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## SUMMARY

- Our long-term forecasts for stocks – and particularly bonds – have improved meaningfully from last year.
- Significantly higher starting interest rates, as well as cheaper starting valuations for stocks, will likely have a positive effect on future returns for balanced portfolios, in our view.
- We see higher long-term upside in developed international stocks than in the US – particularly in our ‘Bull Case’ scenario – but remain cautious tactically.

03.13.2023

## RiverFront’s 2023 Long-Term Forecasts: The Selloff’s ‘Silver Lining’: Stock and Bond Forecasts Higher Across the Board

At RiverFront, we believe in ‘process over prediction.’ This is the idea that a dynamic investment process built to adapt to unexpected events is more important to long-term investment success than anchoring on any particular forecast. Nonetheless, we view long-term (5-to-7 year) capital market forecasts as a useful part of our process to help identify and monitor what we think are important long-range drivers for markets. Today we deliver an update to our capital market assumptions (CMAs) from a year ago with an emphasis on what has changed in the macroeconomy and in our forecasts over the last 12 months.

### Part I: The ‘60/40’ Is Not ‘Dead’ – We Believe It Just Got Resurrected

Last March we said, “elevated valuations, rising inflation, and more restrictive central bank policy suggest lower-than-average forward long-term return assumptions in our Base Case\* for all US asset classes.” But we certainly did not expect that bond yields would correct in such a violent and historic fashion over the next 12 months! This led to a chaotic year for balanced investors. US government bonds – as epitomized by the ICE BofA Treasury 10+ year index – fell by roughly – 28% for the year, and the S&P 500 endured a –25% peak-to-trough drawdown, before ultimately rebounding in Q4. Crucially for many investors, the

classic ‘balanced portfolio’ of 60% US stocks and 40% bonds – arguably one of the most popular asset allocations – had one of its worst return years in a century due to weakness in both stocks and bonds (see [Outlook 2023: Market in Transition](#)). But ‘the past is not prologue,’ as the saying goes. And in the wake of 2022’s destruction, the seeds of a better future for balanced investors were sown, in our view.

#### Our long-term CMAs for US

**stocks and US Aggregate bonds have improved meaningfully versus our 2022 estimates (see chart 1).**

\*RiverFront’s 2022 capital market assumptions, see [RiverFront’s 2022 Long-Term Forecasts: Reflationary Recovery or Inflationary Inferno?](#), used three scenarios (Pessimistic (Bear), Base, and Optimistic (Bull)).

### CHART 1: IMPROVED EXPECTED RETURNS VS LAST YEAR

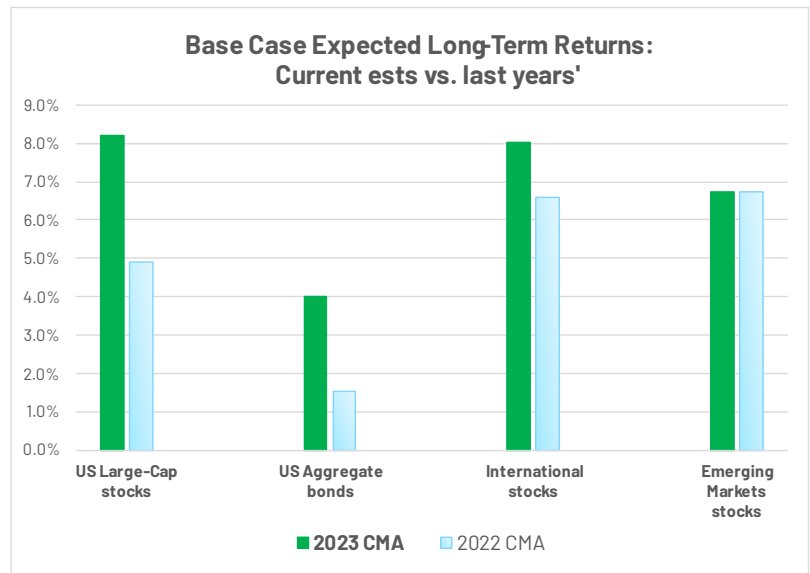


CHART 1 shown for illustrative purposes. Index and asset class definitions are available in the disclosures. The assessment is based on RiverFront’s Investment Team’s views and opinions as of the date of publication. Each case is hypothetical and is not based on actual investor experience. The returns are no indication of RiverFront portfolio or product performance. These views are subject to change and are not intended as investment recommendations. There is no representation that an investor will or is likely to achieve positive returns, avoid losses or experience returns as discussed for various market classes.

Our work suggests that significantly higher starting interest rates, as well as cheaper starting valuations for stocks, will likely have a profoundly positive effect on future returns, in our view.

## CHART 2: 2023 RIVERFRONT LONG-TERM TOTAL RETURN FORECASTS

Long-Term Total Return Forecast (Annualized, Nominal, in USD)	Pessimistic: Bear Case	Base Case	Optimistic: Bull Case
US Large-Cap Stocks	2.6%	8.2%	11.8%
Developed International Stocks	1.0%	8.0%	14.3%
Emerging Market Stocks	0.0%	6.8%	13.5%
US Aggregate Bonds	4.4%	4.0%	3.4%
US High Yield Bonds	1.6%	5.6%	6.8%

Shown for illustrative purposes. Index and asset class definitions are available in the disclosures. *The table above depicts RiverFront's predictions for 2023 using three scenarios (Pessimistic (Bear), Base, and Optimistic (Bull)). The assessment is based on RiverFront's Investment Team's views and opinions as of the date of publication. Each case is hypothetical and is not based on actual investor experience. The returns above are not an indication of RiverFront portfolio or product performance. These views are subject to change and are not intended as investment recommendations. There is no representation that an investor will or is likely to achieve positive returns, avoid losses or experience returns as discussed for various market classes.*

Perhaps the best news of all: due to valuation resets and market calamity over the last year we do not believe we need to make 'heroic' assumptions around stock and bond valuations to generate better future returns. We decided to leave the majority of our long-term assumptions relatively unchanged from last year for 'terminal' (cycle-ending) bond yields, price-to-earnings (P/E) multiples on stocks and corporate earnings growth over the forecast horizon... with a few exceptions, noted in the section below.

