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Schwab's 2025 Long-Term Capital Market Expectations

January 3, 2025 ▪ Emre Erdogan ▪ Seth McMoore

Continuing last year's trend, our 2025 outlook shows fixed income benefiting from high rates, while equities face a narrowing edge over risk-free investments.



To achieve long-term financial goals, it's important to keep your expectations grounded in what's actually happening in the financial world—markets are dynamic and can shift quickly.

Periodically reassessing your financial goals helps ensure they stay aligned with current market conditions, an essential part of any prudent investment plan. But finding reliable projections isn't always easy. That's why Schwab Asset Management® takes a disciplined, data-driven approach when updating our long-term Capital Market Expectations (CME). Based on quantitative and qualitative input from senior investment professionals, these forecasts provide insight into how different types of investments—like stocks and bonds—might perform over the next 10 years or more.

*CMEs are **nominal**, meaning they include the impact of inflation; **annualized**, representing average yearly returns; and calculated over a **10-year horizon**, providing potential market performance a decade into the future. Importantly, CMEs are based on representative benchmark indices, rather than specific investment vehicles like exchange-traded funds (ETF) or mutual funds. As a result, they do not account for costs such as fees or taxes.*

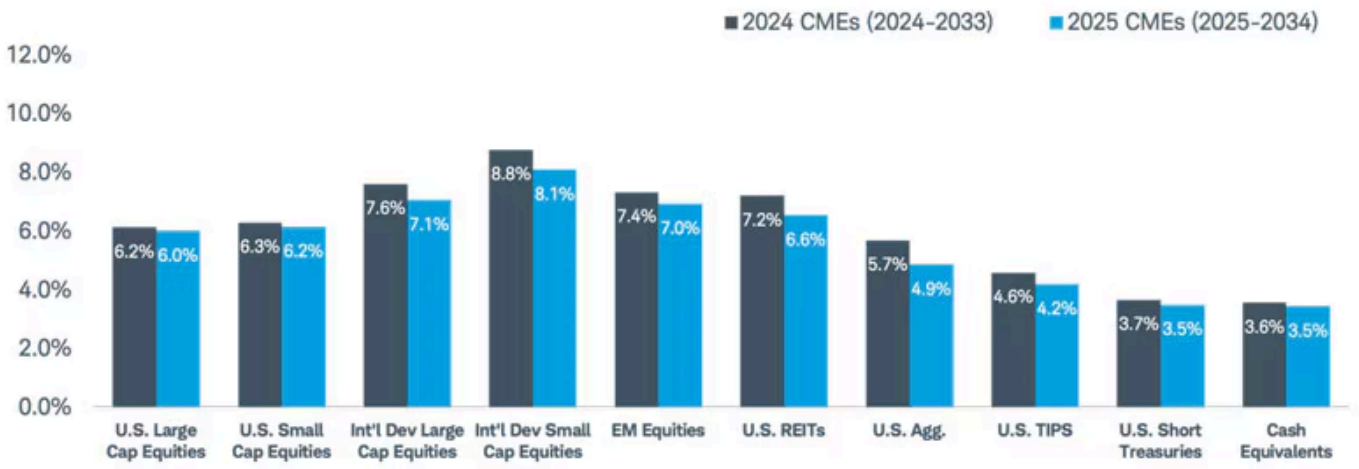
Schwab Asset Management's latest long-term forecasts, based on data through October 31, 2024, provide insights for major asset classes over the 2025–2034 period. By grounding decisions in well-

informed expectations, investors can more confidently plan for the future.

What is your outlook over the next decade?

Even with the Federal Reserve lowering short-term interest rates, our 2025 outlook highlights continued opportunities in fixed income, supported by historically high rates, though slightly lower than last year's peak. For equities, we remain focused on the equity risk premium (ERP)—the extra return stocks are expected to deliver over "risk-free" investments like Treasury securities as compensation for higher risk. While the expected ERP has slightly shifted since last year, it remains historically low, largely due to elevated bond yields. In short, while stocks are still expected to outperform bonds, the gap between their expected returns remains narrow.

