RBC Global Asset Management

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Recalibrating return expectations for the road ahead

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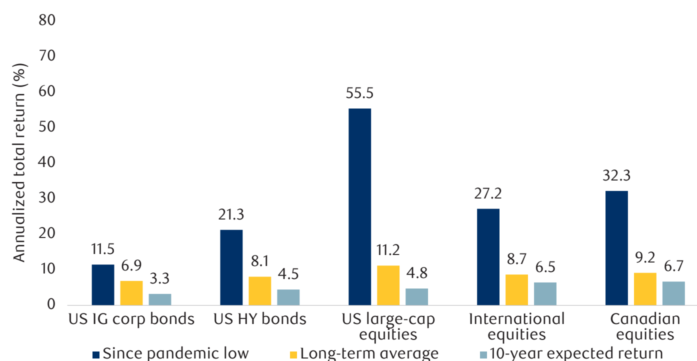
While markets are not far off their highs, they have become increasingly volatile as investors recognize the maturing recovery, the onset of less accommodative monetary policy and a variety of global macroeconomic risks. Nevertheless, our base case does not anticipate a recession within the next 12 months and we remain modestly overweight risk assets, although we have been adjusting our risk exposure down from peak levels over the last six months. Over the last two years, investors have been rewarded with extraordinary gains for holding onto their investments, but it is now important to pause and reset return expectations as the factors that contributed to these strong gains are unlikely to be repeated going forward. Understanding the forces that are pulling prospective returns lower can help investors navigate the road ahead.

The powerful market rebound since the March 2020 lows has been supported by massive fiscal programs and extremely accommodative monetary policy. The quick bounce back in economic activity following severe lockdowns and the fact that asset prices had fallen considerably from their pre-pandemic highs supercharged returns over the period. The rally has been broad-based across many asset classes, with returns that have significantly outpaced their long-term averages (Exhibit 1). However, these drivers of market strength have been fading in recent months and are unlikely to provide the same support going forward. As a result, we have been cautioning investors to temper their return expectations across all asset classes. It's that old adage – past returns are not indicative of future performance.

Exhibit 1: Strong returns relative to historical average – Risk asset total returns



Note: As of December 31, 2021. Returns are annualized. The ICE BofA US Corporate Index, ICE BofA US High Yield Index, S&P 500 Index, MSCI EAFE Index and S&P/TSX Composite Index were used to represent US IG corp bonds, US HY bonds, US large-cap equities, International equities and Canadian equities, respectively. Pandemic low from March 23, 2020 to December 31, 2021, 10-year expected returns are RBC GAM 10-year expected return forecasts. Long-term average returns are calculated from August 31, 1986 for US IG and HY bonds, December 31, 1970 for US large-cap equities, December 31, 1969 for international equities and January 31, 1956 for Canadian equities. Source: RBC GAM

Significant valuation risk in fixed income

While there are certainly many asset classes that we could discuss here, we will try to keep it broad. We begin with sovereign bonds as the yield on these securities can serve as a base upon which expected returns on riskier assets are built. Although yields have risen in recent quarters, they are still close to their lowest levels in the past 100 years (Exhibit 2). The forward 10-year return on a bond is well estimated by its yield-to-maturity at the date of purchase. Given current yield levels, we can expect an annualized return of just 1.8% on a 10-year U.S. Treasury Bond. It is also our expectation that yields will rise gradually over the coming years as the real interest rate, or after-inflation rate of interest, increases with the normalization of the economy and the withdrawal of stimulus. This will act as a further headwind to bond returns. For these reasons, our view is that sovereign bonds may generate low or even negative total returns over the next several years.

Corporate and high yield bond prices have seen strong appreciation since the early days of the pandemic. Credit spreads jumped in February/March 2020 as the market feared that many corporate borrowers would not be able to repay their debts. Thanks to enormous government outlays to both corporations and individuals, many borrowers were able to stay afloat and recover from the initial pandemic lockdowns. Credit spreads have since narrowed to levels that are below the long-term average and below the pre-pandemic lows (Exhibit 3). The combination of narrow spreads and the low absolute level of interest rates on sovereign bonds means that the yield to maturity is now just 2.4% for corporates and 4.9% for high yield bonds. Moreover, should credit spreads revert towards their historical average, the resulting increase in yield would further weaken returns for these asset classes.

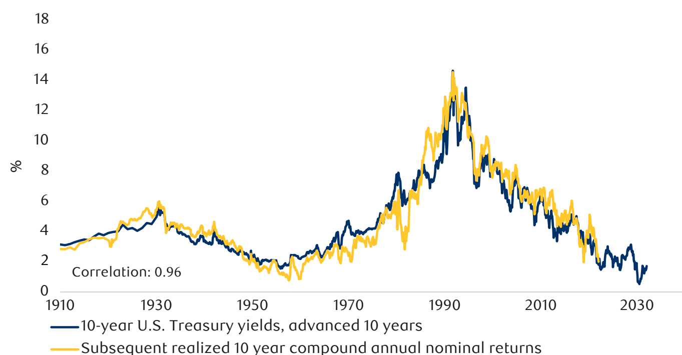
Fading tailwinds for equity markets

While stocks continue to offer superior return potential relative to fixed income, there are several factors that may limit the magnitude of future gains going forward. Most importantly, the tailwinds from low valuations and a rebound in earnings from depressed levels have moderated.