### Selected Areas Where our Assumptions Changed from Last Year:

- **Terminal 10-year Treasury yield forecast is slightly higher across all scenarios:** Based on our view of slightly higher sustained inflation and more aggressive Federal Reserve response across the forecast horizon.
- **We slightly increased our view of forward earnings growth for US stocks in all three scenarios:** Based on our historical research that suggests nominal earnings growth tends to be relatively positive in an inflationary backdrop. We are less sure of this relationship internationally but did increase our forecast for international earnings growth in the Bull Case only.
- **In our Bear Case for US stocks, we have slightly lowered the expected P/E multiple:** Given the historical connection between sustained high inflation and lower valuation. For developed international, we left valuation multiples mostly unchanged, as international multiples are already depressed relative to history.
- **More optimistic on US dollar in higher inflation scenarios:** Our opinion of the US dollar has improved somewhat from last year. Given the US' more efficient economy and advantageous position versus Europe and Asia with regard to commodity supply, we now expect the dollar to be stronger relative to most foreign currencies in a 'stagflationary'<sup>1</sup> backdrop than what we assumed in last year's analysis. This comes despite high dollar valuation on a purchasing-power parity basis, which may constrain how much further the dollar can appreciate in the long-run.

<sup>1</sup> Stagflation is the persistent high inflation combined with high unemployment and stagnant demand in a country's economy.

## Part II: Macroeconomic Backdrop: Similar to Last Year's Assumptions

We did not materially alter our macro assumptions from last year (see [RiverFront's 2022 Long-Term Forecasts: Reflationary Recovery or Inflationary Inferno?](#)), simply because our long-term macro fundamental view hasn't changed dramatically. Global inflation has started to moderate in most regions, but remains much higher than the past few decades, making inflation control job #1 for major central banks. We maintain core inflation forecasts across our three scenarios that are higher than the Consumer Price Index (CPI) average of the last couple of decades. History suggests to us that higher inflation tends to beget lower P/E multiples on stocks. However, there is a fair degree of variation around that relationship, in our view, depending on underlying growth and profitability metrics, as well as the bond market's response to inflation.

With bonds, interest rates have already normalized much faster than we were assuming. This suggests to us that higher structural bond yields can start compounding earlier in our forecast horizon, leading to meaningfully higher expected aggregate returns (see [CHART 2](#)). In our opinion, bonds have reasserted themselves as a useful portfolio return source and diversifier for the first time since the 'Great Financial Crisis' (GFC). This is a major positive for balanced investors, in our view.

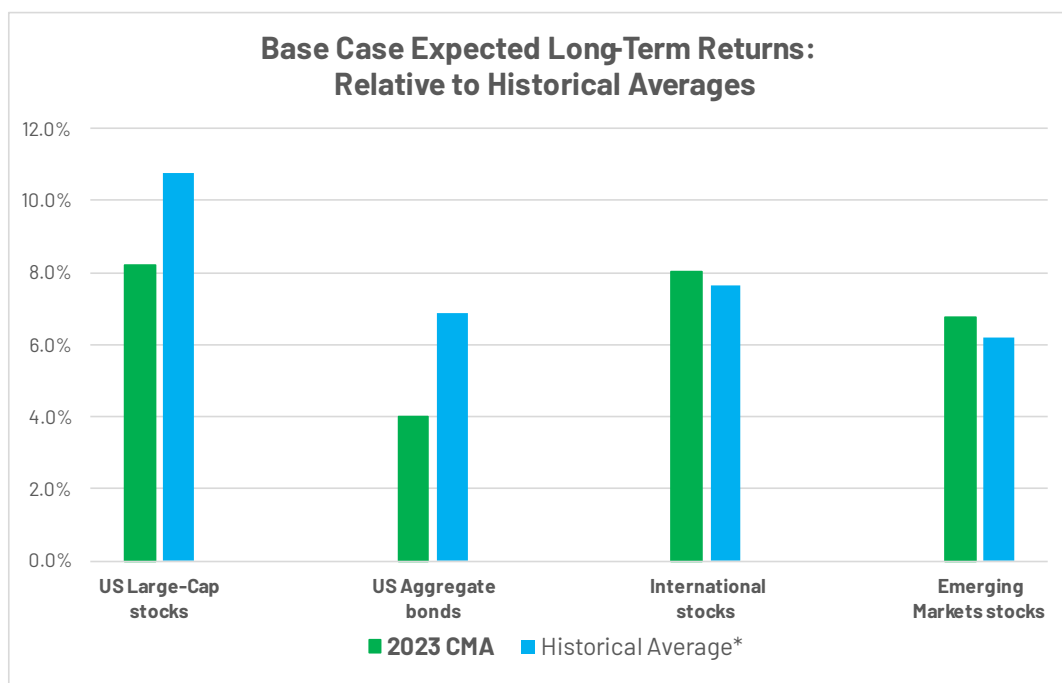
### US Economy Proving Resilient Thus Far... Rest of the World More Tenuous

Despite the Fed's efforts to slow the economy, the US has remained relatively resilient over the past year, though our Base Case assumes a mild recession at some point in the next 12 months. Europe and Asia appear more likely to enter recession soon. China's economy is just now reaccelerating after the shelving of their misguided 'zero-COVID' policy and is on arguably a different 'heartbeat' than the developed world. However, we believe structural economic growth in China will be much lower than historical averages due to the increasing maturity of their economy, the 'Cold War 2.0' with the US, and increasing demographic challenges. By many accounts, China's population is now shrinking for the first time since the 1960s (see [Section below: Globalization Not Dead, Just Different](#)).

