WILMINGTON TRUST

Capital Markets FORECAST

December | 2012

2013–2019

Dollars, debts, and demographics

Wilmington Trust Investment Advisors, Inc.

KEY POINTS

- With our Capital Markets Forecast 2013–2019, we are chiefly concerned with forecasting the rank order of asset class returns, which helps us establish the asset allocations of our model investment strategies. We forecast asset class volatility levels and returns to help evaluate investors' appetites for risk and their ability to meet their investment objectives.
- By the end of our forecast horizon, we will be 10 years from the Great Recession of 2007–2009. Economic growth and the financial markets should have "normalized" by that time.
- Over the forecast period, we expect worldwide and U.S. economic growth to average 3.3% and 2.4%, respectively, with growth generally greater in the latter years.
- We forecast average U.S. inflation of 2.0% and that the yield of the 10-year U.S. Treasury note will end the period at 3.5%, leading to inflation-lagging returns on U.S. Treasury securities and investment-grade corporate, municipal, and mortgage-backed securities.
- We expect mid-single-digit returns on most stocks.
- We are more optimistic about the prospects for emerging stock markets, value-oriented large-capitalization stocks in developed international markets, and non-core bonds, such as the sovereign debt of emerging economies and speculative-grade municipals.
- We do not claim precision in our Capital Markets Forecast; rather we seek to understand forces that may help to shape investors' experience in the years ahead.

At Wilmington Trust Investment Advisors, our annual Capital Markets Forecast significantly influences our asset allocation advice. The heart of our forecast is a survey of the valuations of all the asset classes we incorporate in our model asset allocation strategies. Like arteries and veins to our effort are our assessments of the likely courses of economic growth, rates of interest and dividend growth, dividend yields, and inflation over the coming seven years. All of these elements bring to life our forecasts of the average returns that the financial markets may provide. Here we summarize our Capital Markets Forecast 2013–2019.

As we undertake our forecast we seek to identify cyclical and structural forces at work in the global economy and financial markets that will shape investors' experiences. Dollars, debts, and demographics are the themes at hand.

Dollars: Many fists—and bank balance sheets—full of them

In our estimation the world is awash in dollars or, more precisely, in various fiat currencies, which are backed by nothing more than the "full faith and credit" of the governments that print them. Since 2008, the Board of Governors of the Federal Reserve System has conjured some $2 trillion. The Governing Council of the European Central Bank has created roughly the same number of euros. The issue is that, just as no contemporary leader had first-hand experience with a crisis as deep as the Great Recession of 2007–2009, the world's leaders are similarly without experience in draining all that "liquidity" from the global financial system. Our forecast of the annualized pace of U.S. inflation is just 2.0%, but we caution that while it is easier to imagine a higher rate, there is significant room for error on both sides of our estimate.

To date, the tidal wave of stimulus that central banks have applied to the global economy does not appear to have greatly affected U.S. consumer prices. These increased at a modest year-over-year rate of 2.4%, on

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FIGURE 1

Federal Reserve "QE programs," higher share prices have coincided

Past performance is no guarantee of future results. Source: Bloomberg

average, between August 2008, when the Federal Reserve started its first round of "quantitative easing"—more simply, asset purchases—and October 2012. The average year-over-year price increase since 1948 has been a much more significant 3.7%. Rather than consumer prices, we believe central bank stimulus has affected the prices of financial assets. As shown in Figure 1, periods of Federal Reserve asset purchase programs have coincided with notable run-ups in the level of the S&P 500 Index. We believe these programs have boosted financial asset valuations—particularly those of stocks—to slightly rich levels, leading us to expect below-average returns.

Debts: In worrisome supply

Just as the world is awash in fiat currencies, so too is it bathed in debt. In the United States, the process of "deleveraging," or cutting debt, that started after the financial crisis of 2008–2009 was, by at least one measure, short-lived. The total debt of the nation, including the borrowings of households, for-profit and not-for-profit businesses, and governments at all levels, hit a cyclical peak of nearly $51.9 trillion at the end of the first quarter of 2009, according to Federal Reserve data. It declined in each of the next four quarters, touching a low of a bit more than $50.6 trillion at the end of the first quarter of 2010. Largely through defaults and debt write-offs—as opposed to payments on our obligations—2.4% of the nation's debts disappeared in 12 months. But our collective debt has since risen in each quarter. At the end of third quarter of 2012, it stood at nearly $53.1 trillion—an amount equal to 3.9 years worth of all the goods and services produced in the United States. Just one generation ago, at the end of 1982, all U.S. debt outstanding amounted to less than $5.6 trillion, about 49 weeks' worth of U.S. economic output.

