Schwab's 2023 Long-Term Capital Market Expectations

January 4, 2023 [Eva A. Xu](https://www.schwab.com/learn/author/eva-xu)[Seth McMoore](https://www.schwab.com/learn/author/seth-mcmoore)

Our current 10-year outlook highlights better opportunities for bonds and a steady outlook for stocks. We continue to project better return opportunities for international stocks.



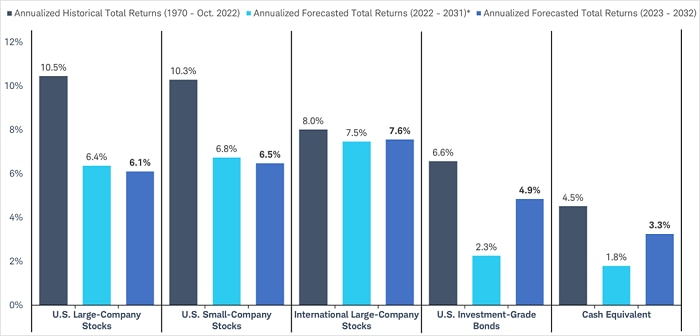
To reach long-term financial goals, investors should have reasonable expectations for long-term market returns. Having overly optimistic expectations could lead investors to save too little, on the belief that their investments will grow fast enough to fund retirement or a child's college education. On the other hand, overly pessimistic expectations may cause an investor to save too much, at the expense of current spending and enjoyment.

To provide a guide for investors, our analysts at Charles Schwab Investment Advisory, Inc. annually update their long-term Capital Market Expectations (CMEs) to accommodate the ever-changing market environment and to provide investors with the most up-to-date projections. Schwab's long-term CMEs are quantitative forecasts that provide reasonable expectations for risks and returns over the next 10 years. These forecasts can play an essential role in a variety of decisions, such as determining optimal portfolio allocations and creating realistic retirement plans.

**Our latest estimates are constructed using data as of October 31, 2022.** These estimates, summarized in the chart below, cover the period from 2023 through 2032.

Over the next decade, we continue to expect market returns to fall short of long-term historical averages. Compared to last year's expectations, our outlook highlights better opportunities for bonds, driven primarily by higher starting yields. While expected stock returns were helped by more attractive starting valuations (i.e., lower market prices due to stock market declines during 2022), they were also hurt by company-level and macroeconomic headwinds, leading to slower-than-expected earnings growth. The net result may be a similar return outlook for stocks. As such, Schwab continues to project better return opportunities for international stocks over the next 10 years, relative to domestic stocks. Given recent market changes, now may be a good time for investors to review their long-term financial goals to ensure that they are based on projections grounded in disciplined methodology.

Historical and projected returns



Source: Charles Schwab Investment Advisory, Inc. Historical data from Morningstar Direct. All data as of 10/31/2022.

\* Estimates published for 2022. Total return = price growth + dividend and interest income. The example does not reflect the effects of taxes or fees. Numbers rounded to the nearest one-tenth of a percentage point. Benchmark indexes: S&P 500® Total Return Index (U.S. Large-Company Stocks), Russell 2000® Total Return Index (U.S. Small-Company Stocks), MSCI EAFE Net Return Index® (International Large-Company Stocks), Bloomberg Barclays U.S. Aggregate Bond Total Return Index (U.S. Investment-Grade Bonds), and FTSE 3-Month U.S. Treasury Bill Index (Cash Equivalent). Note: U.S. Investment-Grade Bond return calculation starts in 1/30/1976 due to lack of prior data. **Past performance is no guarantee of future results.**

