CROSSMARK GLOBAL INVESTMENTS

What's Inside

Accepting Average

The likelihood of mediocre future returns

Written by:

Robert C. Doll. CFA®,
Chief Investment Officer,
Crossmark Global Investments

Introduction

Over the last 10+ years, U.S. equity outperformance has been caused by increased profit margins, the accretive impact of share buybacks, dollar weakness, and most significantly, an outsized expansion in equity multiples. There are risks to all of these sources of outperformance, suggesting that a neutral long-term strategic allocation to U.S. equities is now likely warranted. Investors should expect meaningfully lower absolute returns from U.S. stocks over the next decade than what they have earned in recent years/decades, barring a continued rise in an already stretched profit margin. A structurally overweight stance is still warranted toward equities versus fixed income, but even a 100% equity allocation is unlikely to meet investor return expectations in the high single-digits. This argues for greater tolerance of volatility and the pursuit of riskier investments and asset classes such as real estate and other alternative investments as potential portfolio return enhancements.

Multiple expansion has been evident in heavily-weighted consumer discretionary, information technology, and communication services sectors. Higher interest rates on a structural basis may cause outright multiple contractions for U.S. stocks. This is particularly true for growth stocks, which have been responsible for a significant portion of U.S. equity outperformance, given their comparatively long earnings duration.

The Current Situation

The investment climate promises to be much more challenging over the next ten years than in recent decades. Stocks, bonds, real estate, and most other assets have benefitted enormously from the persistent decline in interest rates since the early 1980s. The era of declining interest rates is over, barring a slide into global deflation that would be disastrous for the prices of risk assets. The current rich valuations for most asset classes represent a significant headwind for real returns over the next decade. Asset prices already discount a rosy future.

Inflation is the most significant wildcard for the long-term return outlook. Current bond yields are consistent with investor confidence that the recent increase in inflation will be transitory. Such complacency is misplaced. A replay of the high inflation of the 1970s is not on the horizon. Still, we expect inflation to be higher, more persistent, and more problematic than most investors and policymakers anticipate. It will be on investor radar screens for years to come.

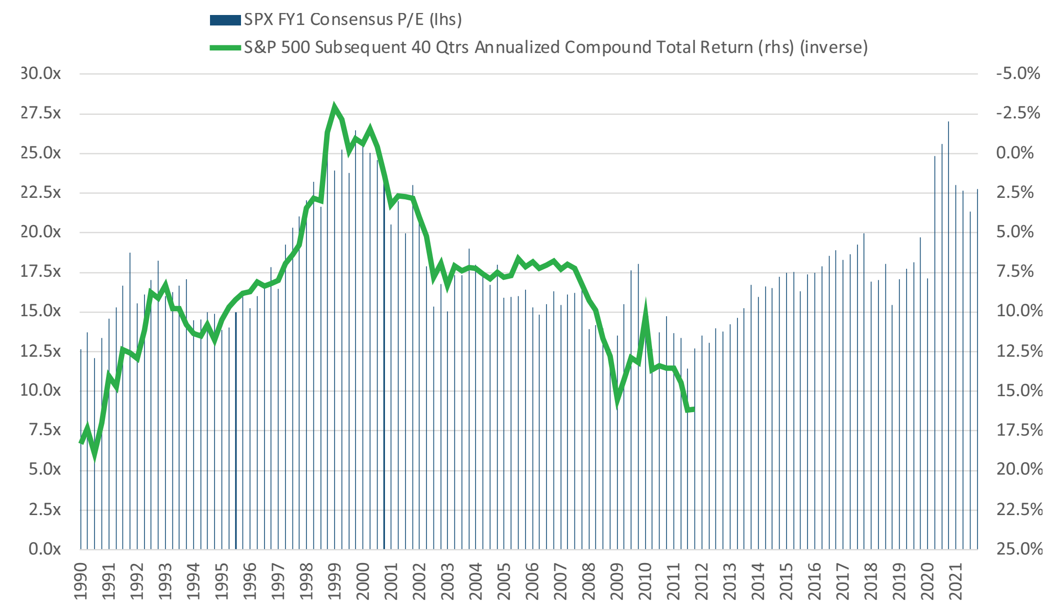
For a conventional multi-asset portfolio consisting mainly of stocks and bonds over the next ten years, the most likely scenario is that global growth will be solid but accompanied by somewhat higher underlying inflation. In such a base-case scenario, interest rates would rise over the next decade, leading to poor absolute real portfolio returns along with greater volatility. Real bond returns would be poor, and a valuation de-rating would significantly offset the benefits of healthy economic growth to risk assets. The overall returns and risk-reward on balanced portfolios would be considerably less favorable than has been the case for most of the past four decades. To an extent, the next decade will result in some payback for the generous returns of the past few decades of falling interest rates. An optimistic scenario would be for government bond yields and corporate earnings to rise modestly amidst decent global economic growth and low inflation. In such a scenario, current valuations would be sustained, government bonds would generate only moderate negative real returns, while equities would produce mid-single-digit real returns. A 60/40 equity/bond portfolio would deliver less than stellar real returns by current standards, but not dismal either.