Europe in recent years has offered a case study in the turmoil that excessive indebtedness can create. From a cyclical low of 7.3% in February 2008, unemployment in the 17-member euro zone climbed to 11.7% in October 2012, according to Eurostat. The upturn in European unemployment occurred more or less in tandem with the rise in U.S. joblessness, but unemployment in Greece, Portugal, and Spain continued to climb even

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FIGURE 2

Features of public debt overhangs: Advanced economies, 1800–2011

Country	Sample period	Average real GDP growth in periods when national debt/GDP: Was less than 90%	Exceeded 90%	Share of years in which debt/GDP exceeded 90%
Australia	1852–2011	4.0%	3.5%	6.1%
Belgium	1836–2011	2.5%	2.7%	20.5%
Canada	1871–2011	3.6%	3.2%	10.6%
France	1880–2011	3.2%	1.9%	28.0%
Greece	1884–2011	4.7%	3.0%	56.1%
Ireland	1924–2011	3.4%	2.5%	15.5%
Italy	1861–2011	3.9%	1.1%	48.0%
Japan	1872–2011	4.2%	0.8%	12.1%
Netherlands	1816–2011	3.3%	2.1%	45.6%
New Zealand	1861–2011	4.8%	3.1%	48.0%
Spain	1850–2011	2.9%	2.1%	18.6%
United Kingdom	1830–2011	2.1%	1.8%	45.3%
USA	1791–2011	3.6%	–1.0%	3.2%

Research by Carmen Reinhart, Vincent Reinhart, and Kenneth Rogoff suggests 90% is a rough but important threshold for national debt / gross domestic product (GDP) ratios. At about that level, economic growth tends to become stunted.

Source: Public Debt Overhangs: Advanced Economies Episodes Since 1800, Carmen M. Reinhart, Vincent R. Reinhart, and Kenneth S. Rogoff. *Journal of Economic Perspectives,* volume 26, number 3. Summer 2012.

as the U.S. labor market began to improve. A significant cause of Europe's current recession, we believe, is the dissipation of bond investors' confidence. Many of them appear to have concluded that, even if times were better, with greater tax revenue to support interest payments, many European governments would be overextended. In Figure 2, we highlight global research, published in the summer of 2012, that found that rates of inflation-adjusted economic growth tend to be lower when ratios of gross national debt to economic output top 90%. The ratio of gross U.S. federal debt to gross domestic product crossed this threshold in 2010 and has remained above it since then.

Demographics: Most of us are not getting any younger

As we prepared our Capital Markets Forecast 2013–2019, we were struck not only by the massive, worldwide easy money policies of recent years—the proliferation of dollars here and competing currencies elsewhere—nor solely by the accumulation of debt, but also by the aging of the populations in developed economies representing key segments of the global economy. Demographics, in a word, are on our minds. Figure 3 depicts the graying of America, where a generation from now 65–90 year olds are expected to account for nearly a quarter of the population, up from the roughly 16% share of population that has

