REGIONS
ASSET MANAGEMENT

Capital Market Expectations (CME's)

2023

Powered By Multi-Asset Solutions (MAS)

REGIONS

2023 Capital Market Expectations Summary

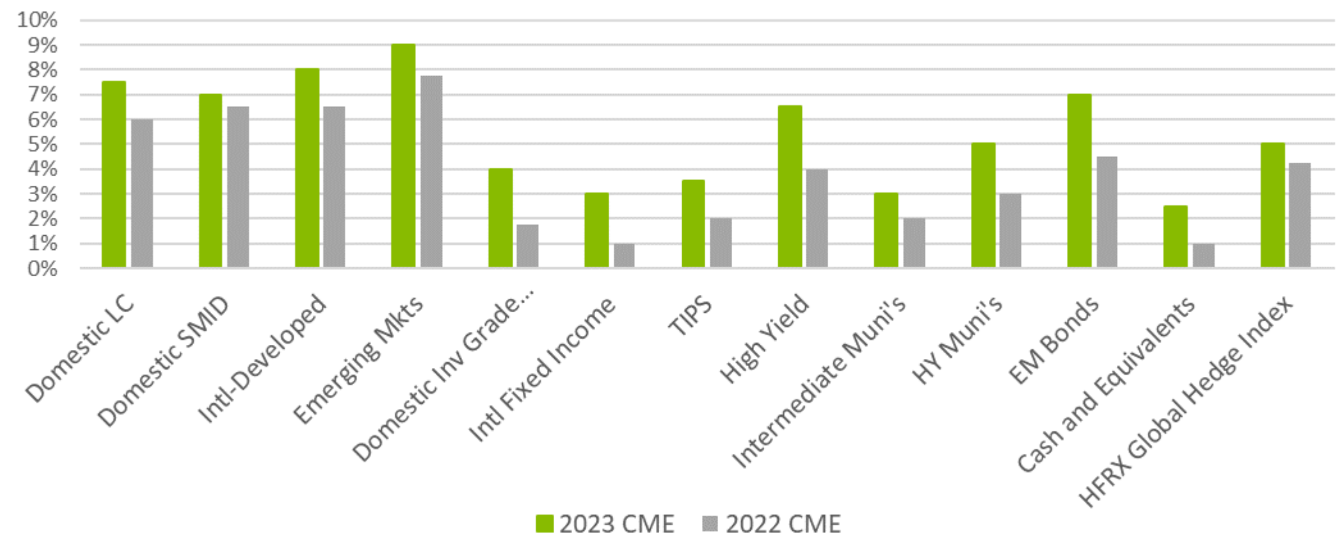
Looking Back: 2022 was challenging for all asset classes as central banks tightened monetary policy at an aggressive pace due to persistently stubborn inflationary pressures into the teeth of a slowing global economy. Developed markets abroad, perhaps surprisingly given the Russia/Ukraine war and energy insecurity fears across Europe, outperformed on a relative basis in ’22 as the MSCI ACWI ex. U.S. ended the year down 15.5% on a total return basis, while the S&P 500 declined 18.1%, the Russell 2500 (SMid) fell 18.4%, and the MSCI Emerging Markets Index fared the worst, dropping 19.9%.

Fixed income provided little in the way of tangible diversification benefits as a low starting point for yields and high sensitivity to rising interest rates generated sizable losses as central banks rapidly increased short-term rates to combat inflation. The Bloomberg Aggregate bond index ended the year lower by 12.8%, closing out its worst year since the index, as we know it currently, was constructed in 1976. The Bloomberg Corporate index fell by 15.6% as longer duration bonds were most negatively impacted by rising interest rates. High yield corporate bonds fared better, the Bloomberg U.S. High Yield index falling 11.2%, as low defaults, higher yields and less interest rate sensitivity (lower duration profiles) proved beneficial.

Alternative strategies were a relative winner in ‘22 as the HFRX Global Hedge Fund Index fell by 4.4%. The broader index was buoyed by discretionary and systematic trend following strategies, with the Macro/CTA Index and Systematic Diversified CTA Index rising 3.7% and 16.9% on the year, respectively. Merger arbitrage (-0.4%) and equity market neutral (flat) were also relatively good places to be amid a backdrop in which there were few places to hide and should remain so in the coming year as higher short-term interest rates and greater dispersion at the industry/sector level within stocks buoy the prospects for active managers in these areas.

Looking Forward: The opportunity set is much more appealing for investors in 2023 as equity valuations are less demanding, albeit still ‘rich’ relative to bonds, and interest rates are higher, increasing expected returns for fixed income and select alternative strategies. With short-term interest rates rising substantially in 2022, the starting point for fixed income investors is more attractive and our 7- to 10-year expectations have been ratcheted higher to reflect that. The fixed income opportunity set holds more appeal than it has at any point in the past decade as higher yields better compensate investors for taking interest rate and credit risk. With the S&P 500, Russell 2500, MSCI ACWI ex. U.S., and MSCI EM all declining by double-digits in 2022, our return expectations on a 7- to 10-year basis have risen. However, we expect higher short-term interest rates and heightened geopolitical uncertainty to pressure earnings and valuations over the near-term, leading us to muted equity return expectations over the balance of the coming year. Higher yields on fixed income also increase the appeal of some alternative investments, specifically alternative credit, arbitrage strategies, and managed futures, and non-directional strategies should prove beneficial to portfolios over the coming year(s).

Expected Returns Increased Across The Board Year Over Year



Asset Class	Asset Class Sub-Type	10-Year Expected Annualized Return	10-Year Expected Standard Deviation
Equity	Domestic Large Cap	7.50%	16.50%
Equity	Domestic SMID	7.00%	19.25%
Equity	International Developed	8.00%	17.50%
Equity	Emerging Markets	9.00%	20.50%
Equity	Global Stocks	8.00%	18.00%
Equity	Commodity-Related Equities	6.50%	23.00%
Fixed Income	Domestic Investment Grade	4.00%	4.25%
Fixed Income	Investment Grade Credit	4.50%	6.00%
Fixed Income	Long Duration Credit	4.50%	11.50%
Fixed Income	International Fixed Income	3.00%	5.50%
Fixed Income	TIPS	3.50%	5.50%
Fixed Income	High Yield	6.50%	9.00%
Fixed Income	Bank Loans	6.50%	8.00%
Fixed Income	Intermediate Municipals	3.00%	4.00%
Fixed Income	High Yield Municipals	5.00%	8.00%
Fixed Income	Emerging Market Bonds	7.00%	9.50%
Alternatives -Liquid	HFRX Global Hedge Index	5.00%	6.50%
Alternatives - L.P.'s	HFRI Global Hedge Index	5.50%	5.50%
Alternatives	Private Equity	9.00%	21.50%
Alternatives	Private Debt	8.00%	12.00%
Alternatives	Private Real Estate - Core	6.00%	12.50%
Alternatives	Public Real Estate (REITs)	7.00%	18.50%
Alternatives	Global Infrastructure	6.50%	15.00%
Alternatives	Commodities	3.00%	17.25%
Cash and Equivalents	Cash and Equivalents	2.50%	0.50%
Cash and Equivalents	Enhanced Cash	3.50%	1.00%

Source: Regions Asset Management

Revisiting 2022's Themes

1. **Global Central Banks Shift Further Away From Accommodative Pandemic-Era Policies**
   - The Fed (FOMC) learned from its mistakes in 2013 that led to the Taper Tantrum and has done an admirable job of communicating and telegraphing policy shifts. It will now be crucial for foreign central banks to do the same or risk market turmoil should they lose credibility. Any deviation from anticipated plan(s) could spook markets and spur bouts of heightened volatility for interest rates and equities on a local or global scale.

2. **U.S. Investors In Search Of Relative Value, Yield Increasingly Look Abroad**
   - Developed and emerging market stocks have lagged U.S. equities for the past 15 years, and that gap has only widened over the past 2-3 years. U.S. investors are underweight/underexposed to foreign stocks, which has been a profitable decision, but foreign stocks are likely to have greater central bank and fiscal support going forward relative to the U.S., and currently have more reasonable economic growth and earnings expectations embedded in their valuations relative to U.S. large cap stocks, specifically.

