You Can't Get There From Here

by

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with

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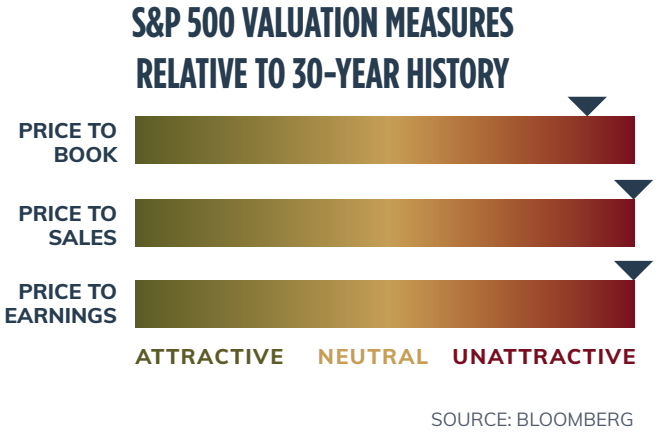
Key Takeaways

- Today's high stock market valuations borrow from future returns
- Rising taxes and possible inflation could pressure valuations
- It's likely long-term returns will be well below historical averages
- Remain invested but diversify away from US Core equity exposures

It was late fall, 1999. The peak of the infamous "Tech Bubble" loomed just a few months into the future. We had invited about a dozen local attorneys and accountants to our "Market Outlook Breakfast" to discuss and answer questions about the red-hot US stock market — which, at that point, was the center of everyone's attention. Much to the consternation of several of my HM Payson colleagues who were hoping to make an optimistic impression on our guests, I stepped through a straightforward set of inputs and assumptions and concluded that it was possible, if not likely, the S&P 500 would provide a *negative* total return over the next 10 years. I recall well the audience met my forecast with bemused indifference — and why wouldn't they? It was going to be different this time: rapidly-evolving technology and the growing impact of the Internet would transform our economy which could then grow forever, they opined. And besides, the argument continued, over all the 10-year holding periods going back to 1925 the stock market had provided a positive return more than 95% of the time. Well, it turned out my forecast was a tiny bit optimistic: our work predicted the market would return -0.5% annually, but it finished the decade down about -0.9% per year. Not a bad forecast![1]

So, what does an old market war story have to do with where we are today? To paraphrase Mark Twain, history seldom repeats itself, but it often rhymes. Indeed, in the rare instances the stock market produced a negative return over a 10-year holding period, it started from high levels of valuation — and today's near-record US stock market valuations are what compel us to pen this note now. We're not saying today is like 1999; but by many measures this market is more expensive.



SOURCE: BLOOMBERG

[1] I think it was more meaningful we got the sign of the returns right. Statistically, we just got very lucky! Assuming an annual standard deviation of 15% for stock returns, as we do in this model, we end up with a 1-standard deviation range of annual returns about +/- 4.5% around our forecasted return over the 10-year holding period. Too, the market obviously never takes a straight line. From 1999 through October of 2007, the market briefly achieved a +2.3% annualized total return before correcting sharply into 2008-2009.

