INVESTMENT INSIGHTS

Analysis, Insights and a Different Perspective October 2022

ECONOMIC AND MARKET OUTLOOK

KEY POINTS

- This issue of Investment Insights provides a long-term economic and market outlook.
- Corporate earnings and economic growth drive the stock market returns.
- While bond returns have been challenging recently, higher yields may provide better prospects going forward.
- Beyond the broad asset classes, some subcategories of stocks may provide long-term investors with opportunities.

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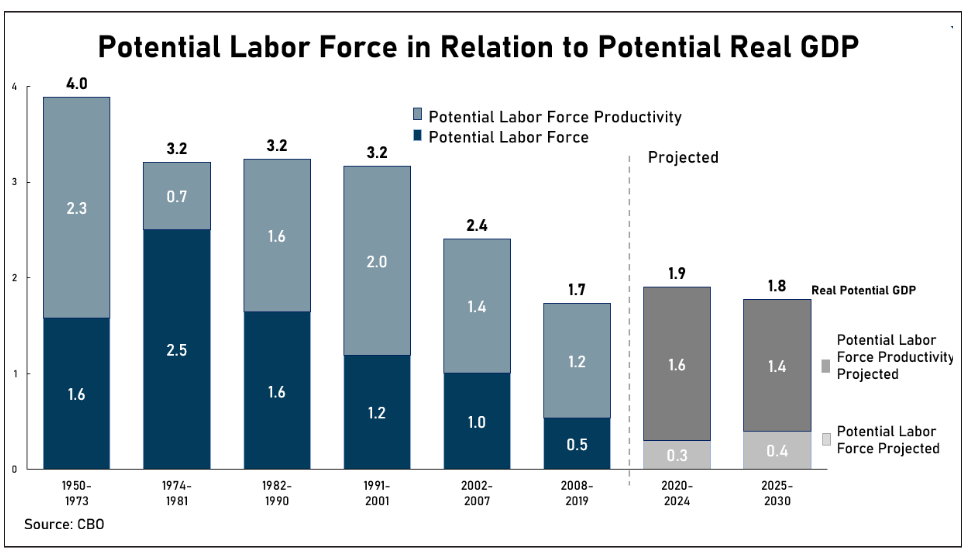
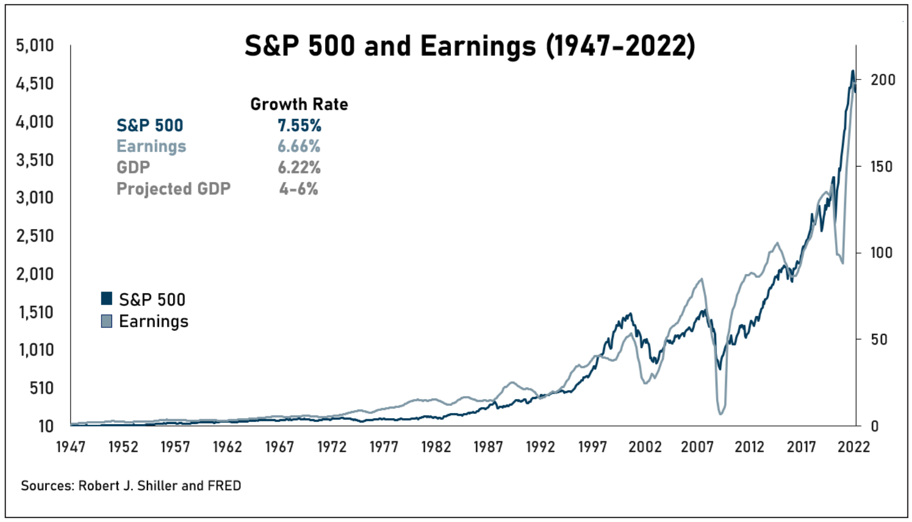
GDP AND STOCKS

Economic growth or Gross Domestic Product (GDP) measures the value of goods and services produced in a given period. While the economy's size or GDP provides insights into current economic trends, when thinking about the economic outlook, the potential GDP can provide investors with clues on where the economy could be heading. The potential GDP is the maximum sustainable rate of economic growth. While GDP has historically grown above and below its potential for short periods, it tends to converge to potential GDP over time. As we work through the near-term challenges of the economy, over the long term, GDP should continue to grow closer to the trend.

Potential GDP cannot be directly observed but largely depends on the supply side of the economy. The production of goods and services depends on the number of workers and their productivity. Over the next 10 years, CBO projects that the U.S. labor force is likely to increase by 0.3% to 0.4%, while labor productivity is expected to increase by 1.4% to 1.6%. Taken together, the potential GPD is expected to grow at approximately 2% on an inflation-adjusted basis.