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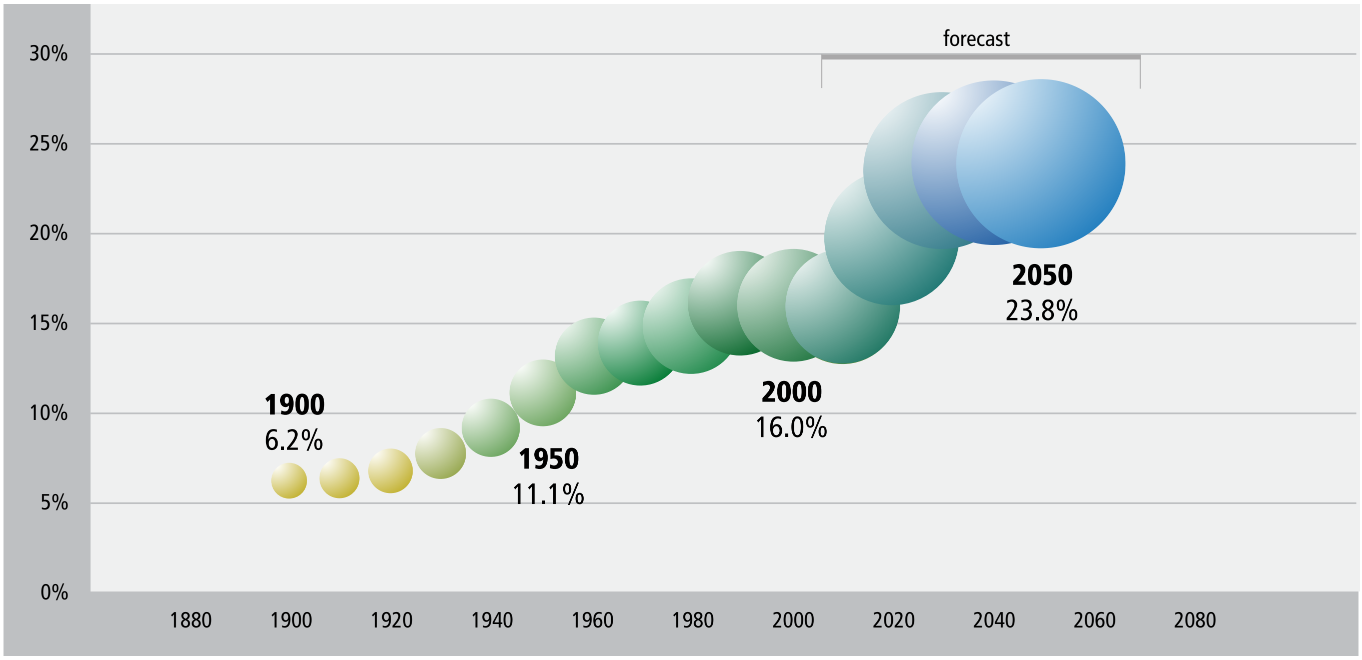
FIGURE 3

The graying of America: 65–90 year olds as a share of the U.S. population



Source: U.S. Census Bureau

prevailed for two decades. Populations also are aging meaningfully in Canada, Japan, and much of Europe.

We expect aging populations to exert important influences on the economy and the financial markets. In the coming years many of the world's citizens will change from accumulators of savings to consumers of savings. In the United States, the aging of the Baby Boomers and the relative youth of the "echo boomers" may create a dearth of workers in the most productive, middle-age brackets. The importance of U.S. immigration is likely to rise. Markets may face headwinds from a slowdown in productivity gains and historically modest economic growth. With many fixed income securities offering low yields, Boomers are likely to keep more of their holdings in higher-risk assets in a bid to improve returns. Ultimately, however, they will be net securities sellers, a headwind to markets.

Our economic outlook: Continued recovery ahead

We expect the U.S. economy to grow at an inflation-adjusted annualized clip of 2.4% between 2013 and 2019. Growth in the near term is apt to be slower; for example, we expect growth through much of 2013 in the 1.5–2.0% range. Our seven-year forecast reflects our assessments of the likelihoods of six potential scenarios, summarized in Figure 4a, and our forecasts for growth in each case. We expect U.S. inflation to average 2.0%, much less than the post-World War II average of 3.7% and in line with the experience of recent years. Many economic resources remain in surplus in the U.S., including manufacturing plants, housing, and labor. This production slack should offset continuing food price increases and any energy price gains, which may be limited by the continued development of U.S. and other energy sources. We believe interest rates will rise, pressured to the upside by a combination of: strengthening economic growth; the beginning, at least, of a long unwinding of easy-money policies by central