3. **Alternative Investments To Garner Increased Interest, Investor Capital**
   - Low/negative bond yields globally coupled with increased uncertainty surrounding asset valuations (stocks, bitcoin) and the path forward for global monetary policy could lead investors to allocate more heavily into alternative solutions less dependent on the direction of broader indices.

4. **'Quality' Factor Exposure Should Lead To Improved Relative Performance For Active Managers In The Coming Year**
   - Beta and leverage, two factors that tend to lead off market bottoms, outperformed in '21, but with economic growth likely to peak in the coming year alongside less accommodative monetary policy, we expect factor tilts toward 'quality' to benefit portfolios.

1) Reaffirmed: While the bulk of monetary policy tightening in the U.S. and abroad is in the rearview mirror, the Federal Open Market Committee (FOMC) has voiced its desire to raise rates to a restrictive level and pause, not pivot toward more accommodative policy. Inflationary pressures should subside over coming quarters but will remain elevated relative to central bank targets, forcing the FOMC, ECB, BoE, and even the BoJ to maintain tighter monetary policy throughout 2023, contributing to heightened economic uncertainty. Tighter monetary policies led to valuation compression in '22, but the bulk of this revaluation is now behind us, and we expect volatility to subside somewhat in '23 as equity prices follow the trend in earnings, which we expect to be lower.

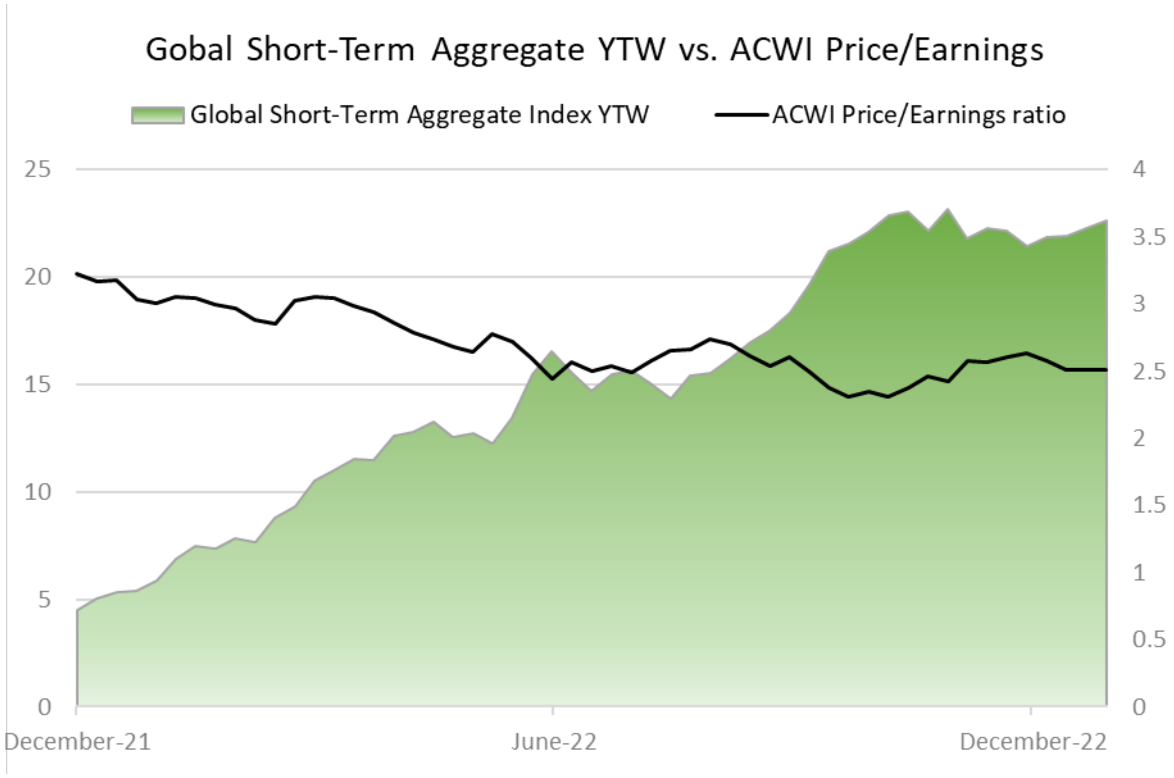
2) Partially Reaffirmed: We entered 2022 with a more constructive outlook on Europe, specifically, but that optimism was called into question by Russia's invasion of Ukraine which led to a rapid rise in prices of energy and agricultural commodities. The euro area will struggle to replace lost Russian crude oil and natural gas imports throughout 2023, leading to persistently elevated inflation in the coming year(s). The European Central Bank and Bank of England will likely need to remain aggressive in tightening monetary policy, weighing on future economic growth prospects. However, rock-bottom growth expectations, reasonable valuations, and a higher dividend yield could be supportive of developed markets abroad in '23, although we do favor emerging markets on a relative basis as a beneficiary of U.S. dollar weakness and China reopening.

3) Reaffirmed: Alternatives held up well on a relative basis as stocks and bonds sold-off in 2022, but liquid alternatives took in a modest net inflow of just over $26B during the year, versus outflows of $200B+ for both stocks and bonds, according to Morningstar. We expect traditional asset classes to fare better in the year ahead, evidenced by our theme tied to the recovery of the balanced portfolio, but uncertainty on the economic, monetary policy, and geopolitical fronts are unlikely to abate, leading to a wide range of potential outcomes for investors in the coming year. Higher risk-free interest rates dim the appeal of certain alternatives, but the asset class benefits from higher yields and as a result we view alternatives as an essential diversification tool and volatility dampener.

4) Reaffirmed: Investors were rewarded, on a relative basis anyway, for owning profitable, dividend paying names in 2022, and we expect the coming year to be a repeat with exposures to 'quality' factors again generating relative outperformance. With central banks continuing to tighten monetary policy into the new year, and with short-term rates expected to remain elevated for some time, owning the best and most consistent operators capable of weathering an economic storm should continue to pay off for investors. Conversely, higher beta and highly levered companies with high earnings variability are likely to underperform as investors seek out and pay a premium for safety and stability.

Revisiting 2022's Themes – In Charts

1) Short-Term Interest Rates On The Rise Globally, Negatively Impacting Equity Valuations



At that start of 2022, many forecasted interest rates to rise but few fathomed the magnitude and speed at which global central banks sought to extract liquidity from financial system. The ripple effects of tightening throughout the global financial system had a predictable negative impact on bonds, but also hampered equity valuations that are based on discounted future cash flows. When the discount rate rises, the present value of future cash flows falls, prompting securities to go through a brutal pricing adjustment, particularly with price/earnings ratios beginning the year at elevated levels. While growth stocks were hit the hardest due to their longer duration cash flows, broader equity indices experienced drawdowns as well, albeit to a lesser extent.

