Financial Symmetry

Financial strategies for every phase of life

Market Outlook — November 2014

We've now had five and a half years of double digit average annual gains in the US stock market. For many investors this outcome was hard to imagine in the depths of the Great Recession. Fear dominated and the future looked bleak, causing many investors to sell stocks at the wrong time.

Our instincts can often send us in the wrong direction when investing, especially at market extremes, which is why we put so much emphasis on research.

Equities Outlook

For US stocks, current valuation metrics are indicating expensive prices, thus low returns over the coming five to ten year timeframe are very likely.

The chart to the right (Figure 1) shows one of the most reliable long term valuation indicators, the CAPE ratio, versus the next five and ten year annualized returns.

When the CAPE is low as in the 1950s and 1980s, the next five to ten year returns are generally above 10% per year, while a CAPE above 20 usually means five to ten year returns below 8%.

It is very important to note that stock prices are much more random over short time periods.

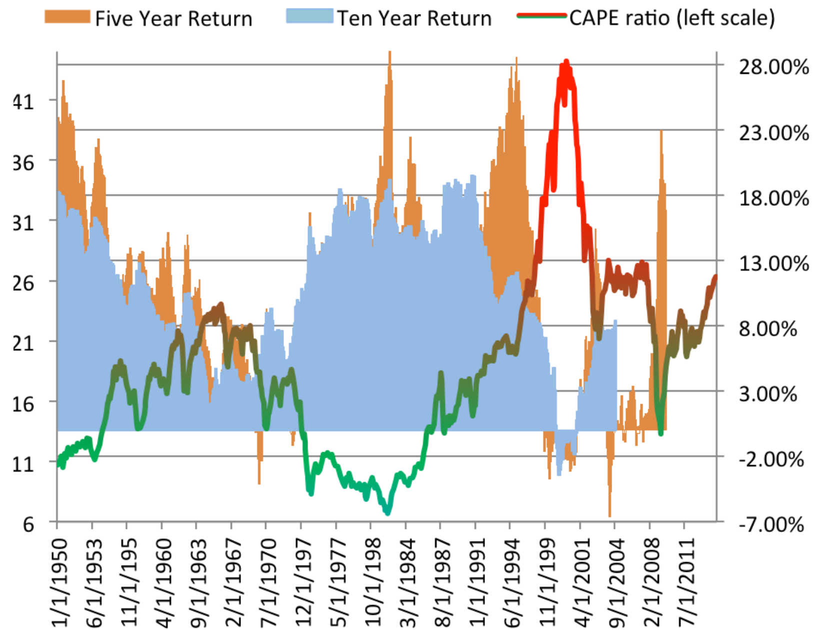

Figure 1 – CAPE ratio is currently at 26. The historical average is 15.

This next chart (Figure 2) shows that when the CAPE ratio has been near 26, as it is now in the US, one year returns have ranged from plus 52% to minus 43%.

When the CAPE is closer to its historical average (Figure 3) there is still a huge range of possible returns, but the odds are higher for returns above 20% per year.

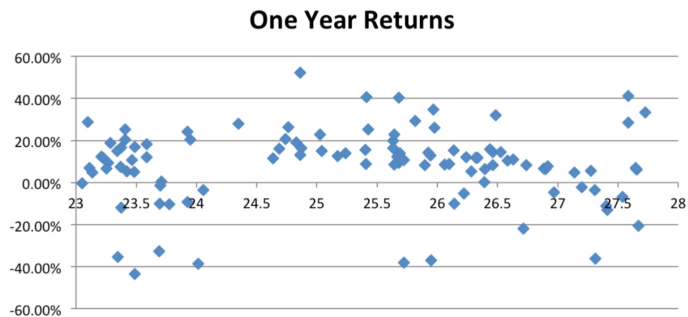

Figure 2 - Starting CAPE ratios between 23 and 28

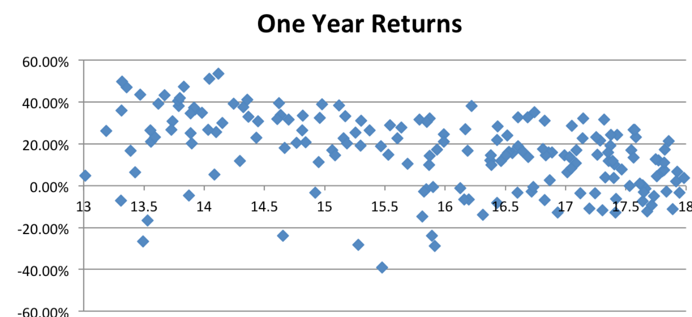

Figure 3 - Starting CAPE ratios between 13 and 18

While the US stock market is expensive, the following table (Figure 4) demonstrates that stock prices are much less expensive in other countries. This means that the odds for higher returns over the next five to ten years are greater for foreign stocks than US stocks.

