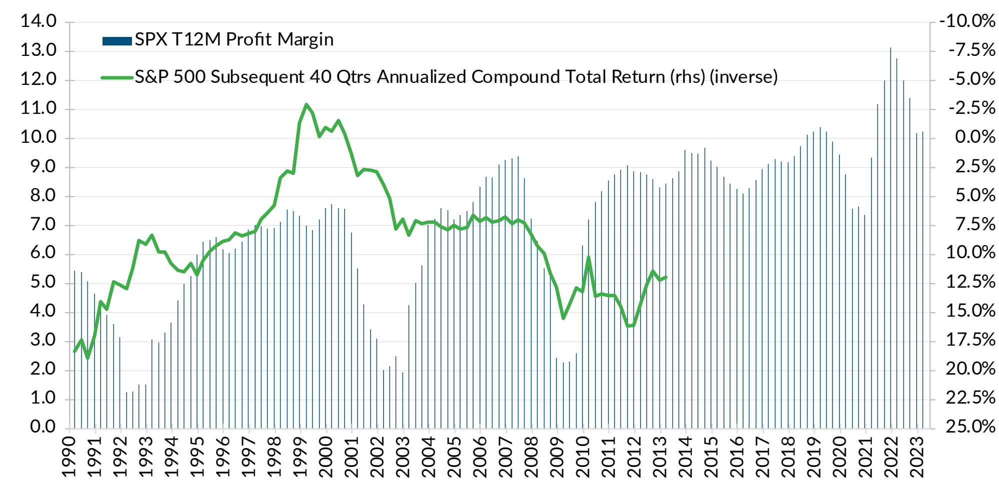
1 Future equity returns as a function of starting P/E ratios



Starting Consensus FY1 P/E	Subsequent 40 Qtrs Annualized Tot. Return	# Obs. (40 Qtrs)	% of Obs. (40 Qtrs)	Subsequent 4 Qtrs Annualized Tot. Returns	Subsequent 12 Qtrs Annualized Tot. Returns	Subsequent 20 Qtrs Annualized Tot. Returns	Subsequent 40 Qtrs Annualized Tot. Return
< 10x							
10-15x	12.92%	31	33.3%	13.31%	15.01%	15.23%	12.92%
15-20x	8.79%	43	46.2%	9.97%	10.63%	9.96%	8.79%
20-25x	1.79%	17	18.3%	(0.80%)	(0.23%)	0.92%	1.79%
> 25x	(1.14%)	2	2.2%	13.72%	(7.23%)	(1.37%)	(1.14%)
> 20	1.48%	19		3.24%	(0.93%)	0.26%	1.48%

Source: Bloomberg. As of 3/31/23.

2 Future equity returns as a function of starting profit margins

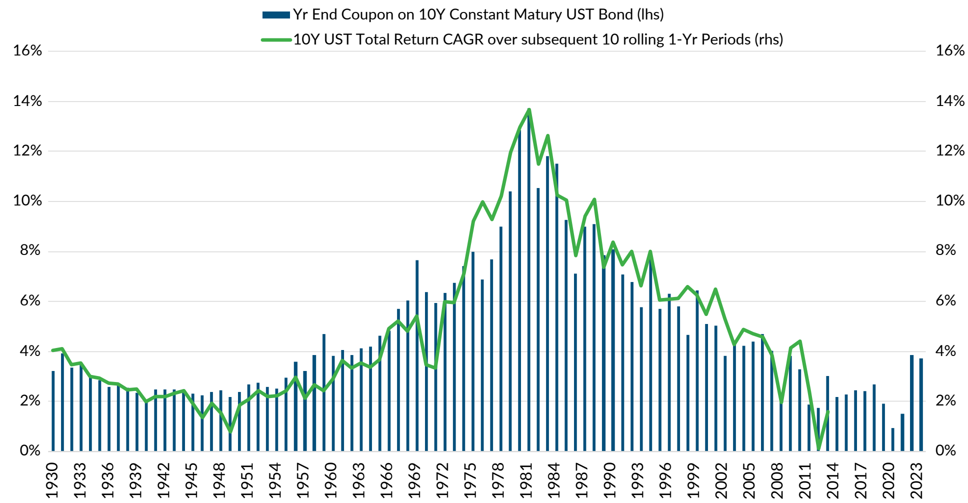


Starting SPX Index T12M Profit Margin	Subsequent 10Y Ann. Tot. Return (%)	# of Obs.	% of Obs.
1-3%	10.09%	13	14.0%
3-5%	9.93%	14	15.1%
5-7%	8.69%	26	28.0%
7-10%	7.75%	40	43.0%

Source: Bloomberg. As of 3/31/23.

Historical Observations (cont'd)

3 **Future fixed income returns as a function of starting interest rates**



10Y UST Yield at start of Year	Subsequent 10-Year Total Return CAGR of 10Y US Treasuries	# Obs.	% of Obs.
0-2%	1.26%	2	2.3%
2-4%	2.70%	38	44.2%
4-6%	4.73%	19	22.1%
6-8%	6.87%	15	17.4%
8-10%	9.56%	6	7.0%
> 10%	12.16%	6	7.0%

Source: Bloomberg. As of 3/31/23.