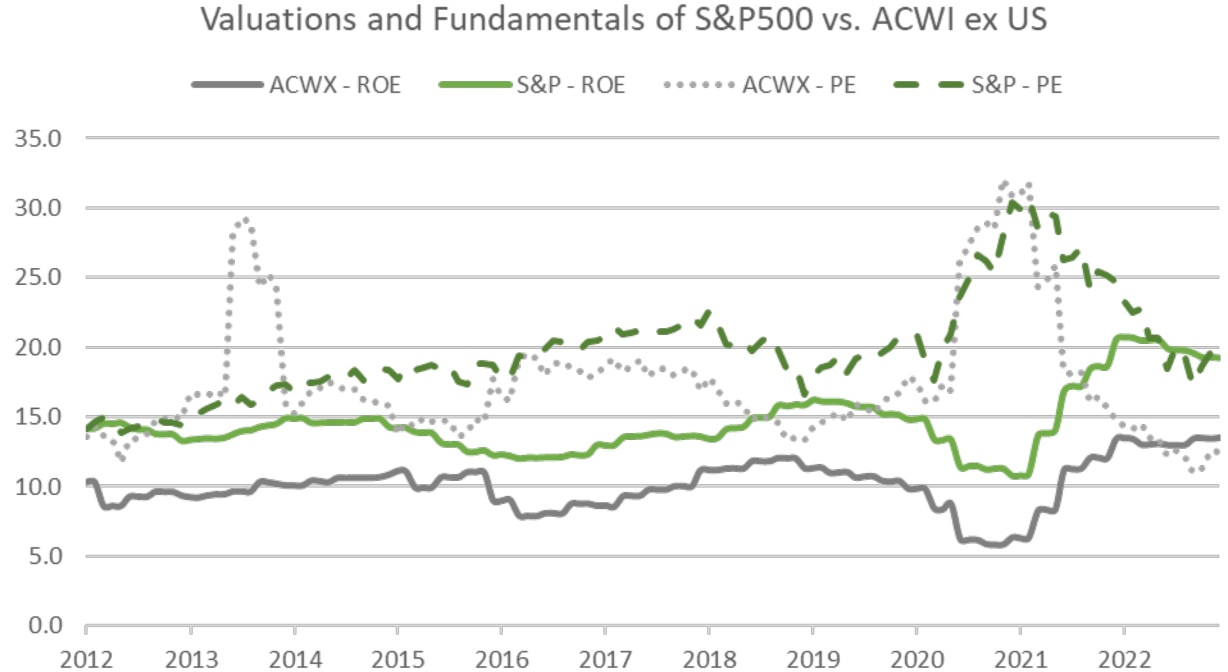
On a forward-looking basis, equity valuations account for current interest rates, but upside surprises to inflation data would present further challenges for stocks, and central bankers alike. Inflationary shocks aren't our base case but can't be ruled out as geopolitical risks and natural resource constraints remain, while accelerated growth in emerging markets, specifically China, could lead to inflation being exporting to the U.S. and other economies across the globe.

The MSCI ACWI ex. U.S. index outperformed the S&P 500 by 2.6% in 2022, although both indices ended the year lower by more than 15%. The outperformance out of international - developed stocks last year is impressive considering the stress on government and corporate balance sheets caused by spikes in energy and electricity prices across Europe and the aggressive response out of the Bank of England and European Central Bank to tighten monetary policy to curb rising prices.

In keeping with the prior decade, developed markets abroad remain 'cheap' relative to the S&P 500, a deserved discount, in our view, given that the return on equity (ROE) for the S&P 500 has consistently been 5% to 6% above that of the ACWI ex. U.S. index, in-line with the price-to-earnings (P/E) multiple difference between the two indices.

The ACWI ex. U.S. index could fare relatively well versus the S&P 500 in the coming year due primarily to index construction/exposures. The ACWI carries a 21% weight in financial services, a sector with a tailwind from higher short-term interest rates; 20% in industrials and materials, potential beneficiaries of China's reopening; and a 20% exposure to 'defensive' sectors such as health care, utilities, and staples. It also doesn't hurt that the ACWI has a 2.5% dividend yield vs. the S&P 500's 1.6%.

2) International Equities Remain Cheap Vs. The U.S.; MSCI Ex. U.S. Exposures, U.S. Dollar Weakness Could Be Catalysts For Outperformance



Revisiting 2022's Themes – In Charts

3) Modest Inflows Into Alternatives In '22, But Investors Remain Allocated Despite Best Relative Return Since 2000

Year	Alternative Mutual Fund Flows (B)	HFRX Excess Return over Balanced Portfolio
2022	26	11.82
2021	39.3	-9.92
2020	9.5	-6.14
2019	-2.4	-11.48
2018	-4.9	-4.53
2017	-1.7	-6.69
2016	-14.6	-4.80
2015	7.3	-4.60
2014	11.6	-10.40
2013	23.0	-8.45
2012	8.3	-6.59
2011	15.0	-13.84
2010	18.2	-5.61
2009	11.1	-2.79
2008	2.7	-7.37
2007	2.9	-2.04
2006	6.1	-0.79
2005	2.1	-0.95
2004	2.4	-4.92
2003	1.2	-3.01
2002	0.6	10.65
2001	-0.1	10.40
2000	-0.9	13.03

Source: Morningstar

Liquid alternative funds had another year of net inflows in '22 while traditional assets experienced an investor exodus over the trailing twelve months. In 2022 alone, U.S. equity and taxable bond funds faced redemptions of $215B and $219B respectively, while daily liquid alternative mutual funds took in a relatively modest $26B.

Fund flow data is historically reactive as we note performance/AUM changes in the early 2000s and post-Global Financial Crisis. This gives us cautious confidence that investors may revisit their allocation or have further difficulty explaining the lack of exposure to the broader alternatives asset class as nothing boosts sentiment like strong returns.

However, relying on past performance is often detrimental to future success and heavy inflows invite unproven strategies to raise capital with limited experience, increasing the importance of manager selection. In our view, alternatives could shift from the leadership position in portfolios experienced last year back to their historical supporting role, maintaining their appeal to investors by dampening volatility and limiting drawdowns.

The backdrop for equities in 2022 was characterized by heightened volatility as the S&P 500 ended either higher or lower by 1% or more on 122 of the 251 trading days last year, up from just 55 such occurrences in 2021. In times of heightened uncertainty and elevated volatility, it's common for 'quality' to shine and outperform broader equity benchmarks, which is what happened in 2022, albeit by a slimmer margin than we would have anticipated.

The S&P 500 Quality index, comprised of the 100 highest scoring companies in the S&P 500 using S&P's three-factor scoring methodology, outperformed the S&P 500 by 2.5% during 2022, but still fell 15.6% during the year.

The last time the S&P 500 experienced back-to-back negative calendar year returns was in the 2000 through 2002 time period, and 'quality' fared quite well relative to the broader S&P 500 as valuations and investor expectations were reset.
The coming year could 'rhyme' with 2022 and in such an environment we would expect 'quality' to extend its winning streak relative to the broader S&P 500.

4) 'Quality' Set To Build On 2022's Relative Outperformance As Profitability And Low Leverage Remain Desirable Traits

Year	S&P 500 Return	S&P 500 Quality Return	Quality Excess Return
2022	-18.13	-15.62	2.51
2021	28.68	28.16	-0.52
2020	18.39	17.55	-0.83
2019	31.47	33.91	2.43
2018	-4.39	-6.79	-2.39
2017	21.82	19.51	-2.30
2016	11.95	9.56	-2.39
2015	1.37	0.38	-0.99
2014	13.67	14.95	1.27
2013	32.37	34.24	1.87
2012	15.99	14.68	-1.31
2011	2.11	10.89	8.78
2010	15.06	14.95	-0.11
2009	26.45	30.46	4.01
2008	-37.00	-34.06	2.94
2007	5.57	15.50	9.93
2006	15.78	17.59	1.81
2005	4.91	5.07	0.17
2004	10.88	11.21	0.33
2003	28.67	28.75	0.08
2002	-22.10	-13.95	8.15
2001	-11.90	-4.18	7.72
2000	-9.11	17.56	26.67

New Themes To Monitor For '23, And Beyond

1. A Bounce Back Year Ahead For The "Balanced Portfolio," But With Bonds Doing The Heavy Lifting

- The 'Balanced Portfolio,' whether it be a traditional 60/40 or 50/50 stock/bond portfolio, turned out its worst calendar year performance since 2008. However, after a year in which a 50% MSCI ACWI/50% Bloomberg Aggregate portfolio returned -15%, our 7- to 10-year forward expectations for a 'balanced' portfolio have been ratcheted higher year over year. Entering 2022 , based on our 7- to 10-year return assumptions and using our strategic asset allocation framework, we expected a 50/50 portfolio to generate an annualized return of around 4.6%, but after a valuation reset amid steep declines for traditional asset classes last year, we now expect a similarly allocated portfolio to generate an annualized return of 6.1%.
- Bonds, exhibited by the 13% annual decline in the Bloomberg Aggregate Bond index, had their worst year in modern history, so it's not a stretch to expect improved absolute performance out of fixed income in '23, and we expect a coupon-plus kind of year out of the asset class as investors prioritize income and stability.
- Equity valuations are likely to remain under pressure over the near-term as monetary policy uncertainty persists and forward earnings estimates are revised lower over coming quarters. Thus, we expect 'the 40%' to drive the bulk of returns for a 60/40 portfolio in the next twelve months.
- Diversification across asset classes and geographies made little difference as correlations approached 1 amid uncertainty on many fronts in '22, but we expect multi-asset portfolios to fare better in the coming year, due primarily to better returns and a more 'typical' volatility profile out of fixed income as global economic growth remains paltry and inflation data trends lower throughout the balance of 2023 and into 2024.

