CONSENSUS: GROUNDHOG DECADE FOR STOCKS

By Ed Easterling
March 22, 2011

There appears to be an underlying consensus that we are likely to repeat another decade of no or low returns from the stock market. That's not just my opinion or outlook, it's collectively yours.

The stock market may not be predictable by the month or year, but its returns over a decade can be reasonably estimated based upon two key measures. This discussion pulls extensive excerpts from *Probable Outcomes: Secular Stock Market Insights*, the recently-released book about the plausible range of scenarios for the stock market and returns over this decade (www.ProbableOutcomes.com).

Over the course of the next few pages, we'll explore the implications of *your* outlook for the two key factors and the resulting probable outcomes for the stock market. Just as Bill Murray woke up to the same thing day after day in the movie "Groundhog Day," it's likely that your outlook foretells a groundhog decade for the stock market that will repeat its near-breakeven returns from the past decade!

Before we journey into outlooks and outcomes, let's explore the principles behind the approach to this analysis and let's put the two factors into perspective.

TWO DRIVERS

Despite the misunderstandings created by conventional wisdom and cheerleading analysts, the value of financial assets is fairly straightforward. First, financial assets are investments that return cash over time. Bonds, for example, pay interest periodically and principal at maturity.

> *By the end of 2019,* Probable Outcomes *will have been the most important book read by investors, financial advisors, and market spectators over this decade.*

Second, the value of a financial asset is driven by its future cash and the market rate of return. We can look at this two ways. If you want a certain rate of return, then there is a price to pay where the cash delivers that return. Analysts call this concept "present value." Alternatively, since the market generally presents us with a price, each purchase represents an implicit rate of return based upon expected future cash. For bonds, this is called "yield-to-maturity." The yield from a bond is often different than its interest rate because it is purchased at a market price that is different than its face value.

Compared to bonds, stocks are a bit more complicated. Unlike bonds that ultimately repay the face value, stocks don't mature in the future. Most importantly, stocks have an uncertain future cash stream. Some stocks pay excess earnings as dividends, while others retain earnings to promote future growth. Regardless, the ultimate value of stocks as financial assets is driven by earnings and earnings growth. That is emphasized by the general acceptance of the price-to-earnings ratio (P/E) as the most recognized measure of stock valuation.

Therefore, the stock market has only two components of return for investors. The first component is dividends—excess cash from earnings paid periodically by some companies to their stockholders. The second component is capital gains—the difference between the purchase price of a stock and the sale price.

Capital gains come from two sources. The first is the growth in earnings per share. The second is any change in the valuation multiple as determined by the market. For example, if HotStock has earnings per share (EPS) of $1 annually and the market price of the stock is $20, then the P/E is 20. If EPS increases to $2 over time and the market maintains the same valuation multiple, then the stock will trade for $40. Conversely, if EPS goes up and the valuation multiple rises, then the capital gain will be even greater…or if the valuation level declines, the market price can reflect a loss even though earnings grew.

The key points to take-away are that (1) stocks are financial assets that return cash or gains over time, (2) their values are driven by earnings and earnings growth, and (3) their prices are determined by the market's valuation multiple.

So what drives earnings growth and the market valuation multiple?

WHO'S DRIVING?

Earnings are the net result for a company after deducting all expenses and costs from sales. Sales generally are the result of production by the company. When we add the consolidated production (i.e., sales) of all companies together, we essentially get the economic measure known as gross domestic product (GDP). Although profit margins tend to rise and fall with the business cycle, earnings are ultimately driven by GDP. Therefore, GDP growth is a good proxy for the long-term growth rate of earnings for the stock market.

For the market valuation multiple, there are two factors. First, market investors are willing to pay higher values when earnings grow faster and, conversely, lower multiples when earnings grow slower. This has not been a factor historically, however, because the long-term growth rate in the economy has been fairly stable near 3% for more than a century. That encompasses most of stock market history. This is, nonetheless, a factor to consider now that some investors and analysts are beginning to wonder about the future long-term growth rate for the economy.

