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10-year return forecasts (2023–32)

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Executive summary

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The Schroders Multi-Asset long-term capital market assumptions are forward-looking estimates of total returns which are an important component for the team's strategic asset allocation modelling and portfolio construction.

This note presents our latest 10-year capital market returns forecasts in local currency terms and provide a brief outline of our methodology. Our approach was developed using a framework predominantly based on market measures allowing for a transparent, timely and systematic process updated twice a year.

Return expectations across asset classes have been raised relative to our Jun-2022 forecasts largely due to further increases in government bond yields. The increased equity return forecasts have also been driven by continued falls in valuations since our last publication.

Cash returns

Developed market

On the basis that we are using the government bond return as an anchor, cash returns are estimated by determining an appropriate term premium. This has been distorted in recent years by central bank asset purchase programmes which have depressed the gap between short and long rates. Consequently, we have taken a pre-financial crisis term premium for the US and UK. For the eurozone and Japan where distortions still exist, and will continue to do so for some time in our view, we have used a smaller term premium than would be warranted by the historical data.

10-year forecast returns: 2023–2032 (p.a. %)

	US	EUR	UK	JP
Cash returns	2.6	1.8	2.2	0.3

Source: Schroders, Thomson Reuters DataStream.

Fixed income returns

Developed market and EM local government bonds

The yield to maturity (YTM) for a risk-free bond considers the coupon income and capital gain or loss that the investor will realise by holding the bond to maturity. However, this also assumes that all coupons can be re-invested at the YTM to the maturity date. Therefore, the relationship between initial yield on a 10-year US Treasury bond and its subsequent 10-year return will vary depending on the extent yields rise or fall in the subsequent 10 years. Despite this uncertainty in subsequent yield moves, Bogle (1991, 2015)[1] showed the strong empirical relationship between the initial yield on a 10-year US Treasury bond and its subsequent 10-year return since 1900.

We adopt this straightforward and intuitive approach to estimating 10-year returns expectations for government bonds in our framework. Specifically, we use the YTM on the 7–10 year Merrill Lynch index to estimate US, EUR, UK and JP bond returns for each calendar year. The return forecast for emerging market local debt was estimated by using the yield to maturity for the JPM GBI-EM Global Diversified Composite index. These estimates of 10-year government bonds act as a key 'anchor' for many of our other asset class return forecasts.

10-year forecast returns: 2023-2032 (p.a. %)

	US	EUR	UK	JP	EM local
Government bond forecasts	3.8	3.2	3.6	0.5	6.9

Source: Schroders, ICE indices, JP Morgan indices.

Inflation-linked government bonds

The yields on US Treasury Inflation Protected Securities (TIPS) have declined dramatically since they were first issued in 1997. TIPS transaction volume was very low relative to nominal Treasuries during an initial period between 1999 and 2004. A high liquidity premium explains why US TIPS have exhibited higher excess returns than nominal Treasuries over this initial period and during the financial crisis in 2008–09.

To mitigate the impact of the initial period after TIPS were first issued, we estimate the return basis between US Treasury bonds and inflation-linked bonds by taking an expanding average from 2004 of monthly excess returns (annualised) between MLX 7–10 year UST index and MLX 7–10 year TIPS index.

We use a similar methodology for the return basis for nominal gilts over inflation-linked gilts, ignoring the stellar returns earned by UK linkers in 2016 after the UK referendum.

10-year forecast returns: 2023–2032 (p.a. %)

	US	UK
Inflation-linked bond forecasts	4.2	4.1

Source: Schroders, ICE indices.

[1]Bogle, J.C., 1991. Investing in the 1990s: Occam's razor revisited. Journal of Portfolio Management, 18(1), pp.88–91.
Bogle, J.C. and Nolan, M.W., 2015. Occam's Razor Redux: Establishing Reasonable Expectations for Financial Market Returns. Journal of Portfolio Management, 42(1), p.119.

Credit returns

Investment grade, high yield and emerging market debt

In estimating 10-year credit total returns, we consider the following return components: government bond returns, returns due to additional spread yield and returns due to downgrades and defaults.

Returns due to the additional spread yield component are estimated using the current option-adjusted spread for a 7–10 year corporate bond index. For investment grade (IG) we take account of the effects of ratings downgrades in forecasting returns. Credit losses from defaults are estimated using long term S&P IG and high yield (HY) default and recovery rates.