Country	CAPE	CAPB	CAPD	CAPCF	Average
Greece	1	1	1	1	1
Austria	5	2	8	3	5
Hungary	4	4	9	2	5
Italy	6	5	4	6	5
Portugal	9	6	2	5	6
Russia	2	3	17	4	7
CzechRepub	8	9	3	8	7
Ireland	3	7	10	11	8
Poland	14	8	7	7	9
Spain	10	14	6	9	10
Brazil	7	11	13	10	10
NewZealand	22	22	5	14	16
France	21	12	18	13	16
Finland	17	23	11	18	17
Belgium	16	15	16	22	17
Norway	19	21	20	12	18
Singapore	11	16	22	27	19
UK	20	24	15	20	20
Egypt	25	27	14	15	20
Israel	13	18	24	26	20
Turkey	15	20	28	19	21
Germany	27	17	25	16	21
Netherlands	18	25	23	25	23
SouthKorea	23	13	42	17	24
China	12	29	31	24	24
Australia	24	30	12	31	24
Taiwan	31	28	19	23	25
Japan	32	10	40	21	26
HongKong	26	19	29	37	28
Chile	30	26	30	28	29
Thailand	29	35	26	29	30
Sweden	28	34	27	34	31
Peru	38	40	21	33	33
Canada	37	32	36	30	34
Malaysia	36	33	32	35	34
SouthAfrica	35	38	33	39	36
Mexico	33	39	41	32	36
Switzerland	34	36	35	41	37
Colombia	39	31	34	43	37
USA	41	37	39	36	38
Philippines	40	41	38	40	40
Indonesia	43	43	37	38	40
Denmark	42	42	43	42	42

Figure 4 - US stocks are among the most expensive globally
Source: http://mebfaber.com/2014/09/08/the-cape-ratio-doesnt-work/

Over the last 45 years, returns on stocks in the three major developed market regions have been very similar (Figure 5).

But there have been numerous cycles where returns in the regions have been quite different. Notice how foreign stocks outperformed US stocks from 2002-2007, but US stocks have done much better since 2008 (Figure 6).

	EUROPE	PACIFIC	US
1970-2014	10.5%	9.6%	10.4%

Figure 5 - Annualized returns by region 1970 – 2014

	EUROPE	PACIFIC	US
2008-2014	0.6%	1.5%	7.1%
2002-2007	15.2%	14.1%	6.0%
1991-2001	10.4%	-1.0%	14.3%
1970-1990	12.6%	17.1%	10.7%

Figure 6 - Annualized returns by region showing divergence over shorter time frames

Source of charts: http://awealthofcommonsense.com/international-stock-market-diversification

While we can't predict the specifics of these cycles, we can see a very clear correlation between relative starting valuations and subsequent relative returns. Foreign stocks are now at their most attractive relative starting valuations since 2002 – which was the beginning of the last cycle where foreign stocks outperformed US stocks (Figure 7).

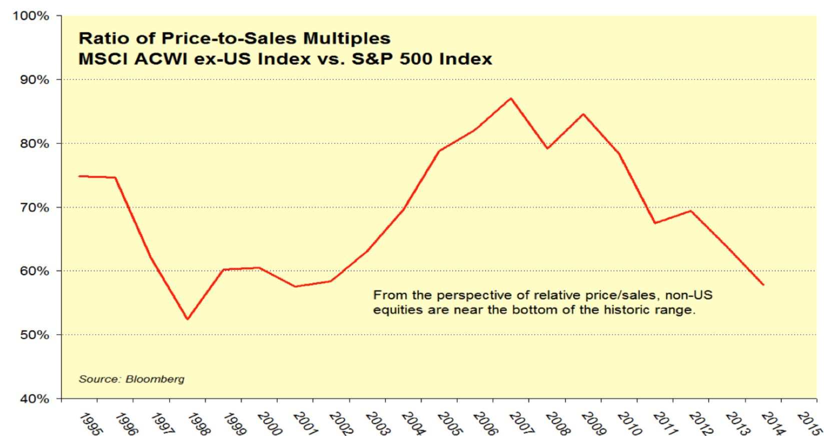

Figure 7 – Relative Price to Sales ratios

Our current equity strategy is defensive due to the expensive US market and the downside risk that it presents. We are targeting the mid-point of client stock allocation ranges to be in a position to take advantage of a selloff if it were to occur while also maintaining enough exposure to benefit in the event of a move higher, since an expensive stock market can get more expensive.