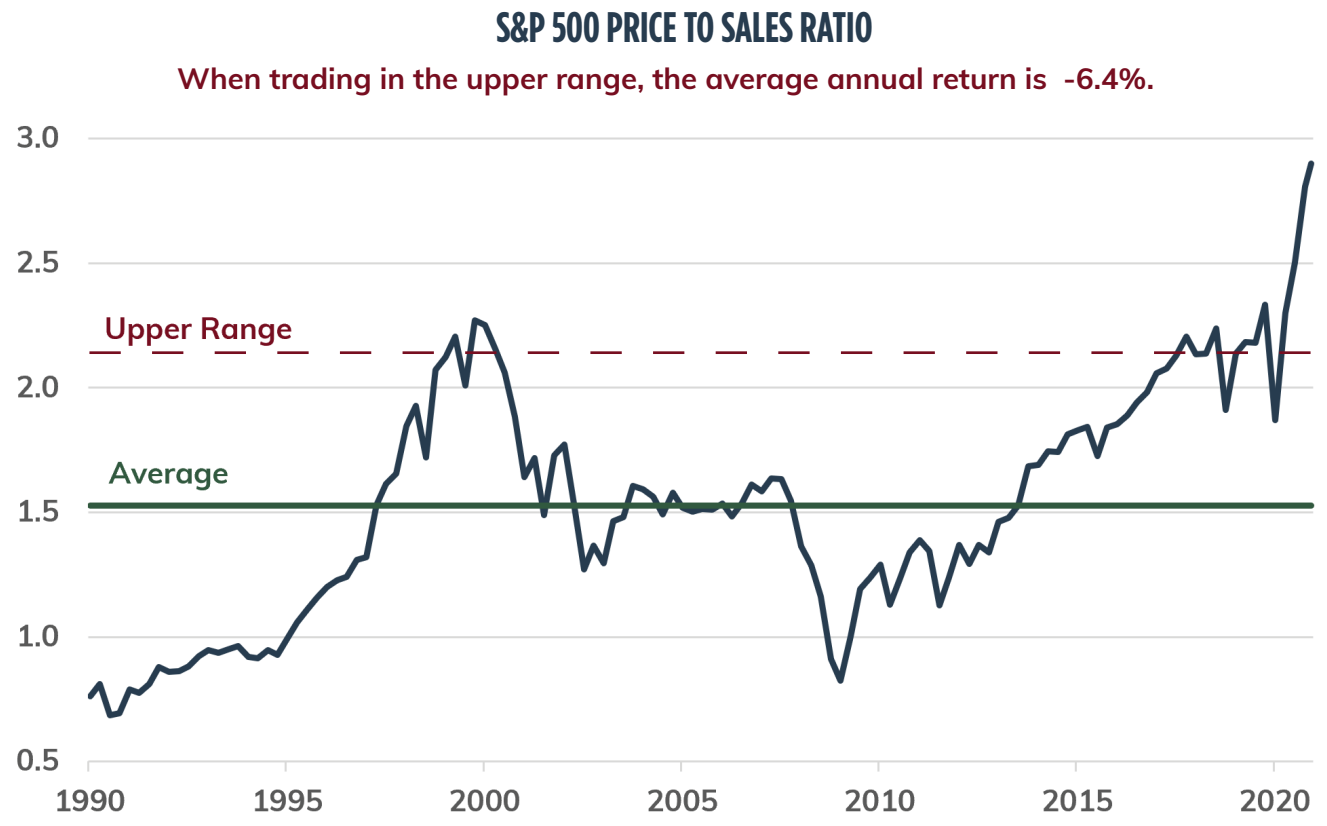
Valuations are Important

Unless one assumes today's levels of valuation will be a permanent plateau, any meaningful reversion to longer-term valuation levels will pose a significant impediment to future stock market returns. We also have a problem with the notion that stocks are "fairly valued" compared to bonds, which are also trading at levels that promise extremely low returns, if any, after inflation. Incredibly, today there are $13 trillion worth of bonds globally offering a negative yield to begin with![2] The confluence of historically low interest rates, favorable tax rates, and very low inflation — and, in the course of the last year, a massive amount of government stimulus — has brought us to the point where it's hard to imagine these conditions could improve or even continue. If anything, it appears interest rates, inflation and taxes are poised to turn higher sooner than later which could begin to put pressure on valuations.

So, just how stretched are valuations relative to their historical levels? A lot, actually. I think a nice clean example is the Price/Sales Ratio (PSR) which measures how much investors have to pay for a dollar of revenue. Sales are easy to measure and less prone to accounting adjustments than earnings. At the height of the Tech Bubble in 2000 the market traded at 2.3x sales. Today that ratio is 26% higher at 2.9x.

