Muted Return Expectations – Reactionary or Rooted in Fact? November 2017

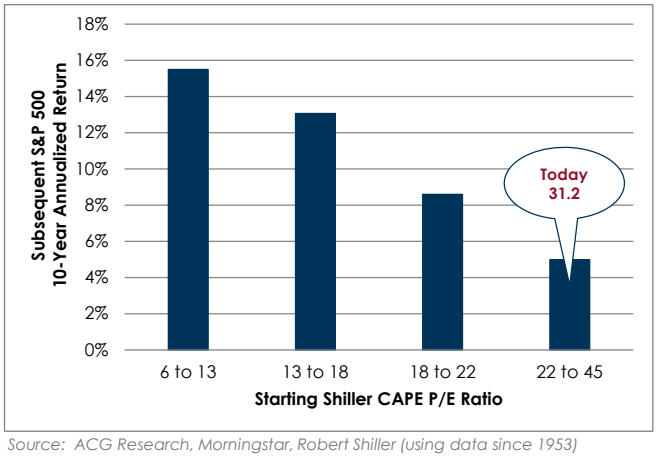
BACKGROUND

- **Many global economies are experiencing low, steady growth with surprisingly low inflation**
- **Developed market equities have appreciated more than 30% over the past two years**
- **Corporate bond spreads are grinding tighter, even as Treasury yields are maintaining their relatively low levels**

World Economic Outlook – The developed markets are still in recovery mode from the financial crisis of 2008/2009. In the US, growth has been at a steady gradual pace, with moderation in all meaningful economic metrics. Only over the past year have short-term interest rates begun to rise, flattening the yield curve and indicating a lack of optimism in long-term growth. Inflation across the globe has been held in check, with unemployment gradually declining without a corresponding increase in wages. Central banks are keeping a close eye on inflation, with the US, Eurozone and UK likely to move from a pattern of "easing" to one of "tightening", in one way or the other.

The Growth Outlook – In the seven decades from the '30s through the '90s, the average annual increase in real US GDP was 3.7%. Since 2000, it has averaged 2.0% with the last seven years averaging 2.1%. Looking ahead, the US economy is expected to grow in the low 2% range for the foreseeable future, roughly 150 bps less than the long-term average. Worldwide, developed countries are also expected to be below historical averages in the low 2% range. Emerging markets have higher expected growth rates, but still on the low side at 4.6%.

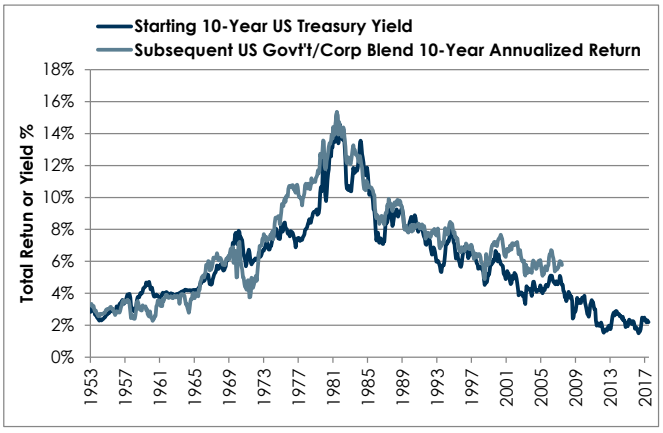
Key Return Factors – Three basic components combine to produce **Equity** returns: Dividend Yield, Earnings Growth and Price-to-Earnings Ratio. With dividend yields hovering in the low 2% range for US stocks and Price-to-Earnings (P/E) Ratios at relatively high levels, the opportunity for future returns is increasingly tied to earnings growth. Countering any growth, though, is the likelihood that P/Es will revert to a level closer to long-term averages.



Source: ACG Research, Morningstar, Robert Shiller (using data since 1953)

In **Real Assets** such as Core real estate, Cap Rates have gradually declined from roughly 6.5% to 4.5% over the past six years, leading to relatively low current levels. With this indicating limited value, consensus expectations are now calling for a slow decline in total return through 2019, with a return in the low 5% range through 2021.

For **Fixed Income**, yield is the overwhelming driver of return. As of September 30, Treasury yields and corporate spreads continue to be relatively low, with the 10-year Treasury at 2.33% and the BBB-rated cohort of corporate bonds yielding just 3.49%. The combination of these two factors implies returns for fixed income instruments are likely to stay in the 2-3% range for the foreseeable future.



Source: ACG Research, Morningstar, FRED (St. Louis Fed)

Upside Surprise Potential – Equities around the globe have been on a slow, but steady path upward for most of the past eight years. The potential for excess returns going forward lies in the growth area. If real growth rates move over 4% and inflation moves above 2%, we may see equity returns more in line with long-term averages. Fixed income returns have a tougher road ahead, with the likelihood for upward movement in both rates and spreads being somewhat elevated. Existing holdings would face short-term valuation headwinds as yields rise.

ACG'S POSITION

Understanding the time horizon of the investment portfolio continues to be a critical factor in determining the appropriate strategic asset allocation. Differences between intermediate-term and long-term return expectations can be relatively large, resulting in the need to assess future performance in the context of smaller embedded risk premia. Taking on additional risk in order to meet a target return may be appropriate in some cases. For the majority of investors, however, maintaining their risk posture may be most prudent, while waiting for growth and higher rates to return.