If valuations between US and foreign stocks were closer, we would want to have 65% of your stock holdings in US markets, and 35% in foreign. But given current starting valuations, we are targeting a split of 50% in US stocks and 50% in foreign stocks, with very little in US small caps, which are even more expensive than US large caps.

Fixed Income Outlook

Currently, we are in a low expected return environment for cash and bonds here in the US.

Our estimates are that returns on cash, i.e. in bank accounts, will likely average between 0% and 2% per year for the next five to seven years. Bonds will probably earn a bit more with average annual returns likely between 1% and 4% for the next five to seven years.

There are many pundits who think interest rates will rise quickly, and have thought so for the last five years.

Looking at historical interest rates, we think it is likely that rates will rise gradually over a long period of time.

Here in the United States, from 1790 to the mid-1970s, interest rates cycled mostly between 2% and 7%, with an average rate of about 5.2%.

Each up or down cycle took 22 to 37 years. Interest rates went to double digits in the late 70's and peaked in 1981. It then took 31 years for rates to bottom below 1.5% in 2012 (Figure 8).

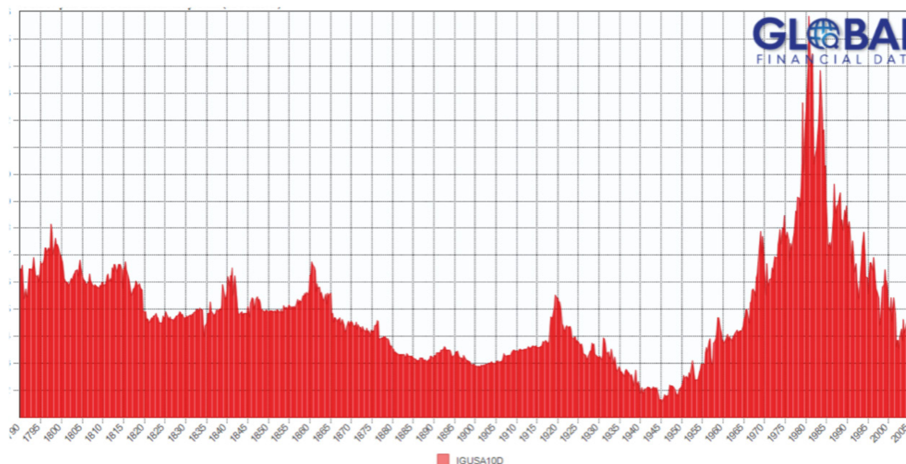

Figure 8 - Interest rates move up or down over a very long period of time

If 1970s interest rates prove to be anomalous, the next top in interest rates will happen somewhere between 2034 and 2049 and the peak rate will be no higher than 7% or 8%. There will be shorter term ups and downs for rates, but if it takes 20 years to get to 7%, then it will be an average increase of less than 0.25% per year.

Of course we probably won't get a steady increase each year, and some years we will see declines in rates, but it doesn't seem likely that there will be many, if any, years where rates rise much faster than 1%.

Given this environment, we do not want to hold much low yielding cash if possible. The long interest rate cycle means it is likely that it will take several years before cash yields are high enough to warrant a considerable allocation. Conversely, long term bonds do not have sufficient yield to take a large position, given that they would fall in price if interest rates were to rise quickly. We therefore are focused on intermediate term bonds in the three to five year range where we get some interest, but do not have the downside risk posed by longer term bonds.

FSI's Take

In a low return environment, it's essential to have an investment strategy that is not too aggressive and relies on longer term odds that are drawn from starting valuations.

Within this strategy, it is equally important to have the flexibility to take advantage of opportunities provided by any quick spikes in interest rates or significant drops in stock prices.

The rest of the time it's best to exercise patience. As difficult as it was for many investors to go against their fear and be more aggressive when faced with short term losses in the depths of the Great Recession, it can be equally difficult to avoid chasing areas of the market which are expensive due to recent strong performance.

Understanding that markets are random in the short term allows us to fine tune our long term strategic approach as conditions change. Our approach is to continually search for the best opportunity today to position ourselves for the long haul.