Over the last ten years, this expansion of the PSR alone accounted for a gain of 7.6% per year — which is over half the total return for the index. A reversion back to a still-robust PSR of 1.75x ten years from now (with a similar growth rate in sales as the last 10 years) would shave 5.1% off the index return annually.

At extreme levels, valuations matter a lot to returns over holding periods even as long as ten years — as they now factor into our current forecast.



SOURCE: BLOOMBERG, NED DAVIS RESEARCH

[2] Bloomberg Barclays Global Aggregate Negative Yielding Bond Index as of March 4, 2020

Framing a Forecast

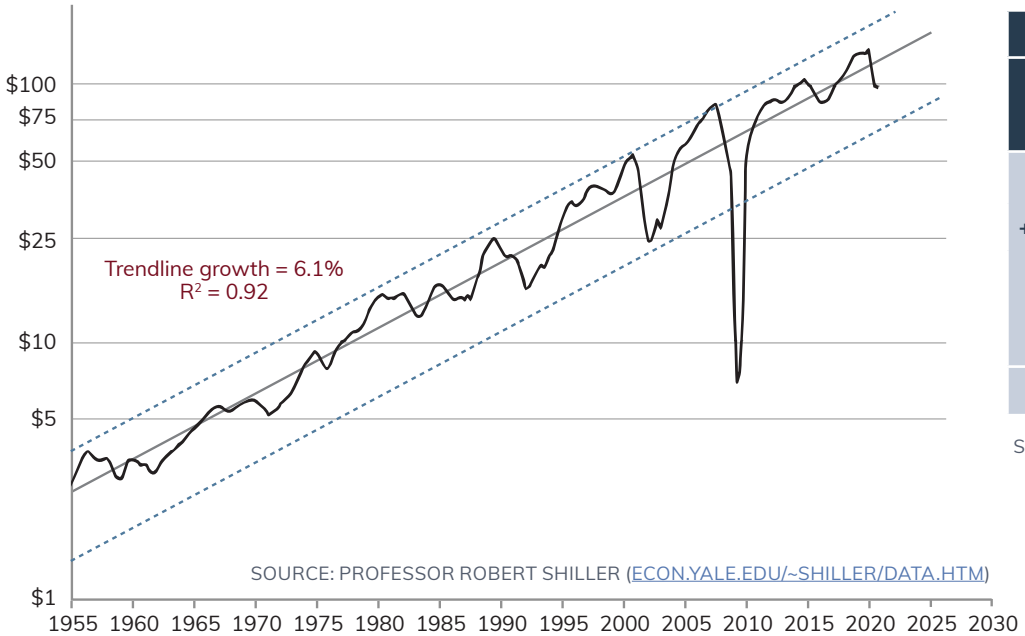
The math behind a return forecast is pretty easy. Stock returns come in the form of dividends, the growth in any number of fundamental factors such as sales, earnings, cash flow or dividends — and the impact of changes in the price multiple of those factors by the end of the forecast period. Using the framework below and the readily available data that comprise it, you can create your own forecast. We'll show you how it works.

The easiest piece of the forecast is the dividend yield. We can simply look it up. Today the yield on the S&P is about 1.5%. The second element of our return forecast is the growth rate of S&P 500 earnings. It turns out that for all the dips and wiggles in the series, over time earnings compound at a fairly persistent 6%[3] — and, even after the series corrected dramatically during the Great Financial Crisis it fully rebounded and went on to exceed its trendline in less than a year[4]. Over the very long-term, the 6% earnings growth rate roughly breaks down into 3% real growth (that is, growth above inflation) and 3% inflation. The ability of equities to pass inflation through to their earnings is an important mechanism by which stocks provide excellent long-term inflation protection as well as real long-term total returns.

