Canadian Long-Run Financial Market Returns

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Highlights

- Over the last decade, Canadian investors have experienced solid 5% to 7% annual portfolio gains, outperforming those of the previous decade. The falling yield environment, coupled with increased risk taking, provided a constructive backdrop for investors. Among the asset classes, US equities stole the show, with a 15% average annual return when translated into C$.
- Though recent returns have been favourable, we believe that returns are poised to come down over the next decade.
- With Canadian and US interest rates currently sitting at close to their longer-term 'neutral' levels, fixed income government and corporate bonds are likely to deliver more modest returns than what we've seen historically.
- The return of equities will be dependent on expectations for corporate profit growth and the multiple investors are willing to pay for those profits. Our assumptions point to equity returns in the 4% to 7% range on average over the next decade. With respect to Canada's equity performance, this would mark the status-quo relative to the past 10 years. However, for the US, it implies a hefty moderation relative to its past showing.
- While there appears to be little scope for domestically-generated corporate profits to run much faster than GDP growth in Canada and the US going forward, the ability for corporations to increase exposure to higher growth emerging markets provides upside to our estimates on profits and equity market performance.

Global Asset Return Expectations: Sit Down, Be Humble

Over the course of the current economic expansion, Canadian investors have experienced impressive portfolio returns (Table 1). Though there have been bouts of weak equity returns (i.e. the oil shock of 2015 and trade tensions in 2018), investment returns have largely been supported by healthy economic growth in Canada and the US, as well as low inflation. Furthermore, central banks in Canada and the US erred on the side of caution by keeping interest rates ultra-low well into the current cycle and then have tightened only gradually. This policy rate backdrop has resulted in continued steady gains for investors in bonds and has generated an increase in risk taking. This, in turn, has boosted equity prices, with US returns averaging double-digit gains. An investor with a portfolio focused on income generation (Table 2) has received an annual return of over 5% on average, whereas an investor in a growth-oriented portfolio has received a return of over 7%. Portfolio returns over the current cycle have eclipsed the average returns of the 2000-09 period.

Over the next decade, we believe that investors should prepare for lower annual portfolio returns. With central bank policy rates expected to average right around current 'neutral' levels, cash returns will likely be higher than the past decade. However, fixed income gains are projected to continue a downtrend that began in the 1980s. US and Canadian equities are likely to deliver moderate returns in the 4% to 7% range, which for the high-flying US market would mark a significant downshift from its unsustainable performance of 2010-18. This outlook embeds some slowdown in global economic growth compared to the recent post-crisis recovery period and a tapering off in the share of profit-to-GDP. All told, we do see positive portfolio returns for Canadian investors, but have reduced the average growth rate by about 1% to 2%.

Table 1: Long-Term Financial Asset Returns (C$)					
	1990-1999	2000-2009	2010-2018	2019-2028 Midpoint	2019-2028 Range
Cash 90-Day T-Bill	6.4%	3.1%	0.8%	2.0%	1.5%-2.5%
Canada 10-Year Government Bond Index	10.1%	6.7%	3.7%	2.5%	2.0%-3.0%
ICE BofAML Canada Corporate Index*	10.6%	6.9%	4.5%	3.5%	3.0%-4.0%
S&P/TSX Composite Index	10.6%	5.6%	5.3%	5.5%	4.0%-7.0%
S&P 500 (US$)	18.2%	-0.9%	11.7%	5.5%	4.0%-7.0%
S&P 500 (C$)	20.8%	-4.1%	15.1%	5.5%	4.0%-7.0%
MSCI EAFE (US$)	7.0%	1.2%	3.8%	5.5%	4.0%-7.0%
MSCI EAFE (C$)	9.4%	-2.0%	6.8%	5.5%	4.0%-7.0%
Income	10.7%	4.9%	4.9%	**3.4%**	**2.6%-4.2%**
Balanced	11.3%	3.8%	5.8%	**4.0%**	**3.0%-5.0%**
Growth	12.1%	2.2%	7.1%	**4.9%**	**3.6%-6.2%**

Source: Bank of Canada, Bloomberg, ICE Bank of America Merrill Lynch, Standard & Poor's, Toronto Stock Exchange, TD Economics.
Asterisks(*): Denotes that data from January 1990-June 1992 was forecasted.