We remain less optimistic than many of our peers as it relates to long-term asset returns in emerging markets (EM). We are constructive on parts of EM (like Southeast Asia, India, Korea and Mexico) that are likely net beneficiaries of China's tension with the US, as well as on regions that are commodity net-exporters. We expect energy, agricultural commodities, and metals demand to remain buoyant in the roughly 3% core inflation environment we are forecasting over much of the horizon.

Last, all of our forecasts predict a global recession at some point during the 5-7 year forecast period, followed by central bank stimulus and a subsequent policy and growth normalization period. The difference in the scenarios comes down to the assumptions around structural levels of inflation, the

### CHART 3: OUR ASSUMPTIONS ARE CONSERVATIVE RELATIVE TO HISTORY



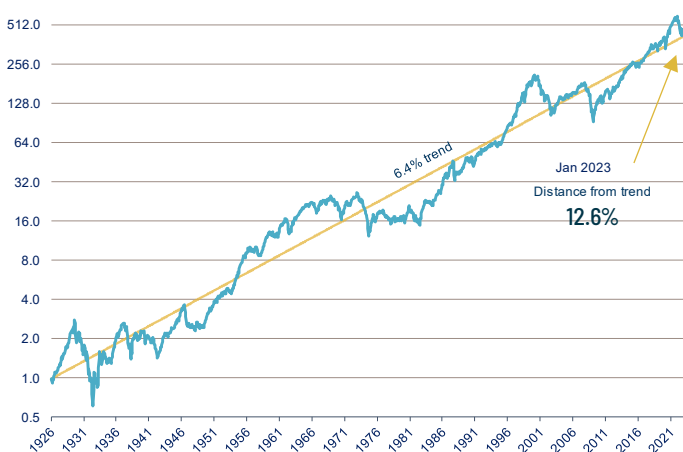
Disclosures: Shown for illustrative purposes. Index and asset class definitions are available in the disclosures. The table above depicts RiverFront's predictions for 2023 using three scenarios (Pessimistic (Bear), Base, and Optimistic (Bull)). The assessment is based on RiverFront's Investment Team's views and opinions as of the date of publication. Each case is hypothetical and is not based on actual investor experience. These views are subject to change and are not intended as investment recommendations. The returns above are not an indication of RiverFront portfolio or product performance. There is no representation that an investor will or is likely to achieve positive returns, avoid losses or experience returns as discussed for various market classes. \*Historical Average of annualized 7-year rolling returns. US Large Cap stocks data begins in 1925, US Aggregate bonds in 1985, International stocks in 1973, and Emerging Market stocks in 1988.

magnitude and longevity of the recession, how central banks choose to combat it, and how quickly economies can bounce back.

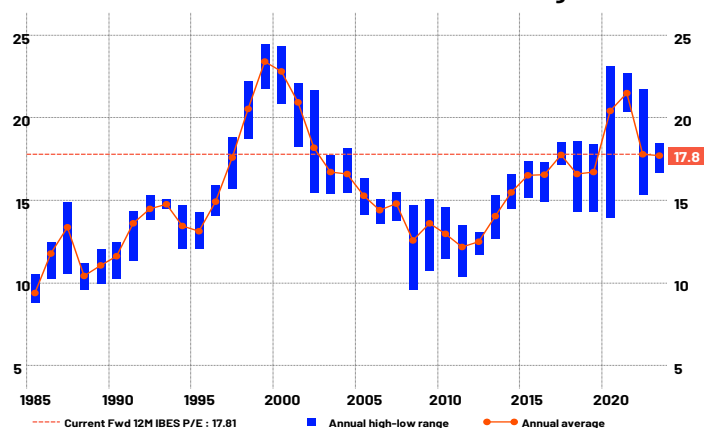
### Our Forecasted Returns: Higher Than Last Year, But Still Lower Than Historical Averages

While our base case return assumptions for US stocks and bonds are meaningfully higher than last year, they remain lower than historical averages (see chart 3, previous page). The reasons for this include our relatively conservative views on economic growth over our forecast horizon, and particularly due to our view of structurally higher interest rates in the US going forward, compared to the post-GFC norm. We believe these factors will limit the valuation expansion potential for US stocks. In fact, in our 'Base Case' (our highest probability outcome), we expect multiples to contract by approximately 1% a year to a terminal multiple of 17x forward earnings. We expect valuations to stagnate around current levels even in our most optimistic macroeconomic 'Bull' Case. This view is reinforced by average valuations on US stocks relative to history, on both our Price Matters® framework (where stock price mean reversion potential appears relatively muted to us – see chart 4, below) as well as on more traditional price-to-forward earnings metrics (see chart 5, below).