The third part of the forecast — the effect of changes in valuation — for some reason always seems to be "controversial" in the moment. There always seems to be some present-day exogenous factor that people are content to use as a reason to believe *this time is different*. For this reason, I guess, today I see market forecasts produced by big consulting firms and the like that seem to ignore the possibility valuations could revert to a lower level. So far as I can tell, these forecasts only consider dividend yield and earnings growth. Easy!

"AS REPORTED" S&P 500 EARNINGS SERIES

(DEC. 1954 - SEPT. 2020)



SOURCE: PROFESSOR ROBERT SHILLER (ECON.YALE.EDU/~SHILLER/DATA.HTM)

EXPECTED TOTAL RETURN			
	To 17X EPS	To 18X EPS	To 20X EPS
Yield	1.5%		
+ Inflation	3.0%		
+ Real Growth	3.0%		
+ ΔP/E	-5.9%	-5.3%	-4.3%
Total	1.6%	2.2%	3.2%

SOURCE: HM PAYSON RESEARCH DEPT.
FORECAST DATE: 2/28/2021

[3] For the statistically inclined, even after its unfortunate detour in '08-09, the full earnings series has an R squared of 0.92, which simply means the series is quite persistent, and at the end of the day a wonderful illustration of why investors can and should maintain a long-term strategy of remaining invested in stocks.

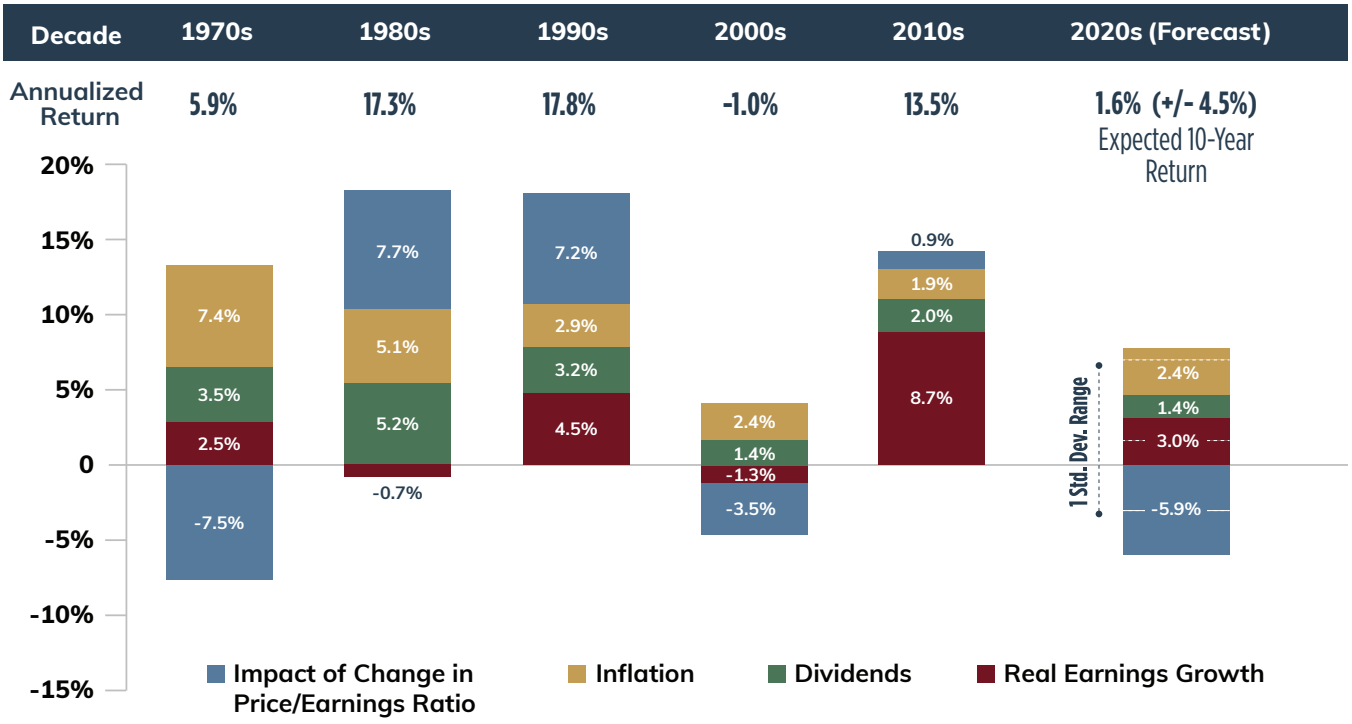
[4] Of course, I created several forecasts with this simple model at the depths of the earnings trough in 2009 which turned out to be right on the money based almost entirely on earnings getting right back to trendline - which at the time I honestly didn't believe would happen. So, I ratcheted down my forecast - only to be proven too pessimistic by the model!