Expected returns over the next 10 years



Source: Schwab Asset Management.

Data: As of 10/31/2024. Forecasts contained herein are for illustrative purposes only, may be based upon proprietary research and are developed through analysis of historical public data.

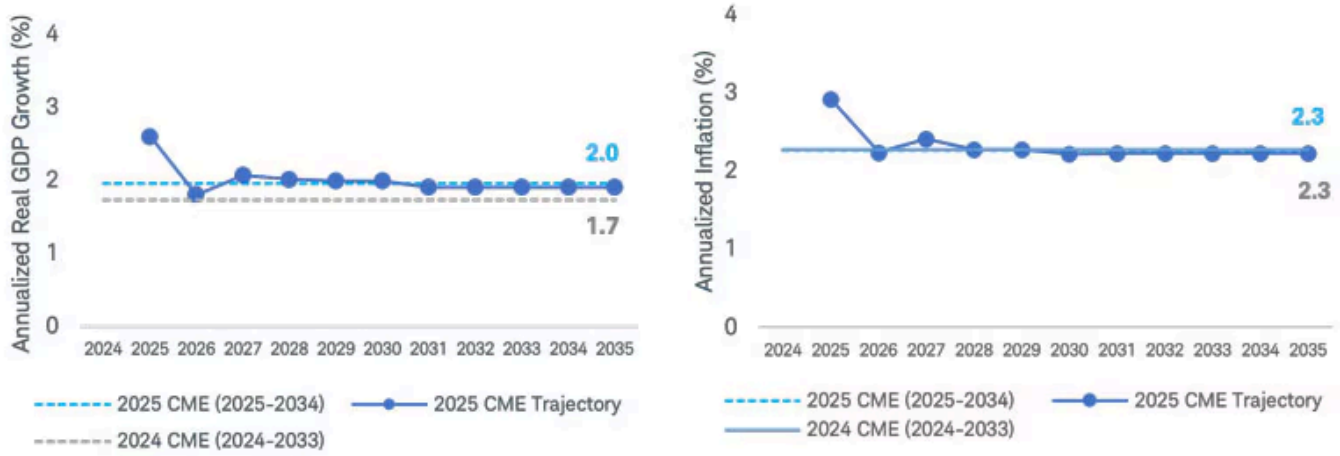
Each bar represents Schwab Asset Management's annualized nominal geometric return expectation for a given asset class. Geometric returns account for the compounding nature of investment returns. All indexes specified utilize a Total Return version of the named index. Total return = price growth + dividend and interest income. The example does not reflect the effects of taxes or fees, unless specified. Where specified, "Net Return" denotes a version of the index that reflects foreign taxes have been subtracted from dividends. Numbers rounded to the nearest one-tenth of a percentage point. Benchmark indexes: S&P 500® Total Return Index (U.S. Large Cap Equities), Russell 2000® Total Return Index (U.S. Small Cap Equities), MSCI EAFE Net Return Index® (Int'l Dev Large Cap Equities), MSCI EAFE Small Cap Net Return Index (Int'l Dev Small Cap Equities), MSCI Emerging Markets Net Return Index (EM Equities), S&P U.S. Real Estate Investment Trust (REIT) Total Return Index (U.S. REITs), Bloomberg U.S. Aggregate Bond Total Return Index (U.S. Agg.), Bloomberg U.S. Treasury Inflation Protected Securities (TIPS) Total Return Index (U.S. TIPS), Bloomberg U.S. Treasury 1-3 Year Total Return Index (U.S. Short Treasuries), and FTSE U.S. 3-Month Treasury Bill Index (Cash Equivalents).

The U.S. economy has proven remarkably resilient, consistently exceeding expectations, despite recent headwinds. As a result, we've modestly increased our 10-year forecast for real gross domestic product (GDP) growth to 2%, up from 1.7%. While encouraging, this remains below the historical average of 2.7% since 1970.