**CHART 4: LARGE CAP STOCKS REAL TOTAL RETURN**



**CHART 5: S&P 500 FORWARD P/E RANGE**



Shown for illustrative purposes only. Source CHART 4: RiverFront Investment Group, calculated based on data from CRSP 1925 US Indices Database ©2023 Center for Research in Security Prices (CRSP®), Booth School of Business, The University of Chicago. Data from Jan 1926 through Nov 2022. Past performance is no guarantee of future results. It is not possible to invest directly in an index. RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation. Blue line represents the Large Cap Real Return Index. Yellow line represents the Annualized Real Trend Line of Large Cap Real Total Return Index according to Price Matters®. Shown for illustrative purposes only, not indicative of RiverFront portfolio performance. Information or data shown or used in this material was received from sources believed to be reliable, but accuracy is not guaranteed. The chart above uses a logarithmic scale. Line movements will be dampened/subdued based on the exponential y-axis. Source CHART 5: Refinitiv Datastream, RiverFront, Data as of 03.06.2023 See Important Disclosures for definitions.

This conservative view on both macro growth and valuation also colors our preference for stocks and bonds that can produce steady cash flow to fund dividends and coupon payments, even in an uncertain macroeconomic environment. We call this overarching theme 'P.A.T.T.Y.' ('Pay Attention to the Yield') and it underpins our belief that the compounding of cash flow back to investors will comprise a meaningful percentage of an investor's overall total return over the next 5-7 years, similar to the decades of the 1960s and 1970s (see [Outlook 2023: Market in Transition](#)).

As for US bonds, the higher starting interest rate is very helpful for forward returns, as we mentioned earlier. However, when placed into historical context, our Base Case terminal interest rate forecast of 4.25% on the US 10-year government bond is still relatively low compared to history.

This mixed view on asset valuation in the US is in contrast to our view of the higher potential for multiple expansion in developed international regions such as Europe and Japan, should our Bull Case play out. Unlike the US, these regions are coming off more than a decade of below-average earnings growth, and thus starting valuation is much lower. In addition, many of these areas have stock markets more heavily tilted towards cyclically oriented business models which rely on reflation (such as materials and energy companies) and/or rising interest rates (financials) to generate earnings growth. While our macro and structural opinions of these areas remain subdued, their cheap valuations, higher dividend yields, and our forecasted macro backdrop of positive growth and moderate inflation sets these regions up for better times ahead, in our

view. Due to these factors, our Bull Case forecast for developed international is meaningfully higher than in the US over the next 5-7 years.

However, as most periods of improved earnings growth for these regions relative to the US have proved short-lived, we have adopted a cautious tactical view around international stocks, choosing to wait until proof of international earnings' sustainability has been established before making what we feel to be significant overweight portfolio allocations to these areas relative to US assets.

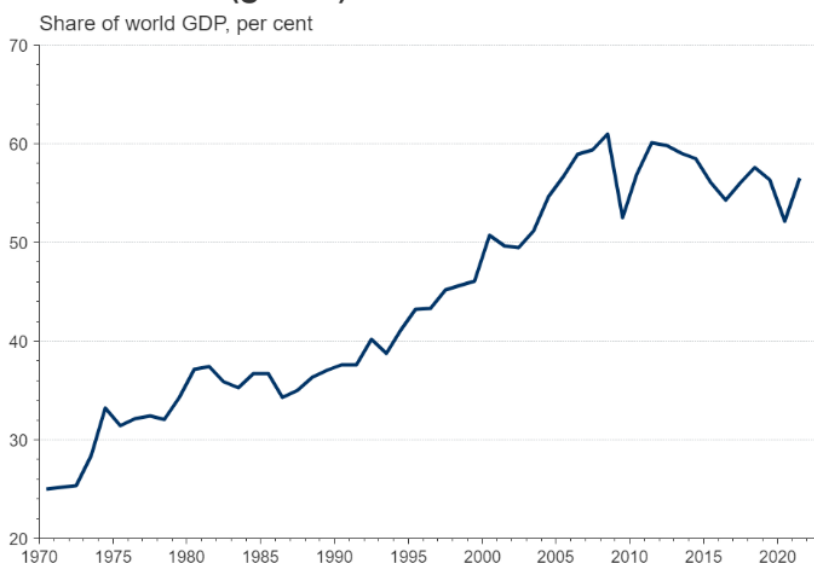
### The Impact of Geopolitics on our Forecasts: Globalization Not 'Dead'...Just Different Than Before

We cannot overlook the impact of increased geopolitical tensions on our 5-to-7 year forecasts. 'Globalization' is a concept that describes the growing interdependence of the world's nations brought about by cross-border trade in goods and services, as well as flows of investment, people, and information. Since the opening of China to the global economy in the 1970s, we think the flow of cheap labor from low-cost parts of the world has not only been a boon to developed world profit margins but also a powerful source of economic growth for India and the developing parts of Asia and Central and South America.

With geopolitical tensions spiking and world trade as a percentage of the global economy stagnating in the last decade (see chart 6, right), it has become popular to suggest that the 'death of globalization' is imminent. We reject this notion; the economic and cultural incentives are simply too powerful for the world to revert to a totally insular mindset, in our view. However, we believe the nature of globalization is changing as political alliances and security risks shift, including a trend towards 'reshoring' (shifting manufacturing back home for industries seen as key to national security) as well as 'friendshoring' (shifting supply chains to other geographies perceived as economically and politically more aligned with the US).