2. A Higher Fed Funds Rate Boosts Expected Returns For Not Just Bonds But Also Select Alternative Strategies

- Entering 2022, our 7- to 10-year outlook for the Bloomberg Aggregate Bond index called for an annualized return of just 1.75% from core, investment-grade bonds, but after a sharp upward move in yields , our revised outlook calls for an annualized return figure more than double that at 4.0%.
- Should inflation trend lower throughout 2023 as we expect, the relative appeal of bonds will likely attract investor interest and capital as real yields rise, forcing prices of longer duration, higher credit quality bonds higher and boosting total returns for fixed income investors.
- Higher risk-free (Treasury) yields increase expected total returns for some alternative strategies forced to hold collateral in short-term Treasury instruments. Specifically, we expect alternative credit strategies, convertible and merger arbitrage, and managed futures to fare well on an absolute and relative basis in an environment characterized by elevated and sustained higher short-term Treasury yields.

3. Real Assets Poised To Deliver Tangible Portfolio Benefits Over A Tactical, And Strategic Time Horizon

- While we expect inflation to trend lower throughout the coming year as demand for goods wanes as job openings fall and unemployment moves higher, we expect Personal Consumption Expenditure (PCE) to remain above the Fed's 2% 'target' into 2024 and perhaps longer, increasing the appeal of income generating assets capable of providing inflation diversification for portfolios.
- A diversified and flexible approach to real assets remains preferable with dynamic exposures to infrastructure, MLPs, REITs, commodities and commodity-related stocks, and even TIPS potentially proving beneficial amid the backdrop we see materializing.

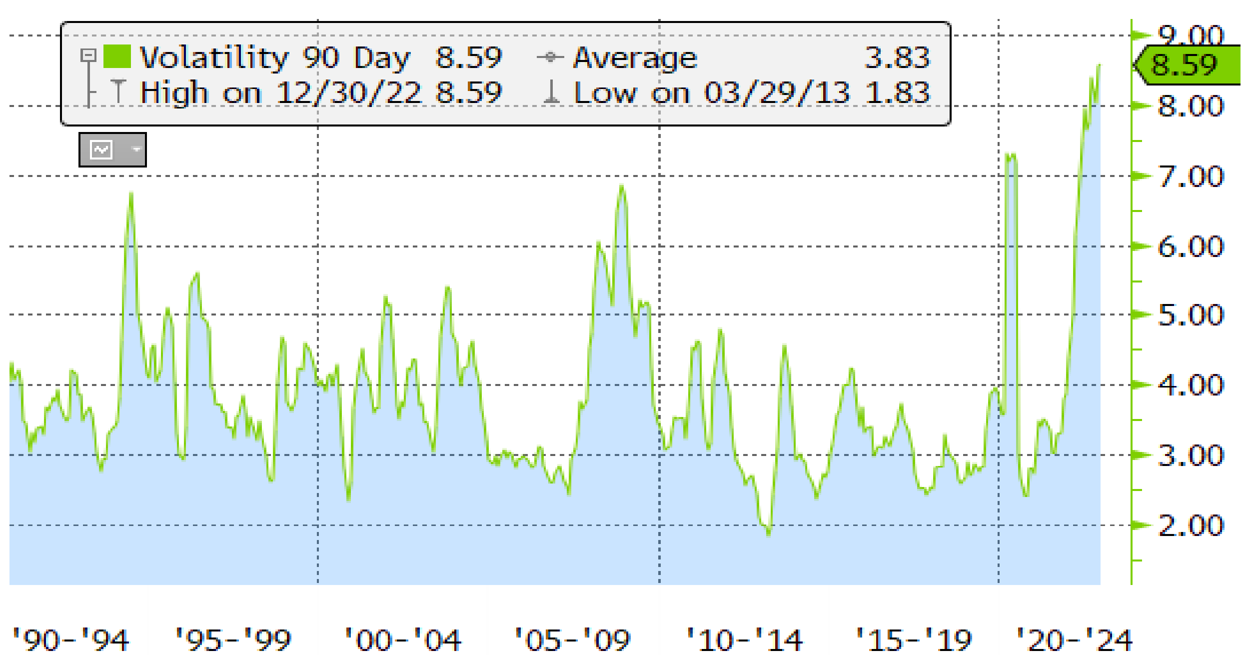
Theme 1: A Bounce Back Year For The "Balanced Portfolio"

After experiencing its worst drawdown since 2008 last year, the "balanced portfolio," either a 50/50 or 60/40 stock/bond portfolio, should bounce back in '23, but buoyed by bonds, not stocks. Our capital market expectations for both stocks and bonds moved higher year over year, but we expect a challenging backdrop for stocks to persist throughout much of 2023 as economic and monetary policy uncertainty remains elevated, leading to concerns surrounding earnings growth, negative earnings revisions, and lower valuations over coming quarters.

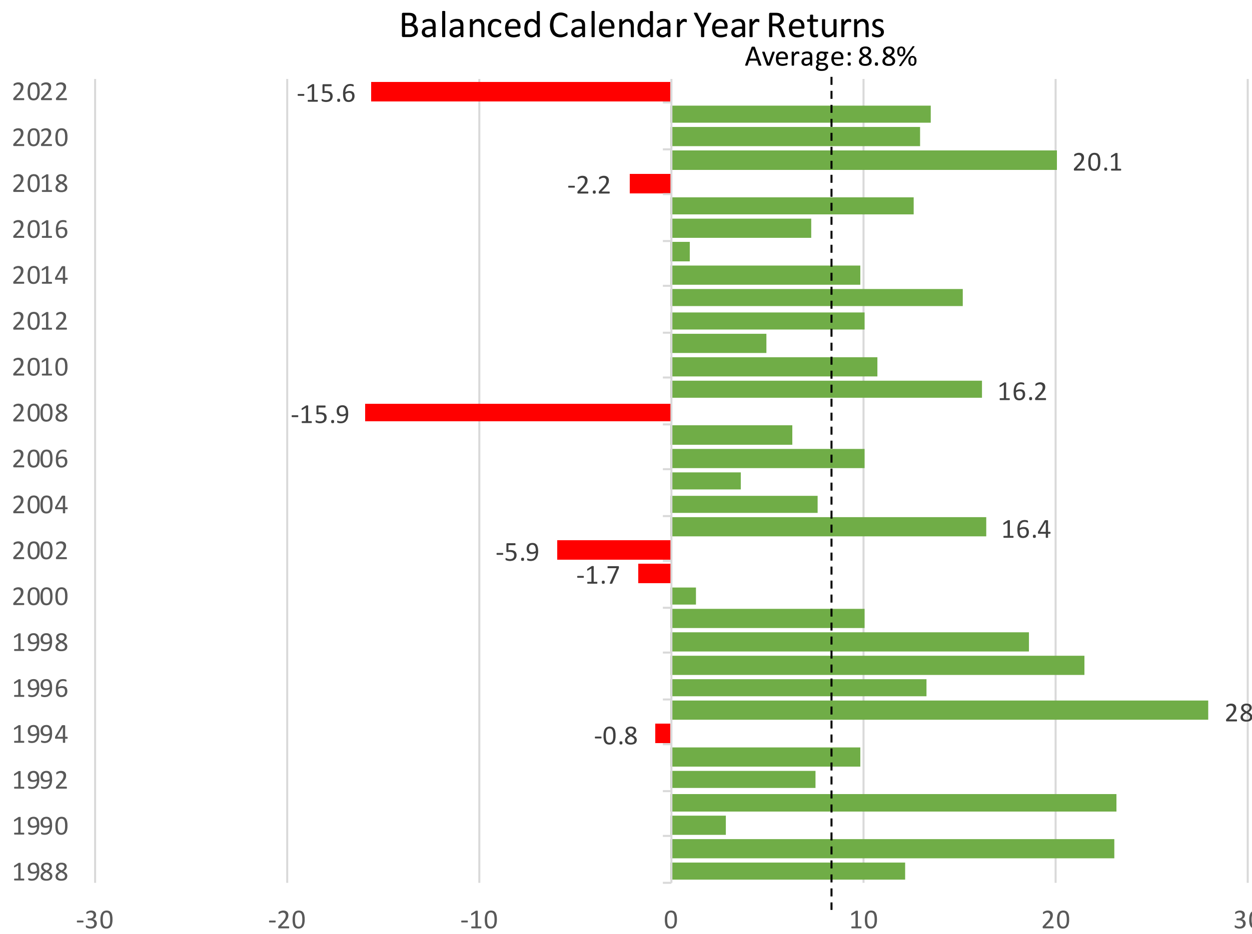
Given the backdrop we anticipate in '23, bonds should again become the "risk-off" asset class of choice. Broadly speaking, bonds offer the most attractive yields we have seen in over a decade, and in the case of investment-grade and high yield corporate bonds, credit quality metrics are encouraging and superior relative to historical norms when entering economic slowdowns/recessions.

