Northern Trust | Jim McDonald Capital Market Assumptions: 5-year Outlook

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Every year, more than 20 investment professionals from across Northern Trust gather to debate the outlook for the global economy, monetary policy, and the capital markets. The result is our updated five year capital market assumptions, which are the foundation for our portfolio construction process. Some of the key themes to emerge from this year's work include entrenched growth, where the slow pace of the global recovery allows the expansion to continue to age, waiting for monetary godot, where a return to historical levels of interest rates is thwarted by subdued growth and dormant inflation, and finally, our valuation superstructure theme, where low interest rates and a rising proportion of higher quality companies support greater than average valuations.

As we consider how these themes will play out over coming years, we believe developed market equities will benefit from an outlook of steady growth and low inflation, which underpins earnings and supports higher valuations. Our return forecast of 6.4% for developed markets is supported by revenue growth of 4.1% and a dividend yield of 2.3%. Additionally, we expect the positive contribution of share buybacks to offset some modest valuation compression. Our return forecast for emerging market equities is higher at 8.4% with the premium to developed markets driven by cheaper valuations and stronger earnings growth.

Our investment grade bond forecasts are helped by the higher level of yields this year. And returns will be supported by the controlled shift upward in rates over the next five years. We only expect the Fed to get the Fed funds rate to 2% by the end of our forecast period, which will look good compared to the Bank of Japan, which we expect to be stuck at zero. We think the slow upward move in US short rates will lead to a 3% yield on the 10 year treasury, as compared to a 0.5% yield on the 10 year Japanese government bond and a 1.8% yield on the 10 year German bond.

We continue to highlight the value of real assets in a portfolio, as a hedge against unexpected inflation. Natural resource equities should outperform commodities while still providing an inflation hedge, while real estate and infrastructure will be attractive to yield seeking investors. Our return forecast for hedge funds has increased due to higher interest rates and equity returns, while we still expect private equity to generate a 2% premium to public equities. So what does all this mean for investors?

While asset returns are expected to remain below long-term historical averages, we expect positive real returns across many asset classes. The populous political movement over the last year has not dramatically changed the global economic outlook, and in some instances has actually led to potential improvement. Our forecasts and returns for risk assets have generally risen from last year, while our fixed income return expectations are broadly unchanged. With inflation expected to remain under 2% in most developed markets, we think investors will be rewarded by remaining fully invested over our forecast horizon.

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