RBC Global Asset Management

JULY 2022

Revisiting our return expectations

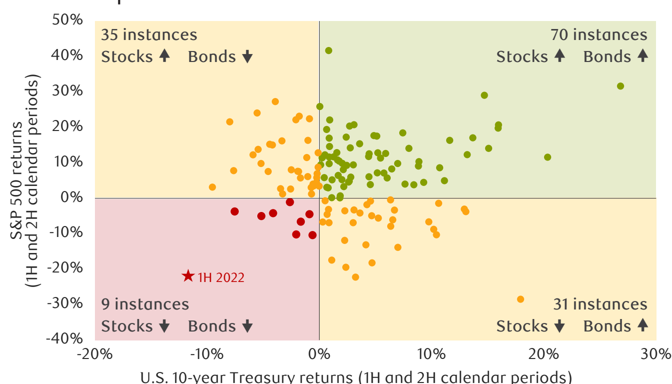
Sarah Riopelle, CFA
Vice President & Senior Portfolio Manager, Investment Solutions
RBC Global Asset Management Inc.

At the start of 2022, we published an article titled *Recalibrating return expectations for the road ahead* in which we cautioned investors to temper their long-term return expectations. At the time, factors such as low interest rates, tight credit spreads and elevated equity market valuations led us to adjust our long-term return forecasts lower as we looked ahead to the next decade. Fast forward six months and financial markets are in a very different place. Given the rapid changes to the investment landscape since the beginning of 2022, we felt it prudent to update our long-term return expectations.

Global financial markets have endured one of their worst starts to a year in decades. Significant economic and geopolitical turmoil and massive changes in interest rates, bond yields, credit spreads and equity valuations have led to corrections in equities and fixed income. While we expected that many of these metrics would normalize, we thought that process would happen gradually over many quarters or even years. Instead, a number of factors came together simultaneously to cause a very swift and significant reset in valuations across many asset classes.

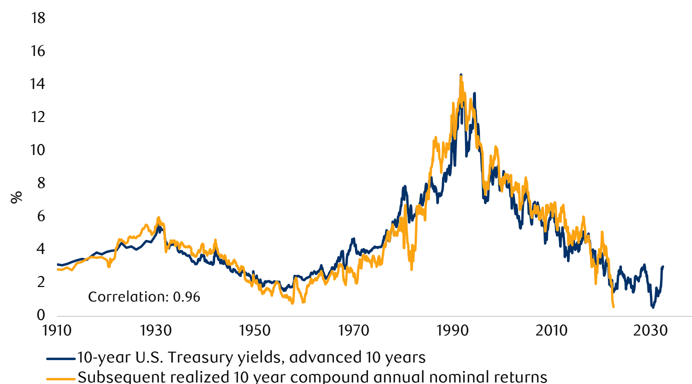
The biggest challenge for investors was how rapidly things changed and how quickly markets adjusted. Prior to the sell-off, valuations for both bonds and stocks were elevated, supported by significant central-bank asset purchases, rock-bottom interest rates and low inflation. These tailwinds quickly became headwinds as central banks acknowledged the need for tighter monetary conditions to combat problematically high inflation that was no longer deemed transitory. Central bank policy pivoted and an aggressive tightening cycle began, dramatically steepening the expected path for short-term interest rates. Valuations in both stocks and bonds experienced a swift and harsh reset, logging their worst six month return in decades. The year so far has been painful for investors, but it is worth noting that periods like this are rare. Since 1950, we have had just 9 instances where stocks and bonds were both down over a six-month period (Exhibit 1).

Exhibit 1: S&P 500 versus U.S. 10-year Treasury returns – First half (1H) and second half (2H) 6-month calendar periods



Note: as of June 30, 2022. Data since January 1950. Source: Robert J. Shiller, RBC CM, RBC GAM

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



Note: as of July 19, 2022. Source: Deutsche Bank, Haver Analytics, RBC CM, RBC GAM

Where do we go from here? The significant reset in asset prices over the last six months has greatly alleviated much of the valuation risk that we saw at the beginning of the year. As a result, we have seen a meaningful and broad-based improvement in our return expectations across many asset classes. While there are a variety of asset classes that we could discuss here, we will focus on the key ones that we invest in.

