WESCAP Group

330 N. Brand Blvd.
Suite 1150
Glendale, CA 91203
(818) 563-5170
(818) 563-5174 (Fax)

www.wescapgroup.com

Economic and Investment Outlook for 2020

This year we wish to focus on the main questions investors are asking coming into 2020: Are U.S. stocks and bonds overvalued? What does this mean for investors?

2020 Outlook Summary

- Economic Growth: Real GDP growth should remain positive around the world for most developed and emerging market economies. Increasing monetary and/or fiscal stimulus around the world should benefit consumers, workers and corporate earnings. Less restrictive U.S. monetary policy and trade tension relaxation is expected to boost U.S. growth later in 2020. There is a shrinking risk of a U.S. or global recession in 2020-2021.
- U.S. Equities: A nearly 30% increase in the S&P 500 in 2019 resulted in most stocks moving from slightly undervalued to modestly overvalued, although low interest rates suggest a fair valuation. This translates to modestly positive returns in 2020 expected for stocks. Low interest rates continue to support stocks, other assets and the economy.
- Foreign Markets: Economic conditions in many larger foreign developed and emerging market countries are expected to improve slightly. Valuations in non-U.S. stock markets are more attractive than in the U.S. There is a reasonable chance of a stable or declining dollar, which would also favor owning more non-currency-hedged foreign stocks and bonds. Therefore, we continue to have a substantial allocation to these markets.
- Fixed Income: U.S. interest rates are expected to rise if inflation accelerates. Therefore, our fixed income allocation is more heavily weighted to short-term and adjustable rate securities and bonds in higher-yielding sectors and countries.
- 2020 U.S. Elections: Current predictive indicators suggest a Republican president and Senate and Democratic House following the elections. This may have positive implications for tax rates and a new negative impact on trade issues. However, a Republican presidential victory is far from assured, and if a Democratic president should be elected, this could cause a 5%-15% stock market decline due to corporate income tax and other regulatory cost concerns. However, a Republican Senate is unlikely to enact another major tax reform. WESCAP does not endorse any candidate or party, but does try to understand the financial impact from possible election results.

U.S. Economic Conditions and Risks

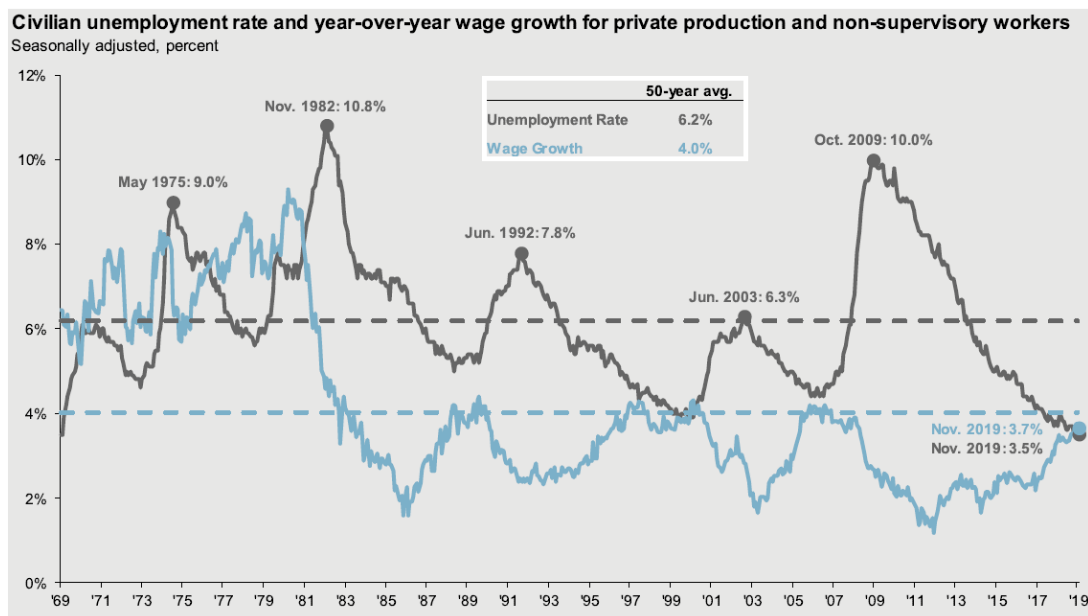
Last year at this time we asked “Will the U.S. enter a recession in 2019?” For a number of reasons, we said “The likely answer is ‘no’.” We are gratified that **our no-recession analysis was correct**, as moving to a vastly more conservative investment stance would have been costly in terms of foregone profits from most stock markets around the world in 2019.

Fundamental economic improvements from a year ago include the U.S. Federal Reserve (the Fed) lowering short-term interest rates several times. This caused the yield curve to reverse its inversion and eliminated one of the recession signals that concerned investors. It also revived a

slowing residential housing market, boosted cash flows and reduced credit concerns for borrowers. The Fed also reinstituted a type of Quantitative Easing (QE) T-bill purchasing program in late 2019, which is scheduled to continue into at least the second quarter of 2020. This modified QE is adding liquidity to the financial system. This additional liquidity is expected to push up both stock and bond prices.

These factors, plus sustained low interest, inflation and unemployment rates suggest that **U.S. recession risk has receded further**. A modest reduction in global trade impediments, a pending orderly Brexit, and continued stimulative monetary policies in Europe, Japan, and China set the foundation for improving global growth around the globe in 2020. Nevertheless, the U.S. will have a recession again someday. What are the conditions that could cause an economic downturn in 2021 or 2022? Typically, **the biggest recession risk is from higher interest rates.** High interest rates cause a contraction in construction, housing and auto sales and cause financial distress to companies that have taken on too much debt. Unemployment jumps, consumer spending shrinks and companies cut capital expenditures, all ingredients needed for a recession.