**CHART 6: GLOBAL TRADE STAGNATING OVER PAST DECADE**

#### World trade (goods)



*Shown for illustrative purposes only. Source: Refinitiv Datastream, RiverFront, Data monthly, as of January 2023.*

### A Case Study in How Globalization is Shifting – The Semiconductor Supply Chain

An industry being acutely impacted by the shifts in globalization is the semiconductor industry. Since semiconductors are used in so many facets of everyday life, they have come into the spotlight as an industry where supply chain concentration has become an issue of national security. Currently, the vast majority of global chip manufacturing comes from Asia, most notably Taiwan, South Korea, Mainland China, and Japan. This is due originally in part to the presence of cheaper labor. We have seen legislation from the US and the European Union (EU) that incentivizes companies to onshore the manufacturing of semiconductors through the use of tax breaks and subsidies. Companies are responding to this legislation, as well as the reality that diversification out of Asia will reduce business risk. Some such companies are Taiwan Semiconductor Manufacturing Company and Intel Corporation, both of which are planning to build out new chip factories ('fabs') in the US and the latter is planning also to build out in the EU. These will provide significant domestic investment – in the ballpark of greater than \$10B per fab – which is expected to benefit the surrounding areas in the form of direct investment and job creation.

We believe going forward, the semiconductor supply chain will continue to become increasingly diversified – with more fabs built in the US and Europe. However, we also believe that policy and business incentives aimed toward diversifying supply chains won't go so far as to completely dismantle the semiconductor supply chain as we know it. In our view, the cost and



time it takes to build out these new and somewhat duplicative fabs and to acquire the high-end equipment used within them will prevent the semiconductor supply chain from becoming completely “de-globalized”.

Even once the fabs are increasingly globally diversified, if they hope to stay on the leading edge of semiconductor production, they will remain reliant on the same handful of companies making the high-end equipment. We believe these dynamics that play into the cost benefit analysis for the semiconductor industry are going to play out similarly throughout different industries, where the end result is a hybrid of the types of globalization we have witnessed the last 10-20 years.

### Investment Implications of a Shift in Globalization

For investors, globalization’s evolution has important implications for asset allocation decisions. First and most obvious, we are less optimistic than many of our peers about investing in China going forward, and our EM forecasts reflect this declining optimism. As China’s economy and ideology continues to diverge from the West, the implicit costs of relying on the region as an economic partner are increasingly outweighing the benefits for the US and Europe. However, there will be net beneficiaries to China’s net loss of trade with the US; among those are areas like India, South Korea, Japan, Taiwan, Poland, Brazil, and Mexico, in our view.

Second, reshoring and friendshoring can create initial supply chain friction and downstream costs for the US and its allies as facilities are built and higher cost labor is utilized. This is one reason that our CMA forecasts in our Base Case scenario assume no upward revision in profit margins over the forecast horizon and assume declining margins in our Bear Case. However, reshoring may also create indirect benefits such as a more reliable and diversified supply chain, as well as a more robust local employment market; note that US manufacturing jobs are now at a 13-year high (see chart 7, above).

Last, we view energy independence as a long-term economic and geopolitical advantage and a reason to remain optimistic about economic and corporate earnings growth in the US. While ‘energy independence’ is a vague term which can be interpreted many different ways, in the broadest definition – not needing to import energy to meet the country’s basic internal energy demand – the US recently achieved this milestone. According to the Energy Information Association (EIA), the US is now a net oil exporter and became the world’s largest producer of oil products in 2021. With Canadian production also on the rise, the continent of North America is arguably the most powerful energy supplier in the world. We believe that North American energy companies are also some of the best-managed and most efficient of their type in the world. In the 3% or higher core inflation backdrop that we are forecasting, we expect diversified US energy companies to continue to be attractive sources of earnings and dividend growth.

We believe the following disciplines will be crucial to deploy for asset allocators given the current backdrop:

- **Dynamic Asset Allocation:** The flexibility to move up and down asset allocations quickly as the fundamental backdrop changes.
- **Active Risk Management:** Deal with potential increases in stock and bond volatility.
- **Ability To Incorporate Alternatives:** The willingness and ability to seek alternative sources of return and income.
- **‘Process over Prediction’:** The willingness to shift strategies in a calm and disciplined way as unexpected events change.

CHART 7: US MANUFACTURING JOBS HIT A NEW RECENT HIGH



*Shown for illustrative purposes only. Source: Refinitiv Datastream, RiverFront, Data monthly, as of January 2023.*

- **Transparency and Communication:** Emotional alpha will be maximized in an environment where the investor and asset manager are in a healthy relationship of trust and two-way communication.

At RiverFront, we are facing this challenge clear-eyed and calm. While we believe building prediction engines are important, we also believe building an adaptable discipline that is consistently applied and strives to minimize emotion gives investors the best chance of long-term success.

## APPENDIX

### DETAILED GLOBAL EQUITY FORECASTS FOR 2023

#### The Search for Historical Analogs

We concentrated our analysis for the sake of forecasting corporate earnings and warranted P/E multiples on the time period from 1985-present. We believe this almost four-decade time period is the most relevant to study in depth; it contains both periods of elevated inflation and deflationary scares, and incorporates a time period where the Fed has taken on more responsibility for proactive countercyclical monetary policy.

To inform our Base and Bull Case scenarios, we focused on the decades between the 1980s and now, specifically analyzing two historical periods with some similarities to the backdrop we are forecasting: 1984-1991, a reflationary time when core inflation stayed stubbornly high; and 2002-2007, when the interest rate regime was similar to the levels we are predicting in our Base Case. Both time periods boasted reasonably strong economic growth but had to contend with a recession at the end of their period. In '84-91, Gross Domestic Product (GDP) growth was strong but was complicated by high inflation and interest rates, thus keeping stock valuations low. 2002-2007 had lower interest rates – and thus higher stock valuations – but rates were much more in line with historical averages than in the post-financial crisis period that followed. In both cases, corporate earnings growth was solid, but markets did not experience much valuation expansion... similar to our Base forecast today.