We stress that long-term projections should be interpreted as underlying trends, with returns on a shorter-term horizon deviating significantly depending upon cyclical conditions. Given expected subpar returns on the main asset classes in the coming decade, effective tactical asset allocations shifts will be necessary for enhancing multi-asset portfolio performance.

Historical Observations

Future returns are often a function of starting points. We provide three measurements supporting the notion that future long-term returns are likely to be muted for U.S. equities.

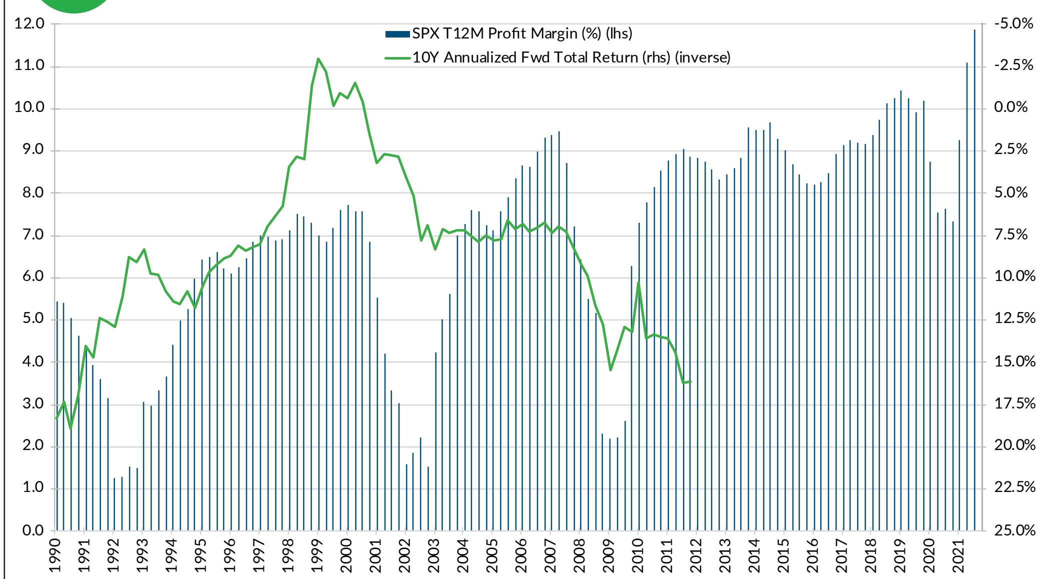
1 Future equity returns as a function of starting P/E ratios.



Consensus P/E	Subsequent 1 year Ann. Tot. Returns (%)	Subsequent 3 year Ann. Tot. Returns (%)	Subsequent 5 year Ann. Tot. Returns (%)	Subsequent 10 year Ann. Tot. Returns (%)
10-15x	13.34	15.12	15.28	13.11
15-20x	9.44	10.50	9.88	8.68
20-25x	3.93	9.98	0.65	2.46
>25x	4.40	(9.66)	(2.02)	(1.33)

Source: Bloomberg. As of 12/31/21.

