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Stocks for the Long Run? Not Now

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Introduction

Valuation is a poor timing tool. After all, markets that are overvalued and become even more overvalued are called bull markets. Over a relatively long time horizon, however, valuation has been an excellent predictor of future performance. Our analysis shows that based on current valuations, U.S. equity investors are likely to be disappointed after the next 10 years. While the equity market could continue to perform in the short run, over the long run better relative value will likely be found in fixed income and non-U.S. equities.

Elevated U.S. Equity Valuations Point to Low Future Returns

U.S. stocks are not cheap. Total U.S. stock market capitalization as a percentage of gross domestic product (market cap to GDP) currently stands at 142 percent. This level is near all-time highs, greater than the 2006–2007 peak and surpassed

U.S. Equity Valuation Is Approaching Historic Highs

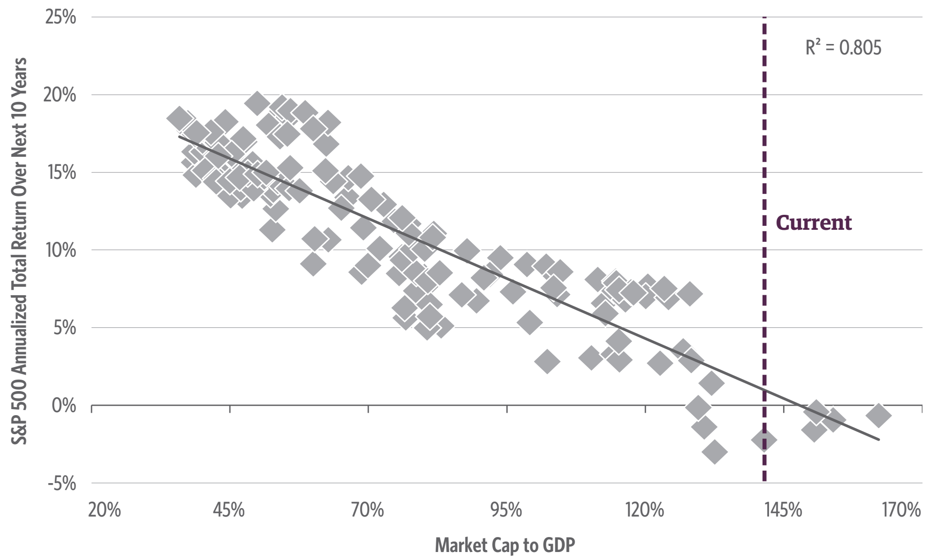
Source: Haver Analytics, Bloomberg, Guggenheim Investments. Data as of 9.22.2017, using Bloomberg consensus estimates for 3Q 2017 GDP. Past performance is no guarantee of future returns.

only by the internet bubble period of 1999–2000. This reading is no outlier: It is consistent with other broad measures of U.S. equity valuation, including Robert Shiller's cyclically adjusted price-earnings ratio (CAPE), Tobin's Q (the ratio of market value to net worth), and the S&P 500 price to sales ratio.

Here is the bad news for equity investors: At current levels of market cap to GDP, estimated annualized total returns over the next 10 years look dismal at just 0.9 percent (before inflation), based on previous trends. Intuitively this makes sense: Looking back at the history of the time series, it is clear that an excellent entry point into the equity market for a long-term investor would have been a period like the mid-1980s, or in the latter stages of the financial crisis in 2009. Conversely, 1968, 2000, and 2007 would have been good times to get out.