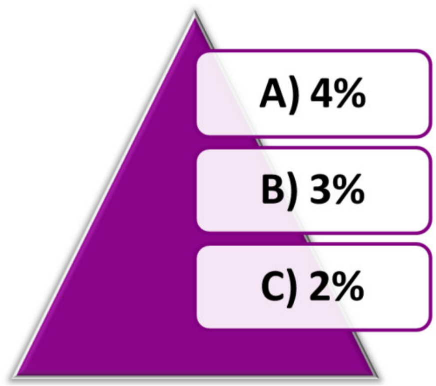
The second factor that drives the market valuation multiple is the inflation rate. When inflation rises, market investors price financial assets to reflect higher returns. This compensates for the loss of value to money caused by inflation. Further, during periods of deflation, the decline in prices over time, earnings growth becomes negative in nominal, reported terms. The result is that both deflation and higher inflation drive down the market valuation multiple (i.e., P/E). Conversely, P/E tends to peak when the inflation rate is low and stable.

The key points to take-away are that (1) economic growth (GDP) drives earnings growth (EPS) and (2) the market valuation multiple (P/E) is driven by the earnings growth rate and the inflation rate.

GETTING TO OUTLOOKS

Pause for a moment to take a pop quiz; let's establish your outlook for this decade.

Over the past century in the United States, real economic growth before inflation has averaged near 3% per year. Over the decades of the 1970s, 1980s, and 1990s, the compounded average annual growth rate was 3.2%, 3.0%, and 3.2% respectively. So during the decade of the 2000s (2000–2009), when consumers were loading up their credit cards, homeowners were said to be using home equity like an ATM, unemployment averaged 5.5% and fell below 4% at times, and leverage was being added to leverage, what was the compounded annual growth rate before inflation rounded to the nearest percent?



The first choice, 4%, is the most logical response. It reflects the perception that much of the consumption and leverage artificially accelerated economic growth. People that choose 4% expect that the factors in the question boosted economic growth above the historical and recent average growth rate.

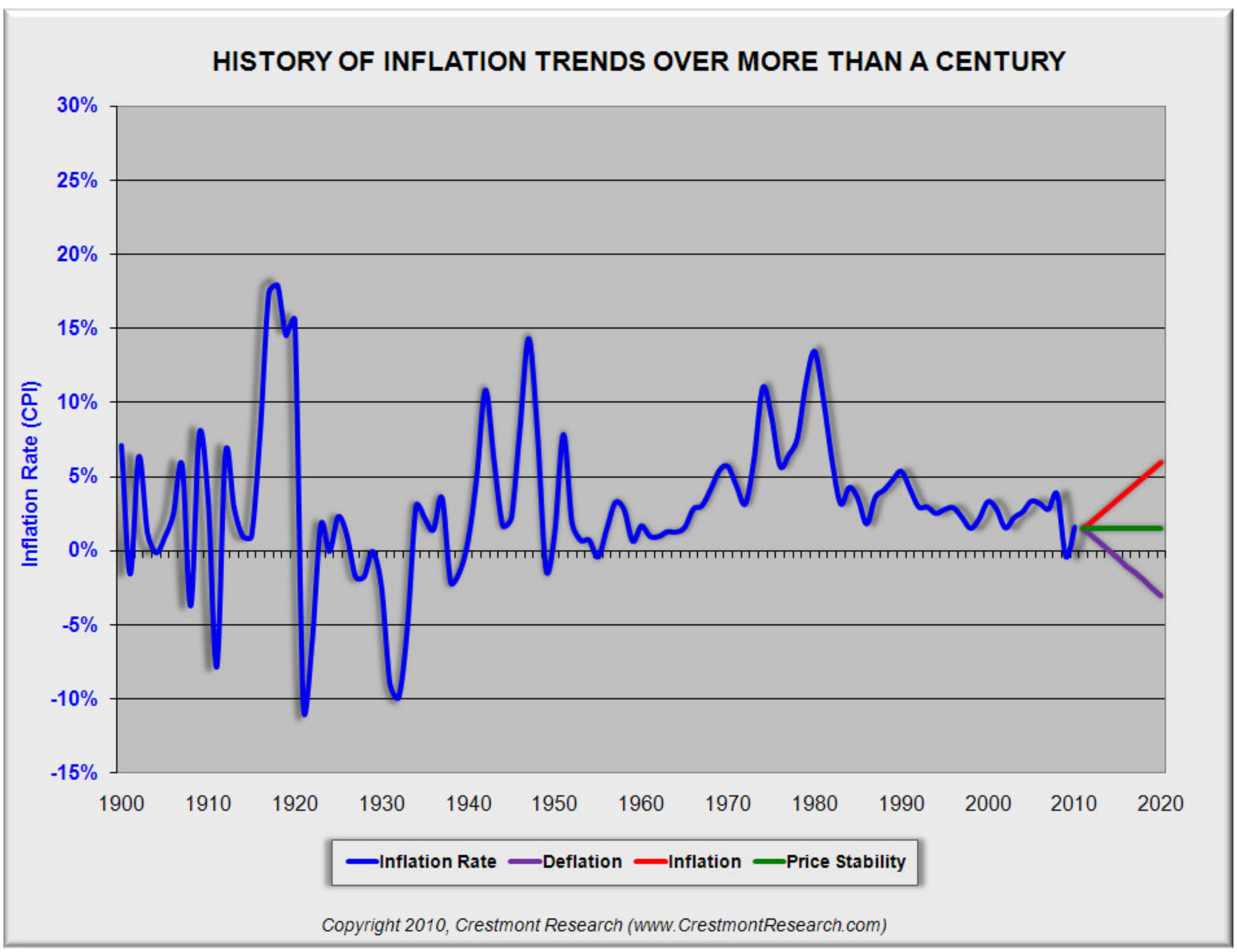
Following such a strong period of economic growth, most people answering "A" expect a period of below-average growth over the 2010s to make up for the excesses of the prior decade. They expect that periods during which growth was fueled by debt will be followed by offsetting moderation as the vestiges of leverage and excess consumption are addressed.

