2023 Capital Markets Assumptions and Asset Class Portfolios Update

The main theme that emerges from our updated 2023 CMA values is that the expected returns for equity and fixed income asset classes are broadly higher (see Table 1). The main impetus for these changes is the higher-than-expected realized inflation over the last year and a half and Fed's subsequent response to this fact. In particular, the Fed has responded aggressively to the observed inflation and raised the Fed Funds rate – the interest rate that serves as the basis for all the other yields in the economy – to a level not seen since 2008.[1] To wit, the Fed has increased the Fed Funds rate by about 450 basis points in eight subsequent tightening cycles, and, according to the information imputed in the Fed Funds Futures,[2] is set to raise the rate by about 75 bps higher, before it's all said and done.

In what follows we discuss the impact of Fed's actions on our forecasts of expected returns for equity and fixed income asset classes.

Table 1

Asset Class		10-year					
		2023		2022		Difference	
		Expected Returns	Standard Deviations	Expected Returns	Standard Deviations	Expected Returns	Standard Deviations
All Cap	Russell 3000 TR USD	6.85%	15.61%	5.83%	15.39%	1.01%	0.21%
Global Equity	MSCI World NR USD	7.06%	15.10%	6.06%	14.88%	1.00%	0.22%
Large-Cap Core	Russell 1000 TR USD	6.83%	15.46%	5.81%	15.25%	1.02%	0.21%
Large-Cap Growth	Russell 1000 Growth TR USD	6.74%	17.04%	5.70%	16.70%	1.04%	0.34%
Large-Cap Value	Russell 1000 Value TR USD	6.91%	15.19%	5.93%	15.12%	0.98%	0.07%
Mid-Cap Core	Russell Mid Cap TR USD	7.07%	17.13%	6.13%	16.96%	0.94%	0.18%
Mid-Cap Growth	Russell Mid Cap Growth TR USD	7.01%	20.27%	6.07%	20.00%	0.93%	0.26%
Mid-Cap Value	Russell Mid Cap Value TR USD	7.10%	16.42%	6.16%	16.33%	0.93%	0.09%
Small-Cap Core	Russell 2000 TR USD	7.09%	19.96%	6.17%	19.73%	0.93%	0.23%
Small-Cap Growth	Russell 2000 Growth TR USD	6.97%	22.76%	6.00%	22.49%	0.97%	0.27%
Small-Cap Value	Russell 2000 Value TR USD	7.22%	18.21%	6.33%	18.03%	0.89%	0.18%
Int'l Developed Mkts	MSCI EAFE NR USD	7.61%	16.79%	6.68%	16.66%	0.93%	0.13%
Foreign Large Cap Core	MSCI EAFE Large NR USD	7.59%	16.89%	6.64%	16.77%	0.95%	0.12%
Foreign Large Cap Growth	MSCI EAFE Large Growth NR USD	7.46%	16.94%	6.39%	16.65%	1.07%	0.29%
Foreign Large Cap Value	MSCI EAFE Large Value NR USD	7.73%	17.71%	6.91%	17.69%	0.82%	0.02%
Foreign Small Mid Cap Core	MSCI EAFE Mid NR USD	7.67%	17.09%	6.80%	16.90%	0.87%	0.19%
Foreign Small Mid Cap Growth	MSCI EAFE Mid Growth NR USD	7.61%	17.88%	6.61%	17.57%	1.00%	0.31%
Foreign Small Mid Cap Value	MSCI EAFE Mid Value NR USD	7.73%	17.35%	7.00%	17.24%	0.73%	0.11%
Cash	Citi Treasury Bill 3 Mon USD	3.71%	0.60%	0.91%	0.60%	2.80%	0.00%
Intermediate Bond	Barclays US Govt/Credit Interm TR USD	4.05%	3.12%	2.10%	3.06%	1.94%	0.06%
Intermediate Muni	Barclays Municipal 7 Yr 6-8 TR USD	2.85%	3.49%	1.32%	3.46%	1.53%	0.03%
Long Bond	Barclays US Govt/Credit Long TR USD	4.32%	9.76%	2.43%	9.45%	1.89%	0.31%
Long Muni	Barclays Municipal TR USD	2.85%	3.99%	1.40%	3.93%	1.45%	0.06%
Short Bond	Barclays US Govt/Credit 1-3 Yr TR USD	3.80%	1.46%	1.59%	1.45%	2.21%	0.02%
Short Muni	Barclays Municipal 3 Yr 2-4 TR USD	2.80%	1.86%	1.30%	1.80%	1.50%	0.06%
Commodity	DJ UBS Commodity TR USD	4.90%	16.02%	3.41%	15.87%	1.50%	0.14%
High Yield	Barclays US Corporate High Yield TR USD	5.82%	7.92%	3.51%	7.80%	2.32%	0.12%
International Bond	Citi WGBI NonUSD USD	3.78%	7.70%	1.80%	8.03%	1.98%	-0.33%
Int'l Emerging Mkts	MSCI EM GR USD	8.69%	21.75%	7.89%	21.73%	0.80%	0.02%
REITs	FTSE NAREIT All Equity REITs TR	6.80%	17.03%	6.04%	16.81%	0.76%	0.22%
Inflation-Protected Bond	Barclays US Treasury US TIPS TR USD	3.68%	5.61%	2.01%	5.62%	1.67%	-0.01%
Balanced	60% Russell 1000/40% LB Govt/Credit Interm.	5.72%	9.59%	4.33%	9.42%	1.39%	0.16%
Bank Loan	S&P/LSTA Leveraged Loan TR	6.36%	6.30%	2.96%	6.23%	3.39%	0.07%
Emerging-Markets Bond	JPM EMBI Global TR USD	5.34%	9.32%	3.78%	9.25%	1.56%	0.08%
Alternative	HFRX Global Hedge Fund Index	5.95%	5.36%	4.41%	5.48%	1.54%	-0.11%
Equity Market Neutral	HFRX EH: Equity Market Neutral Index	2.45%	3.89%	0.57%	3.91%	1.88%	-0.03%
Event Driven	HFRX Event Driven USD	5.76%	5.92%	4.34%	5.96%	1.42%	-0.03%