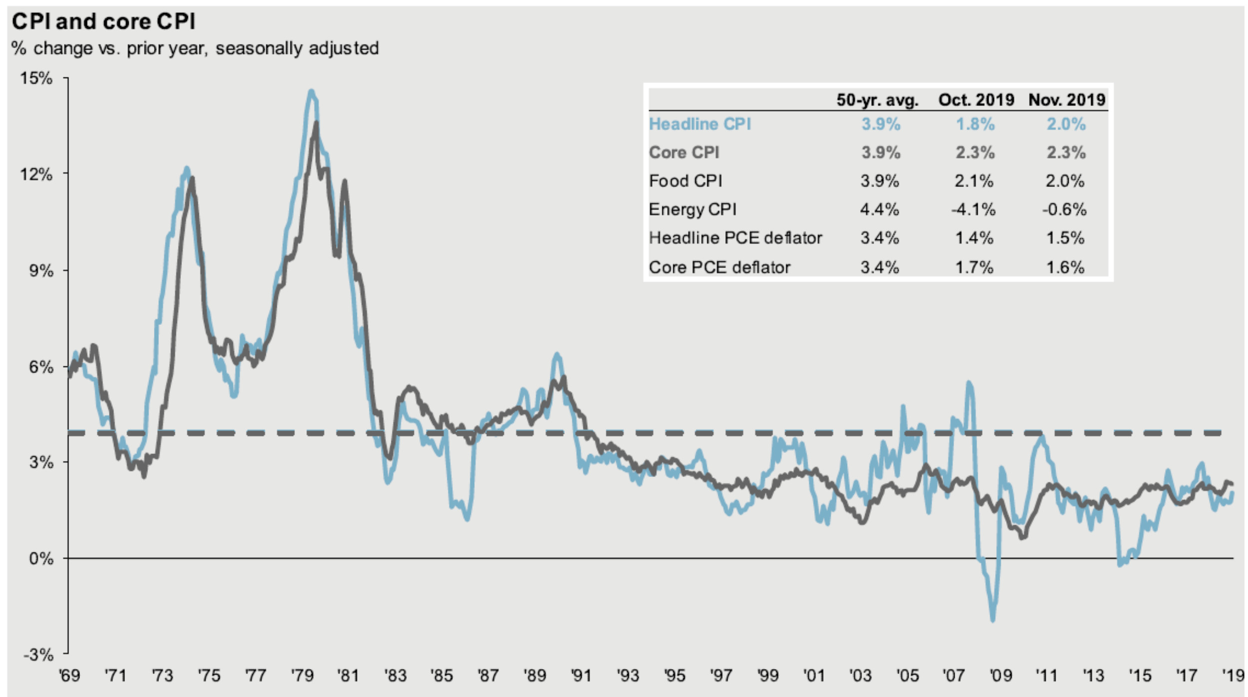
We have identified two scenarios that could cause interest rates to move up significantly within the next 3 years. **One higher interest rate scenario involves inflation rising by several percentage points.** Since wages account for nearly 70% of the economy, rising wages combined with declining labor productivity could cause inflation to rise enough to convince the Fed to raise interest rates enough to trigger a recession that would then cool down wage inflation. The black line below shows the November U.S. unemployment rate hitting a low of 3.5%. Wage growth has been doing the opposite, recently hitting a decade high annualized growth rate of 3.7% (blue line).



Source: BLS, FactSet, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of December 31, 2019.

Note that if productivity growth is 2%, then unit labor costs are expected to rise 1.7%, which would not accelerate inflation. However, if wages rise 5% per year (possibly in 2021-22) and if productivity drops to 1%, then labor costs rise by 4%/year. These rising costs can be absorbed

by firms by reducing profit margins or they can be passed on via higher prices, resulting in higher inflation. If the latter occurs, then overall inflation could rise from about 2% now (see chart below) to over 4%, likely forcing the Fed to raise interest rates in response.



Source: BLS, FactSet, J.P. Morgan Asset Management.
CPI used is CPI-U and values shown are % change vs. one year ago. Core CPI is defined as CPI excluding food and energy prices. The Personal Consumption Expenditure (PCE) deflator employs an evolving chain-weighted basket of consumer expenditures instead of the fixed-weight basket used in CPI calculations.

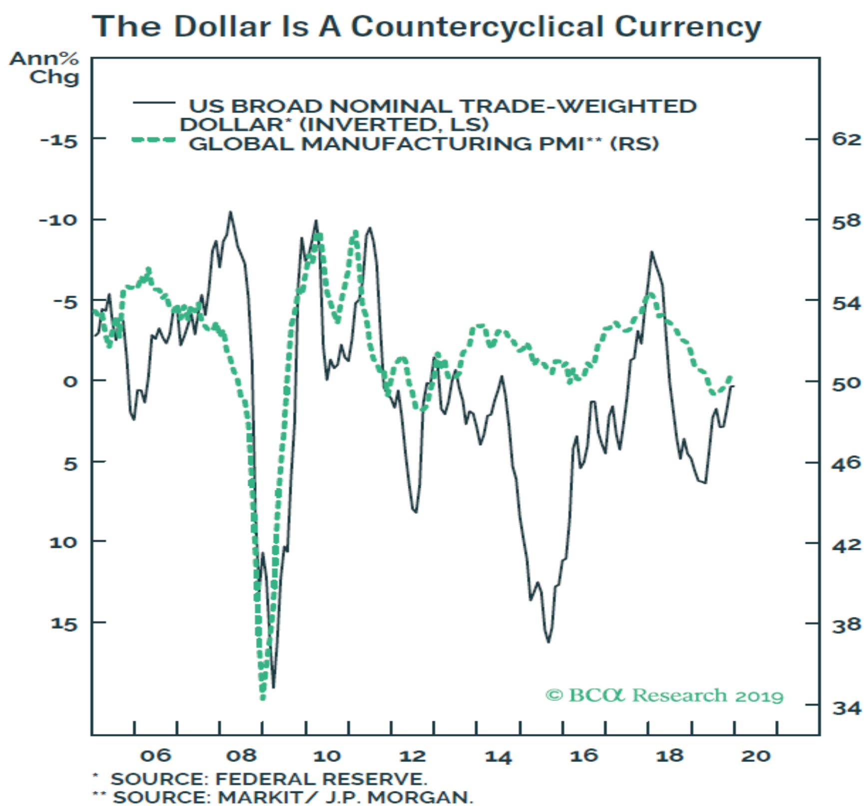
Labor productivity tends to deteriorate as less-skilled workers are drawn into the workforce. However, new technologies as well as the recent trend of baby boomers delaying retirement could keep productivity higher than expected. These factors, plus globalization of production and some services produces deflationary price and wage pressures and which have kept domestic wages from rising more rapidly when compared to past experiences with such low unemployment rates.