The second choice, 3%, is the contrarian response. It reflects a belief that this time was not different. Though some of the factors included in the question may have impacted economic growth, people who choose 3% either don't believe that those factors had much effect, or presume that there may have been similarly unique factors during prior decades. Nonetheless, economic growth of 3% has endured for more than one hundred years and has been very consistent in recent decades. Some people in this group believe that 3% is likely for this decade, while others have begun to adopt the notion of a New Normal with slowing growth due to recent trends in demographics, government policy, taxes, etc.

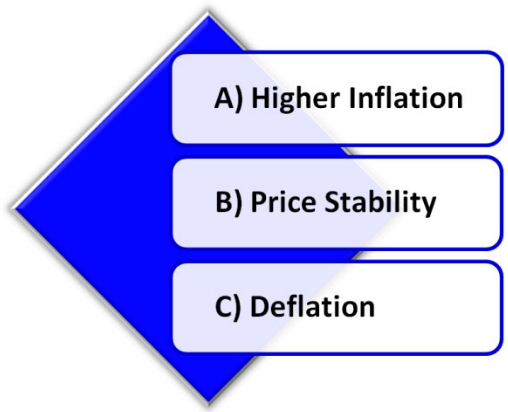
The third choice, 2%, is the correct response, despite being least selected. Many investors are surprised that the decade of the 2000s experienced compounded annual growth of only 1.8%. Some economists say that it was a decade sandwiched by two recessions, while others blame it on the severe recession of 2008 and the related financial crisis. Yet excluding the recession of 2008 from the decade, the growth rate for the first eight years of the 2000s was still only 2.6%. Further, cumulative economic growth throughout the decade of the 2000s did not exceed 2.7%. It would have required an unusual surge—near 4.5% annually—in the final two years for the full decade to reach the historical average annual growth rate of near 3%.

This sets the stage for a dilemma. Will the decade of the 2010s restore the long-term average by growing at 4%, thereby defying the predominant belief of a slow-growth decade? Was the prior decade of the 2000s an anomaly, with future economic growth simply returning again to its long-term trend of 3%? Did something change ten years ago, and has economic growth downshifted to a level near 2%, or as some might contend, could the rate be even lower due to the economic, financial, and/or policy headwinds in front of us? All three scenarios are plausible, which makes economic growth Major Uncertainty #1. The answer to the dilemma has very significant implications for stock market returns over this decade and longer.

But the pop quiz isn't over. We need your outlook for the inflation rate. Here's a picture of the inflation rate for more than a century.



The rollercoaster ride reflects an undulating cycle that does not ride a consistent wave of time. There's no right answer for this question either…at least not until 2019. But there are three plausible scenarios. Does your outlook include a trend of deflation (the purple line in the graph), the calm of price stability (the green line), or a trend of rising inflation (the red line). Actually, for the decade's outcome, it does not matter as much what happens in the interim, where do you expect us to be in 2019 and the then foreseeable future?



YOUR OUTLOOK ➔ PROBABLE OUTCOME

Some of the outcomes have relatively similar results. They are designated with categories of bears as an illustration of magnitude. To facilitate the discussion, the categories of bears are conveniently assigned according to the story of the three bears. The fourth set of outcomes, when P/E remains high under price stability, reflects a bear in hibernation. If this decade ends with P/E still high, then there will not have been progress through the secular bear market, so it will have remained in hibernation.

