BNY MELLON
WEALTH MANAGEMENT

Executive Summary: 2022 10-Year Capital Market Assumptions

The annual publication of our 10-Year Capital Market Assumptions (CMAs) affords the opportunity to share our projections for asset class returns, volatilities and correlations over the next decade. We consider this yearly exercise to be of importance given the role played by the CMAs in shaping the design of our investors' long-term policy portfolios. This year, we take into account higher inflation, a moderating pace of growth, the transition away from extremely accommodative policy, and current capital market conditions.

The CMA paper discusses three key findings of our 10-year outlook:

- Inflation is expected to increase moderately
- Traditional fixed income anchors are likely to generate negative real returns
- Alternatives will need to play a larger role in portfolios to combat the low yield environment

Inflation: Transitory or Sustained

After a decade of low inflation, price pressures have been on the rise as major economies around the world reopen. In October, U.S. consumer prices rose at their strongest pace in three decades. Unprecedented amounts of monetary and fiscal stimulus, along with supply-chain disruptions, labor shortages and a host of other catalysts, have contributed to a run up in inflation.

The debate whether this will prove to be transitory or sustained, depending on which metric you use, varies. Supply chain issues and other costs associated with reopening appear to be showing signs of abating, while labor shortages and wage growth may be longer-term catalysts. As a result, we have weighed supply-side price increases against longer-term structural factors such as demographics, globalization, and technological improvements in considering if higher inflation will be transitory or sustained (see Exhibit 1). To create our three-year economic and recessionary scenarios, we've also considered some of the uncertainties surrounding inflation and the Federal Reserve's policy response.

Inflation Debate

Transitory	Persistent
Supply chain disruptions	Wage accelerations
Auto prices	Rents
Semi-conductor shortage	Demand-pull factors
Energy prices	

Methodology: Planning for uncertainty

Like last year, there is still a notable degree of uncertainty. In partnership with the BNY Mellon Investment Management Global Economic and Investment Analysis Group, we have incorporated a scenario-based approach to estimating three key inputs into our return forecasts: short-term interest rates, inflation and GDP growth. We have assigned probability weights to plausible three-year recovery and recessionary scenarios, including two that outline if higher inflation proves stickier than anticipated.

40% Probability	25% Probability	25% Probability	10% Probability
Good Recovery	**Overheating**	**Tight Money**	**Bad Recovery**
• Vaccines prove effective and global herd immunity is reached over the next 12 months • In countries where the vaccine rollout has been rapid, activity moves beyond it pre-COVID level and rapidly approaches its pre-COVID trend • Pandemic savings remain largely unspent. Labor market frictions put some upward pressure on inflation, but most of this is now behind us. • The Fed begins to taper gradually in December 2021 and raises the Fed funds rate in line with current guidance • Equities drift higher and a minor correction occurs in mid-2022	• Recovery is stronger than in the base case as households dip into their pandemic savings • More supply constraints due to labor supply issues and disruptions to trade resulting in greater inflationary pressure • The taper begins n December 2021 in line with "Good Recovery" • Inflation expectations are destabilized, high inflation proves stickier than anticipated, and the Fed is forced to increase rates more aggressively • Yields rise more than in "Tight Money" and equities start to fall in late 2022 as aggressive Fed action is required	• Recovery is similar to the "Overheating" scenario • The Fed begins to taper in November 2021 reducing purchases by $15 billion each month • Concerned this isn't enough, the FOMC surprises markets and raises the Fed funds rate by 25 basis points in March and June of 2022 • Yields climb in 2022 • This results in a short slowdown then a resumption of growth as inflation is contained • Overall, this is a less negative outcome compared to the "Overheating" scenario	• Governments begin reimposing restrictions in late 2021/early 2022 as the delta variant continues to circulate • The macro impact is less severe than earlier shutdowns as economies have adapted • The delta variant surges in emerging economies with further restrictions required and remains an issue in 2022 into 2023 • US and Europe are affected by supply-side constraints due to lockdowns in emerging economies • Demand falls with supply limiting inflationary pressures • Global growth is sluggish as recovery is de-synchronized

Note: Percentages represent projected probability of each scenario occurring. The economic scenarios are provided by the BNY Mellon Global Economics and Investment Analysis Team. Please refer to the Q4 2021 Vantage Point publication for the full analysis behind each economic scenario.