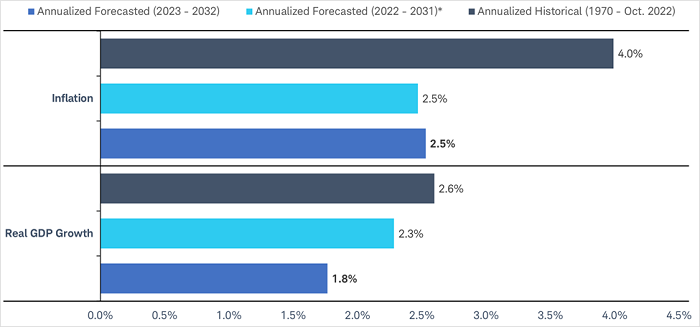
The past year proved to be challenging for investors as financial markets around the world, and across all major asset classes, suffered steep losses. The simultaneous decline of both stock and bond markets, a trend not frequently seen in the markets, was the result of myriad factors including rising interest rates, high inflation, slowing economic growth, and heightened geopolitical tensions. The volatility and asset repricing that occurred over this past year has led to some notable changes in our forecasts for 2023.

***Macroeconomy*.** Inflation has been much higher and more persistent than many investors anticipated. Some factors fueling this are a decade of easy monetary policy, unexpected supply-chain disruptions, and tight labor markets. With the goal of lowering inflation, central banks, led by the Federal Reserve, have aggressively tightened monetary policy at the fastest pace in decades. A consequence of these interventions is an expectation of slower economic growth in the near term. When constructing our forecasts for inflation and real gross domestic product (GDP) growth over the next decade, we use a survey-based approach, which accounts for the entire 10-year path. This incorporates near-term effects of elevated inflation and dampened GDP prospects in our long-term estimate. Despite these disruptions in the short term, we expect inflation and GDP to return to a steady state. As such, inflation expectations remain similar to last year at 2.5% per year over the coming decade, while average annualized GDP growth expectations have come down from 2.3% to 1.8%.

***Bonds*.**Bond yields surged in 2022 as central banks were forced to reassess their monetary policy, becoming more hawkish in response to high inflation. While bond investors incurred steep losses in 2022 due to asset repricing in response to rising interest rates, the resulting higher starting yields have doubled most of our bond expectations. For example, U.S. investment-grade bonds are expected to return 4.9% annually over the next decade, compared to our forecast last year of 2.3%. Similar to bonds, cash-equivalent investments such as Treasury bills also have benefited from these higher starting yields. A potential benefit of the shifting landscape is that real return forecasts (i.e., returns after removing the effect of inflation) are now positive for most bonds, providing a more attractive source of income.

***Stocks*.**Stocks slumped worldwide during 2022, with the S&P 500® index down almost 20% by year end. Typically, a steep market decline would mean higher expected returns due to a lower and more attractive starting valuation. However, a lower market price isn't the only factor currently at play in the markets. Equity valuations are also driven by expected cash flows (i.e., earnings and dividends). Abrupt policy changes from central banks, going from supporting nominal growth at all costs to focusing on reining in inflation, have slowed economic growth expectations. The impact of all this feeds into our valuation model, suggesting that any potential attractiveness due to lower stock prices is offset by a more tepid earnings growth outlook. Note that while absolute return expectations remain similar to last year, the components that make up those returns have changed drastically. For example, expected equity risk premium, which indicates when stocks are expensive or cheap relative to a "risk-free" investment (such as a Treasury security), has steeply declined. This means that while stocks still tend to have higher expected returns than bonds, the spread has tightened greatly.

Historical and projected inflation and real GDP growth



Source: Charles Schwab Investment Advisory, Inc.

Historical inflation data from U.S. Bureau of Labor Statistics. Historical real GDP data from U.S. Bureau of Economic Analysis. Forecasted data from Consensus Economics. All data as of 10/31/2022.

\* Estimates published for 2022. Numbers rounded to the nearest one-tenth of a percentage point. Annualized historical inflation based on monthly Consumer Price Index for All Urban Consumers. Annualized historical real GDP growth based on annual real Gross Domestic Product (Not Seasonally Adjusted). Note, real Gross Domestic Product (Not Seasonally Adjusted) for 2022 calculated using quarterly data through Q3 2022 (Second Estimate). **Past performance is no guarantee of future results.**

How do you calculate your long-term forecasts?

