Q&A: Five-year forecasted returns

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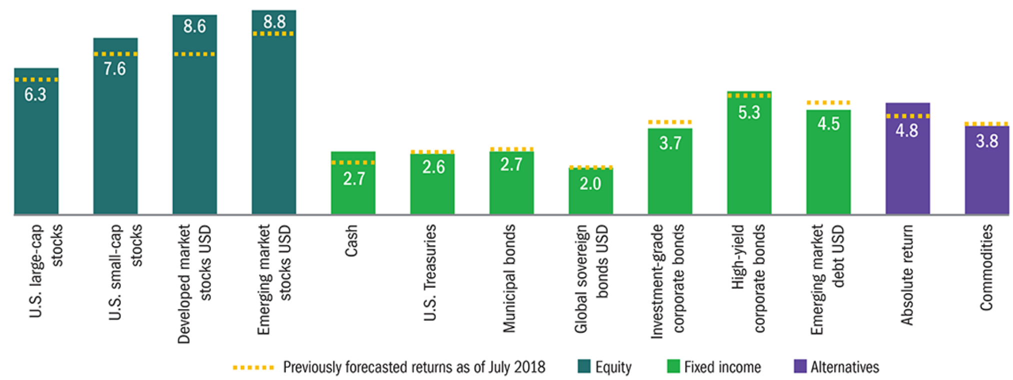
Growth is slowing. Valuations have improved. Cash is returning. Trade chatter is a risk. The key takeaways from our five-year forecast, explained.

Joshua Kutin
Head of Asset Allocation, North America

The most recent update to five-year forecasted returns from Anwiti Bahuguna and the Global Asset Allocation Team forecasts slightly more positive returns across asset classes than last time, but they're still lower than historical averages. Josh Kutin gets into the details below.



Source: Columbia Threadneedle Investments as of December 2018. Past performance does not guarantee future results.

Q: What do you expect for economic growth?

Josh: Every six months, we try to figure out what's going to happen over the course of the next five years. I say that casually, but when you look at forecasted returns, it's important to consider the time horizon. We would have different results if we were focused on what's going to happen tomorrow or a month from now. For this exercise, we focus on a five-year horizon and identify how different economic scenarios could play out. Our most likely scenario (50% likelihood) is that the economy will slow down and growth will return to trending levels. This isn't a dire scenario, but it's a little less profitable than we've seen in recent years. The next likely scenario (40%) is that chatter around trade and tariffs will derail growth. And the least likely scenario (10%) is that some of the business-friendly stimulus we saw last year continues longer than we expected. Overall, economic growth is slowing and the likelihood of the less-favorable economic scenarios has increased since the last time we did this exercise.

Q: Why are the forecasted returns low?

Josh: Ah, yes — that's one of the most common questions we get! Long-term equity forecasts typically result in at least double-digit returns, but we've had single-digit return expectations the last several times we've done this exercise. The answer stems from growth expectations; over a five-year horizon, the consensus is that we'll have some sort of negative economic event, which is keeping the forecasted returns to single digits. They are still positive, but less than historical averages. For advisors and investors, considering single-digit returns may help set expectations for what a portfolio may return over the next five years.

Q: Forecasted equity returns have increased since six months ago, despite lower economic growth. How is that possible?

Josh: It's the result of improving valuations. The scenarios we just reviewed revolve around growth expectations, but there are additional inputs. One of them is valuation. Despite everything that's going on in the world, equity valuations (or the price you pay for the potential risk/reward of equities) have improved. The high volatility at the end of 2018 helped bring valuations down since our last forecast. And as a result, our forecasted equity returns increased a little bit.

Q: International equity has a higher forecasted return than the U.S. Why?

Josh: If you look at long-term asset class results, it's common for international asset classes to outperform. Everyone generally agrees that international equities (emerging markets in particular) have more volatility, which is consistent with a higher return. That's why it's quite common to see higher forecasted returns for international asset classes. Beyond that, valuations in international markets have improved, which introduces additional opportunities.

Q: How should I interpret the return on cash?

Josh: There's a lot of discussion and uncertainty surrounding fixed-income markets, but this is one area where there's consensus. A lot of people agree that it's reasonable to expect over a 2% return from cash going forward (and possibly higher). Over the last decade, cash was returning closer to 0%, so it wasn't really an option as a yield-producing asset class. It is now. This makes for a very different portfolio construction exercise, particularly when there are single-digit expectations for some equities. Cash is now a competitor for other asset classes. It's more relevant than it's been for a while, and we're considering that as we build multi-asset portfolios.

Equity forecasts are based on three components: expected dividend payments, expected earnings growth and change in valuation levels (price-to-earnings ratios). Expected earnings growth is driven by expected economic growth, input cost changes and pricing power. Fixed-income forecasts are based on the shape of the yield curve, direction of interest rates, increase/decrease in yield spreads and timing of those changes. The major asset classes are based on the following indices: U.S. large-cap stocks (S&P 500 Index), U.S. small-cap stocks (Russell 2000 Index), Developed market stocks USD (MSCI EAFE Index), Emerging market stocks USD (MSCI EM Index), Cash (Citigroup U.S. Domestic 3-Month T-Bill Index), U.S. Treasuries (Bloomberg Barclays U.S. Treasury Index), Municipal Bonds (Bloomberg Barclays Municipal Bond Index), Global sovereign bonds USD (Bloomberg Barclays Global Treasury Index (excl. U.S.), Investment-grade corporate bonds (Bloomberg Barclays U.S. Aggregate Credit Index), High-yield corporate bonds (Bloomberg Barclays Corporate High Yield Index), Emerging market debt USD (JPMorgan EMBI Global Diversified Index), Absolute return (Citigroup U.S. Domestic 3-Month T-Bill Index, Commodities (Bloomberg Commodity Index).

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