While the risk of a near-term recession remains low—evidenced by tighter credit spreads and high equity valuations—a slowdown could still materialize as the effects of earlier rate hikes take hold. Over the long term, we expect growth to stabilize at a more moderate pace, influenced by structu challenges like slower labor force growth. Since robust economic growth is essential for strong market returns, this slower pace shapes our outlook.

Inflation has eased since its pandemic-era highs as supply chain issues and pent-up demand normalize. While inflation is closer to trend levels this year, it remains above central bank targets and continues to pose a risk for investors. Our long-term inflation forecast holds steady at 2.3%, reflecting confidence in the Fed's ability over the long-term to guide inflation toward its neutral rate.

Expected inflation and real GDP growth



Source: Schwab Asset Management.

Data: Consensus Economics as of 10/31/2024.

The dark blue line reflects the expected 10-year trajectory of macroeconomic expectations as of 10/31/2024. The dashed lines reflect the 10-year weighted average 2024 and 2025 CMEs. Forecasts contained herein are for illustrative purposes only, may be based upon proprietary research and are developed through analysis of historical public data.

While the risk of a near-term recession has eased, unexpected economic disruptions or sharp market reversals can't be ruled out. Inflation remains a key concern for investors, especially with a new administration taking over. Factors like government spending, rising U.S. debt, and potential fiscal

policy shifts could increase inflationary pressure and present structural challenges. A well-constructed portfolio with assets that respond differently to varying market conditions can help manage unpredictability and deliver consistent, risk-adjusted returns over time.

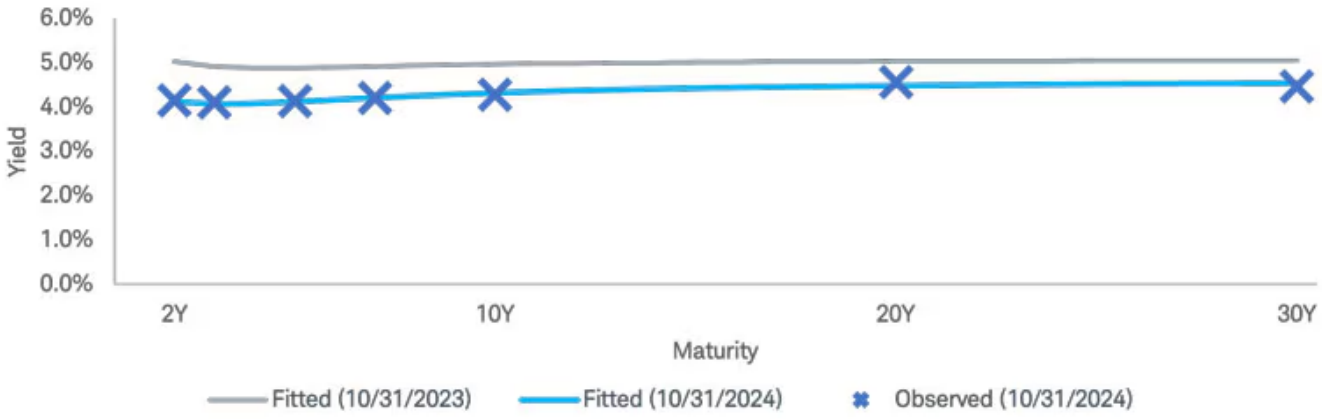
Bonds, for example, are offering more attractive yields than in recent decades and can provide reliable income during economic slowdowns, barring default. To address inflation risks, consider adding inflation-resilient assets to your portfolio. These might include investments tied to physical properties or with returns linked to inflation, such as real estate investment trusts (REIT) and Treasury Inflation-Protected Securities (TIPS). If inflation picks up unexpectedly, TIPS accruals can outpace breakeven rates, while rising rents and property values may help make REITs a reasonable hedge.