I think in today's environment the primary exogenous consideration is the fact that after more than a decade of central bank manipulation the markets have become desensitized to negative real interest rates. Over the last 10 years interest rates have been contrived by central banks as the direct result of their Quantitative Easing programs launched during the Great Recession — and pulled out of semi-retirement during the pandemic. In our opinion, there is nothing normal about bond valuations and interest rates today.

What if interest rates were allowed to return to "normal"? In broad strokes, we would say the ten-year US bond would have to provide at least a 2% real return, which today would translate into something in the range of a 4% yield. Unthinkable in today's environment! The 10-year bond hasn't traded as high as 4% since 2010. We believe under such a scenario it is perfectly reasonable to assume the stock market could revert to a still quite-generous earnings multiple of 17x. Even on our Shiller trendline earnings, which are above actual recovery earnings right now, the S&P 500 is trading at 30x — and trading at an elevated 22x on 2021 estimated earnings.

We don't mean to imply a false precision to this exercise, but if in 10 years the S&P 500 were to trade at 17 times our very persistent trendline earnings projection, the decline in the price multiple would result in an annual -5.9% contribution[5] to the market's total return, which leads us to our +1.6% average annual return forecast looking out 10 years. The most important take away from this exercise is that it is highly probable US stock market returns over the next 10 years, and possibly longer, will be far below historical average returns as a function of its current valuations.

ELEMENTS OF HISTORICAL RETURN



SOURCE: THOMSON-REUTERS , BLOOMBERG, HM PAYSON RESEARCH DEPARTMENT. FORECAST DATE: 2/28/2021

[5] OK, here the math gets a little geeky but any scientific calculator can handle it. You take the 10th root (for ten years) of the percentage change in the PE and multiply the result by the average annual earnings growth over the period, in this case 1.06 (or 6%). If you are interested and would like some help with this please feel free to call Shawn or me.

Rising Taxes and Inflation

There are some shorter-term market considerations laying in plain sight that could prove to be a headwind to US stocks looking ahead. In our communications over the last few years, we've used the data in the dividends and capital gains tax table below to justify above-average market valuations in the low-inflation and very low capital-gains environment we were experiencing.

However, the Biden administration's tax plan calls for taxing dividends and capital gains at the same rate as ordinary income for individuals with incomes greater than $1,000,000 — which would move us into a very high tax environment.[6] Empirically, higher dividend and capital gains tax rates are less favorable for equity valuations. Indeed, often capital gains tax increases result in market losses over the next six months.[7] And, although the data doesn't yet reflect higher inflation, we see inflation forces gathering based on the upward moves in copper, lumber, energy, etc. Taken together, much higher taxes and an uptick in inflation are likely to eventually impact valuations.