Per the Bureau of Labor Statistics, labor productivity increased 1.5% for the 12 months ending last September. This is close to where it has been since 2017, so **the continuing drop in the unemployment rate has not yet had a noticeable effect on productivity. Both wage growth and productivity are key variables to monitor over the coming 24 months.**

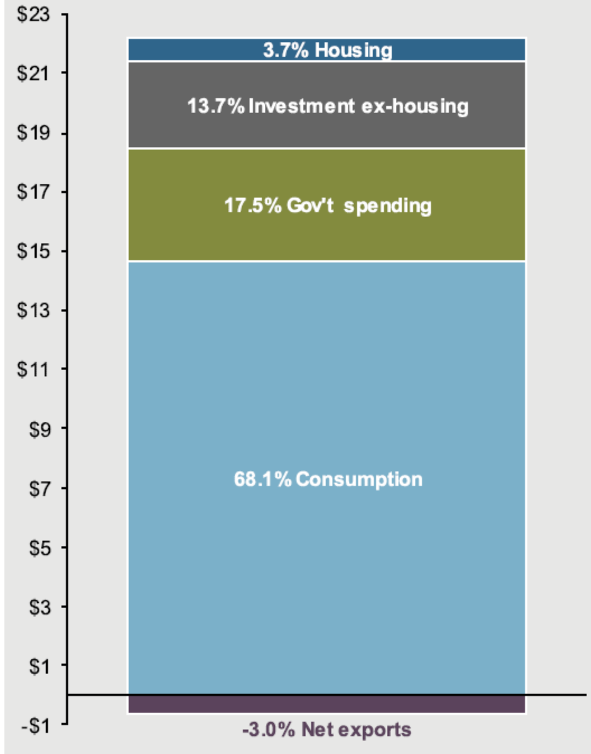
The second scenario that could cause interest rates to move up would be a large reduction in U.S. bond buying. New issuance of U.S. Treasury securities is expected to remain high due to large budget deficits. So far, demand has been equally strong, with much of the supply being absorbed by yield-hungry foreign buyers. With interest rates at or below zero in much of Europe and Japan, the positive interest rates in the U.S. are quite attractive to foreign investors. Inflows of foreign capital to acquire U.S. fixed income keeps interest rates in the U.S. from rising much. It also keeps the dollar strong relative to many other foreign currencies. However, it would not take much to change this.

For European and Japanese investors owning U.S. high-quality bonds, the cost to hedge back into their own currencies would more than offset the yield pick-up by investing in the U.S. Therefore, logic dictates that the bulk of their bond holdings in the U.S. are not currency hedged. If the dollar continues to slide, as it has recently, then these foreign investors could very well sell their U.S. bond holdings and move these assets back to their own or other countries. This could cause an escalating cycle of bond sales, dollar devaluation and rising U.S. bond and mortgage rates. If interest rates rise enough, it would cause problems for the U.S. economy.

These rising interest rate scenarios are not likely to unfold any time soon, if at all. However, if they do become reality in 2021 or 2022, this could be the trigger to send the U.S. into an economic slowdown and possible recession. **Higher interest rates would also reduce bond and stock valuations as will be discussed later in this report**.

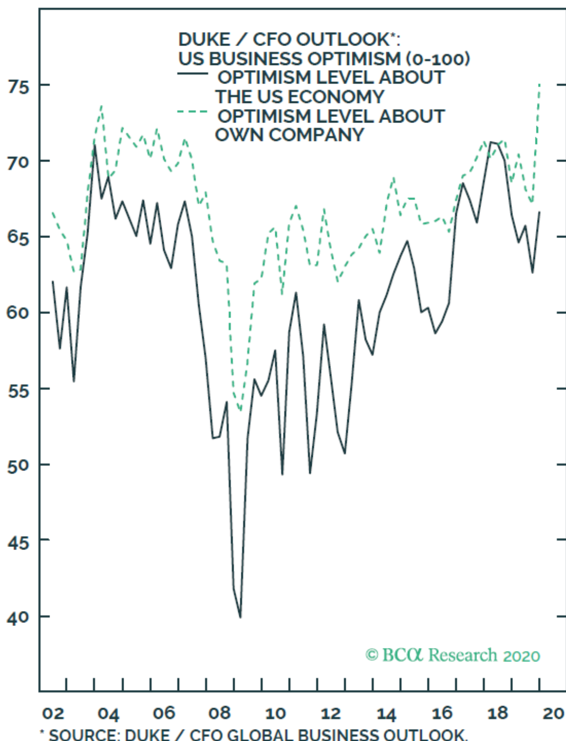


The U.S. dollar tends to outperform when global economies are weaker and vice versa as can be seen in the above chart. The U.S. is less cyclical than more manufacturing and export reliant countries. With China and Europe showing some recovery following a relaxation in the "trade wars" and the UK no longer facing a "hard Brexit", most global economies and currencies are expected to rebound. Additionally, the Federal Reserve cutting interest rates in 2019 and instituting a new round of QE T-Bill purchases will tend to push interest rates down in the U.S. in the short-run. These lower interest rates make the U.S. a less attractive place to invest. Lower U.S. interest rates also tend to result in a falling dollar relative to other currencies. A falling dollar may help U.S. exporters, but not importers. It could also boost U.S. inflation.