Historic sell-off in bonds has moved yields to more sustainable levels

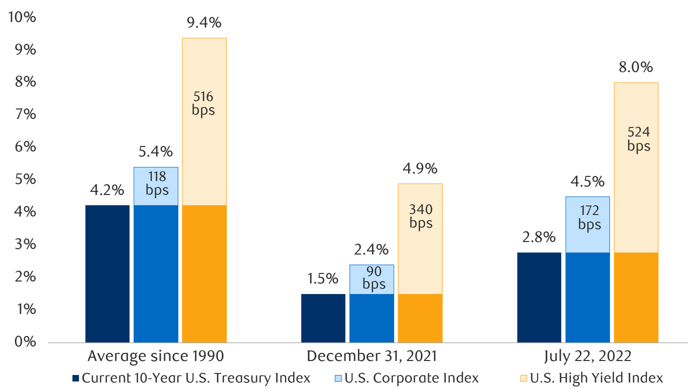
The rapid and significant re-alignment of interest-rate expectations over the past six months caused a fixed-income sell-off of historic proportions. Our expectation was that yields would rise, but gradually, as the real interest rate, or after-inflation rate of interest, increased with the normalization of the economy and the withdrawal of stimulus. While we may have been correct on the direction of yields, the timeframe over which this adjustment happened was compressed. As a result, we think that the worst of the sell-off in sovereign bonds could be behind us and our expectation for total returns from here is now much more constructive than it has been for quite some time.

A good way to forecast the long-term return on sovereign bonds is to simply use the current yield to maturity. Exhibit 2 plots the yield on the U.S. 10-year Treasury note alongside the subsequent realized 10-year compound returns. Notice that the two lines have tracked closely over time, and especially so during periods of low and stable rates. This relationship suggests that the current yield close to 3.0% is a reasonable expectation for the annualized return for 10-year Treasury bonds bought today and held over the next decade, representing a marked improvement over the 1.5% return that we had penciled in at the start of the year. Higher yields also mean that there is more opportunity for bonds to provide an offset to equity market volatility in a balanced portfolio. While there is still a risk of capital losses in the near-term if inflation remains problematically high, our models suggest that once inflation peaks and ultimately subsides the appropriate yield is around 3% for the U.S. 10-year T-Bond. As a result, we are now expecting low to mid-single digit returns on sovereign bonds over the decade ahead.

Spreads on corporate investment-grade fixed income and all types of high-yield bonds have also widened meaningfully since the start of the year and are now much closer to their long-term averages. At the beginning of this year, the combination of narrow spreads and the low absolute level of interest rates on sovereign bonds meant that the yield to maturity was just 2.4% on investment grade debt and

4.9% on high yield bonds (Exhibit 3). With the adjustment so far this year, those numbers have risen to 4.5% and 8.0%, respectively. So, much like government bonds, the starting point of higher yields and wider spreads has improved the forward looking return estimates. There is a growing risk that the economy falls into recession, weakening credit quality and driving yields on all grades of corporate bonds higher, but our longer-term expected return forecasts have already improved considerably.

Exhibit 3: Yield to maturity



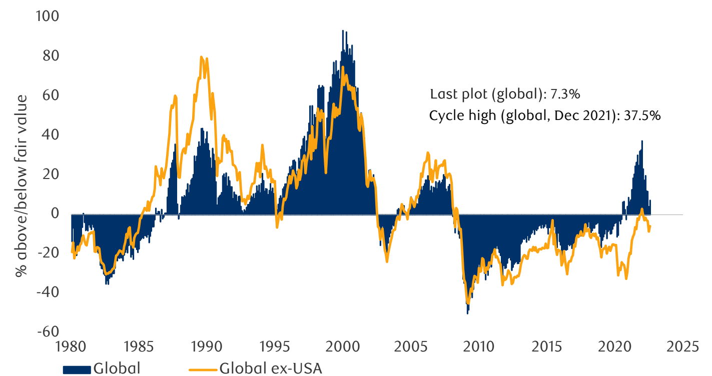
Note: current spread as of July 22, 2022. Shaded areas within the bars indicate the yield spread versus the U.S. 10-year Treasury bond yield. Source: ICE BofA, RBC GAM

Valuation risk moderates in equities

Fear of inflation, a shift to aggressive monetary tightening and the increased risk of recession sent most equity indices into bear market territory in the first half of the year. Especially painful declines in the more expensive areas of the market such as growth and technology stocks pushed our composite of global equity valuations back towards the neutral level from its prior overvaluation (Exhibit 4). This GDP-weighted composite suggests that valuations are now only 10% above fair value, down from 35% at the end of 2021. As a whole, equities are now much more reasonably valued, though they are certainly not cheap, at least not in aggregate. Digging into the various markets that make up this composite, we still observe a significant discrepancy between regions. The U.S. remains toward the more expensive end of the spectrum, while equity markets outside North America are more fairly valued or even becoming particularly attractive in areas like emerging markets.