'Stickier' inflation driven by labor market tightness could force the FOMC to hike the Fed funds rate beyond what is currently expected, placing additional upward pressure on the short-end of the yield curve, while also pulling the long-end lower and further inverting the yield curve as recession risks rise. While we are tempering our near-term expectations for stocks, we expect bonds to post a "coupon-plus" type of return over the coming year.

Volatility For The Balanced Portfolio Should 'Normalize' In '23 From Elevated Levels As Interest Rate Volatility Subsides



Historically, The "Balanced Portfolio" Bounces Back Quickly, And Sharply, After A Down Year



"Balanced Portfolios" Have Historically Delivered Appealing Volatility-Adjusted Returns Over Time With Short-Lived Negative Periods

In the post-Global Financial Crisis world, with few exceptions, bond volatility has remained low, leading to a historically strong period of risk-adjusted returns for balanced portfolios. Bonds can be beneficial not just via lower correlations to stocks, but also by the lower volatility nature of the asset class relative to stocks. 2022 was an outlier in this regard as interest rate volatility was a constant, leading to excessive volatility and drawdown for fixed income, and balanced portfolios alike. However, we expect interest rate volatility to subside over coming quarters, particularly in the back-half of the year, leading to improved risk, or volatility-adjusted returns.

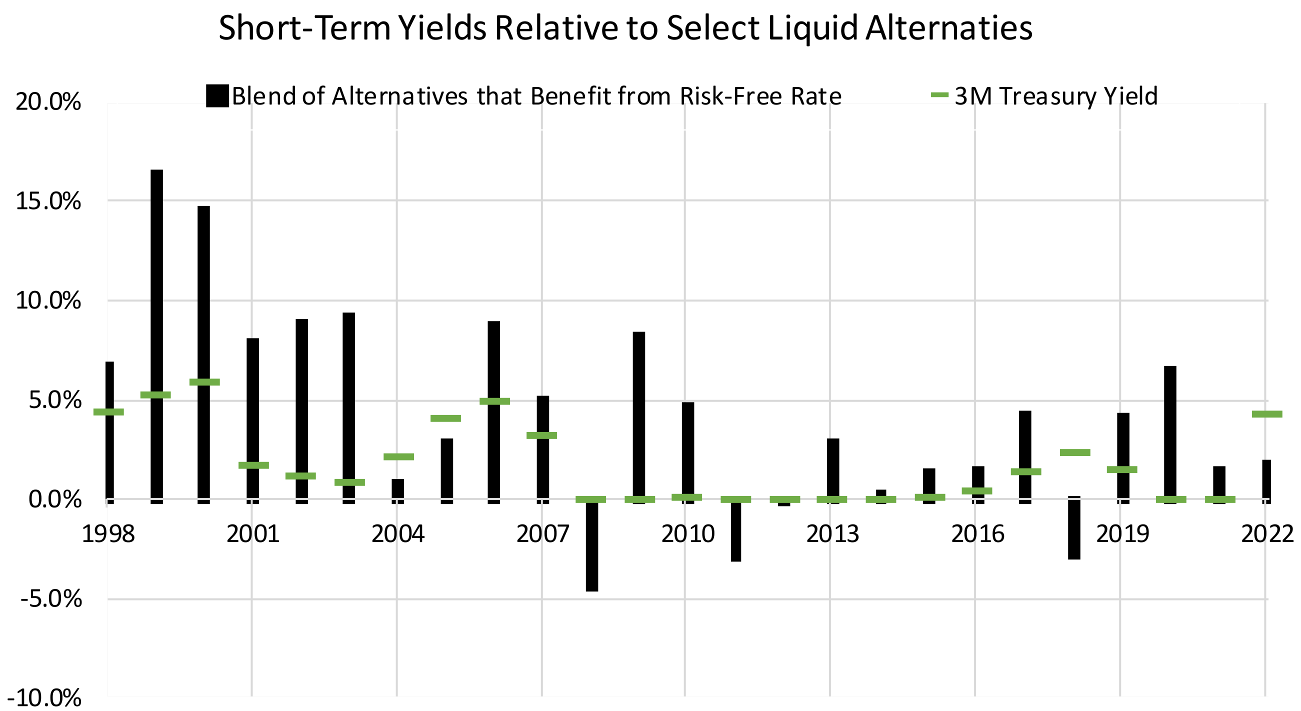
Source: Bloomberg

Theme 2: Higher Short-Term Yields A Boon For Investors In Bonds And Select Alternatives

Elevated and 'stickier' than anticipated inflation led to a more aggressive pace of monetary policy tightening than many, including us, anticipated, and sent interest rates and bond yields soaring in '22, painfully paving the way for higher expected future returns. The FOMC delivered the sharpest rise in the fed funds rate dating back to 1986 which had a meaningful negative impact on bond prices and therefore returns during the year, generating the first back-to-back negative calendar year return for bonds in the last 30-plus years. Increases in yields, while painful, are a strong predictor of future returns. Since 2000, there has been a 0.94 correlation between the 5-year rolling return for the Bloomberg Aggregate Bond Index and the starting yield for the index. This dynamic bodes well for investors in core, investment-grade fixed income with a five-plus year investment time horizon.

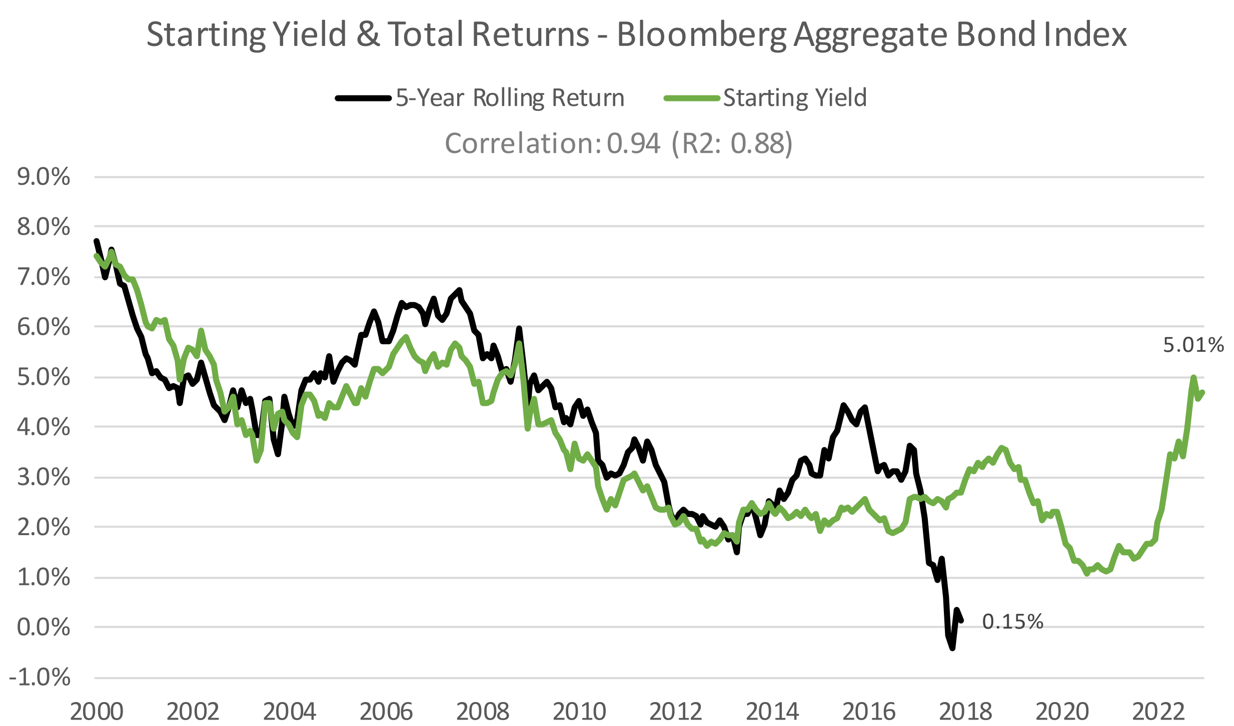
Bonds, broadly speaking, have gone through a difficult repricing that sparked a rise in standard deviations (volatility), and though inflation remains high from an absolute standpoint, the expected trend is lower which should gradually allow interest rate volatility to subside.