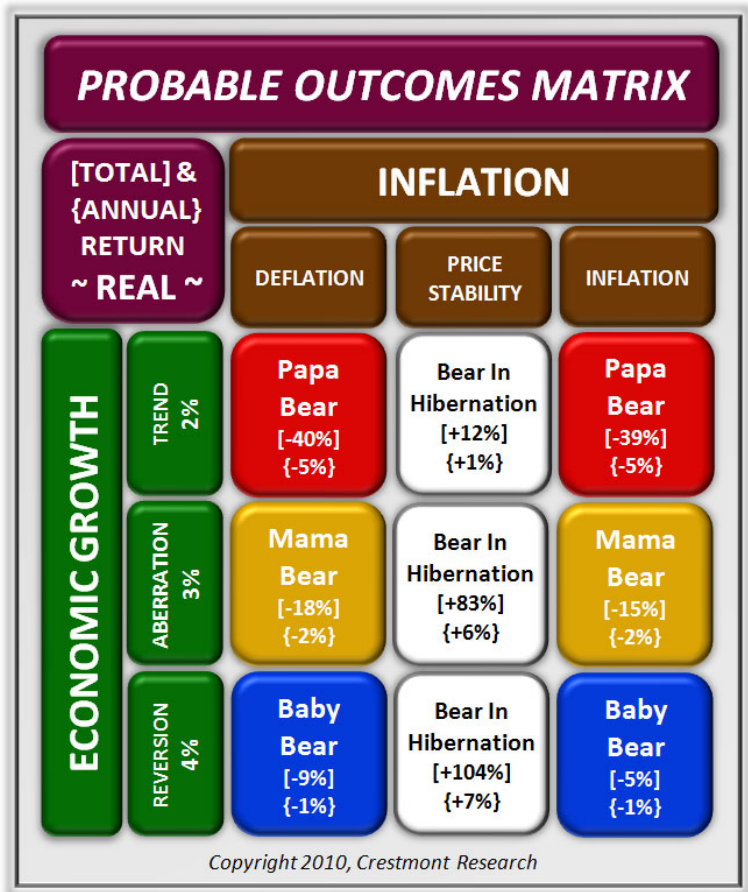
Keep in mind that the results can appear quite different in nominal terms (i.e., what gets reported on monthly statements) versus real terms (i.e., the true purchasing power excluding the effects of inflation and deflation).

For this discussion, it is important to have a common basis of comparison across the various scenarios to put their effects into perspective. For example, consider two of the scenarios with 3% real economic growth. The nominal total return including dividends is a loss of –36% with deflation, but a gain of +15% with inflation. Which would you prefer?

Not so fast. When both are adjusted for the impact of the inflation rate, thereby better aligning the investment results with lifestyle and pension obligations, the real returns reflect a loss of –18% with deflation and a loss of –15% with inflation. Though there is a slight edge to the inflation scenario, the results are substantially similar in terms of ultimate purchasing power.

Papa Bear is the designation for two probable outcomes. The most significant driver of returns over decades and secular market cycles is the change in P/E. From the relatively high levels of 2009, the scenarios make P/E necessarily vulnerable to decline (and not positioned for potential increase). Therefore the two scenarios of inflation and deflation drive significant declines in P/E and attendant declines in valuation. Beyond the normal impact of deflation and inflation on P/E, the slower economic growth from the Trend scenario (i.e., GDP continues at the pace of the past decade, 2% or so) packs an additional two-fisted punch to the results: first, EPS is lower due to slower economic growth; second, P/E shifts downward under all inflation-rate scenarios due to the impact of reduced economic growth on the discount rate.

