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Are Minimal Returns in the Future for Equities?

In mid August, all three major indexes - S&P 500, Dow Jones Industrials and the Nasdaq - simultaneously hit new highs for the second time in a week. With primarily good news in recent market performance, why are an increasing number of big name firms and analysts projecting minimal returns for the stock market over the next five to ten years?

At the root of their concerns is that the current market is speculation driven. With interest rates at record lows, investors are looking to riskier assets for return on their investments, fueling demand for equities, particularly equities with dividends. That demand drove stocks to a Shiller PE ratio in excess of 27 in August. Over the last 10 years, the ratio average has been 15, putting stock valuations 71% higher than their 10-year average. For stocks to move higher - beyond the impact of pure speculation - according to fundamental valuation, they have to increase real revenues and earnings.

The source of those increased earnings is the big concern. The U.S. economy has failed to achieve significant growth momentum for 10 years and the recent trend is not encouraging.

Source: U.S. Bureau of Economic Analysis.

Over 70% of the current U.S. GDP is from consumer spending, which is another concern. While unemployment is below 6% nationally, the underemployment rate is closer to 14.6%, wages are stagnant, personal debt levels are high, and one in seven Americans are on food stamps. A number of moves are underway to increase minimum wage levels across the U.S., however, increasing labor costs without corresponding increases in productivity has the potential to depress corporate profits, putting downward pressure on earnings per share.

The largest companies in the S&P 500 report considerable income from overseas sales, but with global GDP in the doldrums as well, these sales may not be enough to make up for a sluggish U.S. domestic market. The Conference Board outlook for global economic growth is a relatively modest 2.4% in 2016 and 2.7% in 2017. This compares to the International Monetary Fund's slightly more optimistic projections of 3.4% in 2016 and 3.6% in 2017.

Among the more conservative market projections are:

McKinsey & Company establishes in a 60-page research report - *Diminishing Returns: Why Investors May Need to Lower Their Expectations* - why total returns from both stocks and bonds in the United States and Western Europe are likely to be substantially lower over the next 20 years than they were over the past three decades.

BlackRock, the world's largest asset manager with over $4.77 trillion in assets under management, anticipates a low-return world, with future market returns likely to be lower than in recent history; volatility increasing and the effectiveness of monetary policy to drive asset values waning.

Goldman Sachs' new report - *Flat is the new up* - anticipates a potential 6-month return of 0.1% for the S&P 500 through the remainder of 2016, resulting in a return of 2.74% for the whole year. From July 1, 2016 through June 30, 2017 the firm's analysts are forecasting a 1.24% return for the S&P 500.

Warren Buffett offers the caution, "Corporate earnings have never been better. As a return on tangible equity, American business has never had it so good: Profits as a percentage of GDP, profit margins up and down the line, business has been very, very good ... *I don't see them jumping a lot from this level"* (emphasis added).

John Hussman, mutual-fund manager and president of Hussman Investment Trust, maintains investors shouldn't expect stocks to gain much more than 1.2% annually for the next decade because the market is fully valued compared with corporate output. "Years of yield-seeking speculation have already driven stock valuations to levels where prospective 10- to 12-year total returns for the S&P 500 are likely to be no different than the near-zero yields available on Treasury securities."

Will the low-return forecasts become reality? Maybe. Maybe not. The future has a way of surprising us. But the concerns presented by the firms and individuals are real and they need to be considered as we plan for retirement and other financial goals. It may be prudent to increase your savings or scale back on retirement plans. You may want to consider alternative investments or different investment approaches. An active management approach that strives to reduce losses in market downturns, has the potential to leverage returns when the market turns back up and benefit from short-term trends.

Investing works best when you take a flexible approach and look for opportunities. This is one reason why we find the trend toward passive investing in index funds distressing.

Every market presents opportunities for profit whether through targeting specific sectors, countries or companies, avoiding drawdowns to capture the benefit of rebounds or even inverse investing. By being open to opportunities, we have the ability to look beyond the overall market return and take advantage of those opportunities.

Japan is a poster child for low to negative interest rates, minimal economic growth, an aging population and a stock market that has gone nowhere in 20 years. But could one have invested successfully in the market? In a June 13, 2016 article in the *Wall Street Journal*, author Ken Brown says yes, but it would take an active investment approach. Low growth has not meant low volatility for the Japanese market, which has fallen by more than 2/3's twice in the last 20 years, only to gain more than 100% in the subsequent market upswing. Successfully trade those moves and opportunity opens up. With that said, all investing carries risk and there can be no guarantee that an active strategy will successfully capitalize on market volatility. There is always the potential for loss as well as gain.

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