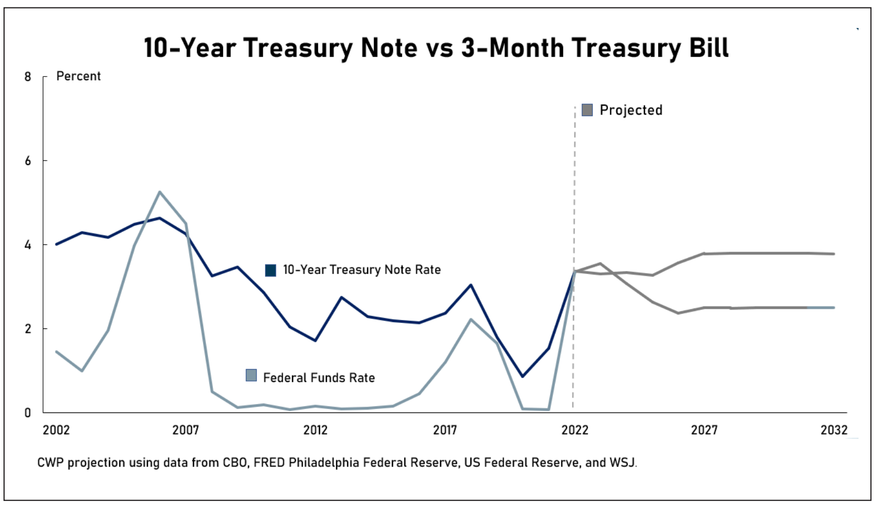


Over long periods, the stock market is driven by corporate earnings and economic growth. We can observe that this has historically been the case in the graph to the right. Since 1947, corporate earnings have grown at about 6.66%, in line with GDP growth. As we discussed above, the GDP growth is expected to be approximately 2% on a real (inflation-adjusted) basis. Assuming inflation moderates over the next 10 years and averages approximately 3%, nominal (non-inflation adjusted) GDP is expected to grow at 4% to 6% over the next decade.



Sources: Robert J. Shiller and FRED

The link between economic growth and the stock market is often debated.[1] That said, we have observed that corporate earnings have historically been strong during solid economic environments and vice versa. Based on the expected economic growth, the expected stock market returns are modest yet lower than what many investors have experienced over the last decade.

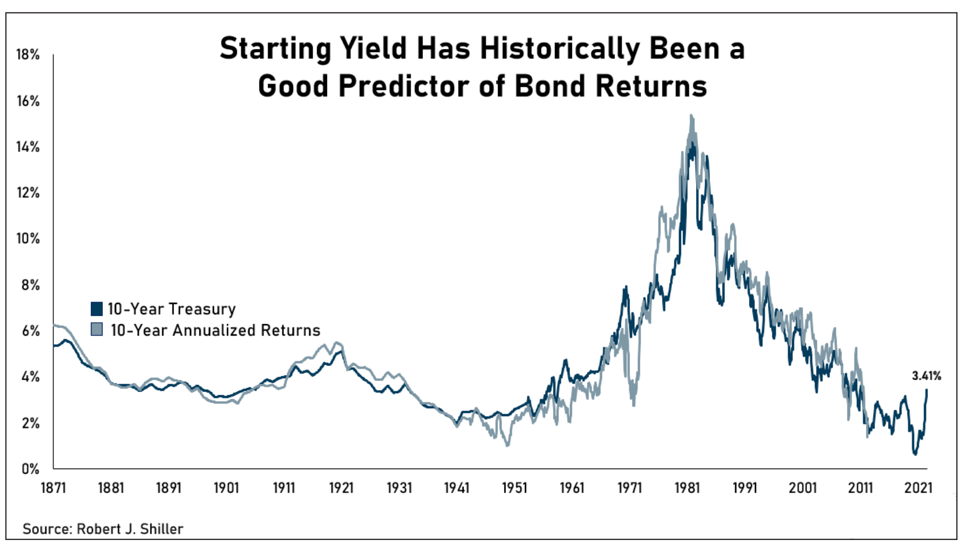


CWP projection using data from CBO, FRED Philadelphia Federal Reserve, US Federal Reserve, and WSJ.

