

Q&A: Five-year forecasted asset class returns

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Downside risks to growth have increased, and trade policy risks have intensified. Here are the key takeaways from our five-year outlook.

The [most recent update to five-year forecasted returns](#) from the Global Asset Allocation Team forecasts lower returns across asset classes. Anwiti Bahuguna explains how the team developed its forecast and makes the case for staying invested.

Forecasted five-year total average returns (%)



Source: Columbia Threadneedle Investments as of July 2019. Past performance does not guarantee future results.

Q: What are the significant changes in the outlook since December 2018?

Anwiti: What most people may notice immediately is that the return forecasts are lower. Six months ago, the S&P 500 5-year forecasted return was 6.3%, and that's been cut to 5.9%. Returns are lower in fixed income as well. A significant driver of the fixed-income revisions was the change in the Fed's stance on rates — the pivot from hiking to a much more accommodative view. Expectations for yields have come down and returns are lower.

Q: How do you develop these forecasts?

Anwiti: Our five-year outlook is based on expectations for future earnings growth, and these expectations have come down to be in line with overall economic growth and inflation data. To develop our forecasts of expected return, we build three scenarios. Our baseline outlook is that we continue to see economic growth — perhaps a bit slower than we've seen recently as the boost provided by 2018 fiscal policy changes fades — but still in the range of 2%. With inflation expected at a similar rate, we see a nominal growth rate of 4%. Add to that the contribution of dividends, and we see stock returns of, essentially, 6%.



Anwiti Bahuguna, Ph.D.
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Q: What are some of the key risks that have developed over the last six months?

Anwiti: The great risk to our baseline case is the trade war. At the beginning of the year, the outlook on trade was a bit more sanguine — there was an expectation that trade talks would yield an agreement. In May, talks faltered, and now it looks like a resolution will probably be delayed. If the trade war continues, the likely immediate effect would be higher inflation. In the final analysis, if there's a significant impact on growth — from a reduction in real purchasing power, reduced business capex and a stock market sell-off — the impact of these tariffs may be deflationary.

Q: Portions of the yield curve are inverted, which historically has been a precursor to a recession. Given the long-term nature of these forecasts, can you speak to that possibility?

Anwiti: The risks of a recession are elevated, but there are some positive data points to consider alongside the slowing growth and inflation numbers and the yield curve. The Federal Reserve Board is paying close attention to the economic data and has stated its commitment to supporting the economy. The Fed has made it clear that, for the foreseeable future, monetary policy will be accommodative, and this is ahead of any data actually indicating a recession. If this is true and the trade war doesn't escalate, it's tough to make the case that a recession will occur. Yield curves are imperfect predictors, and they can also steepen. This hasn't happened yet, but the Fed has not implemented any cuts yet either. It's not out of the realm of possibility that we see a recession in the next three to five years, but we would not make the case for one in the next 12 months given the data and the Fed's prudent stance on monetary policy.

Q: What is the key takeaway from an asset allocation perspective?

Anwiti: Stay diversified! Don't let the recent data drive harmful long-term decisions. If you look at year-to-date returns across asset classes, they are very strong. Equity has been strong in the U.S. and internationally. Bond returns, especially in high yield, have also been very strong. For asset allocators, the forecast argues for staying invested while being mindful of the tactical changes that may need to happen.

Diversification does not assure a profit or protect against loss. Investing involves risk including the loss of principal.

The S&P 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks.

Past performance is not a guarantee of future results.

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 (FTSE 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 (FTSE U.S. Domestic 3-Month T-Bill Index, Commodities (Bloomberg Commodity Index).



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