INVESTING SPECIALISTS

Experts Forecast Long-Term Stock and Bond Returns: 2018 Edition

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08 Jan 2018

As 2017 dawned, few market experts had high hopes for stocks' returns over the next seven to 10 years; after all, the market had already staged a strong run stretching back to March 2009.

With stocks posting another stellar year last year--and with valuations that could hardly be described as cheap--most serious experts are even more circumspect in their long-range return expectations today.

True, economic fundamentals are fine: The economy is solid, unemployment remains low, and corporate earnings growth has been robust. But much of that good news is arguably already priced into stocks' valuations today.

At first blush, forecasting the market's returns, even on a long-term basis, might seem like folly. It's impossible to predict the future, right? But like it or not, market-return assumptions are an essential input for your financial plan. Without some reasonable expectation of what your portfolio will return, you can't know how much you'll need to save and for how long. You can't know whether saving for retirement should be your sole financial preoccupation or whether you can hit other goals, such as college funding, along the way.

To help you arrive at an educated guess of how much the market will contribute to the success of your plans, I've gathered return expectations from market experts both inside and outside of Morningstar. Note that the specifics of these return estimates vary a bit; some of these return expectations are inflation-adjusted while others are not. In addition, some of the experts cited below forecast returns for the next decade, while others employ slightly shorter time horizons. In any case, these return estimates are more intermediate-term than they are long. As such, they're the most relevant to investors whose time horizons are in that ballpark, or to new retirees who face sequence-of-return risk in the next decade. Investors with very long time horizons of 20 to 30 years or longer can reasonably assume that market returns will run in line with their very long-term historic norms: 8%-10% for stocks and half that amount for bonds.

John C. Bogle, founder of Vanguard Group
Highlights: 4% returns for stocks, 3% returns for bonds over the next decade (October 2017)

In an interview this past October, the Vanguard founder continued to assert that future returns from the major asset classes will be muted. As always, Bogle backs into his return forecast by looking at the equity market's current dividend yield, then factors in expected earnings growth and P/E multiple expansion or contraction. The S&P 500 currently yields less than 2%, and Bogle expects that earnings growth will run in the range of 4%, down a bit from its current torrid pace. He then gives that 6% expected return (the 2% dividend yield plus 4% earnings growth) a haircut to account for expected P/E contraction, bringing his self-described "reasonable expectation" for stocks down to 4%. To arrive at his 3% return expectations for bonds over the next decade, Bogle uses a blend of the starting yields for Treasuries and high-quality corporates.

GMO

Highlights: -4.4% real (inflation-adjusted) returns for U.S. large caps over the next seven years; 2% real returns for emerging markets equities (October 2017).

You didn't expect a sunny return forecast from GMO, did you? True to pessimistic form, especially in the late innings of a bull market, the firm's real-return expectations for most equity categories are negative, with a handful of exceptions. GMO's outlook for U.S. large-cap growth stocks and what the firm classifies as "low-quality" U.S. large-cap equities is especially dour; the firm expects real losses in the neighborhood of 5%-7% over the next seven years. For GMO, emerging markets equities are the sole bright spot on the horizon for stocks: The firm expects emerging markets equities to return an inflation-adjusted 2% over the next seven years, while its real-return expectation for value-oriented emerging-markets equities is a sunny 7%. Indeed, the firm notes that the expected return advantage of value-priced emerging markets equities relative to the next-best asset class is the largest it has observed in more than two decades. It's worth noting that the firm's pessimism U.S. equities has cost it on the return front over the past several years: Wells Fargo Absolute Return (WARAX), which GMO manages, has recently struggled and earns a Neutral rating from Morningstar's analyst team.

Morningstar Investment Management

Highlights: 1.8% 10-year nominal returns for U.S. stocks; 2.5% 10-year nominal returns for U.S. bonds (Sept. 30, 2017).

Like GMO and Research Affiliates (below), Morningstar Investment Management's return expectations for U.S. stocks and bonds are low, if not downright discouraging, especially when you factor in inflation. But the outlook is more optimistic for foreign equities: MIM expects U.S. holders of international developed equities to earn nearly 5% on a nominal (noninflation-adjusted) basis, and U.S. holders of emerging-markets equities to earn more than 5% nominally. (Note that those forecasts are down substantially from a year ago, owing to very strong performance from foreign stocks over the past year.) Morningstar Investment Management provides its latest return expectations in Morningstar Markets Observer; the latest issue will be out this month.

Research Affiliates

Highlights: 0.3% real returns for U.S. large caps during the next 10 years; 0.8% real returns for the Barclays U.S. Aggregate Bond Index (Dec. 31, 2017).

I love Research Affiliates' intuitive and user-friendly scatter plot depicting the firm's expectations for 10-year returns and volatility from the major asset classes as well as portfolios. Users can use the tool to see the firm's return/volatility expectations for numerous asset classes, as well as backward-looking data. The firm's recent 10-year risk/return expectations, based on its "valuation-dependent model," suggest that investors who are inclined to stick with a plain-vanilla U.S. stock/bond portfolio should curb their enthusiasm: A 60% U.S. equity/40% bond portfolio will only barely break into the black on an inflation-adjusted basis over the next decade. Like GMO and Morningstar, the firm has higher return expectations from foreign stocks and especially emerging markets, however. It's expecting a 4.5% return over the next decade from the MSCI EAFE index (developed markets foreign stocks) and a nearly 6% return from emerging markets equities.

Charles Schwab Investment Advisory

Highlights: 6.7% expected nominal return from U.S. large-cap stocks from 2017-2026; 3.1% nominal returns from U.S. investment-grade bonds (August 2017)

Charles Schwab Investment Advisory (a separately registered investment advisor and affiliate of Charles Schwab & Co. Inc.) was forecasting higher equity returns than many of the other firms in our survey--roughly 7% on a noninflation-adjusted basis for U.S. and foreign large caps as of August 2017. (Given stocks continued run in the second half of 2017, it's possible the firm has ratcheted its expectations downward since then.) Moreover, the firm's return expectations for foreign equities wasn't appreciably better than for U.S. stocks. But like most of the other firms, Charles Schwab Investment Advisory expects returns over the next decade to be lower than in the past 45 years, owing to high stock valuations, among other factors.

Vanguard

Highlights: Nominal U.S. equity-market returns in the 3% to 5% range during the next decade; 5.5% to 7.5% returns for non-U.S. equities; 2% to 3% expected returns for global fixed-income markets (December 2017).

In its 2018 Economic and Market Outlook, Vanguard's Investment Strategy Group projects higher risks and lower returns for 2018 and beyond. "Elevated valuations, low volatility, and secularly low bond yields are unlikely to be allies for robust financial markets over the next five years," the firm's researchers wrote. In line with many of the other firms' return projections, Vanguard believes that the prospects for foreign equities are better than for U.S. stocks, accentuating the value of maintaining a globally diversified equity portfolio. Vanguard describes its outlook for global fixed-income assets as "positive but muted," noting that tightened credit spreads point to less variation in the returns of fixed-income subasset classes over the next decade than in previous periods.

Christine Benz does not own shares in any of the securities mentioned above. Find out about Morningstar's editorial policies.