AVERAGE S&P 500 PRICE TO EARNINGS RATIO

(1914 TO 2020)

INFLATION	TAXES ON DIVIDENDS AND CAPITAL GAINS: Low	TAXES ON DIVIDENDS AND CAPITAL GAINS: High
>4%	14.4x	11.2x
0-4%	20.1x	16.3x
<0%	22.3x	12.4x

CURRENT S&P 500 FORWARD P/E = 22x

SOURCE: CAPITAL IQ, IRRATIONAL EXUBERANCE BY ROB SHILLER, VALENS RESEARCH ANALYSIS

Additionally, based on the administration's plan to raise the corporate tax rate, Wall Street analysts estimate a 7-10% hit to S&P 500 earnings.[8] Assuming even a modest 3-4x decline in price/earnings ratios, the all-in tax effect on stock valuations could produce a 20-40% drag on returns over the intermediate term.

Bonds are No Bargain

Obviously, we don't enjoy hanging all this black crêpe around the discussion of expected equity returns. We can at least feel good about the high returns we have earned. But we would say — and as the Shiller graph implies — the strong index returns we've enjoyed over the last decade or so in the wake of the Great Recession have borrowed heavily from future returns. And, stocks are not the only asset class priced to provide low returns. Bonds are as expensive as they've ever been, and so provide paltry returns. The notion that stocks are "cheaper" than bonds is a pretty low bar! Why should we feel good about calibrating equity valuations against an asset class that is virtually guaranteed to provide negative real returns over the next 10 years? If stocks do provide any return premium over very expensive bonds today, it is pretty small — and it could disappear quickly with even a small rise in interest rates.

To be clear, we are not "calling a top" in the market — but merely recognizing the market might be near an inflection point where pressure on high valuations from rising interest rates, inflation, and tax rates could exceed the long-term growth drivers of return. Our clients know we remain fully invested in our equity portfolios rather than attempt to move in and out of the market. The entire premise of our approach to building equity portfolios is to improve upon the growth and value characteristics of the indexes and the "average" stock. Over the course of the last year, in many portfolios we have committed up to 20%

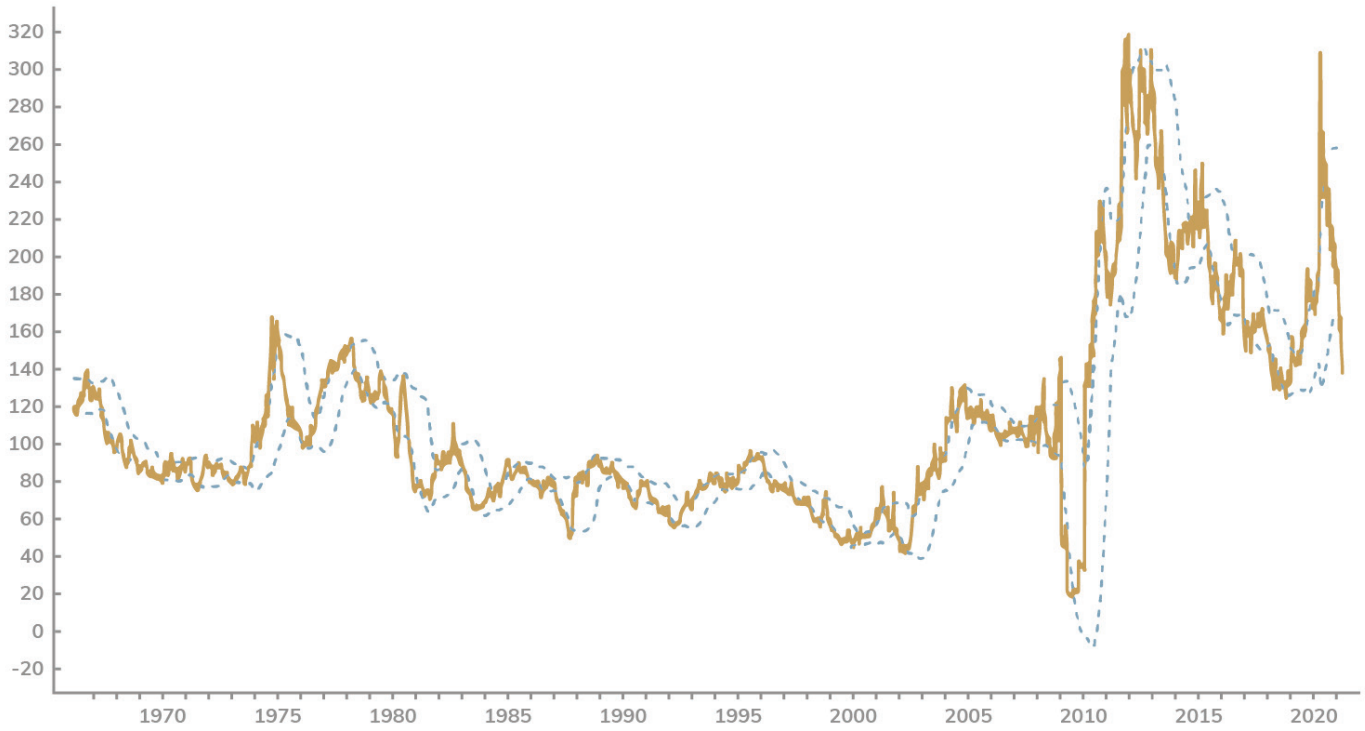
[6] The Tax Foundation - Details and Analysis of President-elect Joe Biden's Tax Proposals, October 2020