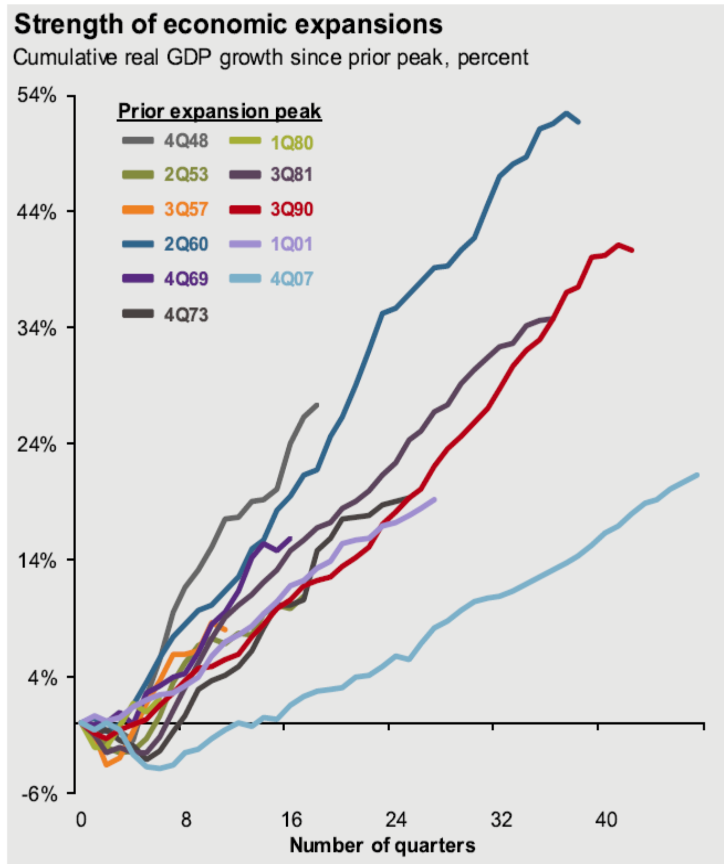


About 68% of U.S. GDP comes from household consumption (chart on right), which has been strong recently thanks to strong employment and wage growth and low household debt service ratios (above chart).

At 13.7% of the economy, a strong contraction in capital expenditure spending (investment ex-housing above right) often precipitates a recession. The recent trade war restrained some capital spending due to supply chain and global growth uncertainties. However, a strong consumer and ample corporate profits were enough to result in positive capital spending growth, albeit somewhat lackluster. Capital spending could be poised for acceleration (excluding Boeing production and oil and gas drilling). A reduction in trade tensions and additional monetary stimulus from the U.S., China and elsewhere has businesses feeling more confident. **Chief Financial Officers (CFOs) of major U.S. firms are now the most optimistic about their own firm's prospects than at any other time over the past 20 years** (left graph, dotted line). **This suggests more capital spending over the next few years**. While future overcapacity may become an issue, **higher capital spending could result in stronger than expected U.S. GDP and earnings growth in 2020 and 2021**. Plus, with a tight labor market, some of the capital spending is likely to go into labor savings



technologies, which could also give a nice boost to unit labor productivity.



The current U.S. business expansion is now the longest in recent history. However, it has been one of the weakest expansions (light blue line, left chart). Inflation-adjusted GDP growth is now only about 20% above pre-financial crisis levels. Many past cycles did not end until real GDP had expanded by 35% to 50%. At the current rate, this could take more than 5 more years. Certainly, some economic malady could end the current economic expansion sooner. **Nevertheless, there is no time clock to predict the end of the current expansion**. An old expression states that bull markets don't die of old age, but are killed—normally by a restrictive Federal Reserve or by investment bubbles supported by too much debt. These appear to be low risks for the next year or two, but should be monitored.

International Economies and Risks

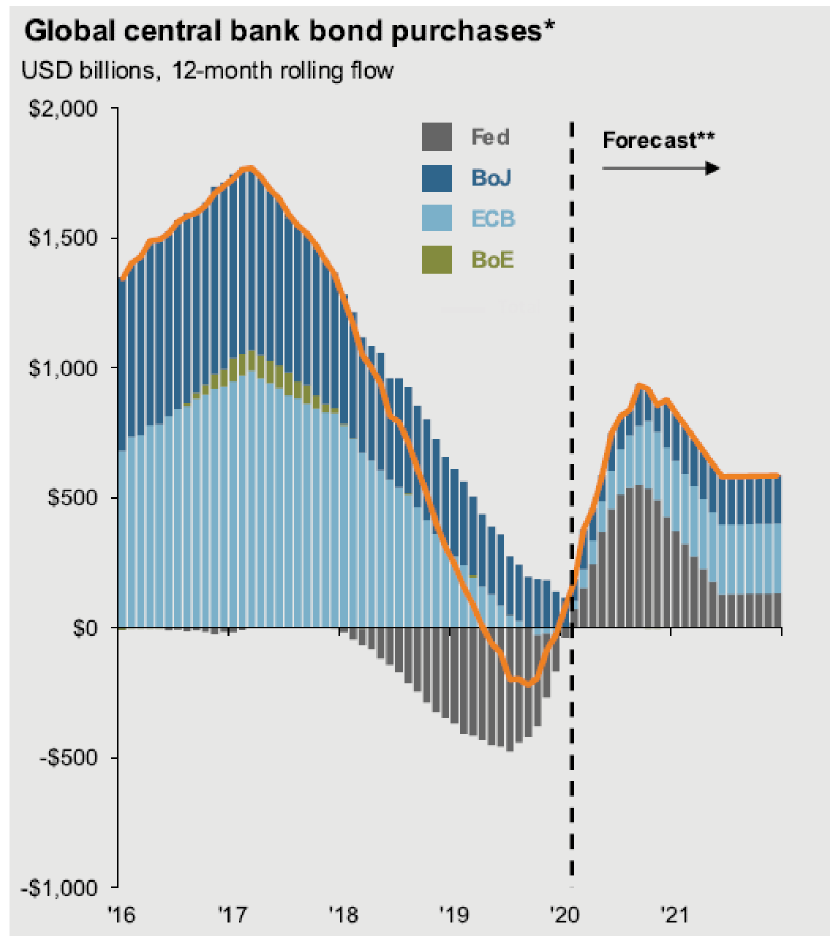
	Real GDP growth (%)				
	2017	2018	2019 F	2020 F	2021 F
World	3.9	3.8	3.1	3.3	3.5
DM	2.4	2.2	1.7	1.4	1.7
EM	4.9	4.9	4.0	4.5	4.7
US	2.4	2.9	2.3	1.9	2.1
Eurozone	2.7	1.9	1.2	1.0	1.2
Germany	2.5	1.5	0.5	1.0	1.1
France	2.4	1.7	1.3	1.2	1.2
Italy	1.8	0.7	0.2	0.5	0.6
UK	1.9	1.3	1.2	1.0	1.4
Japan	2.2	0.3	1.0	0.1	1.1
India	6.9	7.4	5.1	6.1	6.5
China	6.8	6.6	6.2	6.1	6.0
Brazil	1.3	1.3	1.1	2.1	2.6
Russia	1.6	2.3	1.2	1.6	2.0