Schwab's long-term forecasts are constructed using a building-block approach, where return expectations are broken down into unique components. Each component is constructed using a quantitative and systematic approach, allowing for consistent forecasts across asset classes. To capture the broad movements of the market, we leverage reliable predictors such as equity valuations and bond yields when constructing the core return drivers of our framework. When possible, we use a forward-looking approach to forecasting returns, rather than basing our estimates solely on historical averages.

For **inflation** **and** **GDP** growth, we use a survey-based approach based on economist expectations. We find this approach beneficial for three reasons: (1) professional forecasters incorporate new, relevant information into their updated expectations; (2) these expectations tend to be consistent with prevailing views about economic policy; and (3) they provide a relatively stable forecast, which is a desirable feature for retirement planning and asset allocation models.

For **U.S. and international large-cap stocks**, we start with the belief that stock markets are a discounting mechanism, meaning the current price attempts to take into consideration all available information about present and future events. As such, we use a valuation-based model that discounts the future cash flows an investor is expected to receive to the current price of a stock. The effectiveness of this approach rests with the inputs that are used. We use forward-looking earnings estimates and macroeconomic forecast data to estimate two key cash-flow drivers: (1) recurring income (i.e., earnings) and (2) capital gains generated by selling the investment at the end of a predefined horizon, such as 10 years. To arrive at a return estimate, we answer the question: *What returns would investors make if they bought a stock at the current price and received these forecasted cash flows?*

For **U.S. small-cap stocks**, we leverage the valuation-based model used for large-company stocks as our base, then analyze and include a "size-risk premium." This is the return that investors in small-company stocks expect to earn over the returns on large-company stocks.

For **U.S. investment-grade bonds** (i.e., Treasuries, investment-grade corporate bonds, and securitized bonds), we believe the future level of return an investor will receive is anchored to a large extent by yields. For example, if an investor buys a 10-year Treasury note with a 3% yield-to-maturity and does not touch the investment until maturity, then the investor will realize a 3% return per year. Given this relationship, we consider the following components when forecasting bonds:

* ***Yield-to-maturity of a "risk-free" bond.*** Treasury notes are fixed-income securities issued by the U.S. government that generate what is considered a "risk-free" rate, because of the negligible chance of the U.S. government defaulting on its debt obligations. In determining a "risk-free" return, the U.S. Treasury does not provide yields for every maturity; therefore, we use a yield-curve-fitting model to account for the missing maturities. This fitted "risk-free" curve provides duration-matched yields for any fixed income asset class we need to model.
* ***Yield spread***. Riskier bonds typically yield more than a risk-free rate due to credit and/or default risk. This additional yield is called the yield spread. The yield spread compensates investors for the risk of default by the corporation that issued the bond, i.e., the possibility that a bond's issuer will be unable to pay its obligations on time, or at all. The lower the issuer's credit rating, the higher the credit risk premium investors typically require for accepting the risk of owning the issuer's debt. In a perfect world, the investor would receive the entire stated yield over the life of the bond, but due to possible default loss and other losses (such as downgrades in the case of investment-grade bonds), some bonds may only earn around 50% of the observed yield spread.
* ***Roll-down return.*** Because investors typically invest in bond portfolios designed to maintain an average duration, we include this additional return. To maintain a target duration, bond managers must periodically rebalance the portfolio by selling bonds as they move closer to their maturity dates. As there is an inverse relationship between bond yields and prices, this process typically results in a gain for an upward-sloping yield curve (where longer-term bonds have higher yields than shorter-term bonds). Note that the opposite holds true if the yield curve is downward-sloping.

For**cash investments,** because they are very short-term in nature (typically not exceeding three months), we assume reinvestment at the end of each period over a 10-year horizon. The expected return from this constant reinvestment is referred to as the expected short rate, which we forecast using a term-structure model.