Elevated valuations could be a headwind

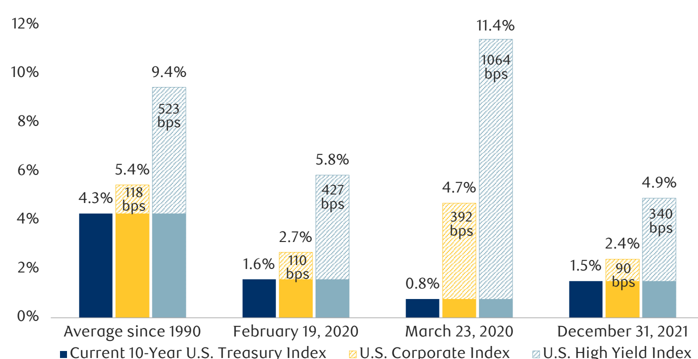
Attractive valuations (i.e. below our calculation of equilibrium) supported equity markets during the post-global financial crisis period, but valuations have now become a headwind for stocks given that our global stock market composite now trades above our estimate of fair value (Exhibit 4). Much of this overvaluation is concentrated in U.S. equities, but we also acknowledge that other markets are no longer as steeply discounted as they were at earlier points in the bull market. History indicates that future returns have been lower, on average, when starting from a point of above average valuations and vice versa for cheap markets.

Exhibit 2: U.S. 10-year Treasury note and returns



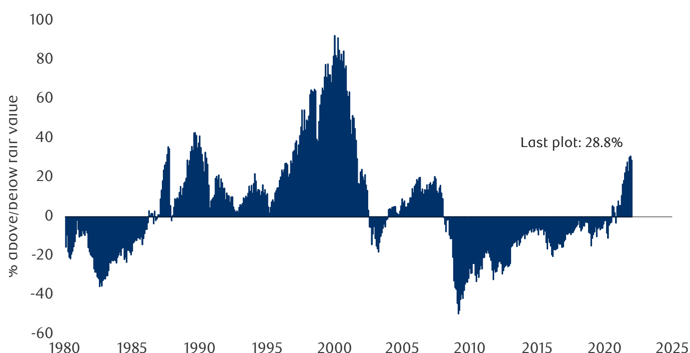
Note: As of January 14, 2022. Source: Deutsche Bank, Haver Analytics, RBC CM

Exhibit 3: Yield to maturity



Note: Current spread as of December 31, 2021. U.S. Corporate Index = ICE BofA US Corporate Index spread, U.S. High Yield Index = ICE BofA US High Yield Index spread. Shaded areas within the bars indicate the yield spread versus the U.S. 10-year Treasury bond yield. Source: ICE BofA, RBC GAM

Exhibit 4: Global stock market composite
Equity market indexes relative to equilibrium

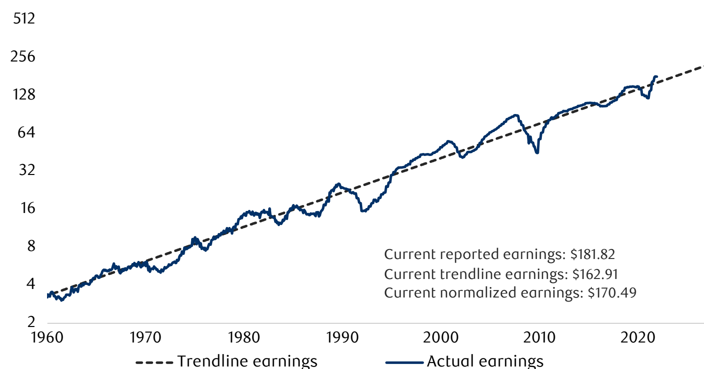


Note: As of December 31, 2021. Source: RBC GAM

Moderating earnings growth

Exceptional earnings growth has been instrumental in the strong rise in equity prices over the last two years, but it may not be able to provide the same lift going forward. Corporate profits have climbed at an astonishing rate since the pandemic recovery began and now sit above the historical trend (Exhibit 5). While strong economic growth could continue to support earnings, further growth from here will be more difficult to achieve with earnings already above their long-term trend.

Exhibit 5: S&P 500 earnings comparison



Note: As of December 31, 2021. Source: RBC GAM

Overall, we remain constructive on the outlook for equity markets, but recognize that future returns will likely be lower than the double-digit gains of recent past. Over the long-term, our forecast is for mid-single digits for the S&P 500, and somewhat higher returns (i.e. high single digits) for other regions that we follow.

Impact to investor portfolios

Combining our asset class views into a balanced portfolio illustrates the effect that lower expected returns may have on investors. Over the last year, a sample balanced portfolio (consisting of 60% equities, 38% bonds and 2% cash) has generated a return of 12.0%. If we look at the 10-year trailing return for that same portfolio, investors would have earned annualized returns of 8.1%. Looking forward, using our long-term forecasts, the expected annualized return over the next decade falls to a range of 4-5%. So in a world where yields are expected to rise from low levels and equity markets valuations are high relative to history, investors need to adjust their expectations to ensure that they can continue to meet their investment goals.

Preparing for the road ahead

Investors have enjoyed a period of strong returns and that may have led them to expect the same in the future. Although favourable conditions for above-average returns may persist a while longer, we believe factors such as low interest rates, tight credit spreads and elevated equity market valuations could lead to lower returns than we have seen since the pandemic started. While every individual has unique circumstances and different risk tolerances, it would be prudent for all to review their investment plans with this in mind so that they remain well positioned to achieve the desired results.

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