In 2020, **world real GDP growth is expected to grow modestly** (Deutsche Bank table at left). **Most of this growth is expected to come from emerging markets.** China's growth may decline slightly, but at 6.1% expected growth it is expected to still be an engine of growth around the world. Growth in capital expenditures and firmer trade expectations are expected to boost 2021 growth further. This baseline excludes shocks to global economies from trade or actual wars, or excessive political upheavals, any of which could dampen growth prospects.

To counteract recent slower-growth trends, global monetary authorities have recently embarked upon another round of Quantitative Easing (QE). **These QE bond purchase programs lower interest rates by increasing bond purchase demand and by injecting money into their respective economies.** Some of this money is then invested in the real economy (jobs, plant and equipment) **and much of it is invested in stocks, bonds and real estate, pushing these asset prices up**. The wealth effect of higher asset prices increases consumer confidence, thus also stimulating additional consumer spending.

The chart to the right shows that the Federal Reserve and other central banks slowed their bond purchases starting in 2017. The disinvesting by the Fed began in 2018. However, the Fed began buying T-Bills in the fall of 2019 and has stated that it will continue to do so into the second quarter of 2020, and could continue thereafter.

Continuing economic weakness in Europe is expected to result in the European Central Bank (ECB) reaccelerating their bond purchases as well. Even though a slowing of these programs is expected in 2021, the bond purchasing programs are not expected to reach their 2019 lows. These activities should keep interest rates lower for longer, and boost economies and asset prices in Europe and the U.S.



Source: J.P. Morgan Asset Management; (Left) Bank of England, Bank of Japan, European Central Bank, FactSet, Federal Reserve System, J.P. Morgan Global Economic Research; (Right) Bloomberg. *Includes the Bank of Japan (BoJ), Bank of England (BoE), European Central Bank (ECB) and Federal Reserve. **Bond purchase forecast assumes no further purchases from BoE; continued BoJ QE of $20trn JPY ann. for 2020 and 2021; restarting of purchases from the ECB at a pace of $20bn EUR per month beginning in November 2019; and Federal Reserve purchases of Treasury bill securities at a pace of $60bn per month through June 2020 per the October 2019 policy statement. Beginning August 2019, maturing MBS holdings will be reinvested in Treasuries up to $20bn per month, anything in excess of that is reinvested back into MBS. The Fed balance sheet continues to rise again due to rising liabilities. ***Including: Australia, Canada, Denmark, eurozone, Japan, Norway, Sweden, Switzerland, UK and U.S.
Guide to the Markets – U.S. Data are as of December 31, 2019.

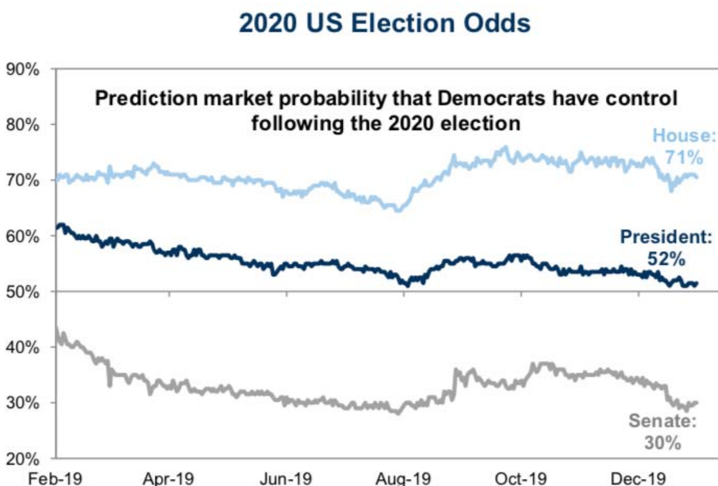
Geopolitics and Elections

Conflicting national, ethnic and religious interests continue to create a background of tension and uncertainty. China is using its economic and military strength to extend its influence through much of Southeast Asia. The recent trade war with the U.S. is just one aspect of increasing tensions between China and the U.S. and its allies that may intensify over time. The state of

affairs in the Middle East, N. Korea, as well as many global protests is evidence of increased global intolerance of the status quo and increased polarization of interests. The post-Soviet Union "peace dividend" of relatively free trade, reduced military spending and peaceful coexistence appears to have been replaced by the "conflict continuum", in which nations allocate a larger share of resources to traditional military pursuits, anti-terrorism, cyber threats, climate change costs, and dealing with increased internal strife. As unfortunate as this trend has been, most people and corporations adapt, which means doing what they can to be productive, to improve, and be better off in the future. As we translate this from the "micro" level to the macroeconomic level, this means that global economies should continue to grow and prosper despite the increased costs of modestly escalating conflicts. In the recent past, newly erupting conflicts heighten fears, which more often than not soon recede and thus create trading opportunities for active securities traders.

Is the Middle East different with its large oil reserves and the problems that would follow from oil supply disruptions due to regional conflicts? The short answer is that major turmoil is no longer certain to follow a large oil price increase or oil supply disruption. The U.S. is nearly self-sufficient in oil due to "fracking" technologies. Furthermore, the U.S. economy is now driven mostly by services and knowledge industries, and therefore the shock to manufacturing from higher oil prices is much smaller now than in prior decades. Oil is not as important for electricity production, as natural gas has replaced both oil and coal as the low-cost not-too-dirty fuel of choice. Certainly, all fossil fuels are slowly falling out of favor as non-fossil fuel alternatives take hold and transportation requires less oil per mile. China is much more sensitive to oil prices and oil supply than is the U.S.