2 Future equity returns as a function of starting profit margins.

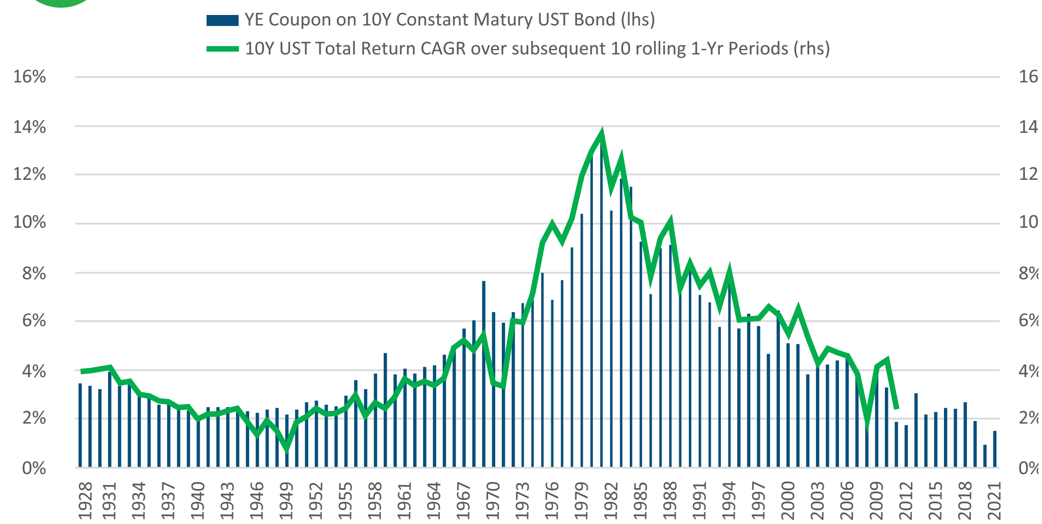


T12M Profit Margin (%)	Subsequent 10 year - Ann. Tot. Returns (%)	# Obs.	% of Obs.
1-3%	10.09	13	14.8
3-5%	9.93	14	15.9
5-7%	8.64	27	30.7
7-10%	7.07	34	38.6

Source: Bloomberg. As of 12/31/21.

Historical Observations
Cont'd.

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



T12M Profit Margin (%)	Subsequent 10 year - Tot. Returns CAGR(%)	# Obs.	% of Obs.
0-2%	2.40%	1	1.3
2-4%	2.76%	33	41.3
4-6%	4.73%	19	23.8
6-8%	6.87%	15	18.8
8-10%	9.56%	6	7.5
>10%	12.16%	6	7.5

Source: Federal Reserve of St. Louis (FRED). As of 12/31/21.

Impact of COVID-19 and Inflation

At the outset of the COVID-19 pandemic, it was reasonable to assume that there would be lasting damage to the global economy. Yet while many segments of the global economy are still struggling to combat COVID-19 and are far from fully re-opening, the outlook today is more favorable than was the case a year ago or even several months ago, given medical developments and aggressive monetary, fiscal and other policies.

Many embrace the notion that global or developed market growth will revert to the last decade's trend once the sugar-high of massive policy stimulus fades. Such a conclusion is likely too pessimistic. The U.S. and European economies faced powerful deleveraging headwinds following the global financial crisis that will not exist in the coming years. Households in both regions are flush with cash, which augurs well for consumer spending as the economic recovery takes hold. Corporate profits have rebounded more strongly than following past recessions, leaving businesses better able to make investments that can contribute to economic growth.

Real global GDP growth is projected to be approximately 3%, which would be moderately higher than the 2 ½ % of the past decade. As has been the case in recent decades, global growth will be led by the emerging market economies, which are projected to expand at a 4.5% annual pace in the decade ahead.

We expect inflation to be moderately higher than developed market central bank target levels and compared with the past two decades given improving economic growth, continued lagging monetary policy for the next several years, and the fading of past globalization restraint on traded goods prices as developing market economies focus on reshoring manufacturing. Most evident in the U.S., the starting point for underlying inflation is more elevated than following the Great Recession, pointing to higher trend inflation than in the last expansion.

Fixed Income

G7 government bonds will suffer significant losses in real terms in the decade ahead as interest rates rise from current emergency levels and growth and inflation exceed current market expectations. Credit/spread product will produce better absolute returns than government bonds, but poor by historical standards. While inflation-protected bonds will also suffer losses in real terms, an above benchmark weighting is appropriate given upside risks to inflation. Based on the current 10-year yield and our projected inflation rates, government bonds in each major market are expected to generate outright losses in real terms.

Equities

In the next few years, the outlook for global equity returns is tempered by a starting point of elevated valuations and corporate profitability, especially in the dominant U.S. market. As such, projected real returns will be well below the norms of recent decades and dependent on the ability of global ex-U.S. markets to rebound after a period of prolonged disappointments in the last cycle.

Global ROE and the P/E ratio are well above the historical average, thereby dampening prospective returns. Currently, global ROE is nearly 14% and more than two percentage points above its mean-reverting average since 1975. Our base-case scenario is that global ROE will stay near its current level over the next decade, in part reflecting sustained higher profitability in the tech sector and increasing profitability in the financial sector. A less optimistic scenario including an ROE reversion to its historical mean is also reasonable, implying global earnings growth below global GDP growth.

Our base case scenario is that U.S. ROE will edge lower over the next decade. By contrast, ROE should have at least modest upside for the global ex-U.S. benchmark over the forecast horizon, with the euro area and the U.K. having the most upside to historical means after a dismal past ten years. We also expect the global trailing P/E ratio to decline from its year-end 2021 level of 22. With interest rates projected to rise over the next ten years, the global trailing P/E ratio is forecast to drift down to approximately 17-18 by the end of the decade.