More details on fixed income and cash equivalents: This year has seen sharp market swings, particularly in bond yields, as markets adjust to the Fed's efforts to lower interest rates while grappling with persistent inflation and elevated federal debt levels. Short-term rates closely follow the federal funds rate, making them sensitive to policy changes, while longer-term rates are driven more by growth and inflation expectations.

These dynamics shape our bond market outlook, which are based on observed yield to maturity (YTM)—which tends to be a reliable predictor of total returns. While flatter yield curves have tempered fixed income expectations, returns are still projected to outperform the past decade, a period marked by historically low rates.

For example, U.S. aggregate bonds are expected to deliver annual returns of 4.9% over the next decade, down from last year's forecast of 5.7%. While this outlook marks an improvement from the last decade, returns are still expected to fall below long-term historical averages, given the low likelihood of a return to the extreme interest rate highs of the 1980's.

U.S. Treasury Curve



Source: Schwab Asset Management.

Data: FRED as of 10/31/2024. For illustrative purposes only.

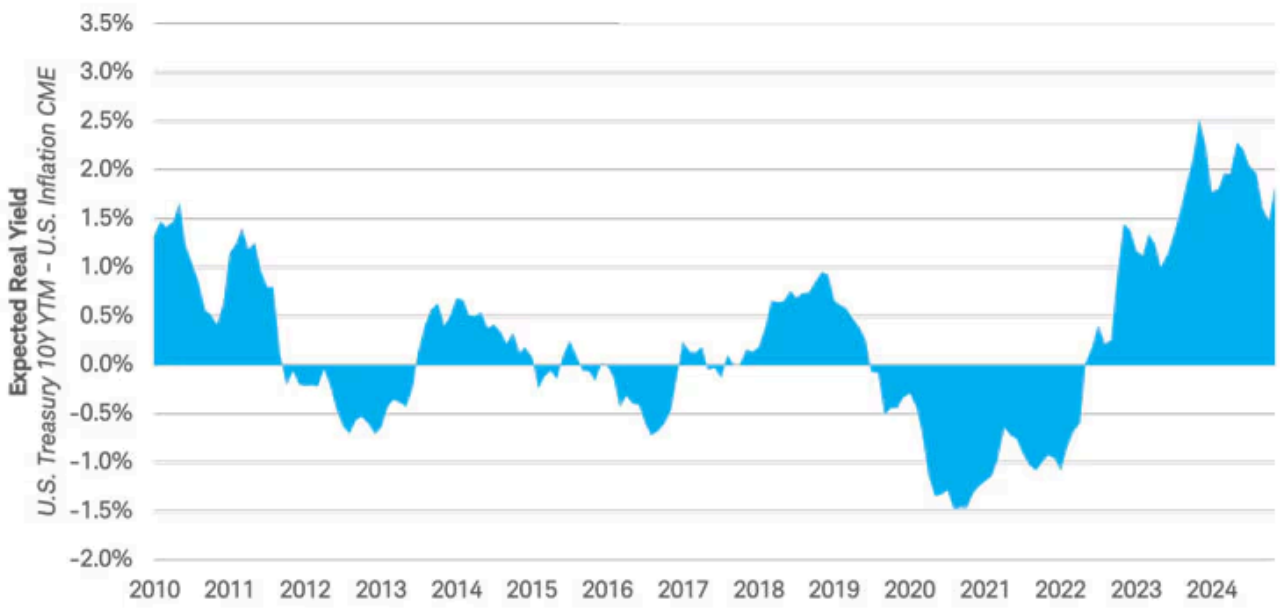
The dark blue markers reflect the observed yield curve as of 10/31/2024. The blue line reflects the fitted Treasury curve as of 10/31/2024. The grey line reflects the fitted Treasury curve as of 10/31/2023. A fitted yield curve is used to show yields for different maturities at different points in time.