10-year forecast returns: 2023–2032 (p.a. %)

	US	EUR	UK	EMD
Investment grade bond forecasts	5.1	4.4	4.9	6.6
High yield bond forecasts	6.6			

Source: Schroders, ICE indices, S&P.

Equity returns

We estimate equity returns by decomposing the country-level total return estimates into the following components:

$$equity\ return\ forecasts = bond\ yield + long\ term\ equity\ return\ premium + valuation\ adjustment$$

Long term country/ region-level equity risk premia (ERP) are estimated by taking an expanding window average of the rolling 12 month equity returns in excess of 10 year government yields. Given the lack of long term data in emerging markets over multiple cycles, we estimate the long-term emerging market ERP using a beta-adjustment to the long-term US ERP.

We believe valuations are an important return component for equities over a 10 year horizon and therefore adjust the long-term ERPs to account for valuations. The Cyclically-Adjusted Price Earnings (CAPE) ratio is a widely used metric that judges whether or not an equity market is fairly valued and forms the basis for our valuation adjustment. Theory supports the idea that valuations, and therefore the required return on equities, should vary with the macro environment. We therefore also estimate a 'macro-sensitive' CAPE for each country/ region and assume current CAPE levels will revert to their respective 'macro-sensitive' levels in order to determine each equity market's valuation adjustment. Given the lack of long term data in EM markets to estimate a robust 'macro-sensitive' CAPE, we assume emerging market country CAPE levels revert to their rolling 10 year average.

10-year forecast returns: 2023–2032 (p.a. %)

	Global	US	EUR	UK	JP	EM
Equity forecasts	9.3	9.1	8.3	9.7	8.2	11.8

Source: Schroders, MSCI indices, ICE indices.

Alternatives

Commodities

We decompose the total returns to commodities into the following components:

$$Commodity\ total\ return\ forecasts = cash\ return + roll\ return + spot\ return$$

The roll yield return reflects the return from rolling from the current futures contract to a longer-term contract to maintain exposure to the commodity after the current contract has expired. The spot return simply reflects the change in the price of the commodity futures for immediate delivery. We estimate the roll return through the long run historical difference between excess returns of the Bloomberg Commodity index, which includes the roll return, and the spot return, which measures only price return. Additionally we model the forecast spot return using the long-run annualised historical average of monthly spot returns of the Bloomberg Commodity index back to 1990.

Private equity

For private equities, we estimate the illiquidity premium by taking the long-term average excess returns over US equities and using the LPX50 index as our asset proxy.

Hedge funds

We use a 50/50 blend of the HFRI Fund of Funds composite index and the Credit Suisse Multi-Strategy Hedge Fund index as a proxy for the asset class returns. We estimate returns from hedge funds by taking the long-run average excess returns of this blended index over US cash.

10-year forecast returns: 2023–2032 (p.a. %)

	Commodities	US private equity	Hedge funds
Alternative asset forecasts	4.5	9.7	7.0

Source: Schroders, Bloomberg indices, HFRI indices, CS indices.

Volatility forecasts

For all assets we make an assumption that volatility will match that of the past 10 years. The measure we use is annualised monthly volatility of the asset's local currency returns, where available.

10-year local currency return and risk forecasts: 2023–2032 (p.a. %)

		Forecast return	Forecast volatility
Cash	US	2.6	0
	EUR	1.8	0
	UK	2.2	0
	JP	0.3	0
Government bonds	US	3.8	5.9
	EUR	3.2	5.5
	UK	3.6	6.7
	JP	0.5	1.9
	EM local (USD)	6.9	11.5
Inflation-linked bonds	US	4.2	6.1
	UK	4.1	6.7
Investment grade bonds	US	5.1	6.8
	EUR	4.4	7.3
	UK	4.9	7.9
High yield bonds	US	6.6	8.5
	EMD	6.6	9.0
Equity	Global	9.3	15.0
	US	9.1	15.0
	EUR	8.3	14.3
	UK	9.7	12.3
	JP	8.2	15.8
	EM	11.8	16.7
Alternatives	Commodities	4.5	14.1
	Private equity	9.7	21.3
	Hedge funds	7.0	8.8

Source: Schroders, Bloomberg indices, CS indices, HFRI indices, ICE indices, JP Morgan indices, MSCI indices, S&P.

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