U.S. Election: The upcoming U.S. elections present a risk to businesses and to domestic stock prices if a progressive Democratic president is elected and if the Senate also turns Democratic. **A Democratic sweep would likely result in most of the recent corporate tax cuts being reversed. Higher regulatory costs would decrease profitability too. U.S. stock prices could decline 10-15%** due to higher government driven cost increases. **Foreign stocks would outperform in this scenario.** So far, the U.S. stock market appears to have not priced in this tax cut rollback risk.



Betting markets (arguably more accurate than polls) slightly favor a Democratic presidential victory and that the Senate remains Republican (Goldman Sachs graph, left). Therefore, there is a strong possibility of a divided government through 2023. Changes in tax law and major changes to health care are unlikely to occur through 2023.

BCA Research has done a detailed analysis of past presidential elections. Their statistical model, which looks at each state

and its economic and voter conditions, shows the president winning two key swing states (WI and PA) and thus winning reelection. However, both states are currently too close to call, so that it is possible that a Democrat could win. A standing president with low unemployment conditions almost always wins reelection absent a recent recession, so history favors an incumbent victory.

Small Decline In State Economies Could Ruin Trump's 2020 Bid

CHANGE IN STATE LEADING INDEX FROM TODAY'S LEVEL (%)	CHANGE IN TRUMP'S APPROVAL FROM TODAY'S LEVEL (%)														
	-5	-4	-3	-2	-1.5	-1	-0.5	0	0.5	1	1.5	2	3	4	5
-2	204	204	204	204	204	204	204	204	215	215	215	215	215	215	215
-1.5	215	215	215	215	230	230	230	230	230	230	230	230	230	230	230
-1	230	230	230	230	230	230	230	230	259	259	259	259	259	259	259
-0.5	259	259	259	259	259	259	259	259	259	259	259	259	259	259	259
0	259	259	259	259	259	259	259	279	279	279	289	289	289	293	293
0.5	289	293	293	293	293	293	293	293	293	293	293	293	299	299	299
1	299	299	299	299	299	309	309	309	309	309	309	309	325	325	325
1.5	325	325	325	325	325	329	329	329	329	329	329	329	329	329	329
2	329	329	329	329	329	329	338	338	338	338	338	338	338	338	338

NOTE: SHADED AREA DENOTES TRUMP WIN.

Such an incumbent reelection is largely dependent upon economic conditions and approval ratings as can be seen in BCA's model predictions above. A small deterioration in economic conditions or approval rating could swing the presidential election to the Democrats. Both factors likely played a role in the recent Phase I trade agreement with China; alleviating some economic concerns and boosting future agricultural exports in some key states.

A Republican reelection could have some unexpected negative economic and stock market consequences. There will no longer be any political or reelection reasons to be lenient on China and other trading partners. **It is quite possible that trade tariffs will be ramped up around the world in 2021** if the current president wants to be tough on trade issues again.

Pre-election headlines are likely to cause stock market volatility, but so long as the Senate stays Republican, there is little for investors to fear in 2020, no matter who is elected president.

Note that WESCAP makes no endorsements nor takes any political stances, but merely tries to understand the likelihood and repercussions of various elections in order to make prudent investment decisions.

Stock Market Fundamentals and Dynamics

With the U.S. economy and households in good shape and with low inflation and low interest rates, positive election year dynamics and another round of Fed QE, the recipe for continued stock market gains is in place. Until one or more of these factors change, any stock market dips should be seen as buying opportunities.

The Coronavirus outbreak, while unfortunate, is not expected to have a long-term impact on most global stock valuations. The SARS and the Ebola outbreaks resulted in double digit

declines in many global stock markets, followed by strong price recoveries when worst case fears did not actually occur. The Coronavirus appears much less deadly than SARS or Ebola, so global stocks should not be as adversely affected and price recovery is expected to be more rapid.

At the end of 2019, the U.S. stock market was trading at 18.2 times 2020 expected earnings. The 25-year average has been a price to earnings (P/E) ratio of 16.3 (JP Morgan 12/2019 Guide to the Markets). While a case can be made for modest overvaluation, a deeper review indicates a fairly valued market. The main reason is low interest rates. Stock valuations can be seen as a function of earnings growth, the risk-free interest rate and the premium that stock investors demand above that risk-free rate to hold stocks.

An example follows: Let's assume a company grows earnings at 5%/year indefinitely, which will be called variable g. Let's assume that stock investors demand a 6% return above the risk-free rate and that the risk-free 10-year Treasury note interest rate is 4%. Therefore, investors demand an annual rate of return of 10% to own this stock (the 6% equity risk premium plus the 4% risk-free rate), also shown as variable r below.

Using the formula P/E = 1/ (r-g), the P/E ratio of such a stock should be 20 (1 divided by 0.05).

Note that if we drop the risk-free interest rate from 4% to 2%, closer to current conditions, then the investors' required rate of return drops from 10%/year to 8%. Using the above formula, the new equilibrium P/E ratio is 33.3 (1 divided by 0.03). In this example, a long-term decline in interest rates increases the value of the stock by nearly 67%. If interest rates later move back to 4% from 2%, then the P/E ratio and stock price should be expected to decline by 40%.