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FIGURE 4A

Six U.S. economic scenarios: We expect government policies to drive the recovery

Scenario	Odds	Annualized, inflation-adjusted U.S. economic growth	Description
Slow growth with normalization	35%	2.8%	In our base case, U.S. growth starts slowly but rises to 3% in the last years as economic activity and interest rates normalize.
Slow growth with persistent economic repression	25%	1.8%	As in our base case, growth starts slowly but fiscal austerity and Fed support persist, leading to growth that is 1% below the baseline.
Global policy success	15%	4.0%	U.S., European, and Chinese authorities succeed in steering policies that enable growth to normalize across the globe.
Prolonged European / Chinese underperformance	10%	2.3%	While the U.S. follows just below its baseline, problems in Europe persist and / or a protracted soft landing in China lasts most of the forecast period.
U.S. policy failure	10%	0.8%	A new recession develops, as policy failures lead to fiscal difficulties, higher inflation, limited financial flexibility, higher unemployment, and extended Fed easing.
De-globalization	5%	0.5%	Global trade recedes and protectionist policies lead to very poor economic results.
Probability weighted average		**2.4%**	

Source: Wilmington Trust Investment Advisors

banks; and perhaps by investors demanding greater compensation for bearing the risks of holding IOUs from governments that sit atop heavily indebted and modestly growing developed economies. The yield of the 10-year U.S. Treasury note, which begins our forecast horizon around 1.6%, could end the period at 3.5%.

An important note about our economic forecasts is our assumption that most of the tax increases and spending cuts that comprise the U.S. fiscal cliff will not be allowed to take effect in 2013. Our estimate is that Congress and the Obama administration will permit, in the near term, somewhere between one-fifth and one-quarter of the scheduled tax increases and spending cuts. If we're right, U.S. economic output in 2013 might be 0.9% lower than it otherwise would be. The recovery has been tepid, but we believe it is resilient enough to withstand such an impact; growth should continue. Importantly, some tax increases and spending cuts would not be a shock. News of large potential adjustments in U.S. fiscal policies has been widespread; presumably, consumers and investors alike are prepared for changes. In contrast, if Washington allows all of the tax increases and spending cuts to take hold in 2013, a new recession almost surely would ensue. In that event, we would revisit our Capital Markets Forecast and asset allocations.

FIGURE 4B

Summary of probability-weighted economic scenarios

	Expected averages, 2013–2019
Inflation-adjusted economic growth	
World	3.3%
Asia	4.8%
United States	2.4%
Europe	1.7%
U.S. inflation	2.0%

Source: Wilmington Trust Investment Advisors

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By the end of our forecast horizon, we will be 10 years removed from the end of the Great Recession of 2007–2009. After a painfully slow recovery, economic growth and the financial markets should have "normalized" by that time.

Our financial markets outlook: Generally modest returns ahead

Armed with a sense of the structural forces at work in the world that may shape the investment landscape, and with our forecasts of economic growth, interest rates, and inflation, we evaluated the relative attractiveness of the various classes of securities to which we allocate assets in our model strategies. Our financial market review and the attendant outlooks are based primarily on current valuations. Here, we advise investors to heed John Maynard Keynes, who said, "The markets can remain irrational longer than you and I can remain solvent." This is to emphasize that, while valuations matter, they are not the only important variable in investing. Trends in investor preferences, for example, matter, too. Consider the December 1996 warning from then-Fed Chairman Alan Greenspan of "irrational exuberance" in the markets. The shakeout in share prices did not commence until March 2000. In the intervening years, many observed that technology, media, and telecommunications stocks appeared to be in a bubble, but their prices, and those of most stocks, continued to climb. For years investors' preferences mattered more than valuations.

Driven by valuations, our forecast suggests asset classes we should have biases for and against. For the 2013–2019 period, our biases are outlined at right.

Preferred

- Non-core fixed income, such as emerging market debt and speculative-grade municipal bonds
- Value stocks
- Large-cap U.S. stocks
- Developed international equity markets, particularly large-cap value stocks
- Emerging equity markets

Non-preferred

- Core bonds, including investment-grade corporate and municipal bonds, mortgage-backed securities, and U.S. Treasuries
- Growth stocks
- Mid- and small-cap U.S. stocks
- Inflation hedges, such as inflation-linked bonds and commodity- and real estate-related securities