1. The tightening episode that famously resulted in the Financial Crisis of 2008.
2. https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html and https://www.frbsf.org/economic-research/indicators-data/treasury-yield-premiums/.

Table 1 (continued)

Asset Class		10-year 2023 Expected Returns	2023 Standard Deviations	2022 Expected Returns	2022 Standard Deviations	Difference Expected Returns	Difference Standard Deviations
Hedged Equity	HFRX Equity Hedge Index	6.82%	7.28%	5.27%	7.43%	1.56%	-0.16%
Bear Market	HFRX EH: Short Bias Index	-5.88%	16.93%	-7.75%	17.87%	1.87%	-0.95%
Multi-Strategy	HFRI Fund of Funds Composite USD	5.62%	5.20%	4.08%	5.30%	1.54%	-0.11%
Alternative Fixed Income	category average: Nontraditional Bond	5.20%	3.24%	3.92%	3.09%	1.27%	0.15%
Managed Futures	Barclay CTA Index	5.54%	3.98%	3.49%	4.39%	2.05%	-0.40%
Long/Short Credit	HFRX Fixed Income-Credit TR USD	6.83%	5.06%	5.94%	5.16%	0.90%	-0.10%
Global Macro	HFRX Macro/CTA	6.06%	6.87%	4.18%	7.15%	1.88%	-0.28%
Private Equity	Russell 2000 TR	9.99%	14.49%	9.19%	14.42%	0.80%	0.07%
Private Credit	S&P/LSTA Leveraged Loan	6.34%	7.34%	6.13%	7.34%	0.20%	0.00%
Private Real Estate	FTSE NAREIT Equity REITs TR	8.26%	9.67%	5.03%	9.62%	3.23%	0.05%
Inverse	S&P 500 TR	N/A	24.59%	N/A	21.15%	N/A	3.43%
Leveraged	S&P 500 TR	N/A	31.34%	N/A	28.71%	N/A	2.63%
Structured - Minimal Market Sensitivity	S&P 500 TR	3.80%	1.46%	1.59%	1.45%	2.21%	0.02%
Structured - Low Market Sensitivity	S&P 500 TR	5.82%	7.92%	3.51%	7.80%	2.32%	0.12%
Structured - Medium Market Sensitivity	S&P 500 TR	5.72%	9.59%	4.33%	9.42%	1.39%	0.16%
Structured - High Market Sensitivity	S&P 500 TR	7.06%	15.10%	6.06%	14.88%	1.00%	0.22%
Inflation	NA	2.40%	N/A	2.40%	N/A	0.00%	N/A

Higher Equity Returns

The main difference driving the changes in our equity expected return forecasts between this year and last year is the starting point, i.e., the current equity prices. Compared to this time last year, the broad market has fallen by about 12 to 14 percent, which has direct impact on two key components in our expected return forecast: the starting dividend yield and the starting price multiple (see Table 2). The former is about 40 bps (1.54 vs 1.13 percent) higher this year than it was last year, and the latter is about 17 percent lower, which, according to our calculations, puts it almost at the equilibrium level.[3] Since, according to our estimates, the P/E levels are at the equilibrium level, compared to last year, the pricing multiple adjustment component has increased from -78 bps to just -8 bps (see Table 2). Our real earnings growth rate forecasts declined slightly, reflecting the wide-spread nervousness about the future trajectory of the economic activity. Finally, our expected inflation forecast is the same as last year and sits at 2.4 percent.[4]

In summary, the difference between our estimates in the dividend yield and pricing multiple adjustments components last year and this year comes to about 110 bps, which is approximately the difference in the equity expected return difference between this year and last year.