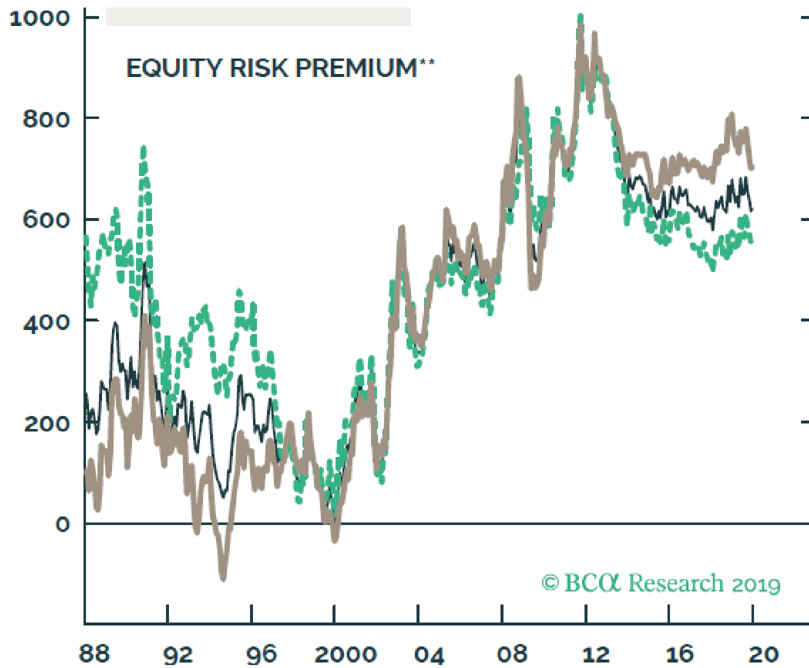
For slower-growing companies, the price impact of changes in interest rates is somewhat muted. If we have a 4% risk-free rate and change the firm's earnings growth rate to 2%/year, then the PE ratio should be 12.5. If we then decrease the risk-free interest rate to 2%, then the P/E ratio increases to 16.7, an increase of 33%.

As interest rates have been declining steadily since 2008 (see page 12 graph), this has favored growth stocks over value stocks. If interest rates rise again, and P/E ratios contract faster for growth companies, it is conceivable that value stocks could show strong outperformance again.

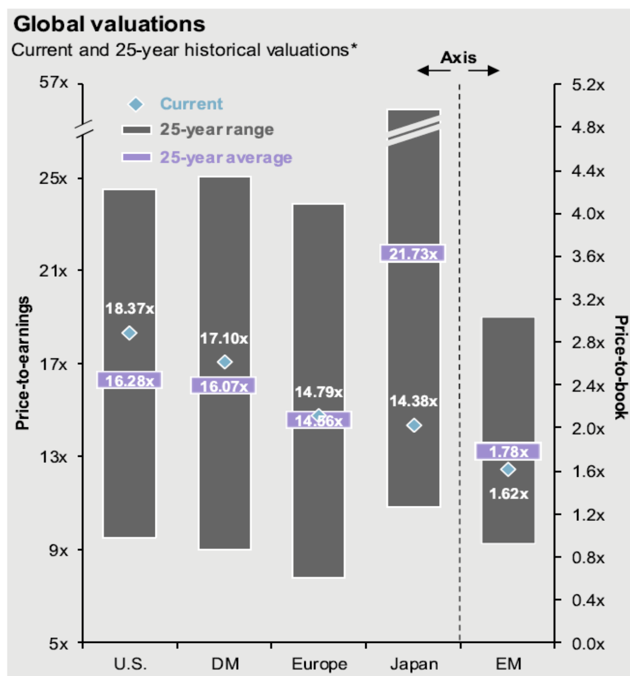
For the near future, as long as interest rates remain low, then a higher valuation on earnings and earnings growth should be expected and the stock market P/E ratio could easily exceed 20 in this case, translating to 15%+ price gains from this factor alone. Over the next 5 years, barring recession and much higher interest rates, the total return from U.S. stocks are likely to be in the 4%-7% annualized return range. If interest rates rise enough, returns could be less than half this amount.

The current equity-risk premium of close to 6% confirms that investors are demanding a fairly-high rate of return in order to hold stocks. The next graph (BCA 2020 Outlook) shows the estimated equity risk premium component of the stock market since 1988. The green dotted line shows what investors require in excess of the prevailing risk-free interest rate to own U.S. stocks. During the dot-com bubble, investors demanded very little extra return, showing the unparalleled (and unwarrated) optimism of the time. Near 2008, investors demanded nearly 8% above the

risk-free rate as worries were high at that time. The current equity-risk premium of about 6% shows that investors still demand a fairly high return to hold stocks and thus **investors are not yet showing evidence of general U.S. stock market over-enthusiasm**. The dark line is for all stocks worldwide. The gray-brown line is for non-U.S. stocks, which show even more investor caution and thus requiring an even higher near 7% return over their respective risk-free rates to entice investors to own these markets.



The next graph (JP Morgan) shows that U.S. stocks are trading noticeably above their long-term historical range. This does not take into account the effect of low interest rates, as discussed earlier, which supports a higher valuation.



The blue diamonds show the current valuations relative to the 25-year ranges and averages. Europe is trading very near its 25-year average and Japan and Emerging Markets stocks are trading below their long-term averages. Interest rates are even lower in Japan and Europe, which should support much higher stock valuations there.

Lower relative valuations and higher equity risk premiums for non-U.S. stocks suggest a 1% to 3% greater return per year to owners of non-U.S. stocks.

Currency changes can add or subtract from these returns, so it makes sense to hedge some of the currency risk.