Neutral

- Hedge funds
- Cash equivalents
- Stocks in aggregate

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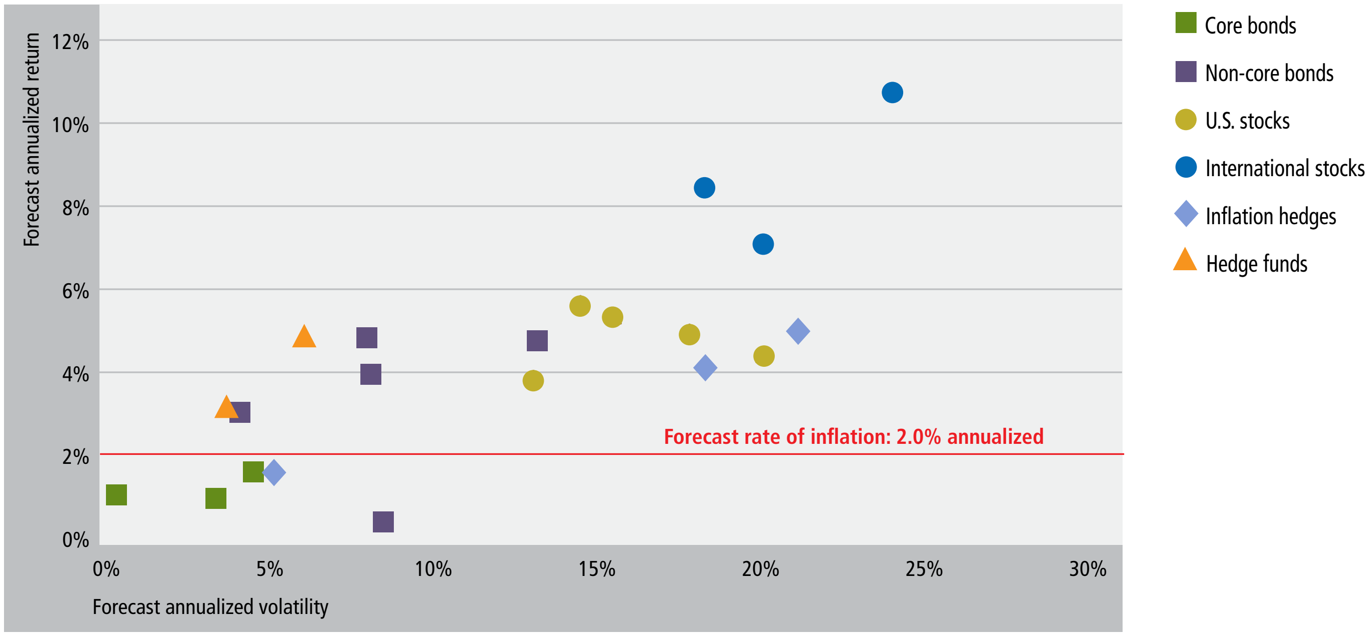
FIGURE 5

Our forecasts of annualized financial market performance, 2013–2019



For all six of the asset categories depicted, we have forecast returns and volatility levels for multiple, more narrowly defined asset classes. We chart here many of the larger asset classes, to emphasize the patterns of performance we expect across the asset categories. Expected return and volatility projections reflect the informed judgments and opinions of Wilmington Trust about likely future capital markets performance. No assurance can be given as to actual future market results or the results of Wilmington Trust products and strategies. Investing involves risk and you may incur a profit or a loss. There is no assurance that any investment strategy will succeed.

Source: Wilmington Trust Investment Advisors

Figure 5 presents an overview of our return and volatility forecasts for a number of asset classes in six broad categories. We expect inflation-lagging returns on bonds that form the core of many investors' fixed income portfolios—U.S. Treasury securities and investment-grade corporate, municipal, and mortgage-backed securities—and mid-single-digit returns on most stocks. We are more optimistic about the prospects for emerging stock markets, value-oriented large-capitalization stocks in developed international markets, and non-core bonds, such as the sovereign debt of emerging economies and speculative-grade municipals. We expect the U.S. dollar to perform weakly, raising attractiveness of non-dollar investments.