Tighter Monetary Policies Globally Boost Outlook For Alternative Strategies Reaping Benefits From A Higher Risk-Free Rate



*Alternatives blend includes HFRX Merger Arbitrage, Convertible Arbitrage, Macro/CTA, and Macro: Systematic Diversified CTA indices.
**Source: Bloomberg

Fixed Income Yields Now Most Attractive In Over A Decade, Leading To Higher Expected Returns



Fixed income isn't the only beneficiary of rising interest rates, as select alternative strategies that utilize cash as collateral or capture a spread linked to the risk-free rate stand to gain as well. Systematic trend strategies are an illustration of this as futures positioning allows these managers to get full notional value while holding most of the portfolio in cash/short-term bonds as low-risk collateral for margin. Another segment that stands to take advantage of higher borrowing rates is convertible arbitrage managers as the most common strategy utilized involves going long a convertible bond and shorting the underlying stock, thus receiving interest on both positions, among other drivers of return.

When we look back, near-zero policy rates since the Global Financial Crisis reduced the return potential for these alternatives, leading to underinvestment, but the investing landscape has shifted in a more beneficial manner, and we expect investors continue to build on their exposures to this asset class as a result. Heightened volatility across asset-classes should also increase demand for diversification strategies, as defensive posturing will likely be rewarded in the near-term.

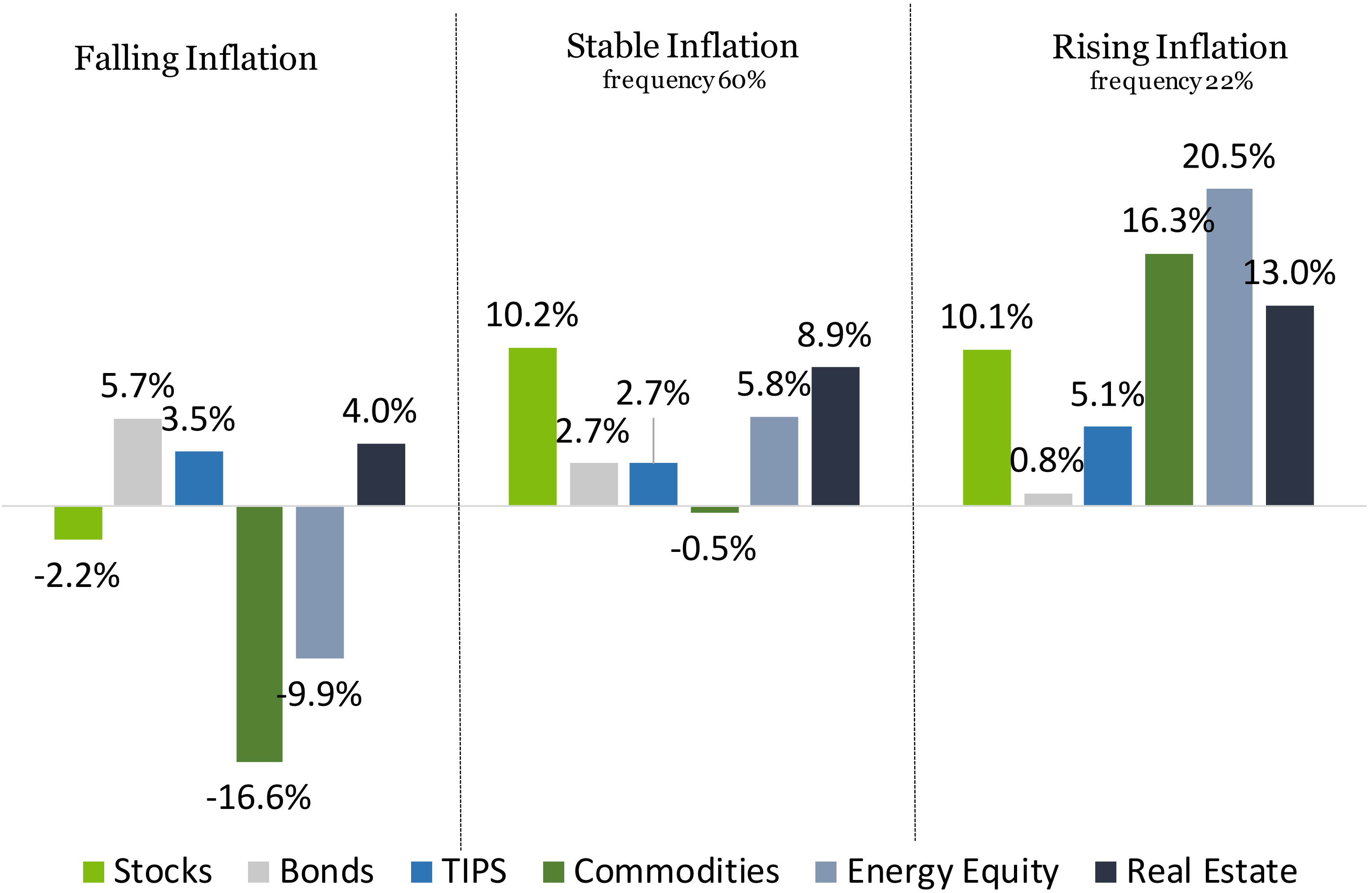
Source: Bloomberg

Theme 3: Real Assets To Deliver Tangible Diversification Benefits

Exposure to real assets should prove beneficial for portfolios in the coming year as investors place a premium on earnings stability and income/cash flow generation, potentially benefitting areas such as infrastructure and energy equities. A diversified and nimble approach to investing in real assets is desirable given that some real assets zig while others zag. Dynamically and tactically tilting portfolios of real assets can mitigate prolonged periods of poor performance.

For example, commodities, as a broad basket, fare best during periods of rising inflation when the outlook for economic growth is improving, and worst in periods of falling inflation/lower expectations for economic growth. However, there are pro-cyclical commodities such as energy and industrial metals, as well as commodities with defensive, safe-haven characteristics such as gold. A nimble and more tactical approach within commodities, specifically, and real assets, broadly, is a requirement to take advantage of short-term dislocations and successfully ride trends as they materialize. Other real assets such as infrastructure, TIPS, and to a lesser degree REITs tend to be more consistent performers and can act as a ballast for portfolios, paying investors to wait for a more favorable backdrop to materialize in areas such as commodities or equities tied to energy and agriculture which hold the potential for outsized returns as the inflation/growth regime shifts.