Table 2: Portfolio Weights					
	Cash	Fixed Income	Equities		
	90-Day T-Bill	Canada Universe Bond Index	S&P TSX	S&P 500	MSCI EAFE
Income	5.0%	65.0%	15.0%	7.5%	7.5%
Balanced	5.0%	45.0%	25.0%	12.5%	12.5%
Growth	5.0%	15.0%	40.0%	20.0%	20.0%

Source: TD Economics. The portfolio weights are chosen based on assessment of a range of investment policy statements. Various portfolios and funds will have different weightings. The weights provided here should only act as an example.

Cash Returns: Starting from the Bottom

Investors in short-term cash securities have received an average return of less than 1% per year over the current expansion. This return pales in comparison to the 3.1% annual return of the 2000s and the 6.4% return of the 1990s. This historically low return is due to the aggressive response by the Bank of Canada to support the economy in the wake of the global financial crisis of 2008/09. At the time, the Bank of Canada cut its policy rate from 4.50% in late 2007, to 0.25% at the depth of the crisis. The policy rate was kept low thereafter - averaging 0.8% from 2009 to 2016. Once signs of improvement in the economy emerged, the Bank started raising its policy rate in 2017. It hiked rates five times, finally reaching the current policy setting of 1.75% in October 2018.

With the Canadian economy currently running at capacity and inflation at its 2% target, our view is that the prevailing policy rate is right around the level that will keep the economy balanced (i.e. a neutral stance). Thus, while monetary policy will be adjusted upwards and downwards over the next 10 years in response to shorter-term swings in growth and inflation, the prevailing rate of around 2% is a reasonable assumption for the average cash rate over the next 10 years.

Risks around our neutral rate estimate that guide our cash rate assumption are two-sided. One inherent challenge is that a neutral rate can change over time in response to global (as well as domestic) economic and financial shifts. For example, one can't rule out the possibility that global central bank policy rates are being held back by a global savings glut, structural increase in demand for safe assets and/or global secular stagnation that could ease over the longer run. Domestically, short-term rates will be driven in large part by Canada's actual longer-term growth performance. Any significant undershoot of GDP growth relative to our current expectations - say, due to a slowdown in labour force and/or productivity growth - would likely translate into a lower average policy rate (Chart 1). The opposite holds true for growth outperformance.

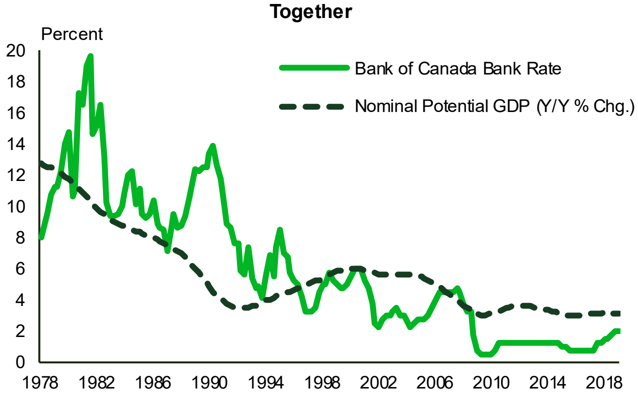
Fixed Income Returns: Got low low low...

Since 2010, the 10-year Government of Canada Bond Index returned 3.7% annually. This compares to the 6.7% annual return of the 2000s and the 10.1% return of the 1990s. With current government yields so low, returns on fixed income will likely continue to decelerate going forward.

It is important to recognize that Canadian fixed income has been on a near 40 year bull run. The decline in Canadian government bond yields was the main driver. The Canada 10-year yield peaked in 1981 at 17% and has steadily declined to less than 2% currently (Chart 2). The reason for this decline is the same as that for the Bank of Canada policy rate mentioned above. Lower economic growth and stable inflation requires lower interest rates.