The probability weighted average estimate for each input is then incorporated into our CMAs. At the margin, this approach has resulted in only modest year-over-year adjustments to our forecasts. With most of the recovery behind us, we have lowered our forecasts for real GDP growth to 1.9% in the U.S., 1.3% in non-U.S. developed, and 3.2% in emerging markets. Although supply-chain disruptions, higher energy prices and labor shortages have resulted in elevated inflation this year, especially in the U.S., our view is that inflation will prove mostly transitory. Still, near-term pricing pressures have led us to increase our longer-term inflation assumption by 0.6% from 2.4% to 3.0%.

Overall, our 10-year return forecasts are generally lower compared to last year with the exception of fixed income returns, which are slightly better due to modestly higher starting-point yields. We expect equity markets to deliver mid-to-high single-digit returns, slightly below our 10-year forecast from last year. Alternative asset classes should provide an additional source of return and diversification, especially those most sensitive to inflation.

Asset Class Assumptions

Equity Markets	After robust equity returns over the past two years, we anticipate mid-to-high single-digit returns due to slowing growth rates and stretched valuations.	**5.9%** U.S. Equity **5.8%** International Developed **7.6%** Emerging Markets
Fixed income	Though yields are expected to rise modestly, they remain historically low for the time being due to the abundance of monetary and fiscal response. Fixed income returns are forecast to be low, but interest payments may offset some potential principal loss due to a rise in interest rates.	**1.2%** U.S. Aggregate **1.9%** U.S. High Yield **0.3%** Global Agg. Ex-U.S. 3.8% EM Local Currency
Alternatives	Alternative asset class returns are mixed with particular strength in asset classes most sensitive to inflation. Given wide return dispersion among strategies, manager selection is critical.	**3.2%** Absolute Return **3.9%** Hedge Funds **7.9%** U.S. Private Equity **4.7%** U.S. Core Real Estate

Key Portfolio Implications

The most important conclusions we draw from the report relate to their profound investment implications. Similar to the investment implications we outlined last year, it is important to consider diversification, a search for yield and inflation protection when creating goals-based, long-term policy portfolios aligned to client goals.

In last year's CMAs, we emphasized that a traditional balanced portfolio of U.S. Equities (60%) and U.S. Investment Grade Bonds (40%) will struggle to generate stable capital growth over the next decade. This belief resulted in the diversified nature of our goals-based policy portfolios, introduced to Wealth Management clients in mid-2020.

Our policy portfolios are diversified and include a range of assets that can perform well in a variety of economic and market backdrops. They have been stress tested under various scenarios, including one of rising inflation. Despite a more challenging decade of muted returns, low interest rates and modestly higher inflation, we believe the recommended actions below will allow investors to continue achieving their goals.

Actions to Consider

For Growth	**Global equity market exposure and greater private equity exposure** Although we expect emerging market equities to outperform U.S. large cap equities in the next decade, investors should benefit from broader diversification. Private equity offers an illiquidity premium and the potential for much higher idiosyncratic returns relative to public equities.
For Income	**Greater emerging market debt, bank loans and private credit exposure** Yields across the U.S. investment grade market are extremely depressed while relatively attractive yields are still offered by emerging market debt, loans and private credit.
For Risk Diversification	**Liquid alternatives multi-asset strategies** Liquid alternatives offer comparable equity diversification benefits, but have greater upside return potential than investment grade fixed income.
For Purchasing Power Protection	**Greater exposure to real assets** Inflation risks are on the rise and threaten to erode the purchasing power of investors' wealth. Real assets can provide a better hedge against this risk relative to financial assets.

Conclusion

CMAs are utilized across a range of investment and planning activities. These assumptions influence our strategic asset allocation models, which are tailored to our clients' objectives and risk tolerance as well as tax sensitivity. From this starting point, we recommend tactical asset allocation shifts based on shorter-term market dislocations as well as tax sensitivity, where applicable.

We welcome you to review our 2022 Capital Market Assumptions. As you navigate the next decade, we at BNY Mellon Wealth Management are available to help you review these assumptions as they relate to your investment plan.

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