[7] www.strategasrp.com

[8] For example: Goldman Sachs Portfolio Strategy Research: US Election – Earnings, valuation, and equity strategies, September 29, 2020

S&P 500 INDEX VS. EARNINGS YIELD RELATIVE TO INTEREST RATES

WEEKLY DATA 1966-02-25 TO 2021-03-05



S&P 500 Earnings Yield (GAAP) to Interest Rate Composite Ratio (2021-03-05 = 137.37)

Earnings Yield High Relative to Interest Rates (Bullish)

Earnings Yield Low Relative to Interest Rates (Bearish)

S&P 500 INDEX PERFORMANCE
FULL HISTORY: 1966-02-25 TO 2021-03-05

Earnings Yield Rate Composite is	% Gain/ Annum	% of Time
Above Top Band	24.01	19.59
Between Bands	7.70	56.71
Below Lower Band	-6.64	23.69
Buy/Hold = 7.03% Gain/Annum		

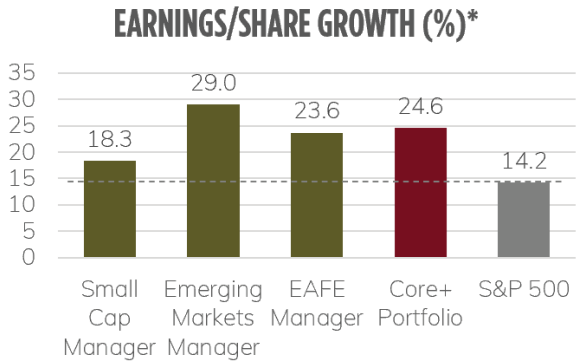
SOURCE: NED DAVIS RESEARCH

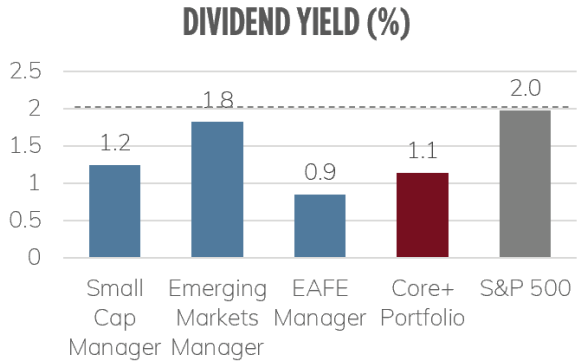
of our equity allocation to outside managers who apply the same approach, but to markets beyond the S&P 500, both in terms of geographical concentration and company size. As we confront higher valuations and low expected future returns in the S&P 500, we find this strategy an effective way to improve upon the characteristics of a Core US equity portfolio. We call this our "Core+" approach (see details on next page).