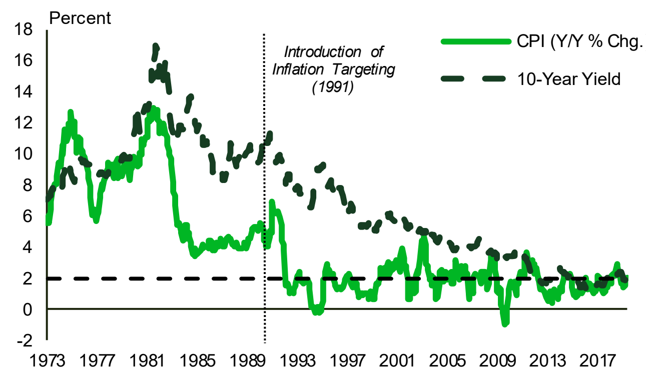
If the Bank of Canada rate should average around 2% over our forecast horizon, the 10-year Canadian Government bond should yield that cash return plus a modest term premium for locking into the prevailing yield for 10 years. The term premium is currently very low in Canada partly due to heightened global uncertainty, but more so because there is little perceived risk that interest rates and inflation will rise more than expected over the maturity horizon. Recall that in the 1970s and 1980s, inflation in Canada was running at double digits and the Bank of Canada had to keep the policy rate high in order to bring inflation expectations down. Now that inflation is restrained on the upside, the risk of meaningfully higher policy rates is lower now than in the past. This means that the term premium and overall government bond yields are constrained on the upside. The resulting return for the Canada 10-year government bond is expected to run slightly above the cash rate at 2.0% to 3.0%.

Chart 1: Potential GDP and Interest Rates Move Together



Source: Bank of Canada, Statistics Canada, TD Economics

Chart 2: Yields Declining With Inflation Risk



Source: Federal Reserve Bank of St. Louis, Statistics Canada, TD Economics

To close out our discussion of fixed income returns, we move to corporate credit. Here, we assess the spread of corporate credit relative to sovereign yields. The broad corporate bond index for Canada has averaged a spread of approximately 1.25% since 2010. The level of debt of corporations and the ability to increase profits in order to service this debt influences the return of fixed income credit (Chart 3). Even though corporations are currently able to service their debts, corporate indebtedness in Canada and globally is elevated, meaning that yield spreads could jump significantly should the corporate profit outlook turn dower. For the purposes of our baseline projections, we assume that corporate spreads on average will be wider than in the past 10 years to reflect this risk.

Equity Returns: Mr. Worldwide

Canadian equities have returned 5.3% annually since 2010. Though this is a decent return, it is below what many investors would have hoped for. Indeed, to supplement returns, many Canadian investors have diversified their portfolios internationally. This has been a very successful strategy. Over this period, the US S&P 500 Index provided a return of 15.1% annually and the MSCI EAFE (developed economies excluding Canada and the U.S.) returned 6.8%. About 3% of annual S&P 500 and MSCI EAFE performance was due to a depreciating Canadian dollar.

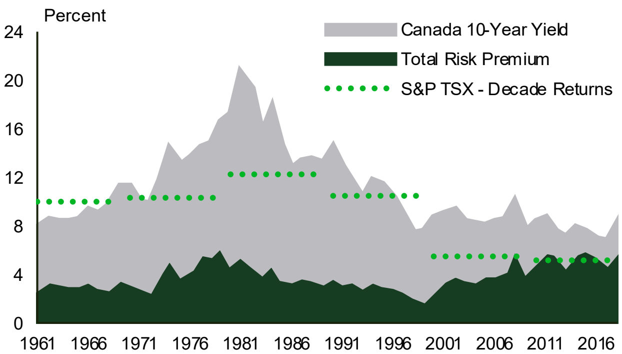
Keep in mind that part of Canada's equity underperformance relative to the US occurred over the final years of the decade. Excitement around US tax reform and a stampede of investment into high tech benefitted the US market, whereas Canada's S&P TSX was held back by low oil prices following the 2015 oil shock and lower relative earnings growth thereafter.

The question on many peoples' minds is, "what will equity markets return going forward?" To answer this question, we consider the equity risk premium relative to our forecast of safe assets. In this way, we can build upon our yield analysis in the previous sections. In Chart 4 we show that the combination of the equity risk premium, plus the Canada 10-year bond yield gives an expected equity return around 8% annually. Though this is a good starting point for understanding the return potential of equities, we need to dig deeper.

To better assess the return potential of equities, we need to look into its primary driver: corporate profit growth. In developed economies around the world, a substantial share of GDP has gone to corporations. That share sits at around 10% to 11% today in both the US and Canada (Chart 5). When we combine this with the expectation that developed economies are only expected to grow around 4% (nominally) over our forecast horizon, domestic profit growth will likely come in around 4%.