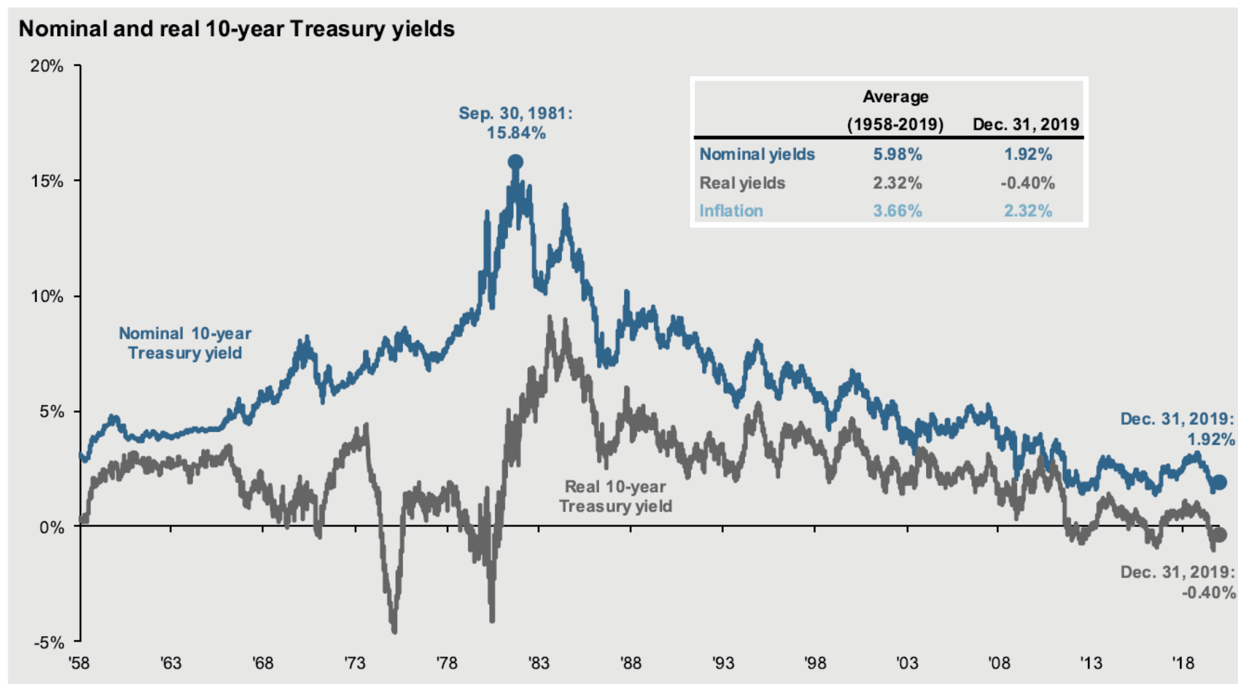
Fixed Income Investments

Fixed income investment yields in the U.S. generally fell last year. Short-term and longer-term interest rates declined in 2019 due to Federal Reserve policy actions and due to continued investor appetite for U.S. fixed income over European and Japanese fixed income investments.

The Fed is likely to keep short-term interest rates low for the next few years or until inflation takes a large unexpected jump. The Fed may keep its QE program in place beyond the second quarter and into 2021 per market expectations (see grey bars, page 7 graph).

However, interest levels are so low now that the reward for investing in fixed income makes a high-quality bond investor wonder if it is worth the risk. As the next graph shows, the 10-year U.S. Treasury Note yield at year-end 2019 was only 1.92% and was negative when adjusting for inflation.

If interest rates should rise suddenly, bond prices will fall. For example, if the 10-year bond yield should rise 1%, then previously issued, lower-yielding bonds would need to drop 9.1% in price to compensate. With a current yield of just under 2%, it would take more than 4 years of interest to make up for this price decline. This is a very long profit breakeven time. Longer than 10-year maturity fixed-rate bonds would fare even worse with an interest rate increase.



Source: BLS, FactSet, Federal Reserve, J.P. Morgan Asset Management.
Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core CPI inflation for that month except for December

There are several alternatives to offset the risk of a potential rise in interest rates. One is to focus on short maturity bonds. **Owning fixed income maturities of 2 years or less reduces the price**

risk and brings down the breakeven time for rising rates from years to months. Another is to own variable rate bonds where the interest rates are reset every 30 to 180 days. The last is to accept either more credit risk or currency risk. The higher current interest rates paid on these bonds reduces the breakeven time for owning these should interest rates rise.

The next chart shows the year-end 2019 yields for various fixed income assets (JP Morgan). The yields are quite low for U.S. Treasury securities. High quality corporate bonds do not yield much more. Municipal bonds have even lower yields and despite their tax advantages, they are not keeping up with inflation and generally have too much interest rate risk. High yield, lower credit quality bonds still offer an attractive rate of return. This would also include bank debt floating rate securities. However, in times of economic distress, defaults are likely to increase enough to make credit-sensitive bonds unattractive. For the next two years defaults are not likely to be a significant issue except in some distressed sectors (e.g. some retailers and some oil/gas drillers).

U.S. Treasuries	12/31/2019
2-Year	1.58%
5-Year	1.69%
TIPS	0.15%
10-Year	1.92%
30-Year	2.39%
Sector	
Corporates	2.84%
U.S. Aggregate	2.31%
Convertibles	5.66%
High Yield	5.19%
Municipals	1.63%
MBS	2.54%
ABS	2.87%
Floating Rate	2.30%

Convertible bonds appear attractive, although they act a lot like stocks and thus do not provide much of a risk buffer when stocks are doing poorly.

High-quality insured mortgage-backed securities (MBS) offer a better than Treasury yield with lower duration and thus offer some risk buffer and slightly higher returns.

Not shown are non-agency (not insured) mortgage-backed securities. They can offer returns 1-3% higher than insured MBS. With a strong consumer balance sheet and reasonably healthy housing market, these **non-agency mortgage investments offer a good balance of risk and return.** Many also have adjustable interest rates or have short durations. These are the types of MBS that are currently favored in this part of the economic and interest rate cycle.

Foreign bonds have a much wider range of interest rates, depending upon country of origin and whether they are issued in dollars or local currencies. Suffice to say some are very attractive while others are not. Additional details are available upon request.

Future Asset Class Returns and Conclusions

Over the next 3-5 years, we expect total average annual investment returns to range as follows:

Major Asset Class	Future Average Annual 3-5 year Total Return *
• U.S. stocks	4-7%
• Developed Market stocks	5-8% (excluding currency effects)
• Emerging, Frontier stocks	6-9% (excluding currency effects)
• Commodity and Energy	0-12%
• High Yield bonds	2-5%
• Emerging Markets bonds	3-6%
• Non-Agency mortgages	3-5%
• Long-Term U.S. bonds	1-4%
• Short/variable U.S. fixed income	2-3%
• Major Foreign Currencies	0-2%
Inflation (not an asset class)	2-4%

* not including ETF, mutual fund or other management fees and costs.

Annual return variation is expected to be high for stocks and less for fixed income investments. A recession or major economic shock would likely result in returns much lower than shown above, except for the last three asset classes. An acceleration in U.S. and global productivity and trade with correspondingly higher GDP growth rates, low interest rates and low inflation could result in better returns.

WESCAP will continue in its efforts to add value by following a disciplined asset allocation tailored to appropriate risks, with frequent rebalancings, taking advantage of market and valuation trading opportunities. Income tax considerations will also be taken into account as appropriate.

For more details on investment return expectations or anything else in this report, please contact your WESCAP Group advisor.