As the Treasury curve normalizes, we expect cash yields to gradually decline and the curve to return to a more normal upward-slope. Locking in longer-term rates can provide some stability and help minimize reinvestment risk. We expect longer-term bonds to maintain a positive term premium, compensating investors for taking on inflation and interest rate risk.

Cash equivalent investments, like Treasury bills, have also seen slightly lower forecasts due to declining starting rates. As the Fed continues to reduce rates, cash equivalent returns are expected to decrease, with our 10-year forecast adjusted from 3.6% to 3.4%. This reflects a shift towards rates that, while higher than the extreme lows of the past decade, fall below today's levels.

When navigating the global bond market, it's useful to focus on real yields—nominal yields adjusted for inflation. Both cash and fixed income returns are expected to outpace inflation, delivering positive real returns and offering potential diversification during periods of economic slowdown.

Expected 10-year Real Treasury Yield Over Time



Source: Schwab Asset Management.

Data: FRED as of 10/31/2024. **Past performance does not guarantee future results.**

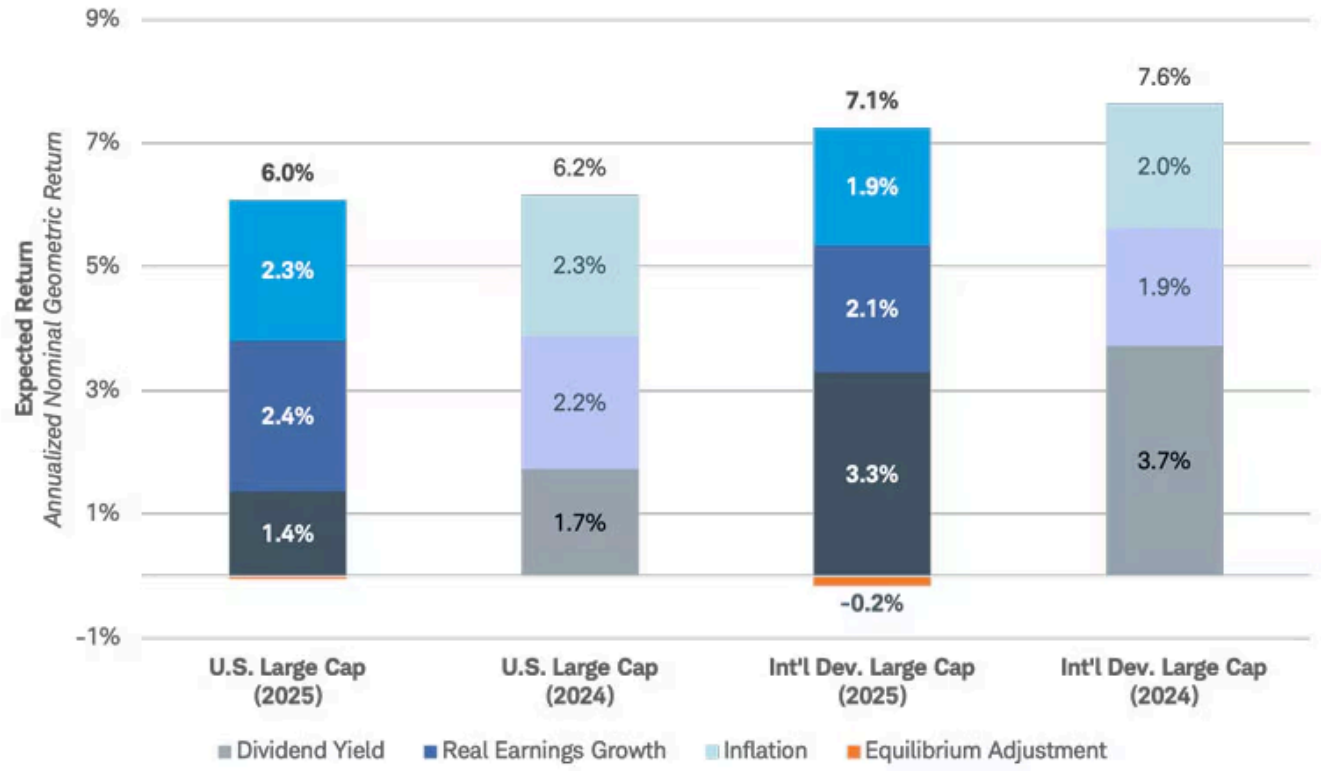
The blue area reflects the expected real yield of the U.S. Treasury 10-year-constant maturity YTM through time. The U.S. 10-Year Treasury Constant-Maturity YTM: An index based on the average yield of a range of Treasury securities, all adjusted to the equivalent of a 10-year maturity. Yields on Treasury securities at constant maturity are determined by the U.S. Treasury from the daily yield curve.

