Outlook: How Crestmont Research Forecasts

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Isn't it ironic that local news includes a weather forecast? News shows broadcast reports about recent events, yet viewers watch the weather segment for tomorrow's outlook.

The first principle of investing is that "past performance is not indicative of future results." Yet, many in the investment industry and investor community rely heavily on the rear-view mirror. Product summaries boast returns for the past 1, 3, 5, and 10 years. Some investors buy currently hot stocks as they cull losers without much regard for their potential. Too often, human nature drives us to anchor on yesterday's trend to extrapolate tomorrow's outcome.

The most common misunderstanding about Crestmont Research is that its articles and charts follow that industry norm. But, Crestmont's identification of secular stock market cycles is not based upon recent eras of strong or weak returns.

Instead, Crestmont is keenly focused on the outlook for most investors' horizons—periods of five to twenty years. Secular calls are driven by current conditions and outlook, not by past trends.

This, of course, may seem counterintuitive. If the market is so challenging to predict over daily, monthly, and yearly periods, how does it become so predictable over decades?

Benjamin Graham, the father of value investing, described with a metaphor this short-term vs. long-term conundrum: "In the short run, the market is a voting machine. But in the long run, it is a weighing machine." Shorter-term periods are burdened with noise that the longer-term periods filter out.

Therein lies Crestmont's objective to inform and present insights about the stock market and future returns that are supported by readily-accepted principles of finance and economics.

The primary principle driving Crestmont's views is present value. Financial assets, including stocks, have value today that is driven by the outlook for their future cash flows.

Financial assets seek to provide a return to preserve the purchasing power of savings and to compensate for risk. Thereby, financial assets adjust their values in response to changes in the outlook for the inflation rate, the gremlin of purchasing power and the value of money.

This is not done by mandate, but rather by the market force of trade-offs. As the inflation rate rises or falls, the level of return required to compensate for inflation likewise rises or falls.

Otherwise, physical investments that increase in nominal value due to inflation would have an edge. Investors could shift to hard assets to hedge inflation. Therefore, financial assets respond to the demand for higher returns by adjusting their coupons or price.

Although new issues of bonds offer a higher stated rate of interest, previously issued bonds decline in price to enable their lower coupons to yield a market rate of return. Stocks, like seasoned bonds, also adjust their prices so future returns will be high enough to compete with hard assets and bonds. This is the reason that a rising inflation rate drives lower the price/earnings ratio ("P/E").

Rarely does inflation peak, or deflation trough, over a few years. More often, each leg of the cycle can take many years or multiple decades.

The eras with inflation rising and falling drive financial asset values lower and higher. The net effect either reduces or enhances the total return of bonds and stocks. And, unfortunately, bonds and stocks trend together during these eras. They do not experience the offsetting movement that often occurs daily and weekly.

Therefore, secular stock market cycles are valuation cycles. The process of rising and falling valuation has a significant effect on realized return. This is the reason that decade-long returns from stocks are rarely even close to average. Almost 80% of rolling decades since 1900 have delivered returns 20% above or below the historical average. For the U.S. stock market, this means that there is an 80% chance that total nominal return for the next decade will be either above 12% or below 8%.

This is where the insights shift from interesting to important. The ultimate placement for a decade above or below the average is not random. Almost all decades with an above-average return start with below-average valuation. Likewise, almost all decades with below-average return start with above-average P/E.

This is one of the rare instances when correlation is the result of causation. The performance of financial assets is driven by financial principles. Present value drives periods of valuation adjustment, which mutes or multiples returns. The most significant determinant of "mute" or "multiply" is the level of valuation for the stock market at the beginning of an investment period.

Stocks have only three components of total return: dividend yield, earnings growth, and the change in P/E. High valuation conditions cause dividend payments to deliver a lower yield. Also, investors are less likely to experience rising valuation from high valuation periods than they are from lower valuation periods. As history and financial principles demonstrate, there is a limit to the range for P/E. Last, since high valuation periods are associated with low inflation periods, the nominal growth of the economy and earnings is lower when valuation is higher.

All three components benefit when valuation starts low. P/E has more room to expand, nominal earnings growth gets a boost from inflation, and dividend yield is mathematically higher. However, this rosy outlook for low P/E and high inflation conditions assumes that inflation is ultimately controlled and returned toward price stability.

Bonds act similarly. The rising inflation rate in the 1970s devastated bonds that had been issued with low rates. Yet new issues with high rates around 1980 delivered large checks and capital gains through the '80s and '90s. Bad was really bad and good was really good, just as it was for the stock market during those periods. Most of all, the outcomes were not random. They were driven by financial principles.

Refuting the myth of long-term stock market randomness provides two major points of value. First, investors and advisors are empowered for action. Market environment impacts portfolio structure and investment selection. Second, investors and advisors are better informed with reasonable expectations about likely returns over investors' horizons. This can significantly affect savings rates and safe withdrawal rates.

Where to start? Waiting for Average succinctly explains Crestmont's Reconciliation Principle (a detailed explanation of the concepts). To better understand P/Es role, see The Truth About P/Es, which may direct your interest toward better Understanding Secular Stock Market Cycles.

For the deepest dive, see Financial Physics and its related summary Putting It Together. As for what to do, see Portfolio Mismanagement and Destitute at 80 (yet keep in mind that Crestmont only describes concepts and does not provide commentary about tactics or securities).

As for my favorite graphs and charts, start with Secular Cycles Explained, Secular Stock Market P/E, and Components of Return. Then explore Stock Market Volatility, Significant Swings, The Impact of Losses, Gazing at the Future, and of course, Crestmont's Stock Market Matrix.

For a summary of the concepts in *Unexpected Returns*, see its Video Series and for *Probable Outcomes*, see Groundhog Decade for Stocks.

Ed Easterling is the founder and president of Crestmont Research. He is the author of award-winning Unexpected Returns: Understanding Secular Stock Market Cycles and Probable Outcomes: Secular Stock Market Insights*. In addition, he previously served as an adjunct professor and taught a course on alternative investments and financial markets for MBA students at SMU in Dallas, Texas. Mr. Easterling publishes provocative research and graphical analyses on the financial markets at www.CrestmontResearch.com.*