Why do you expect long-term returns to be lower than historical averages?

When planning for the future, relying solely on historical returns can create unrealistic expectations. When actual returns do not match expectations, it can have big financial consequences—such as a delayed retirement or difficulty paying for big expenses such as a college education. Rather than base our forecasts solely on history, the CMEs leverage forward-looking information, such as consensus-driven earnings estimates and macroeconomic forecast data, to create a more robust picture of future returns. Over the next decade, Schwab expects market returns to fall short of long-term historical averages due to deviations from historical interest rates, economic growth prospects, and equity valuations.

* ***Interest rates.***While current and expected interest rates are notably higher than they were just a year ago, they are still much lower than they have been historically, especially compared to the high-interest-rate environment of the 1980s. Although our estimates account for this higher-rate environment, they are still not likely to be as high as what we have seen historically.
* ***Economic growth.*** Stubbornly high inflation has led central banks to aggressively tighten monetary policy, slowing near-term economic growth worldwide. Additionally, consensus forecasts over the long term have also declined. A robust economy is fundamental to achieving healthy returns from financial markets. According to consensus forecasts, economists expect real GDP growth to be 1.8% per year, on average, over the next 10 years. This outlook is notably lower than its historical average growth rate of 2.6% per year since 1970.
* ***Equity valuations***. Any potential attractiveness due to price declines in 2022 seemed to be counteracted by a more tepid earnings growth outlook. While expected earnings growth slowed somewhat in the near term, growth rates came down most notably in the medium term (three to five years). The end result is a return outlook similar to last year's, as these lower earnings expectations already appear to be reflected by the current price. As such, Schwab continues to expect stock returns to remain below historical levels.

Why do you expect international stocks to outperform U.S. stocks?

We project U.S. large-company stocks to return 6.1% annually over the next 10 years, compared with 7.6% for international large-company stocks. This is mainly due to differences in valuations between U.S. stocks (as measured by the S&P 500 index) and international stocks (as measured by MSCI EAFE index). International stocks are generally riskier than U.S. stocks and investors expect to be compensated for taking on this additional risk. While we recognize that historical returns for international stocks have lagged domestic stocks, the expected cash flows given the current price suggest they have a better chance of outperforming over the next 10 years. This is still the case even after accounting for the additional risk.

What can investors do now?

Due to the power of compound returns—the cumulative effect that gains or losses have on an original investment—even relatively small differences can result in large changes over time. Therefore, what investors do (or don't do) today can have a sizeable impact on the likelihood of achieving their long-term investment goals. By incorporating realistic return assumptions into the financial-planning process, investors are better able to plan for their long-term financial goals.

If you don't have a long-term financial plan, now is a good time to start putting one together. If you already have one, then consider revising it based on Schwab's updated CMEs. As always, keep in mind that it is impossible to predict with 100% certainty what will happen with any individual investment. As such, CMEs should not be used for timing the market; instead, these estimates should be used as a guide to set reasonable long-term expectations for financial goals and asset allocation plans.

Our [seven investing principles](https://www.schwab.com/investing-principles) can help you get started and stay on track, but here are a few things to consider now.

* Establish a financial plan based on your goals. Be realistic about your goals and be prepared to change your plan as your life circumstances change. Use our updated expected returns to help you be more realistic when creating your financial plan.
* This year our expected returns for bonds went up, but that doesn't mean you should correspondingly reduce the amount you save. Expected returns fluctuate from year-to-year and are far from a guarantee. The more you save, the more cushion you can have in case actual returns don't meet what we expect.
* Build a diversified portfolio based on your tolerance for risk. Various asset classes—such as stocks, bonds, or cash—[behave differently](https://www.schwab.com/resource-center/insights/content/whats-your-portfolio-role-various-asset-classes) in changing market environments, and it has been nearly impossible to predict which asset classes will perform best in a given year. Instead of chasing past performance, create an appropriately diversified portfolio that can help minimize the effects of market ups and downs.