Figure 12.2. Probable Outcome Matrix (2010–2019): The Four Bears (REAL)

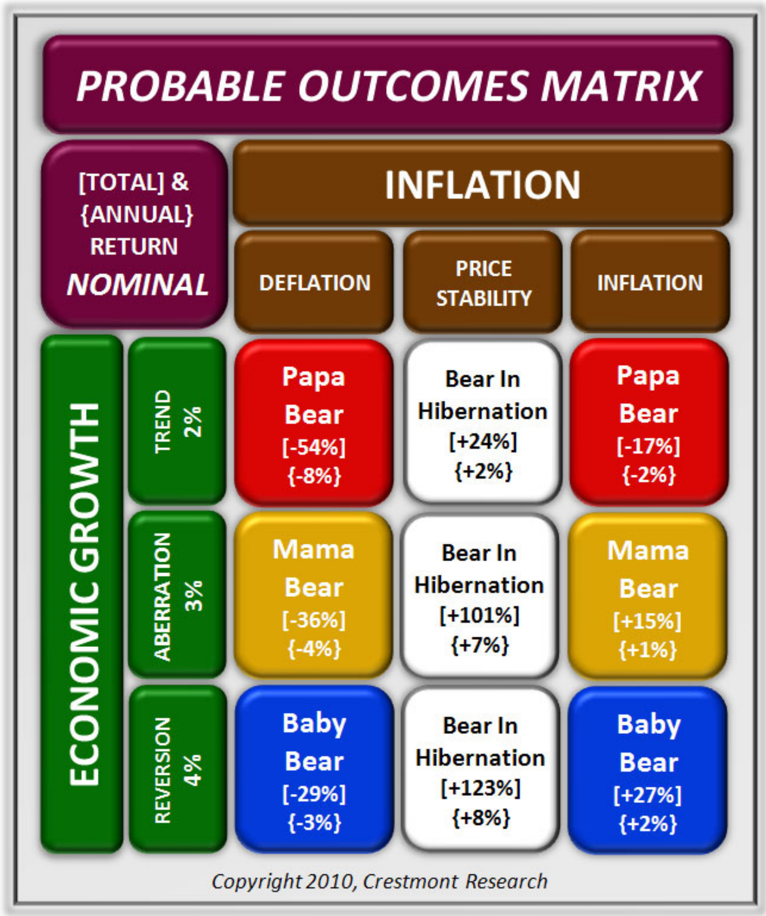


Papa Bear is a gruesome grizzly. Under deflation, the nominal loss is –54%. Even the inflation scenario leaves the portfolio down –17%. In real terms, after compensating for deflation and inflation, both scenarios effectively provide losses near –40% of the portfolio's value. This represents a compounded annual loss of –5%.

Mama Bear, while less bad than the ol' grizzly, captures two places as well. She prowls on the ground of slightly faster economic growth, but is still burdened with adverse inflation-rate conditions. Economic growth increases to 3% annually, which gets rid of the two-fisted punch. Not only does EPS grow a bit faster but also P/E is not discounted below 10 due to slower growth. Nonetheless, Mama Bear delivers real losses of –18% and –15% for the deflation and inflation scenarios respectively.

Baby Bear follows in the deflation and inflation footsteps of its two predecessors, yet receives a boost from higher economic and EPS growth. Though Baby Bear may appear cuddly and cute, this critter is cruel, with a snarl just as bad as its bite. An investor's stock market portfolio does not escape the claw marks, and ends down slightly in real terms at the end of the decade.

Figure 12.3. Probable Outcome Matrix (2010–2019): The Four Bears (NOMINAL)



Bear In Hibernation signifies that the stock market does not make progress in the secular bear cycle. At the end of the decade, all three scenarios still have a relatively high P/E due to low inflation under the condition of price stability. As a result, investment returns will not have met most expectations. Investors could receive compounded annual returns of 1%–7% in real terms. In nominal terms, returns of 2%–8% will be somewhere between somewhat disappointing and reasonably acceptable, albeit below average and below many expectations.

The outlook from that point, however, is that the Bear will still need to run its course before a bull can take the lead. If this scenario occurs, be aware that investors will likely become complacently comfortable with the modest returns and their reasonable gains in purchasing power. They will likely begin to hope for the next secular bull, as the secular bear of the 2000s will appear to have been tamed. But, P/E will not be positioned to expand—it will still be at high levels. High P/E is bear territory, and cannot be bull ground. Secular bears must reach the point of low P/E due to inflation or deflation before the cycle can transition to the secular bull.

This significant point is worth emphasizing again: A secular bull market cannot start within the current decade without a dramatic decline in market valuation and P/E. The decline would need to be driven by a period of significant inflation or deflation, rather than by a short-term financial crisis.

RAINBOWS

Investors are confronting the reality of the current secular bear market. It is both the consequence of the previous secular bull market and the precursor to the next secular bull. The duration of the current secular bear period is uncertain. Should inflation or deflation overcome the economic environment in the near term, this secular bear could end sooner. That reality, however, would cause significant losses to stock market portfolios. If inflation or deflation slowly creeps into the economy, over the next decade for example, then this secular bear will have been one of the longer ones. However, if this decade repeats the relatively low inflation of the past decade, then the secular bear should remain in hibernation.