Currencies

The U.S. dollar was arguably modestly undervalued just before the 2008/2009 global financial crisis, but it is now somewhat overvalued versus other major currencies. Over a multi-year horizon, this argues against further relative common currency gains for U.S. stocks from the foreign exchange effect.

Three main related themes underpin our long-term outlook for the U.S. dollar and currencies more generally. The first is the gradual decline in the U.S. trade-weighted dollar, reflecting the historically elevated current level and the diminishing U.S. share of global GDP. The second, which is the corollary, is that currencies such as the euro and the yen will be the primary beneficiaries of the dollar's decline because of their weak starting point. The third theme is the increasing role of China in global activity and international investment portfolios, which will translate into a further appreciation of the yuan against the dollar.

Traditional Balanced Portfolios

Extremely low or negative bond yields have led some to proclaim the end of the 60/40 portfolio as the bedrock of asset allocation. Others argue that investors will likely need to take on more risk to achieve their portfolio return objectives. The future is unknowable, but the safest bet is that a balanced portfolio of stocks and bonds, or even a more diversified portfolio of public and private assets, will deliver returns over the next ten years or so that are below those of the past few decades.

Since 1970, global equities have delivered a 5.8% real compound annual total return, while G7 10-year government bonds have produced a 3.2% real compound annual return. The 60/40 portfolio generated a 5.1% real compound return. Since the early-1980s, the 60/40 portfolio has benefitted from the trend decline in interest rates, and the negative correlation between equity and bond returns during recessions or growth scares.

Our forecast that bonds will generate negative real returns over the coming decade will thus be a drag on aggregate portfolio performance. It will also increase the risk that bonds will not provide an offset, or at least not much when equities are declining. Indeed, there are increasing odds that rising yields (and hence negative bond returns) will trigger losses in equities periodically in the years to come. The macro backdrop will not be as adverse as in the 1970s/early-1980s, but simultaneous losses in both stocks and bonds would mark a dramatic change from the climate most investors are accustomed to, as well as damage aggregate long-term returns.

Conclusion

The next decade promises to be difficult for fixed-income assets, with current negative real yields generating losses in real terms for most portfolios. Losses will be most severe in the first half of the next decade as bond yields gradually normalize. Credit/spread products will provide little buffer, despite outperforming similar-duration government bonds. Inflation-protected bonds will also suffer losses in real terms but are comparatively attractive as a hedge against upside inflation risks.

Global equity returns in the coming decade will be subpar by current standards, with dividends a significant portion of expected returns. Returns are restrained by the high starting point of both profitability and valuations. Investors should expect historically low real returns on multi-asset portfolios in the decade ahead. Bonds will be the main drag on portfolio returns, but equities, credit, and commodities are also projected to generate subpar real returns in the coming ten years. Nonetheless, investors should maintain a structural overweight on risk assets within a multi-asset portfolio because of the exceptionally poor outlook for fixed-income assets. Generating market-beating returns will likely require more deft tactical allocations shifts than in the past four decades.

Ultimately, portfolio returns hinge on the economic outlook and starting point for asset valuations, which bodes poorly for the next decade. Given an expected backdrop of solid but unspectacular economic growth, current elevated valuations, and rising interest rates, the next ten years herald a period of payback for the outsized gains of recent decades. Consequently, buy-and-hold strategies will likely prove less profitable than before and reward effective tactical asset allocation shifts based on cyclical economic and policy forces.

Investment Implications

- Multi-asset portfolios will deliver historically subpar returns in the coming decade.
- Conditions will favor active over passive management.
- Losses on government bonds are inevitable in the absence of a deflationary global economy; 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	**4-6%**
U.S.	4-6%
Non-U.s. Developed Markets	4-6%
Emerging Markets	5-7%
Bonds	**0-2%**
U.S. Government	-1-1%
U.S. Investment Grade	0-2%
U.S. High Yield	2-4%
Emerging Market Sovereign	3-5%
Cash	**1-3%**
Inflation	**2-4%**

About Crossmark Global Investments

Crossmark Global Investments is a faith-based firm that creates, manages, and distributes values-based investment strategies that equip financial intermediaries and their clients to align their wealth with their passions and convictions. For over 30 years, the firm has delivered uniquely constructed products based on its proprietary, disciplined, and repeatable process. Founded in 1987, the firm is headquartered in Houston, Texas.
For more information visit: www.crossmarkglobal.com.