Over most long periods, stocks have delivered higher returns than bonds, albeit with much higher volatility, and we believe investors with long-term investment horizons will need to hold more stocks in the years ahead to make progress toward their long-term goals. For this reason the derivation of our equity forecasts may be of particular interest to our clients. Our forecasts of equity asset class returns are derived from three inputs: starting dividend yields—specifically, yields as of September 30, 2012—and our estimates of annualized dividend growth and valuation changes. Consider large-capitalization U.S. stocks. Our forecast of their annualized return, 5.4%, reflects a starting yield of 2.1% and forecasts of 3.7% annualized dividend growth and a –0.4% decline in valuations. Our return forecast for emerging stock markets, 10.7%, reflects a starting yield of 2.9% and forecasts of 6.4% annualized dividend growth and a 1.3% increase in valuations.

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Beyond forecasts: Expectations, perspective matter

As we said at the outset, our annual Capital Markets Forecast significantly influences our asset allocation advice, but it does not dictate our advice. At any given time, the specific asset allocations of our model strategies may reflect current valuations—they are the bedrock of our return forecasts but they can rise or fall meaningfully over the course of a year—as well as trends in the financial markets and the collective judgment of our Investment Strategy Team, which is responsible for both our forecasts and our model strategies.

Finally, it's important to understand that we do not expect precision in our forecast. We are chiefly concerned with forecasting, as well as possible, the rank order of asset class returns, which can help us effectively guide investors with various investment objectives and appetites for risk. We also want to remind our clients—and ourselves—that investing is a long-term proposition. Amid the cacophony of opinions about the latest developments out of Wall Street, Main Street, Washington, and the wider world, we seek to understand forces that may help to shape investors' experience in the years ahead. For additional information about our Capital Markets Forecast, please consult a Wilmington Trust Investment Advisor or Officer.

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An Overview of Our Asset Allocation Strategies
Wilmington Trust offers five model asset allocation strategies each for taxable and tax exempt investors with particular sets of risk tolerances: Aggressive, Growth, Growth & Income, Income & Growth, and Conservative. Each strategy can be implemented with or without allocations to hedge funds. On a quarterly basis we publish the results of all of these strategy models versus benchmarks representing static investments without tactical tilts.

Model Strategies may include exposure to following asset classes: U.S. large capitalization stocks, U.S. small-cap stocks, developed international large-cap, developed international small-cap and emerging market stocks, inflation hedges (including global inflation-linked bonds and commodity-related and global real estate-related securities), investment-grade bonds (corporate or municipal), high yield corporate bonds and floating-rate notes, and cash equivalents. Directional and absolute return hedge funds are distinct to the strategies with hedge funds. Each asset class carries a distinct set of risks, which should be reviewed and understood prior to investing.

Risk Assumptions
All investments carry some degree of risk. This report uses the return volatility, as measured by standard deviation, of asset classes as a proxy for illustrating risk. Volatility serves as a collective, quantitative estimate of risks present to varying degrees in the respective asset classes (e.g., liquidity, credit, and default risks). Certain types of risk may be underrepresented by this measure. **Investors should develop a thorough understanding of the risks of any investment prior to committing funds.**

Correlation
Correlation is used to compare assets to one another, measuring the degree of relationship between the returns of the two asset classes and characterizing it in a range between -1.00 (Perfectly Negatively Correlated -- the returns of two asset classes move in exactly opposite directions from one another) and +1.00 (Perfectly Positively Correlated -- the returns move in lock-step with one another). If correlation is 0.00, the two asset classes exhibit no relationship in the movement of their returns. Correlation assumptions are based on Wilmington Trust forecasts.

Quality Ratings
Quality ratings are used to evaluate the likelihood of default by a bond issuer. Independent rating agencies, such as Standard & Poor's and Moody's Investors Service, analyze the financial strength of each bond's issuer. Moody's ratings range from Aaa (highest quality) to C (lowest quality). Bonds rated Baa3 and better are considered "Investment Grade". Bonds rated Ba1 and below are "Below Investment Grade" (also "High Yield" or "Speculative"). Similarly, Standard & Poor's ratings range from AAA to D. Bonds rated BBB- and better are considered "Investment Grade" and bonds rated BB+ and below are "Below Investment Grade".

Investing involves risk and you may incur a profit or a loss.

Past performance is no guarantee of future results.

Diversification does not ensure a profit or guarantee against a loss.

There is no assurance that any investment strategy will be successful.

Indices are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses, such as management fees and transaction costs, that would reduce returns.

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