Diving further into the outlook for equities: The S&P 500® has achieved another strong year, which begs the question: How much room is left for further growth? Higher index prices have created a tougher starting point for valuations, but the resilience of the U.S. economy and improved earnings growth outlook have helped offset some of that potential drag. While we still see opportunity in U.S. markets, lofty valuations come with equally lofty expectations. If earnings growth doesn't deliver, future returns could be at risk.

U.S. large cap equities are expected to deliver annualized returns of 6% over the next decade, wh international developed market equities are projected to slightly outperform at 7.1%. This edge comes from more attractive valuations, even as U.S. equities benefit from stronger earnings growth. International equities can also offer higher expected dividend yields and greater volatility—which investors expect to be compensated for. Including some international exposure to your portfolio can help balance vulnerabilities while adding potential opportunities for growth.

That said, both U.S. and international developed market returns are expected to fall below historical averages. For that to change, we'd need to see either lower prices or stronger earnings growth.

Expected equity return drivers



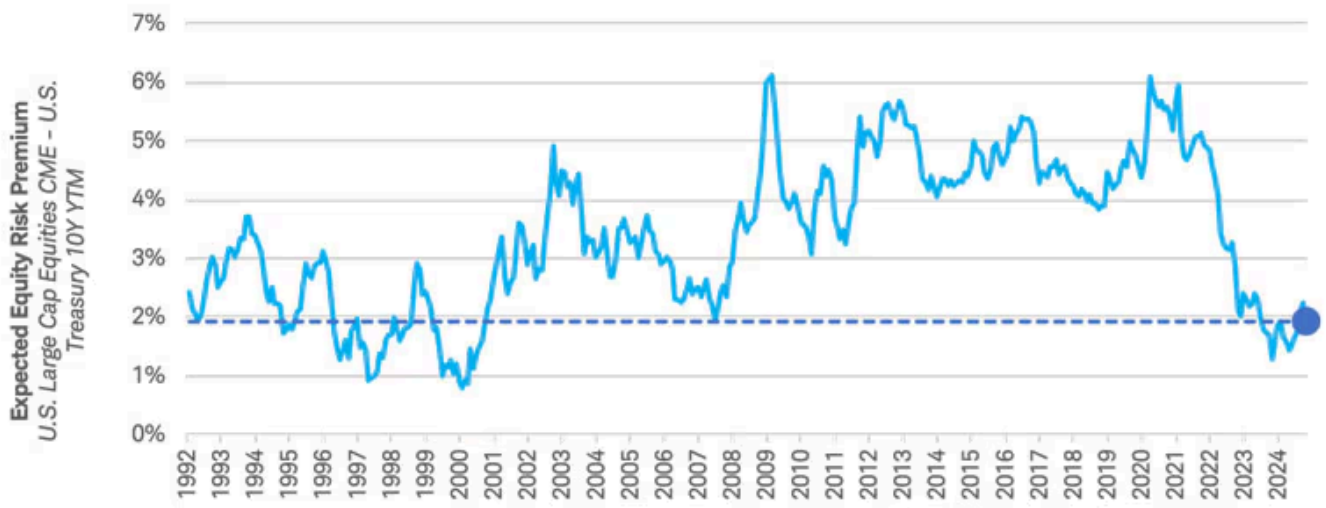
Source: Schwab Asset Management.