Historical Performance Of Stocks, Bonds, And Select "Real Assets" In Different Inflation Regimes



20-Year Correlations	Stocks	Bonds	TIPS	Energy Equities	Real Estate	Commodities
Stocks	1.00	-0.19	-0.14	0.74	0.76	0.29
Bonds	-0.19	1.00	0.80	-0.18	-0.06	-0.09
TIPS	-0.14	0.80	1.00	-0.06	-0.07	0.07
Energy Equities	0.74	-0.18	-0.06	1.00	0.52	0.52
Real Estate	0.76	-0.06	-0.07	0.52	1.00	0.19
Commodities	0.29	-0.09	0.07	0.52	0.19	1.00

Source: Bloomberg

**Average annual real returns in Falling, Stable, and Rising inflation periods. March 1997 – December 2021. A Rising inflation period is defined when the 3M YoY CPI monthly moving average is greater than the 12M CPI moving average by at least +0.5%. A Falling inflation period is defined when the 3M YoY CPI monthly moving average is greater than the 12M CPI moving average by less than -0.5% or more. Stable is any period not defined as Rising or Falling. Index Data: Stocks – S&P500 Index; Bonds – Bloomberg US Aggregate Index; TIPS – Bloomberg US TIPS Index; Commodities – Bloomberg Commodity Index; Energy Equity – S&P Energy Index; Real Estate – FTSE NAREIT All Equity Index. Source: eVestment*

Revisiting Prior Assumptions: 5-Year Lookback (2018-2022)

What a difference a year can make! When we went through this exercise at the end of 2021, our return assumptions, broadly speaking, appeared far too conservative, but after a steep drawdown across asset classes last year and with 2017, a strong year for stocks and good year for bonds, 'rolling off' that is no longer the case. Just one asset class – large-cap U.S. stocks – has now outperformed our return expectation half-way into the lookback window.

On both an absolute and relative basis, U.S. equities have fared quite well when compared to developed and emerging market equities abroad. As noted above, U.S. large-cap stocks is the only asset class that has outperformed our return expectation up to this point, but U.S. small and mid-cap (SMid) has fallen just shy of our projection, posting a respectable 5.9% annualized return over the trailing five years. To say that international – developed and emerging market stocks have been a disappointment would be an understatement, with both asset classes lagging our expected return substantially at the halfway point, and EM posting a negative annualized 5-year return. However, the next five years could bring with it mean reversion that favors the rest of the world (RoW) on a relative basis as easy monetary policies boosted demand and valuations for longer duration stocks such as those housed within the communication services and information technology sectors, which together account for 30% of the S&P 500 vs. closer to 17.5% of the MSCI ACWI ex. U.S. index. As we saw last year, an end of the easy money era and rising short-term interest rates had the most profound negative impact on longer duration growth stocks as investor preferences shifted toward profitable, cash flow generating, dividend paying companies in more defensive (health care, consumer staples, and utilities) and even some cyclical sectors (energy, financial services, industrials). Higher for longer short-term interest rates are likely to bring about a period of mean reversion favoring value relative to growth and RoW relative to U.S. large-caps due to how these indices are constructed and exposures, or the lack thereof, to growthier and/or longer duration stocks.

When we published our CMEs at the end of 2017, the yield on the Bloomberg Aggregate Bond index was just 2.71% and due to a lower starting yield and longer duration profile, i.e., greater interest rate sensitivity for the index at that time, our 3% annualized expected return for the Agg over the next decade has proven to be too aggressive at the half-way mark. At the end of 2022, the yield on the Bloomberg Agg was almost 2% higher at 4.68%, a reasonable baseline for the expected five-year forward return for the index, but we now forecast a relatively conservative 4% annualized return for the Agg over the next 7- to 10-years and would not be surprised if the Agg outperforms that expectation. Inflationary pressures subsiding over coming quarters will make fixed income assets more appealing as 'real' rates rise and we expect a bounce back year for bonds in 2023 as a result, led by higher quality Treasuries and investment-grade corporate issues.

2022 marked a pronounced shift in the monetary policy regime as global central banks were forced to pivot away from ultra-easy policies in place since early 2020 and into inflation fighting mode as higher prices for goods and services (labor) risked becoming entrenched. This regime change led to a sharp revaluation of asset prices across the board with stocks and bonds initially bearing the brunt of this shift, while hedge funds and other non-directional strategies significantly outperformed traditional asset classes. After 2022's selloff, equity valuations are more reasonable and bond yields better compensate investors for taking credit and interest rate risk, thus, we expect hedge fund-like strategies to play more of a supporting role within portfolios instead of outperforming both stocks and bonds as the broader HFRX Global Hedge Fund index did last year. Higher bond yields make us more confident the HFRX can reach our 4.25% annualized return over the back-half of the 10-year window, and we have ratcheted higher our expected return for the asset class over the next decade to 5% due to this increased conviction.

	Large-Cap (S&P 500)	SMID (R2500)	Intl-Developed (MSCI ACWI ex U.S.)	Emerging Mkts (MSCI EM)	Core Fixed Income (Bloomberg Agg)	Intl Fixed Income (Global Agg ex U.S.)	TIPS	High Yield	Emerging Market Debt (J.P. Morgan EMBI)	Aletrnatives (HFRX Global Hedge Fund Index)
Trailing 5-Year Total Return 1/1/18-12/31/22	**9.42%**	**5.89%**	**0.88%**	**-1.40%**	**0.02%**	**-3.07%**	**2.11%**	**2.31%**	**-1.31%**	**1.41%**
2017 FINAL Assumptions (7-10 Years Forward)	**6.00%**	**6.50%**	**6.50%**	**8.00%**	**3.00%**	**2.00%**	**2.75%**	**4.75%**	**5.25%**	**4.25%**
Trailing 5-Year Volatility 1/1/18-12/31/22	**18.69%**	**22.57%**	**17.23%**	**18.83%**	**5.09%**	**7.86%**	**5.81%**	**9.11%**	**11.12%**	**5.05%**
2017 FINAL Assumptions (7-10 Years Forward)	**16.00%**	**20.00%**	**18.00%**	**25.00%**	**4.00%**	**8.00%**	**6.00%**	**9.50%**	**10.00%**	**6.00%**

***All Figures Annualized**

Source: Morningstar

Building Blocks Of CMEs

Equity

Equity capital market expectations are derived from established fundamental drivers of return including income estimates and capital appreciation forecasts.

Equity Expected Return = Earnings Growth Expectations + Expected Dividend Yield + Expectations for Valuation Expansion or Contraction

- Expected earnings growth is tied to economic growth, which is impacted by variables such as monetary policy, population growth, and productivity, all of which require other assumptions to be made, increasing the likelihood of deviation from actual experience across the forecasted time horizon.

- Expected dividend yield is a relatively straightforward input as we can use the trailing yield of an index and adjust for expected annual dividend growth, a figure unlikely to change much from one year to the next. This is the easiest component of expected return to forecast but is also the least variable from year to year, and thus shouldn't cause the final return estimate to shift much.

- Expansion/contraction in valuations (earnings multiples) are tied to expectations surrounding economic growth, monetary policy (easy monetary policy leads to higher forward earnings multiples, i.e., expansion, while tighter policy leads to lower multiples, i.e., contraction), and investor sentiment (risk appetite), among other variables. Valuations are often intertwined with global central bank policy regimes as valuations expand as liquidity is injected and compress as liquidity is removed. We're in a period in which liquidity is going to be drained from the global economy, which should compress forward price-to-earnings (P/E) and other valuation metrics over time. Notably, valuations will likely trend lower but remain elevated relative to historical levels due to how much liquidity has been injected in recent years.

Of the primary inputs into expected equity return, valuation contraction was the primary contributor or source of weak equity market performance in 2022. However, in 2023, we expect the earnings growth component to be a drag as economic growth remains paltry and profit margins come under pressure from a combination of falling goods prices and elevated services, i.e., labor costs.

Fixed Income

Formulating capital market return expectations for fixed income is a simpler exercise with fewer variables relative to what is required for equities.

Fixed Income Expected Return = Current Yield-To-Worst + Change in Default Expectations + Expected Base Currency Gain/Loss (USD)

- Current yield for 'risk-free' bonds such as U.S. Treasuries, or yield-to-worst for corporate credit and other riskier types of debt, are observable and the primary contributor to expected forward returns for fixed income. A bond's yield or yield-to-worst should be an investor's expected return, assuming the issuer makes coupon payments on time and avoids default, which is why formulating an expected return for core, investment-grade fixed income is a more straightforward exercise with fewer assumptions required than it is for riskier bonds such as high yield corporates and emerging market debt.

- Default expectations must be a consideration for investment-grade and high yield corporate bonds, and it is our expectation that defaults for high yield issuers, will rise from current low levels over coming years. This is the primary reason our forward return expectation for the asset class is well below the current yield-to-worst (YTW) for the Bloomberg U.S. High Yield index.