Exhibit 4: Global stock market composite

Equity market indexes relative to equilibrium

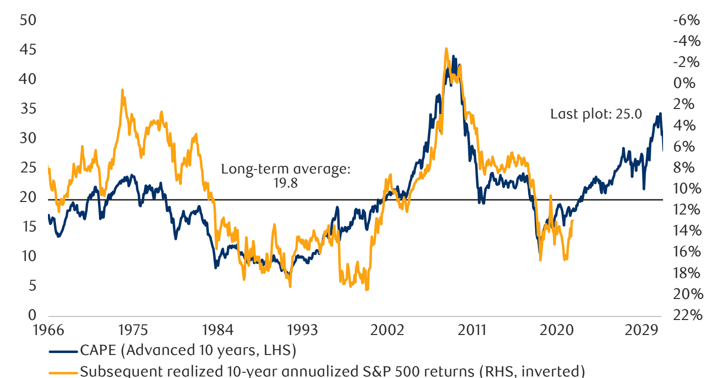


Note: as of July 25, 2022. Source: RBC GAM

Much like bonds, the recent sell-off in equities has also boosted their return potential over the longer term. Exhibit 5 plots Shiller's Cyclically Adjusted P/E (CAPE) along with the actual realized returns for the S&P 500 (which are reversed on the chart). This charts shows that there is a fairly strong link between these two metrics as stocks tend to deliver stronger forward returns when starting from cheaper levels and weaker returns when starting from more expensive levels. Based on this relationship, so far this year the return potential has increased from 3% to 6%, still relatively modest but certainly better than it was. Turning to our own long-term return expectations for stocks, we are now looking for

Exhibit 5: Shiller's CAPE

Real S&P 500 Index / 10-year average of real EPS



Note: as of Jul 25, 2022. Source: Macrobond, Bloomberg, RBC GAM

mid-single digit returns for U.S. equities and higher returns for regions outside of the U.S. where valuations are relatively attractive.

While the long-term return potential has improved for stocks, we must again highlight that near-term challenges still exist given the rising risk of recession and uncertainty around the outlook for corporate profits. In a recessionary scenario, stocks could experience more weakness over the near term. When taken in the context of a longer-term view, however, sell-offs tend to lower valuations, creating the conditions for improved return-potential assuming that economies and markets eventually recover as they have in the past.

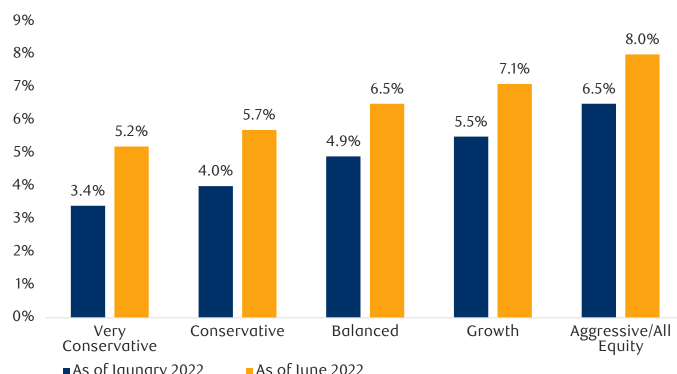
Impact to investor portfolios

What does all of this mean for a long-term balanced investor? Using the neutral weights in our various investor risk profiles, we can combine our long-term return expectations for the various asset classes and develop a view for a diversified investment portfolio. We wanted to see how the expectations for these multi-asset portfolios have evolved over the last 6 months as markets have corrected and go-forward expected returns have improved. For a balanced investor, we were looking at a return of about 4.9% over the next decade. Given the lower starting point for both stocks and bonds, the expected annualized return over the next decade has improved to 6.5%. And it is worth highlighting the improvement in the return expectations for our more conservative profiles as those clients have had a particularly difficult time over the last six months (Exhibit 6). So, in a world where bond yields are at much more reasonable levels and equity market valuations have moderated, the return outlook for a long-term balanced investor has improved significantly since January, though they remain below their long-run average (Exhibit 7).

The path forward

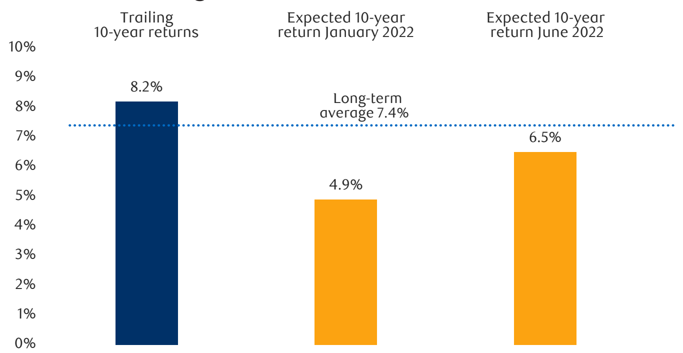
Financial markets have experienced a significant pullback with many asset classes posting double-digit losses so far this year. While this has certainly been a painful period for investors and we don't want to minimize the impact that it has had, the silver lining is that it has corrected some of the valuation excesses in the market and improved our long-term return expectations. So, we are again asking you to recalibrate your return expectations for the road ahead – only this time the news might be good!