Data: As of 10/31/2024. Forecasts contained herein are for illustrative purposes only, may be based upon proprietary research and are developed through analysis of historical public data.

Each bar reflects Schwab Asset Management's long-term geometric return expectation for a given asset class. The assorted colors within each bar signify the return contributions from individual building blocks used for constructing CMEs. The "equilibrium adjustment" reflects an adjustment toward the market-derived equilibrium return using a modified Black-Litterman model. Benchmark indexes: S&P 500® Total Return Index (U.S. Large Cap), MSCI EAFE Net Return Index® (Int'l Dev Large Cap).

When comparing stocks and bonds, it's helpful to consider the equity risk premium (ERP)—the extra return stocks are expected to deliver over "risk-free" investments like Treasury securities as compensation for higher risk. The expected ERP has dropped to around 2%, well below the highs seen after the Great Financial Crisis.

Expected equity risk premium through time



Source: Schwab Asset Management.

Data: Bloomberg as of 10/31/2024.

Total return = price growth + dividend and interest income. The example does not reflect the effects of taxes or fees. Benchmark Index: S&P 500® Total Return Index (U.S. large cap equities). The U.S. 10-Year Treasury Constant-Maturity YTM: An index based on the average yield of a range of Treasury securities, all adjusted to the equivalent of a 10-year maturity. Yields on Treasury securities at constant maturity are determined by the U.S. Treasury from the daily yield curve. **For illustrative purposes only. Past performance is no guarantee of future results.**

Elevated uncertainty and potential risks

While many investors had hoped for a return to normalcy, risks remain. Geopolitical tensions, elevated U.S. debt levels, and uncertainty surrounding President-elect Trump's proposed policies on taxes, immigration, tariffs, and deregulation all add to the complexity. Persistent market imbalances—

like the shape of the yield curve, concentrated equity markets, and tighter credit spreads—further complicate the investment landscape.

Investors should keep their focus on long-term financial goals, not get distracted by short-term market noise. The most effective way to navigate uncertainty is through the strategic asset allocation process. Diversification is more than simply spreading investments across various asset classes—it's about building a portfolio that includes asset classes that respond differently to market conditions, like economic slowdowns or rising inflation. A well-constructed portfolio can be the key to steady risk-adjusted returns over time.

What can investors do now?

The power of compound returns—the cumulative effect of gains or losses over time—means that even small difference in portfolio return can have a substantial impact over time.

- **Establish realistic financial goals:** Develop a financial plan tailored to your personal goals and be ready to adapt as life circumstance change. Schwab Asset Management's CMEs can help you create a plan with more realistic expectations.

- **Maintain savings discipline:** While returns can fluctuate form year-to-year, resist the urge to reduce your saving in response to market volatility. Expected returns are not guaranteed, and the more you save, the greater cushion you'll have if actual returns fall short of expectations.

- **Build a diversified portfolio:** Construct a portfolio aligned with your risk tolerance, using a mix of asset classes that perform differently under various market conditions. Since predicting the best-performing asset class each year is challenging, diversification helps mitigate the impact of market volatility and reduces the risks of chasing past performance.

Schwab Asset Management's CMEs are designed to guide realistic long-term planning, not to time the market. By incorporating these projections, investors can set realistic expectations for their financial goals and asset allocation strategies.

If you don't have a financial plan, now is a great time to create one. If you already have one, consider revising it with Schwab Asset Management's CMEs in mind.

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Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed income investments are subject to various other risks including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. Lower rated securities are subject to greater credit risk, default risk, and liquidity risk.

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Forecasts contained herein are for illustrative purposes only, may be based upon proprietary research and are developed through analysis of historical public data.

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