For our optimistic 'Bull Case' scenario, in addition to aspects of the '84-91 and '02-07 periods, we also considered a period marked by extraordinarily low inflation and interest rates; the post-financial crisis period of 2009-2021. This period was not a great time for economic growth or even corporate earnings growth, but paradoxically was a 'Goldilocks' period for stocks. Extraordinarily low inflation and interest rates, combined with massive monetary accommodation in the aftermath of the financial crisis (and much later during the pandemic), caused the fed funds interest rate target to average less than 1% over this time period, forcing yield-seeking investors into stocks in droves and pushing valuations to extended levels. This lack of high risk-free rates of return ushered in the 'T.I.N.A.' era ('There Is No Alternative' to stocks), and 'growth' stocks – whose valuations are highly sensitive to interest rate levels – outperformed value-oriented stocks by a historic margin.

To craft our Bear Case scenario, we also considered the extended 'Stagflation' period from 1969-1983, a difficult time for the economy when the Fed had to contend with see-sawing inflation. The Fed was forced to push interest rates extraordinarily high, maxing out at an implied fed funds rate of 19% in the summer of '81. During this period, a series of four rolling recessions confounded the Fed, and stock market index price returns were low – similar to our Bear Case forecast. Two major caveats: even in our Bear Case, we do not foresee inflation as consistently high as we saw in '69-83, when core CPI inflation year-over-year growth averaged 7.5%. The aging of the developed world, a global workforce, US energy independence, productivity gains driven by the advent of the semiconductor, and proactive Fed policy are five reasons that we believe inflation will be structurally lower going forward than during that period. Thus, while we assume low earnings growth, our profit margin and valuation assumptions are not as dire as 1969-81.

**BASE CASE ASSUMPTIONS: 'Back To the Future' – Inflation back to 80s-90s levels, rates similar to early 2000s, reasonable earnings growth, limited valuation expansion.**

- Historical Analogs: 1984-1990, 2002-2007
- In our Base Case, we are assuming ~7% corporate earnings growth, based on slightly better than trend-like economic growth; reflationary backdrop leads US and rest of the world to reasonably strong Gross Domestic Product (GDP) growth over the next few years. We are assuming little structural reform and slightly lower profit margins, with a slightly higher tax regime vs. the current environment.

- For the US, we assume ~0.5%/year contraction in P/E multiple, with core inflation close to long-term average of 3% and Fed remains in rate hike mode until a mild recession asserts itself relatively early in the forecast period; terminal P/E ratio at end of cycle is ~17x.
- For Developed International Markets, we assume 14.5x multiple for Europe and 13.5x for Japan, which represents a small amount of expansion from current depressed levels, given a more favorable industry composition for cyclical and value-oriented stocks; assuming Earnings per Share (EPS) growth of 4% in both Europe and Japan, respectively.

**BULL CASE ASSUMPTIONS: 'TINA 2.0' – A reversion to relatively low interest rates and high valuations.**

- Historical Analogs: 2009-2021
- For the US we forecasted an 18x forward P/E terminal multiple, which would represent a similar valuation to today. This is assuming earnings growth of 10%, contained core inflation averaging 2.5%/year, a 3.25% terminal US 10-year treasury yield, flat to slightly higher profit margins from current due to operating leverage for cyclical companies, and a slightly weak US dollar. It bears noting that the S&P 500 has averaged corporate earnings growth of close to 8% since 1985, and close to 12% over the past five years (source: Refinitiv Datastream), so this level of growth would only mean US corporate earnings maintaining the recent historical rate.
- For Europe we are applying a 16x multiple - with 7% earnings growth, reflecting multiple expansion off of depressed levels due to operating leverage and a return to long-term average earnings growth. In Japan, we also assign a 14.5x multiple on 7.5% growth in earnings, assuming some profitability benefit due to improved corporate governance and efficiencies. For emerging markets, an optimistic outcome would include some multiple expansion from current levels and 7.5% earnings growth, as economic growth. Regions that produce commodities and large, fast-growing countries like India more than offset economic losses from China's reversal away from Western integration.

**BEAR CASE ASSUMPTIONS: 'A Stagflationary Slog'<sup>2</sup> – Inflation saps returns.**

- Historical Analogs: 1969-1983
- Multiples shrink meaningfully across all geographies as the pernicious combination of higher structural inflation and lower economic growth pervade the globe. For US markets, our assumption includes a 14.5x terminal multiple on earnings and earnings growth of roughly half historical averages at around 3.5%, compounded by higher taxes, lower profit margins and a relatively weak US dollar.
- In Europe, Japan and Emerging Markets, the lower structural efficiency and higher funding costs and labor rigidity inherent in those economies means less ability to pass along inflationary pressures, resulting in lower earnings growth than in the US. Under this 'grey sky' scenario, we are also forecasting contracting valuations in international regions even from the relatively modest valuations of today, due to the mixture of higher inflation and lower economic growth.

**DETAILED FIXED INCOME FORECASTS FOR 2023**

The impact of the Fed's rate hiking cycle goes beyond simply fighting inflation; the move higher in Treasury yields has changed the expected return trajectory for asset allocators. Higher interest rates give bond investors the opportunity to earn a return closer to the 4% spending rate that many financial planners model for clients in retirement. While 4% is not a 'magic' number, higher interest rates allow for a higher expected return and lower amount of risk to be taken by bond investors. Furthermore, the resilient labor market we are forecasting in our Base Case would likely force the Fed to maintain a higher interest rate environment, to keep inflation from reaccelerating. The combination of higher starting yields in the bond market, a strong labor market, and a hawkish Fed has reset our return expectations in bonds higher in our 2023 Base Case forecast.