Table 2

	2023	2022
D/P	1.54%	1.13%
Real Earnings Growth Rate	1.80%	1.90%
P/E Adjustment Rate	-0.08%	-0.78%
Geometric Adjustment	1.18%	1.18%
Inflation	2.40%	2.40%
Nominal Arithmetic	6.85%	5.83%
Real Arithmetic	4.45%	3.43%
Nominal Geometric	5.66%	4.65%
Real geometric	3.26%	2.25%

3. We use realized P/E ratio for our pricing multiple analysis. To calculate our long-term equilibrium P/E level estimate, we assign a weight of 70 percent to the most recent observation and then a weight of 30 percent to the monthly average of realized P/E's since 1970. Our equilibrium P/E estimate errs on the side of assigning more relevance to more recent P/E levels in the equilibrium level calculations than more distant past.
4. Expected inflation is different from the realized inflation because the market (so far) expects the Fed to stay firm in its fight against inflation. The realized inflation will certainly turn into expected inflation, if the Fed ever capitulates in this fight.

Higher Fixed Income Returns

Let's start with stating that longer-term bond yields are averages of shorter-term yields over the lifetime of the longer-term bond (plus a bond risk premium or term premium).[5] Because of this, the rise of the Fed funds rate and the expectation of it staying elevated over the immediate future, will raise the yields on bonds of all maturities. However, the upward shift in the yield curve has not been parallel over the last year. In fact, due to the unequal rise in the yields across maturities, we have been living under the specter of the dreaded inverted yield curve for several months now. The market, through the inverted yield curve (and the Fed Funds futures), is signaling its collective belief that the Fed will start aggressively lowering the Fed Funds rate at around the end of year 2023.[6] Because the long-term rates are just averages of future short-term rates, market's expectation of significantly lower future short-term rates gets translated into lower current long-term rates (hence the inverted yield curve).[7]

The upshot of all of this is that our 10-year forecasts for fixed income securities is higher across the board, although it is more significantly higher at the shorter duration than longer duration for the reasons explained earlier (see Table 3).

Table 3

Bond Type	Constant Maturity (In Years)	2023		2022	
		10yr	20yr	10yr	20yr
Zero Coupon Bond	0.25	3.55	3.81	0.90	1.12
	0.5	3.61	3.86	1.07	1.28
	0.75	3.63	3.89	1.11	1.34
	1	3.58	3.84	1.20	1.43
Coupon Bond With Semiannual Coupon	2	3.52	3.84	1.58	1.80
	3	3.55	3.88	1.67	1.89
	4	3.54	3.85	1.76	1.99
	5	3.52	3.83	1.82	2.02
	6	3.58	3.85	1.86	2.09
	7	3.47	3.83	1.77	2.01
	8	3.61	3.90	1.76	1.98
	9	3.59	3.92	1.74	1.97
	10	3.31	3.89	1.73	2.02
	11	3.27	3.87	1.80	2.11
	12	3.28	3.86	1.88	2.19
	13	3.31	3.85	1.97	2.26
	14	3.37	3.84	2.05	2.32
	15	3.44	3.83	2.11	2.37
	16	3.53	3.83	2.16	2.39
	17	3.62	3.84	2.19	2.38
	18	3.70	3.85	2.17	2.34
	19	3.76	3.87	2.11	2.26
	20	3.79	3.91	1.99	2.15
	21	3.72	3.92	1.93	2.11
	22	3.64	3.92	1.88	2.08
	23	3.57	3.92	1.83	2.06
	24	3.49	3.92	1.79	2.04
	25	3.43	3.92	1.76	2.03

Description: Constant maturity Treasury bond portfolios at various maturities.

5. Bond Risk Premium (BRP)/term premium is a reward for risk differences, when comparing two Treasury bonds with different maturities. There can be an inherent risk from holding short-term bonds and rolling them over, say, a ten-year period (e.g., the risk of the real yield dropping in the future). More typically, however, there is more risk from holding a longer-term bond, compared to rolling over shorter-term bonds. This risk mostly comes from inflation uncertainty. BRP can be either positive or negative, although, as of late, this quantity has been positive: https://www.frbsf.org/economic-research/indicators-data/treasury-yield-premiums/.
6. Two distinct scenarios here are that the Fed "breaks the economy" (the more likely scenarios), or the Fed and the rest of us get lucky in that the inflation recedes due to Fed's aggressive monetary stance, but we don't have a recession.
7. There is, in fact, an alternative explanation for the current inverted yield curve, which posits that BRP is negative for longer-term bonds, compared to short-term bonds. This could, conceivably, be the case, but does not hold currently: https://www.frbsf.org/economic-research/indicators-data/treasury-yield-premiums/.

Disclosure:

Equity Tier Acronyms: LC: Large Cap; SC: Small Cap; V/G: Value, Growth; MC: Mid Cap.

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