- Appreciation or depreciation of the U.S. dollar versus foreign currencies is a variable to consider but given that the bulk of our exposure to foreign bonds is tied to U.S.-dollar denominated debt, this isn't an input that's going to cause large shifts in forward expectations. However, should our outlook call for significant appreciation or depreciation of the U.S. dollar, this could impact the ability of foreign issuers to make payments and avoid defaults, so significant currency moves would be factored into forward return expectations in this way.

The rise in global bond yields has improved the opportunity set in fixed income due to the strong correlation between starting yields and long-term returns. This provides a better starting point for fixed income investors than we have seen in the past decade.

Conclusion

2022 brought with it a painful repricing of risky and less risky assets alike, but after a valuation reset investors are now presented with a more attractive opportunity set across which to allocate capital. We ratcheted upward our annualized return expectation for most covered asset classes year over year, driven by less demanding valuations for equities and higher yields offered across the fixed income landscape, which also serves to boost expected returns for select alternative strategies as well.

On a relative basis, the largest shifts in expected returns took place in fixed income as U.S. Treasury yields moved sharply higher in 2022 and credit spreads on investment-grade and high yield corporate bonds widened meaningfully year over year. The combination of higher yields and wider credit spreads now more appropriately compensates investors for taking on interest rate and credit risk more than at any other point in the past decade, in our view. With core, investment-grade bonds now expected to annualize a 4% return over the next decade, should inflation trend lower over coming quarters as we expect, competition for capital between stocks and bonds is likely to intensify and likely benefit bonds on a relative basis in the coming year.

For stocks, while expected returns moved higher across the board, the near-term path remains highly uncertain with a broad range of potential outcomes due to economic, monetary policy, and geopolitical uncertainty. As a result, we are tempering expectations for stocks over the coming year and expect a choppy and challenging backdrop to persist, with higher for longer short-term interest rates limiting near-term upside. We expect performance dispersion between industries/sectors as well as across geographies to widen over coming quarters, a better environment for active managers.

Select alternative investments are more attractive after a tumultuous 2022 as higher short-term Treasury yields benefit strategies forced to hold cash/collateral in Treasuries. Alternative credit, arbitrage strategies (merger, convertible), and managed futures are areas we would highlight as holding more appeal now relative to prior years from an expected total return and diversification perspective. Less liquid alternatives such as private real estate and private equity, among others, face the prospect of valuation write-downs over coming quarters due to the lagged impact of public market pricing on private market valuations. However, after this valuation reset occurs, investors willing and able to allocate capital in the back-half of ’23 and early ‘24 should be rewarded.

Monte Carlo Analysis of Selected Portfolios

Asset Mix	Project Year	95th	75th	50th	25th	5th
Growth	10	14.30%	10.20%	7.30%	4.60%	1.00%
Balanced	10	10.30%	7.80%	6.10%	4.50%	2.30%
Current Income	10	8.00%	6.40%	5.40%	4.30%	2.90%

Forecast displays 5th/25th/50th/75th/95th percentile ranges of 2,000 MVO Monte Carlo simulations for projected ten-year annualized returns as of December 15, 2021. The equity portion of the portfolios is 65% U.S. equity and 35% global ex-U.S. equity. The bond portion of the portfolios is 80% U.S. investment grade bonds, 10% global ex-U.S. bonds and 10% U.S. corporate high yield bonds. The diversified strategies portion of the portfolios is 100% HFRX Global Hedge Fund index.

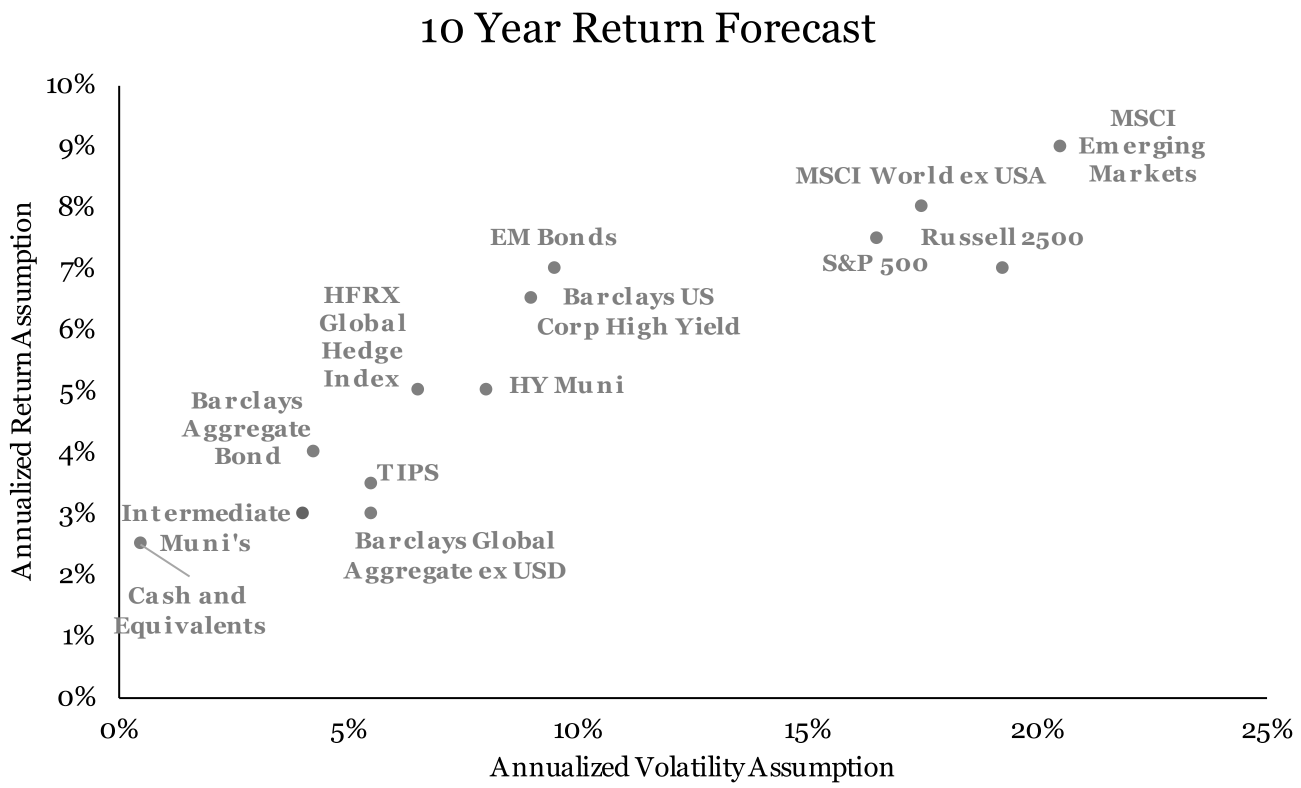


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Chart Source: Morningstar Direct

Appendix/Important Disclosure

Asset Class Statistics (Simulated)

Asset Classes	Arithmetic Mean	Geometric Mean	Standard Deviation	CVaR Cutoff 5.0%
DS	4.4	4.2	6.1	8.4
Equity	7.8	6.5	16.1	24.0
Taxable FI	2.0	2.0	3.7	5.9
Tax Exempt FI	2.2	2.1	3.7	5.8

Correlations

	DS	Equity	Taxable FI	Tax Exempt FI
DS	1	0.75	0.1	0.14
Equity	0.75	1	0.01	0.01
Taxable FI	0.1	0.01	1	0.71
Tax Exempt FI	0.14	0.01	0.71	1

Asset Mix Statistics (Simulated)

	Taxable		Tax Exempt	
Asset Mix	Geometric Mean	CVaR Cutoff 5.0%	Geometric Mean	CVaR Cutoff 5.0%
Aggressive Growth	6.3	22.1	6.3	22.1
Growth	5.8	18.4	5.9	18.4
Growth w Income	5.1	13.6	5.1	13.6
Balanced	4.5	10.4	4.6	10.4
Income w Growth	4.1	8.8	4.2	8.7
Current Income	3.5	6.3	3.6	6.3
Enhanced Income	2.2	5.1	2.3	5.1

Source: Regions Asset Management and Morningstar Direct

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