The path dependent nature of yields on fixed-income total returns are crucial to long-term forecasting. Last year we wrote: "the quicker rates rise, the more near-term pain is felt in bond prices... but we believe the long-term investor has more time in which to reinvest and compound higher coupons, which can lead to improved returns for patient investors." While 2022 was painful from both a price and diversification standpoint, the difficult medicine that we were expecting to come over several

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<sup>2</sup>Stagflation is the persistent high inflation combined with high unemployment and stagnant demand in a country's economy.



years came in one year. Out of every tragedy there is opportunity. The opportunity in this case, is that bond investors will have a higher starting yield and can reinvest at higher yields in subsequent years. The move higher in interest rates of more than 2% ended a historically low yield regime and entered a new higher yielding regime.

Therefore, in each of our three scenarios, we assume that interest rates have normalized, with the US 10-year Treasury yielding 4.25% as our Base Case. The subsequent Bull and Bear Case for bonds has the US 10-year Treasury yielding falling and rising by 1%, respectively. Given we believe that Treasury yields have normalized, our forecasted terminal rate under each scenario is driven by spread movement of investment grade corporate bonds and mortgage-backed securities, which represent roughly 52% of the Bloomberg Aggregate Bond Index.

### 2023 Fixed Income Forecasts: Spreads of Corporates and MBS Drive the Terminal Rate

Given the uncertainty of the path of interest rates over the next seven years, we have chosen to create three fixed income return forecasts: a Bear Case, a Base Case, and a Bull Case. We started by focusing on the Bloomberg Aggregate Bond Index (Aggregate) by forecasting yields for the following components of the index: Treasuries, agencies, mortgage-backed securities, and corporate bonds, as well as the index itself. This approach allowed us to reconcile the index forecast with a bottoms-up sector forecast.

We made several assumptions to generate the forecast for the Aggregate total return approximately seven years forward. First, we assumed that the 10-year Treasury yield - adjusted for corporate bond and mortgage-backed spread widening and tightening - would be representative of the Aggregate's yield. Next, the Aggregate's current yield and duration were used to calculate future price changes. Lastly, we assumed the terminal rate (starting yield of the Aggregate plus the change in the 10-year yield versus our projection minus the sum of the weighted corporate bond and MBS spread changes) was used to calculate income. Using this structure, the forecasts were generated for the Aggregate.

#### Base Case Fixed Income Assumptions

Under the Base Case scenario, bond investors receive 4% per annum and the terminal rate on the Aggregate is 5.04%. Given the current rate hiking cycle and the significant yield movement over the last year, we assume that investors will receive the terminal rate gradually over the seven-year period in equal increments. Under this scenario corporate bond and mortgage spreads are unchanged from levels as of January 31, 2023.

#### Bear Case Assumptions

Under the Bear Case scenario, bond investors receive 4.4% per annum and the terminal rate on the Aggregate is 4.05%. Given the current rate hiking cycle and the significant yield movement over the last year, we assume that investors will receive the terminal rate gradually over the seven-year period in equal increments. Under this scenario corporate bond spreads tighten by 0.5% and mortgage spreads tighten by 0.42% from levels as of January 31, 2023.

#### Bull Case Assumptions

Under the Bull Case scenario, bond investors receive 3.4% per annum and the terminal rate on the Aggregate is 6.19%. Given the current rate hiking cycle and the significant yield movement over the last year, we assume that investors will receive the terminal rate gradually over the seven-year period in equal increments. Under this scenario corporate bond spreads widen by 1% and mortgage spreads widen by 0.33% from levels as of January 31, 2023.

### 2023 Extension to our Fixed Income Forecasts: Introducing High Yield Bond Estimates

In addition to forecasting the Aggregate, this year we are adding high yield to our long-term fixed income forecasting. When attempting to forecast the annualized returns for high yield, we must focus on the path to the terminal yield, the annual default rate, and the loss upon default to determine the annual income. Following our format for forecasting the Aggregate we ran a Base, Bull, and Bear Case for high yield returns over the next seven years. In our three scenarios we made several assumptions. We assumed that the yield of the ICE BofA High Yield Index on January 31, 2023, was the starting yield and that the duration of the index remained constant for the seven-year period. Lastly, we assumed that the yield of the index plus the yield change of the five-year Treasury minus the spread change of high yield determined the terminal rate. Below you will find the details to each scenario.

#### Base Case High Yield Assumptions

Under the Base Case scenario, high yield investors will receive 5.6% per annum and the terminal rate would be 9.3%. Defaults begin year one at the long-term average of 3% and peak in year two at 7%, returning to the long-term average in years four through seven. There is a 40% recovery rate of principal once companies' default, which leads to an average loss of 1.5% per annum in income for investors. The combination of defaults remaining below the 10% threshold that occurs during prolonged recessions and an average recovery rate led to a smaller haircut on the investor's return.

### **Bull Case High Yield Assumptions**

Under the Bull Case scenario, high yield investors will receive 6.8% per annum and the terminal rate would be 6.5%. Defaults stay at the long-term average of 3% for the first three years and then fall to 2% in years four through seven. The 50% recovery rate of principal once companies' default is above average, which helps to mitigate the loss that investors endure. The average loss of income is 1.2% per annum for investors. The combination of defaults hovering at or below the long-term average and above average recovery rates reduces the loss by 0.33% per annum versus our Base Case.