RATES AND BONDS

The ultimate path of the economy depends on the actions taken by Federal Reserve (FED) to keep the economy from overheating from inflation. The FED is currently raising interest rates to slow the overheating of the economy and moderate inflation. The Fed expects to raise the short-term interest rate to 4.4% by year-end, and rates are expected to remain well above the average of the previous 10 years and could remain well above the rates during the recessionary market environment.

Curiously, this implies that the Fed expects the so-called "soft-landing," a scenario under which the Fed controls inflation without significantly slowing the economic growth. In fact, not a single member of the Federal Open Market Committee expects negative GDP growth according to its September projections. It is likely that if economic activity indicators continue to show weakness, the Fed will eventually reflect the economic slowdown in its forecasts.



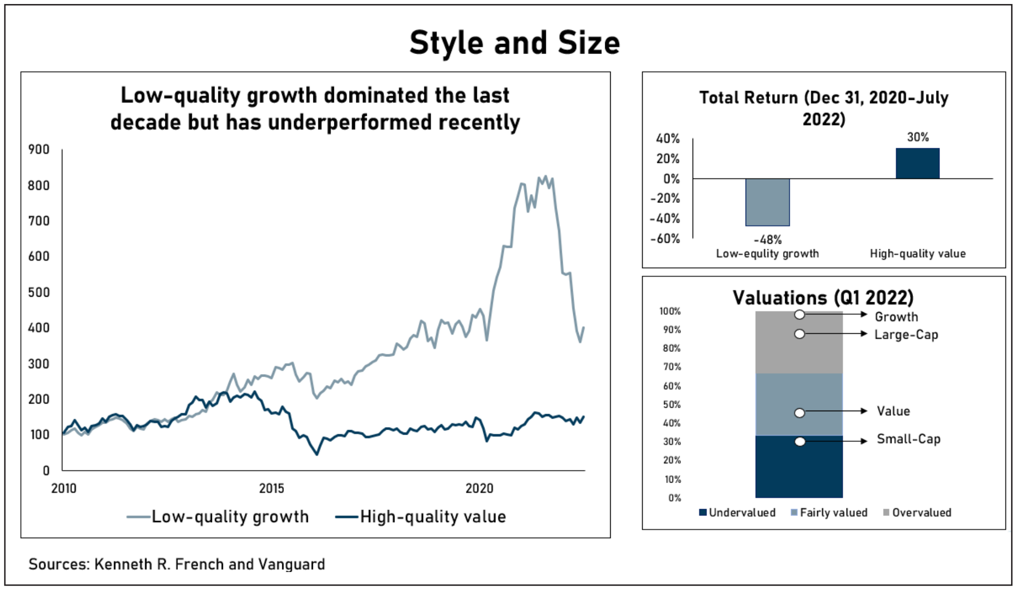
Source: Robert J. Shiller

Given the inverse relationship between interest rates and bond prices, bond returns have been particularly challenged this year. The rising interest rate environment has resulted in bond prices declining across various maturities this year. While the bond market returns have been challenging

1 Note: This is especially the case across countries as a number of studies suggest that countries with higher economic growth do not necessarily have faster stock market growth. In our example, we took at look at U.S. market only.

recently, the prospects are better going forward. The long-term outlook for bonds depends on the initial yield of the bonds, as shown in the graph on the next page. The yield on many interest-rate securities available today is higher than it has been for many years, allowing investors to have more competitive returns.

OTHER ASSET CLASSES



Beyond the broad asset classes like stocks and bonds, certain trends in the sub-asset classes may be different from what investors have experienced in the past. The most common sub-asset classes for stocks have two dimensions: style and size. Style describes the type of stock, and the most common styles are value stocks (buying cheap companies) and growth stocks (buying fast-growing companies). Over the past decade, growth stocks have outperformed their value counterparts. Recently the trends have changed, but the duration of the change remains uncertain. Thus, it is important for investors not to be over-allocated to the factors that worked the best over the past 10 years. Instead, focusing on quality may help stock investors earn competitive returns.

Another dimension by which stocks can be characterized is size which groups stocks based on the company size. Large-company stocks have had the best performance over the past 10 years, but currently, small-company stocks are relatively more attractive from a valuation perspective.

Finally, international equities are likely to provide valuable diversification going forward. U.S. equities significantly outperformed international equities over the past 10 years. The U.S. may also continue to outperform over the next decade, but matching the level of outperformance archived over the last decade seems unlikely. Note that we do not think international equities will necessarily outperform the U.S. over the next decade. Instead, we think if the U.S. outperforms, the difference will likely be smaller than in the past decade. As such, international equity currently provides a compelling diversification benefit and remains a key part of a diversified portfolio.