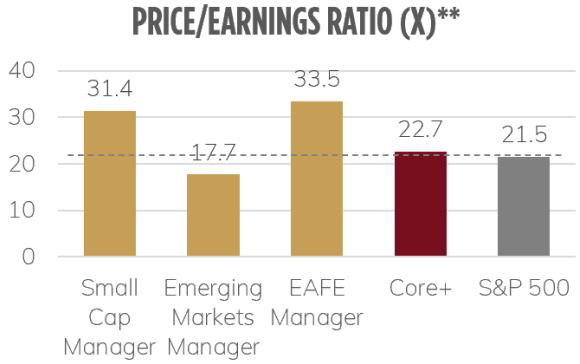
Obviously, to avoid earning low returns in the S&P 500 we need to invest our portfolios in a way that sensibly distinguishes them from the index.[9] Even though our HMP portfolios possess superior growth and value characteristics, the inclusion of our "outside" portfolio exposures improve our diversification away from the index.

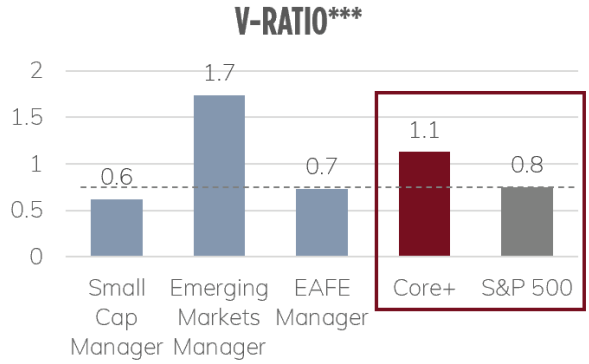
[9] To this point, in the decade following the '99-'00 bubble in technology stocks our institutional equity portfolio composite outperformed the S&P 500 by nearly 4% per year! To differentiate ourselves from the index we were invested in smaller- and middle-sized companies outside of the technology sector, for the most part. Our returns were still less than 5% annually, but at least they were positive. The roughly 45% extra return we earned over that period proved to be especially important to clients who needed to draw down funds each year to operate. And, in particular, our foundation clients, who are required by tax law to withdraw 5% of their portfolios annually, fared very well by virtue of our extra return. Of course, "past results are no guarantee of future returns"! (HMP Composite Data presentation, footnotes and methodology are available upon request).

Core+ Equity Strategy









DATA FROM BLOOMBERG AS OF 2/26/2021

*BEST LTG EPS = CURRENT ESTIMATED CAGR OF THE OPERATING EARNINGS PER SHARE (EPS) OVER THE COMPANIES NEXT FULL BUSINESS CYCLE (TYPICALLY3-5 YEARS)

**BEST PRICE TO EARNINGS RATIO FORWARD 12 MONTHS / RESPECTIVE INDEX 20-YEAR AVERAGE P/E (EAFE GROWTH =16-YEAR AVERAGE)

***V-RATIO = (BEST LTG EPS + DIVIDEND YIELD)/BEST PRICE TO EARNINGS RATIO

Conclusion

Sure, the little model we used for forecasting future returns is pretty simple. But, it does a good job because the investment world is a mean-reverting place: things like price-multiples, growth rates, and equity fundamentals tend to meander around "normal" levels. Underlying elements of our simple earnings series are reliably mean-reverting over time too, such as profit margins. Will we get as lucky with this updated forecast as we were back in '99? Not likely. In our view, what is likely is that foreseeable real and nominal US equity returns will be well below their long-term averages. Even if our 10-year forecast is low, it's possible that stocks provide below-average returns for longer, as they did over the span of the '60s and '70s when they returned 6.7%. The confluence of the data simply indicate it's a particularly good time to diversify away from the S&P 500.