Fixed Income

The 40+-year era of falling and low government bond yields has passed, but the adjustment to the era of higher real policy rates, higher inflation, and greater inflation uncertainty will take time. G7 government bonds have suffered severe losses as yields have risen. Even more painfully, adjusted for inflation, G7 10-year government bonds generated a loss of approximately 20% in 2022. The combination of rising nominal bond yields and high inflation have wiped out more than ten years of real returns for G7 10-year government bonds. Despite the sharp rise in 2022, yields are expected to climb over the course of the next decade, consistent with the rise in central bank policy rates. While the recent surge in bond yields improves the outlook for bonds over the next decade, real returns will still be low compared with recent decades. We expect yields to climb above current levels over the next ten years, in response to sustained higher policy rates and inflation, and greater uncertainty. Active management will be well-positioned to potentially outperform buy-and-hold and passive strategies.

Equities

The long-term outlook for global equities has brightened modestly following last year's bear market, but aggregate real returns in the decade ahead will significantly lag those of the past 40 years. We anticipate a swing in relative performance from the U.S. to non-U.S. markets given the relative earnings and valuation starting points. Global equities have enjoyed an extraordinary 40-year run after inflation, equivalent to approximately 7% compounded annually. Three factors determine the outlook for prospective returns over the next decade, namely the growth of corporate earnings, the anticipated P/E ratio and the dividend yield.

- Earnings Growth: Earnings growth will likely be tepid in the decade ahead, against a backdrop of moderate global economic growth and an already very elevated return on equity (ROE). The implication is that real corporate earnings growth will be below that of global real GDP growth.
- P/E Ratio: The global P/E ratio has fallen below its historical mean over the past 18 months, while the U.S. P/E ratio remains above its historical mean . This implies potential non-U.S. upside in the decade ahead. Combined with our expectation that bond yields will rise modestly further over the next decade, the implication is that the equity risk premium will narrow. Unfortunately, the U.S. valuation starting point is high relative to past experience, providing a headwind to valuations.
- Dividend Yield: Dividends should contribute significantly to equity returns in the decade ahead, indeed generating approximately 50% of the total returns. The dividend payout ratio is near the lower end of the historical range, indicating ample scope for dividend payments to be sustained in a moderate global growth climate.

Overall, we expect global equities to generate an annual real return of approximately 3%, which is below that of the past decade, but sufficient to support decent total returns in multi-asset portfolios. Higher persistent inflation and higher bond yields represent the chief downside risk to our base-case global equity return projection. A combination of lower-than-projected inflation and sustained elevated ROE could enable equities to generate a higher return than our forecast.

As mentioned, relative earnings and valuations point to a shift in relative performance in the decade ahead. U.S. ROE is hovering near a record-high of 20% (above even the peak in the booming late 1990's) versus a more subdued global ex-U.S. ROE of 12%. A normalization of U.S. ROE implies that U.S. real earnings will contract over the next decade, while global ex-U.S. real earnings rise. We also expect the U.S.' valuation premium to narrow over the forecast horizon, contributing to global ex-U.S. relative outperformance. U.S. relative performance is at an all-time high after more than ten years of sustained gains. Relative performance is also correlated with the U.S. dollar exchange rate, which is near a 20-year high. The dollar is even more elevated on a real trade-weighted exchange rate basis, and is expected to depreciate in the decade ahead.

Commodities and Currencies

Commodities prices should move modestly higher in real terms over the coming decade but conditions for a Supercycle upswing are not on the horizon.

- The transition to a "green" economy may spur demand for select industrial metals, but does not change the fundamental declining intensity of commodity usage in economic output, as the share of services in global GDP rises.
- Economic growth in China, whose demand for many industrial commodities accounts for more than 50% of the global total, will continue to slow relative to the past few decades, thereby tempering demand for commodities.

Conclusion

The outlook for global portfolio returns over the next decade has improved modestly following last year's decline in both stocks and bonds. Still, aggregate real returns will be lower than over the past 40 years because the era of low/falling inflation and interest rates is over. As noted earlier, the bloodbath in the bond market has wiped out more than a decade of prior gains, and has significantly offset the still solid returns in global equities. We expect the wide gap in global equity and G7 10-year government annual returns over the past ten years to narrow as equity returns moderate and bond returns improve. From a strategy standpoint, our forecasts justify a structural overweight on equities in a multi-asset portfolio, along with an overweight in non-U.S. equities. Given the projected depreciation of the U.S. dollar, returns on a U.S., dollar-based portfolio would benefit from overweight exposure to non-dollar assets, particularly non-U.S. equities. Within fixed income, laddered government bond portfolios are appropriate, with only a modest average spread between short- and long-duration exposures. Credit should generate superior total returns compared with government bonds.

Lower expected real returns in the coming decade should favor more active and tactical management, although that is fraught with risk as well as potential reward. Buy-and-hold strategies will produce decent if unexciting overall returns. Last year's bear markets in global equities and bonds should boost real returns on balanced portfolios in the decade ahead.

Investment Implications

- Multi-asset portfolios will deliver historically subpar returns in the coming decade.
- Conditions should favor active over passive management.
- Government bonds should provide modest nominal returns; credit will outperform, but returns will be low.
- Global equity returns will also be subpar, but stocks warrant a structural overweight within multi-asset portfolios.
- Expected U.S. dollar depreciation will boost global returns when measured in dollars.

10-Year Return Forecast by Asset Class	Forecasted Return Range (%)
Equities	5-7%
U.S.	4-6%
Non-U.S. Developed Markets	5-7%
Emerging Markets	5-7%
Bonds	1-3%
U.S. Government	0-2%
U.S. Investment Grade	1-3%
U.S. High Yield	2-4%
Emerging Market Sovereign	3-5%
Cash	2-4%
Inflation	2-4%

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