### **Bear Case High Yield Assumptions**

Under the Bear Case scenario, high yield investors will receive 1.6% per annum and the terminal rate would be 12.5%. Defaults begin year one at 5% and then spike in year two to 12%, not returning to the long-term average of 3% until year seven. Additionally, given the dire environment and the elevated defaults recovery rates are below average at 30%. Investors are placed in a no-win situation in this scenario because the economic pressure on highly leveraged companies creates an income loss of 2.1% per annum for investors.

## **CONCLUSION: AGGREGATE FIXED INCOME MUCH MORE ATTRACTIVE TO US THAN LAST YEAR**

We think the resetting of the interest rate environment last year has opened the door of opportunities for fixed income investors. We believe that there is less concern moving forward of the price depreciation of a bonds outstripping its income generation as it pertains to high quality investment grade bonds. Hence, the Aggregate is poised to bolster returns for investors as it is comprised of high-quality investment grade corporates and mortgage-backed securities. Given that we believe yield movements will be more gradual in the future, we have forecasted the Aggregate to return 4% per annum for the next seven years.

On the flip side, more leveraged companies will have a tougher time as higher yields will lead to defaults. While we are not expecting defaults to rise above the long-term average, defaults cause both loss of principal and income generation. Hence, over the next seven years we believe high yield investors will have to weigh the risk/reward carefully before jumping in for an additional 1.6% per annum over the Aggregate. We are forecasting high yield to return 5.6% per annum.

#### **Important Disclosure Information:**

*The comments above refer generally to financial markets and not RiverFront portfolios or any related performance. Opinions expressed are current as of the date shown and are subject to change. Past performance is not indicative of future results and diversification does not ensure a profit or protect against loss. All investments carry some level of risk, including loss of principal. An investment cannot be made directly in an index.*

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*All charts shown for illustrative purposes only. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.*

*Emotional alpha is a term we use to define the value of helping a client navigate market swings without making decisions purely on emotion.*

*In a rising interest rate environment, the value of fixed-income securities generally declines.*

*When referring to being "overweight" or "underweight" relative to a market or asset class, RiverFront is referring to our current portfolios' weightings compared to the composite benchmarks for each portfolio. Asset class weighting discussion refers to our Advantage portfolios. For more information on our other portfolios, please visit [www.riverfrontig.com](http://www.riverfrontig.com) or contact your Financial Advisor.*

*The Institutional Brokers' Estimate System (IBES) is a database used by brokers and active investors to access the estimates made by stock analysts regarding the future earnings of publicly traded American companies.*

*Price-Earnings Multiple (P/E Multiple) is the price of the stock over the earnings per share. The earnings per share are found on the income statement. It is the total net income that the company has earned (revenue minus the costs) divided by the number of outstanding shares.*

*Price-Earnings Ratio (P/E Ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings.*

*Gross domestic product (GDP) is a monetary measure of the market value of all final goods and services produced in a period (quarterly or yearly) of time.*

*A real estate investment trust (REIT) is a company that owns, operates, or finances income-generating real estate. Modeled after mutual funds, REITs pool the capital of numerous investors. This makes it possible for individual investors to earn dividends from real estate investments – without having to buy, manage, or finance any properties themselves.*

*The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them. Changes in the CPI are used to assess price changes associated with the cost of living. The CPI is one of the most frequently used statistics for identifying periods of inflation or deflation.*

*Earnings per share (EPS) is a figure describing a public company's profit per outstanding share of stock, calculated on a quarterly or annual basis. EPS is arrived at by taking a company's quarterly or annual net income and dividing by the number of its shares of stock outstanding.*

*Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.*

*Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.*

*Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.*

*Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero).*

*Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.*

*Buying commodities allows for a source of diversification for those sophisticated persons who wish to add this asset class to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any commodity purchase represents a transaction in a non-income-producing asset and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.*

*High-yield securities (including junk) are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities.*

*Technology and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.*

*RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation. Blue line represents the Large Cap Real Return Index. Yellow line represents the Annualized Real Trend Line of Large Cap Real Total Return Index according to Price Matters®. Shown for illustrative purposes only, not indicative of RiverFront portfolio performance. Information or data shown or used in this material was received from sources believed to be reliable, but accuracy is not guaranteed. The chart above uses a logarithmic scale. Line movements will be dampened/subdued based on the exponential y-axis. Trend, according to Price Matters® is the slope of an exponential growth function that closely tracks a real (inflation-adjusted) long term Index for that Asset Class. Distance from Trend is the distance of the trend line relative to the current index level expressed as a percentage.*

#### *Index Definitions:*

*Standard & Poor's (S&P) 500 Index TR USD (Large Cap) measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.*

*Bloomberg US Aggregate Bond Index measures the performance of the US investment grade bond market. The index invests in a wide spectrum of public, investment-grade, taxable, fixed income securities in the United States – including government, corporate, and international dollar-denominated bonds, as well as mortgage-backed and asset-backed securities, all with maturities of more than one year.*

*ICE BofA High Yield Index TR USD (High Yield) tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. Index constituents are capitalization-weighted based on their current amount outstanding times the market price plus accrued interest.*

#### *Asset Class Definitions:*

*Developed International: MSCI EAFE Real Total Return Index-The MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada.*

*Emerging Markets: MSCI Emerging Market Equities Real Return Index-MSCI Emerging Markets Index measures equity market performance of emerging markets. The index consists of approximately 25 countries representing 10% of world market capitalization.*

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