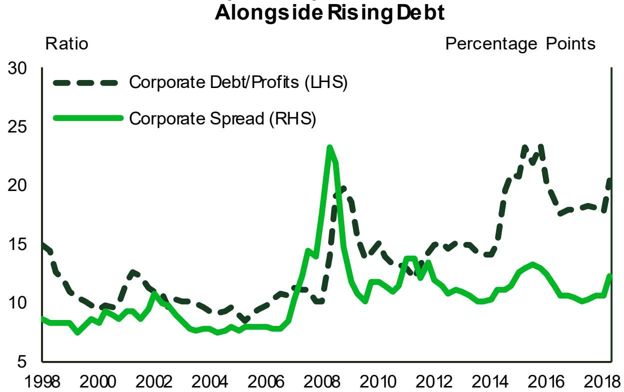
For equities, it is important to note that earnings of S&P 500 and TSX Composite companies have outpaced those of overall domestic corporations. The annual growth rate of earnings per share of S&P 500 companies was 11.2% from 2010 to 2018, more than double US domestic corporate profit growth of 4.5% (Chart 6). For the TSX Composite, the growth of earnings per share was 6.3%, compared to 2.9% for Canadian corporate profits. The outperformance of publicly traded corporation profits explains the outperformance of equities relative to the overall economy.

Chart 4: Expected Equity Return Holds Firm



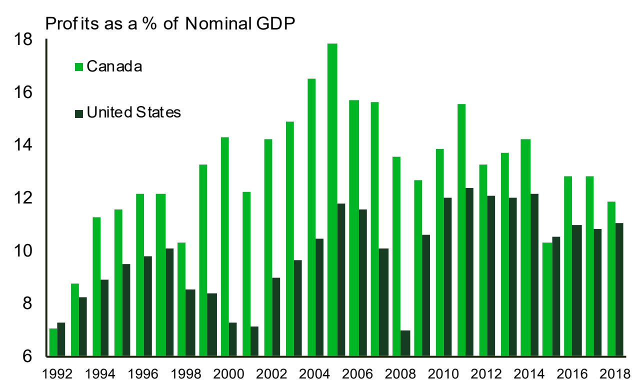
Source: Federal Reserve Bank of St. Louis, NYU (Damodaran), Toronto Stock Exchange, TD Economics
Notes: Assumes Canada has a zero country risk premium to that of the US.

Chart 3: Corporate Spreads Remain in Check Alongside Rising Debt



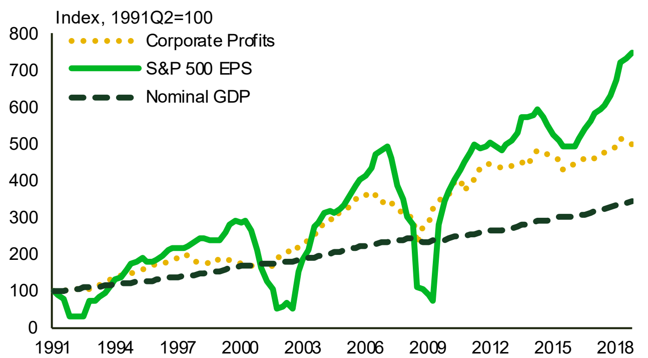
Source: ICE Bank of America Merrill Lynch, Statistics Canada, TD Economics

Chart 5: Corporations' Slice of the Economic Pie



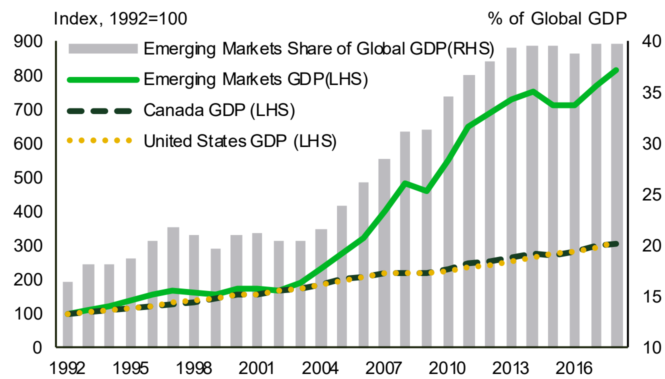
Source: Bureau of Economic Analysis, Statistics Canada, TD Economics

Chart 6: Stock Index Earnings Outpace Profit Growth and the Economy



Source: Bloomberg, Bureau of Economic Analysis, TD Economics

Chart 7: Emerging Economies Rising Share Of the Global Economy



Source: Bureau of Economic Analysis, IMF, Statistics Canada, TD Economics

Going forward, there will be three major factors that will dictate whether equities can continue to outperform: cost pressures, global reach, and valuations.