Market Cap to GDP Has Been a Strong Predictor of Future Equity Returns

Data Since 1970

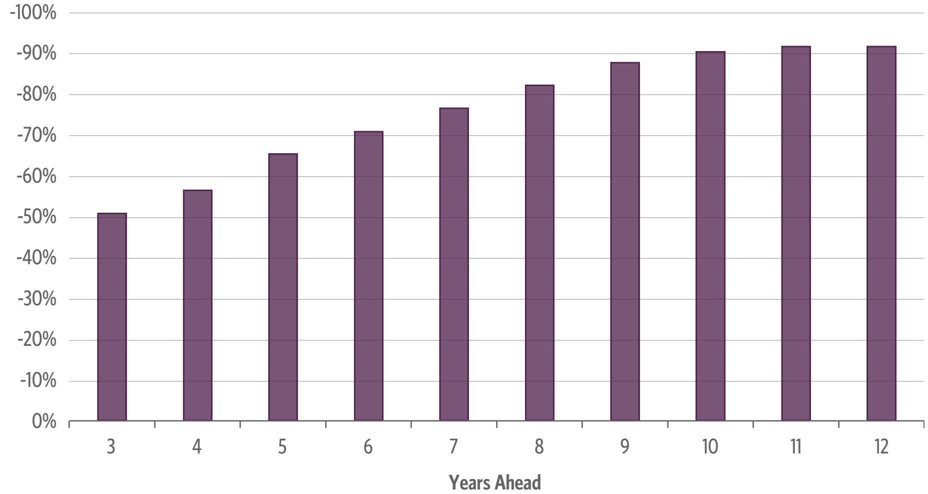


Source: Haver Analytics, Bloomberg, Guggenheim Investments. Data as of 9.22.2017. R^2 is a statistical measure of how close the data are to the fitted regression line. Past performance is no guarantee of future returns.

Market cap to GDP is a useful metric because it has proven to be an accurate predictor of future equity returns. As the chart below shows, market cap to GDP has historically been highly negatively correlated with subsequent S&P 500 total returns, particularly over longer horizons where valuation mean reversion becomes a significant factor. Over 10 years, the correlation is -90 percent.

Market Cap to GDP Has Been a Good Predictor of Equity Returns 10 Years Out

Correlation of Market Cap to GDP with S&P 500 Forward Return



Source: Haver Analytics, Guggenheim Investments. Guggenheim calculations based on Haver Analytics data. Data as of 9.11.2017. Past performance is no guarantee of future returns.

It would be easy to assume that the rise in stock valuations is justified by low rates. A similar argument is made by proponents of the Fed model, which compares the earnings yield of equities to the 10-year Treasury yield as a measure of relative value. While there is some relationship between interest rates and valuation as measured by market cap to GDP, low rates do not explain why equities are so rich. At the current range of interest rates (2–3 percent), we have seen market cap to GDP anywhere from 47 percent to current levels of 142 percent—hardly a convincing relationship. In short, interest rates tell us little about where market cap to GDP, or other valuation metrics, "should" be.

High Equity Valuations Are Not Explained by Low Rates Alone

Data Since 1952

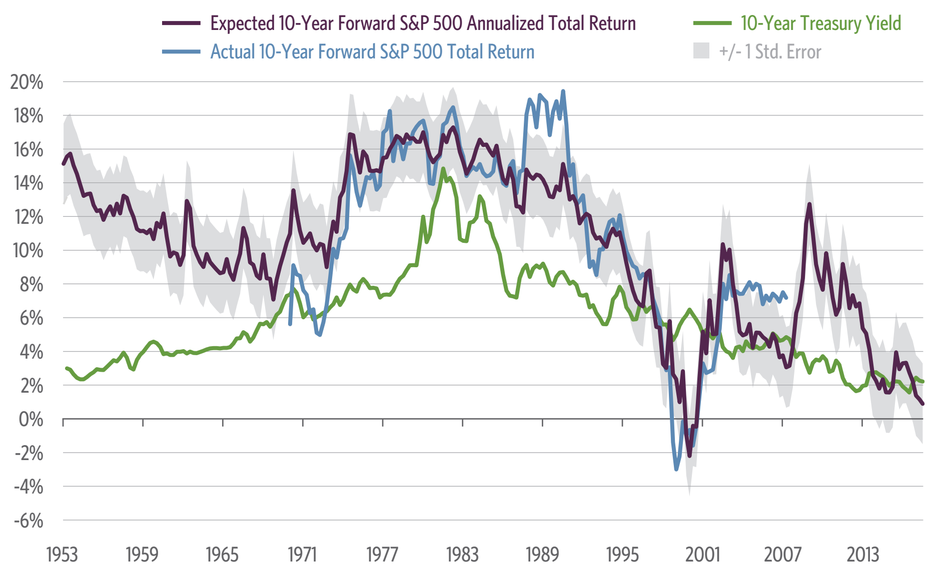
Source: Haver Analytics, Bloomberg, Guggenheim Investments. Data from 1952 through 9.22.2017, using Bloomberg consensus estimates for 3Q 2017 GDP. R^2 is a statistical measure of how close the data are to the fitted regression line. Past performance is no guarantee of future returns.

