STUDY SESSION

2

Capital Market Expectations

A necessary task in the investment management process is to formulate capital market expectations. These forecasts of risk and return for various asset classes form the basis for constructing portfolios that maximize expected return for given levels of risk.

This study session examines the process of setting capital market expectations and covers major tools of economic analysis. A central theme of both readings is that a disciplined approach to setting expectations will be rewarded. After outlining a framework for developing expectations and reviewing potential pitfalls, the first reading focuses on the use of macroeconomic analysis in setting expectations. The second reading in this session builds on that foundation to examine setting expectations for specific asset classes—fixed income, equities, real estate, and currencies.

READING ASSIGNMENTS

Reading 3	Capital Market Expectations, Part I: Framework and Macro Considerations by Christopher D. Piros, PhD, CFA
Reading 4	Capital Market Expectations, Part II: Forecasting Asset Class Returns by Christopher D. Piros, PhD, CFA

LEARNING OUTCOMES

READING 3. CAPITAL MARKET EXPECTATIONS, PART 1: FRAMEWORK AND MACRO CONSIDERATIONS

The candidate should be able to:

- **a** discuss the role of, and a framework for, capital market expectations in the portfolio management process;
- **b** discuss challenges in developing capital market forecasts;
- **c** explain how exogenous shocks may affect economic growth trends;
- **d** discuss the application of economic growth trend analysis to the formulation of capital market expectations;
- **e** compare major approaches to economic forecasting;
- **f** discuss how business cycles affect short- and long-term expectations;
- **g** explain the relationship of inflation to the business cycle and the implications of inflation for cash, bonds, equity, and real estate returns;
- **h** discuss the effects of monetary and fiscal policy on business cycles;
- **i** interpret the shape of the yield curve as an economic predictor and discuss the relationship between the yield curve and fiscal and monetary policy;
- **j** identify and interpret macroeconomic, interest rate, and exchange rate linkages between economies.

READING 4. CAPITAL MARKET EXPECTATIONS, PART 2: FORECASTING ASSET CLASS RETURNS

The candidate should be able to:

- **a** discuss approaches to setting expectations for fixed-income returns;
- **b** discuss risks faced by investors in emerging market fixed-income securities and the country risk analysis techniques used to evaluate emerging market economies;
- **c** discuss approaches to setting expectations for equity investment market returns;
- **d** discuss risks faced by investors in emerging market equity securities;
- **e** explain how economic and competitive factors can affect expectations for real estate investment markets and sector returns;
- **f** discuss major approaches to forecasting exchange rates;
- **g** discuss methods of forecasting volatility;
- **h** recommend and justify changes in the component weights of a global investment portfolio based on trends and expected changes in macroeconomic factors.