Beyond the inflation rate, economic growth also will have an impact on the future of this secular bear. Following last decade's below-average economic growth, this decade could generate above-average growth to offset the recent shortfall. The result would be a solid boost to earnings in this decade. Economic growth, however, also could have downshifted during the last decade to a lower level for the foreseeable future. The result would be a significantly lower range of P/Es, but not necessarily a progression through the secular bear market. The economic growth rate can shift P/E upward or downward, but only inflation or deflation can end a secular bear market.

Whether this secular bear cycle ends in five years, ten years, or beyond, the result will be the start of the next secular bull market, which will bring an extended period of above-average returns. Spring finally will have sprung. This longer-term view of secular stock market cycles is the reason to look out across this secular bear to the next secular bull. The operative word is "across" this secular bear and not "past" it.

"Across" recognizes the reality of the risks and opportunities presented by secular bear markets. "Past" is the ostrich-like approach of ignoring reality with blind hope for an unrealistic outcome. "Across" is enabling, while "past" is disabling.

For investors who are accumulating for the future, secular bear markets are times to build savings for later investment. This is done not only through contributions but also through prudent investing with an absolute return approach to investment returns. The absolute return approach uses the dual strategy of risk management and investment selection.

Investment portfolios should be diversified across a range of investments that are diligently selected and actively managed, especially ones that control risk and enhance return. In particular, investors should not avoid the stock market or bond market. Instead, their objective should be to seek in both markets investments that incorporate elements of skill to enhance returns. Secular bear markets are not periods during which to avoid investing; they are periods that demand an adjustment to investment strategy.

For investors who are more dependent on their current assets, including pension funds and retirees, investment strategy should be paired with the early recognition of lower returns over this decade. The principles of absolute return investing are important for preserving capital and generating much-needed returns. But potentially more important than managing the investment portfolio, pension funds and retirees would be well served in this environment to manage their assumptions and expectations. Earlier recognition of secular bear market conditions enables potentially painful adjustments to be smaller. Delaying action until crisis has onset generally brings greater adverse consequences. It is not prudent to hope for the next secular bull market to arrive sooner as a way to address shortfalls. The longer expectations take to adjust, the greater the gap to fill with an increasingly short time to fill it.

WHAT TO DO

Whereas *Unexpected Returns* introduced and explored the concepts behind secular stock market cycles (extended periods of above-average and below-average returns), *Probable Outcomes* delves into greater details and applies the concepts to assess the probable outcomes for stock market returns based upon a range of assumptions. The book explains why stock market returns and volatility are likely to repeat the course of the past decade (the 2000s)—a Groundhog Decade! *Probable Outcomes* does not simply present a forecast or prediction for the stock market over the 2010s, it's a detailed analysis of outcomes based upon the fundamental principles that drive stock market returns.

In addition, the discussion extends into the implications across a range for both individual and institutional investors. Most of all, the book enables investors and advisors to take smaller actions today in order to avoid the more dramatic responses required by future shortfalls. Ten years from now, a response of "who knew?" won't be much comfort for retirees in the employment line at the local job fair. A rational understanding of stock market history and the drivers of longer-term returns can help today's retirees avoid that surprise.

Beyond this article, more details and a complement of graphics and insights can be found in the recently-published *Probable Outcomes* (www.ProbableOutcomes.com) as well as www.CrestmontResearch.com. If you read the book, then pass along your copy to a friend, colleague, client, or advisor.

Most importantly, investors and advisors can assess this decade with more reasonable expectations and then adjust their plans accordingly. This could include the use of today's new tools and resources or simply a more conservative outlook for returns from the portfolio. Recognition is the first step toward capitalizing on the future. The best outcome for investors over a groundhog decade will result from using the approaches that would have been successful over the past decade.

Ed Easterling is the author of recently-released Probable Outcomes: Secular Stock Market Insights *and award-winning* Unexpected Returns: Understanding Secular Stock Market Cycles*. Further, he is President of an investment management and research firm, and a Senior Fellow with the Alternative Investment Center at SMU's Cox School of Business where he previously served on the adjunct faculty and taught the course on alternative investments and hedge funds for MBA students. Mr. Easterling publishes provocative research and graphical analyses on the financial markets at www.CrestmontResearch.com.*