Fixed Income Offers Better Relative Value

For a measure of relative value, we compared expected returns on equities over 10-year time horizons (as implied by the relationship with market cap to GDP) to the expected return on 10-year Treasurys—assuming that the return is equal to the prevailing yield to maturity. Typically, equities would have the higher expected returns than government bonds due to the higher risk premium, but in periods when equity valuations have become too rich, future returns on U.S. stocks have fallen below 10-year Treasury yields. Not surprisingly, past periods where this signal has occurred include the late 1990s internet bubble and 2006–2007.

The chart below demonstrates that if equities over the next 10 years are likely to return just 0.9 percent, 10-year Treasury notes held to maturity—currently yielding about 2.2 percent—start to seem like a viable alternative. The fact that S&P 500 returns over the past 10 years have not been as low as the model predicted can at least be partially explained by extraordinary monetary policy, which may have helped to pull returns forward, but in doing so dragged down future returns.

Expected S&P 500 Return Is Lower than the 10-Year Treasury Yield



Source: Haver Analytics, Bloomberg, Guggenheim Investments. Data as of 9.22.2017, using Bloomberg consensus estimates for 3Q 2017 GDP. Historical 10-year forward estimates calculated using market cap to GDP methodology. Past performance is no guarantee of future returns.

Conclusion

Based on the historical relationship between market cap to GDP ratios and subsequent 10-year returns, today's market valuation suggests that the annual return on a broad U.S. equity portfolio over the next 10 years is likely to be very disappointing. As such, investors may want to seek better opportunities elsewhere. Equity valuations are less stretched in other developed and emerging markets, which may present more upside potential.

In fixed income, low yields should not deter investors, as our analysis indicates that U.S. Treasurys should outperform equities over the next decade. But as we explained in The Core Conundrum, low Treasury yields should steer investors away from passively allocating to an aggregate index that overwhelmingly favors low-yielding government-related debt. In particular, sectors not represented in the Bloomberg Barclays Aggregate Index, including highly rated commercial asset-backed securities and collateralized loan obligations, can offer comparable (or higher) yields with less duration risk than similarly rated corporate bonds. We believe active fixed-income management that focuses on the best risk-adjusted opportunities—whether in or out of the benchmark—offers the best solution to meeting investors' objectives in a low-return world.

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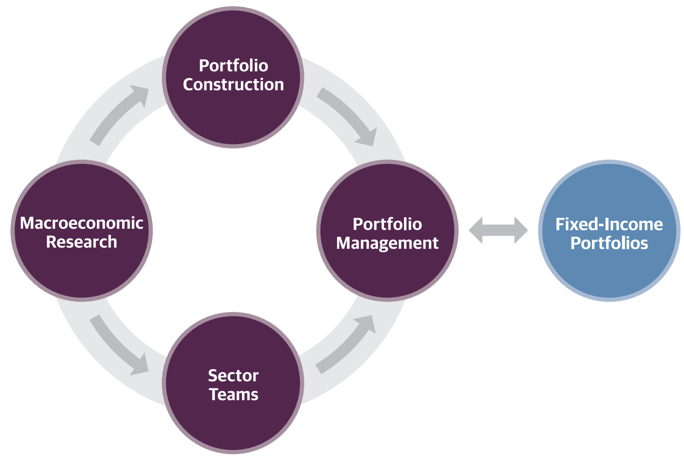

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