Exhibit 6: 10-year annualized expected returns by profile



Note: as of June 30, 2022. Returns are annualized. Very Conservative = 2% Cash, 73% Fixed Income, 10% Canadian equities, 8% U.S. equities, 3.5% European equities, 1.6% Asian ex-Japan equities, 1.9% Japanese equities. Conservative = 2% Cash, 58% Fixed Income, 13% Canadian equities, 15% U.S. equities, 6% European equities, 2.75% Asian ex-Japan equities, 3.25% Japanese equities. Balanced = 2% Cash, 38% Fixed Income, 15% Canadian equities, 25% U.S. equities, 7.5% European equities, 3.5% Asian ex-Japan equities, 4% Japanese equities, 5% Emerging Market equities. Growth = 2% Cash, 23% Fixed Income, 18% Canadian equities, 30% U.S. equities, 9.5% European equities, 4.4% Asian ex-Japan equities, 5% Japanese equities, 8% Emerging Market equities. Aggressive Growth/All-Equity = 2% Cash, 29% Canadian equities, 38% U.S. equities, 10% European equities, 4.6% Asian ex-Japan equities, 5.4% Japanese equities, 11% Emerging Market equities. Cash = FTSE Canada 30 Day TBill Index, Fixed Income = FTSE Canada Universe Bond Index, Canadian equities = S&P/TSX Capped Composite Total Return Index, U.S. equities = S&P 500 Total Return Index (CAD), European equities = MSCI Europe Total Return Net Index (CAD), Asia Pacific ex-Japan equities = MSCI AC Asia Pacific ex Japan Total Return Net Index (CAD), Japanese equities = MSCI Japan Total Return Net Index (CAD), Emerging Market equities = MSCI Emerging Markets Total Return Net Index (CAD). 10-year expected returns are RBC GAM 10-year expected return forecasts. The above does not reflect transaction costs, investment management fees or taxes. Past performance is not a guarantee of future results. Source: RBC GAM

Exhibit 7: Return expectations for a Balanced Portfolio – Expected 10-year returns relative to historical averages



Note: as of June 30, 2022. Returns are annualized.10-year expected returns are RBC GAM 10-year expected return forecasts for a Balanced portfolio. The above does not reflect transaction costs, investment management fees or taxes. Past performance is not a guarantee of future results. Source: RBC GAM

Disclosure

Please consult your advisor and read the prospectus or Fund Facts document before investing. There may be commissions, trailing commissions, management fees and expenses associated with mutual fund investments. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. RBC Funds, BlueBay Funds and PH&N Funds are offered by RBC Global Asset Management Inc. and distributed through authorized dealers in Canada.

This has been provided by RBC Global Asset Management Inc. (RBC GAM) and is for informational purposes, as of the date noted only. It is not intended to provide legal, accounting, tax, investment, financial or other advice and such information should not be relied upon for providing such advice. RBC GAM takes reasonable steps to provide up-to-date, accurate and reliable information, and believes the information to be so when provided. Past performance is no guarantee of future results. Interest rates, market conditions, tax rulings and other investment factors are subject to rapid change which may materially impact analysis that is included in this document. You should consult with your advisor before taking any action based upon the information contained in this document.

Information obtained from third parties is believed to be reliable but RBC GAM and its affiliates assume no responsibility for any errors or omissions or for any loss or damage suffered. RBC GAM reserves the right at any time and without notice to change, amend or cease publication of the information.

This document may contain forward-looking statements about a fund or general economic factors which are not guarantees of future performance. Forward-looking statements involve inherent risk and uncertainties, so it is possible that predictions, forecasts, projections and other forward-looking statements will not be achieved. We caution you not to place undue reliance on these statements as a number of important factors could cause actual events or results to differ materially from those expressed or implied in any forward-looking statement. All opinions in forward-looking statements are subject to change without notice and are provided in good faith but without legal responsibility.

® / ™ Trademark(s) of Royal Bank of Canada. Used under licence.
© RBC Global Asset Management Inc. 2022

Publication date: July 28, 2022