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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

Last year did not work out the way most strategists expected. Should we really be surprised? According to Joachim Klement, who tracks the forecasts of strategist' from prominent banks around the world, it was just another year of useless one-year forecasts. He is more surprised that we even listen to them. There does, however, seem to be a significant difference between short-term forecasts, especially one year or less, and looking out several years. Longer-term, Klement admits that there can be some value to forecasting. If you think about it, the cash generation of the S&P 500 must change at the same rate as the economy over time since the revenues of the companies in the market represent most of the economy. It is our daily expectations that get us into trouble. However, we search for the latest guru to enlighten us as to the coming year anyway.

For the calendar year of 2018, the average forecast for the S&P 500 at the beginning of the year was for the market to be up 10.3%. The actual result was a decline of 6%, or a miss of -16%. Maybe this year they will have more success. However, these big misses are the rule, not the exception. Klement says that strategists have been wrong by a spread of more than 10% in 13 of the last 20 years for the S&P 500. Can they at least predict the right direction? Apparently not. They missed forecasting the direction of the market - whether it would have a gain or loss for 11 out of the last 20 years. That means the coin in your pocket has a better chance of predicting stock market returns this year than the experts. If you think this makes the stock market a casino over the next few months, you are probably right. Investors are always trying to forecast the market and economy. It's just human nature. The common expectation is that the market anticipates the economy by six to twelve months. The challenge is that investors are 'adjusting' their expectations daily. The part that is hard to remember is that in the long-term, which is several years and decades, the economy grows by about 5% annually including inflation. Corporate earnings also grow by, you guessed it, about 5%. If you want to predict how much GDP will grow by in the next decade, it is a pretty good bet to go with 5%. Predicting the next quarter becomes an art which even the Federal Reserve has not perfected. The economy is relatively consistent over time, but stock market returns are anything but stable. They spend about 75% of the time outside a positive 8% to 12% annual growth range. If the average return is 10% for the last 100 years, you would expect returns to congregate around that average, but they don't. What is an investor to do?

For starters, looking past the next few months is almost mandatory if you want to be successful long-term. During the recession of 2008, the worst quarter for GDP growth was a decline of 8%. However, within three quarters we were growing again. Corporate earnings are more sensitive than economic growth, partly because a share of GDP is government goods and services, which are much more stable. Strong markets also seduce us to pay too much in the good times for a company's expected growth of earnings. In the recent selloff, which so far has been 20% from the market peak, put us below the market average valuation for the last 30 years for one year forward expected earnings. Maybe there is a recession sooner rather than later, and this is just the halfway point of the recent market decline. It is still a reasonable point to own stocks, because earnings are up 30% from 12 months ago, and prices are lower than one year ago. One never knows exactly what the near to intermediate future holds. However, it gets easier when all you need is average. The time it will take to recover if this is not the bottom of the current market selloff is shorter than it was 12 months ago. Unless you think the economy is going to shrink for the next several years, we always get a recovery. We are supposed to learn from history, but it always seems different this time.

"It falls into that long, dismal catalogue of the fruitlessness of experience and the confirmed unteachability of Mankind. Want of foresight, unwillingness to act when action would be simple and effective, lack of clear thinking, confusion of counsel until the emergency comes, until self-preservation strikes its jarring gong – these are the features which constitute the endless repetition of history". Churchill speaking to Parliament in 1935 regarding Germany. We want to believe that somebody can lead us to the investment promised land. It will not be that person on your television or some other form of media. Want more proof, look at the 10 'experts' from Barron's roundtable last year. Their investment picks for 2018 were not very inspiring. Sometimes average is all you need to make a good year.