Over the current expansion, labour's share of GDP has been on the decline globally. Populist movements around the world have spawned in response to this widening inequality. Tight labour markets and potentially an increase in the bargaining power of workers could cause wages to rise, eating into margins. On the other hand, increasing productivity and automation may not be passed on to workers, which would further push a greater share of GDP to corporations.

Another factor that will helped grow profits is corporations' ability to keep expanding their net globally. Since the early-1990's emerging market economies have doubled their share of global GDP (Chart 7) and their GDP growth rates are expected to be 1% to 3% above that of advanced economies (see Box 1 for an assessment of the risks around emerging market exposure). If emerging markets continue to grow at this faster pace and corporations are able to take advantage of this, we believe corporate profit growth could increase to roughly 5% to 7% annually.

Next we consider equity valuations. Whether we look at present, forward looking, or cyclically adjusted price to earnings ratios, all are above historical averages. If we assume that profits grow at 5% to 7% and valuations move to historical norms, we widen our range for equity returns to 4% to 7%.

Factored into our return estimates are neutral assumptions on commodity and exchange rates. Given that the Canadian dollar is already within the ballpark of an estimated equilibrium level of 78-80 US cents, we are comfortable assuming the currency holds relatively close to current levels. Ditto for oil prices, which are close to our estimated break-even level of about US$60 per barrel. A forecast which has only modest changes over the next few years would have little impact on 10-year average returns.

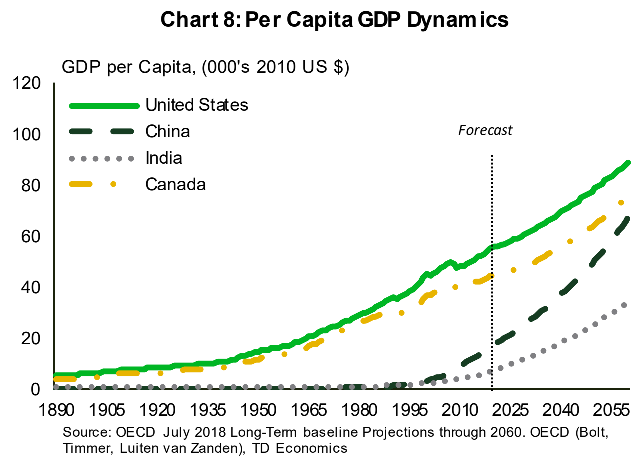
Putting this all into context

Table 1 divides up our forecast for financial market assets into cash, fixed income, and equity market returns. For cash returns, we find that policy rates should average around 1.5% to 2.5% in Canada. This assumes that inflation expectations remain anchored at 2% and that the real neutral rate remains fairly steady and well below historical norms. For fixed income, we take the policy rate range and add on an assumption for the term and credit premium. For equities, we add an equity risk premium of 2% to 4% to the return of government bonds, giving us a 4% to 7% equity return forecast.

Though the future is uncertain, what we have done in this report is apply our assumptions for economic growth, inflation, and corporate earnings power in a fundamental framework that allows for a mapping of the future path of financial asset returns. Happy investing!

Box 1: Emerging Market Caveats

The assumption that emerging market economies will continue growing at faster rates than advanced economies is based on the belief that they have room to catch-up. Here we look at GDP per capita of emerging markets to determine the production/income deviation between economies. From this we can see that the emerging world has significantly more room to close the gap with the advanced world. In order for the gap to close in any meaningful way, emerging markets will have to grow at a faster pace than advanced economies (or see populations stagnate – which is already happening). Based on current GDP and population growth rates from the OECD, it will take China (for example) several decades to catch-up to advanced economy levels. Growth in economies such as China could therefore outperform versus advanced economies for some time still (Chart 8).



But what if emerging economies can't catch-up? The history of economic growth has seen many starts and stops. The GDP per capita of the US and Canada has widened relative to China and India for much of the 20th century.[1] Strong economic growth has helped close this gap over the last few decades. If the emerging world finds a steady state without closing the gap, growth rate assumptions for emerging market economies and corporate profits will be permanently lower.

Endnotes and References

1. Bolt, Jutta, Marcel Timmer and Jan Luiten van Zanden (2014), "GDP per capita since 1820", in Jan Luiten van Zanden, et al. (eds.), How Was Life?: Global Well-being since 1820, OECD Publishing. http://dx.doi.org/10.1787/9789264214262-7-en With most crops p