BLOG POST
A Dismal Forecast?
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Given the run up in equity returns over the past decade, and current valuations relative to historical averages, we have to wonder how much gas is left in the tank to keep sending the major indexes to new highs. Can future earnings support current equity market valuations? Likewise, can fixed income deliver positive real returns with the prospect of higher inflation?

It might not seem so in the short-run, but in the long-run, asset valuations must be linked to some fundamental metric, such as a company's earnings. Markets tend to become overheated occasionally, where investors might not be mindful of what they pay today for tomorrows earnings. As a consequence, markets tend to mean revert over time, swinging between periods of overvaluation to undervaluation.

If markets are indeed overvalued today, what might that mean for returns over the coming years? To tackle this question we've tapped into the research of GMO, a renowned investment advisory firm that periodically publishes forward-looking assumptions about asset class returns over the next seven years (GMO's forecast is publicly available at www.gmo.com).

While the forecasts rely on numerous assumptions and inherent errors, they can be useful for forming asset allocation decisions. The GMO framework is to evaluate current valuations, assume a long-term inflation rate and estimate a forward-looking real return for a set of asset classes. Below are the results of GMO's most recent forecast:

Equity Market Forecasts:

Stocks	Annual Real Return Over 7 Years
U.S. Large Cap	-8.0%
U.S. Small Cap	-8.5%
International Large Cap	-2.8%
International Small Cap	-1.8%
Emerging Markets	-1.3%
Emerging Value	3.3%

Source: GMO

GMO's grim outlook doesn't paint a pretty picture. Deviations from long-term trends seem to drive much of the negative sentiment in their forecast. For example, the current S&P 500 P/E multiple of roughly 33x is well above the long-term median of 16x. A reversion just back to the median P/E would suggest a significant pullback for the broad equity market.

Furthermore, the market capitalization of the Wilshire 5000, which tracks publicly traded stocks in the U.S., is almost twice our country's GDP – an all-time high.

The takeaway from GMO's analysis is that the equity markets seem increasingly ripe for a correction, and not the type we experienced in 2020, but a longer lasting pullback. Indeed, one particularly bad year (or two) could lead to a negative annualized return over a seven-year horizon. We most recently experienced this after the sharp pullback during the financial crisis of 2008.

Fixed Income Forecasts:

Bonds	Annual Real Return Over 7 Years
U.S. Bonds	-3.1%
International Bonds Hedged	-4.5%
Emerging Debt	-1.4%
U.S. Inflation Linked Bonds	-3.1%
U.S. Cash	-1.0%

Source: GMO

As with the equity markets, GMO is forecasting negative real returns for fixed income as well. Given the current level of interest rates, keeping up with inflation could be problematic. Furthermore, if interest rates increase substantially, investors could incur capital losses along with an erosion of purchasing power.

Based on GMO's estimates, cash will not suffice as a shorter-term hedge on a real return basis (i.e., cash will lose purchasing power as its value won't keep up with inflation). Furthermore, inflation-linked bonds are exposed to duration risk that would offset any adjustments to their coupons.

Of course, as we have seen in the past, GMO's forecasts could be considerably off the mark. Using historical data to support a view of over or undervaluation could downplay the role central banks have taken after the financial crisis to provide market liquidity. Central bank intervention in the markets is a dynamic without much in the way of precedent.

Furthermore, with low to negative interest rates around the world, there is little incentive for investors to rotate en masse out of equities into bonds as they have done in the past. This suggests that equity valuations could stay above trend longer than expected.

There are ways to navigate market uncertainty, such as adopting a strategy that seeks to mitigate the impact of sharp drawdowns that could lead to extended losses in your portfolio. A tactical strategy that allocates across various segments of the market could add value relative to the broader benchmarks.

These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forward looking statements. U.S. inflation is assumed to mean revert to long-term inflation of 2.2% over 15 years.