ABR Dynamic Funds' Series on Stagnation Solutions: Part 1

Introduction: Concerned about the Possible Stagnation of U.S. markets?

Preface

Over the 30-year period from 1989 to 2018, Japan's Nikkei 225 stock index was down 33.6% (-1.4% annualized, not including dividends). We are not predicting those numbers in the U.S. over the next 30 years, but we are simply noting that extended disappointments are possible in developed-economy stock markets.

This introduction is the first installment in a short series on some possibilities that investors, who have lowered their expectations to realistic outlooks for stocks and bonds over the next decade, may want to consider for partial equity replacement.

Introduction

We think that heeding short-term forecasts does not offer a reprieve from lower medium-term equity return forecasts, and the short-term forecasts should be entirely ignored. In our latest newsletter, we highlighted the terrible predictions and forecasts that came from many experts over the past year. Here is just one recent example:

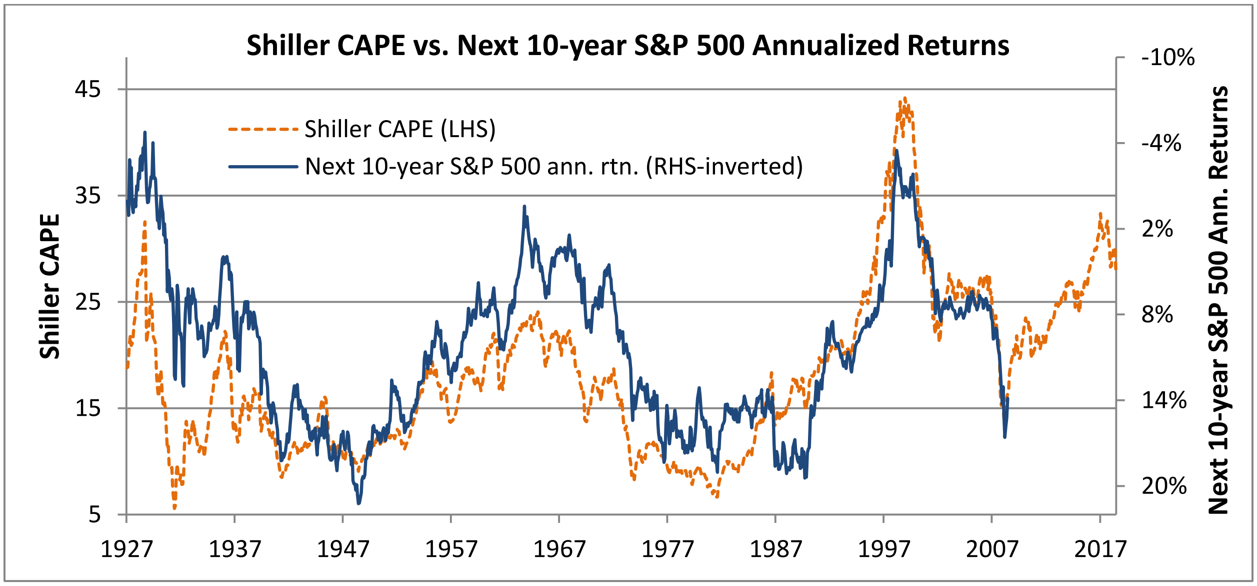
- **At the end of third quarter 2019**, the headline was "U.S. Stocks Rise to Cap Volatile [Third] Quarter," and the article included **"underneath the surface, it was a dizzying three months for markets….Many investors say they are bracing for more turbulence ahead."**

- Then, **in mid-January 2020**, the same source brought us the headline **"Stocks Have Rarely Been This Quiet in the Past 50 Years,"** and the article included "the S&P 500 is in one of its longest streaks without a 1% daily move in the past five decades…."

At least they essentially admitted how wrong their implications for fourth quarter 2019 turned out to be. **Unfortunately, though, these wild misses have been all too common. Daniel Kahneman noted that "people who spend their time, and earn their living, studying a particular topic produce poorer predictions than dart-throwing monkeys…."** It's not an exaggeration. Many short-term predictions amount to little more than performance chasing. Did you catch it in the first bullet point above? The "prediction" was little more than expecting the last 3 months to continue.

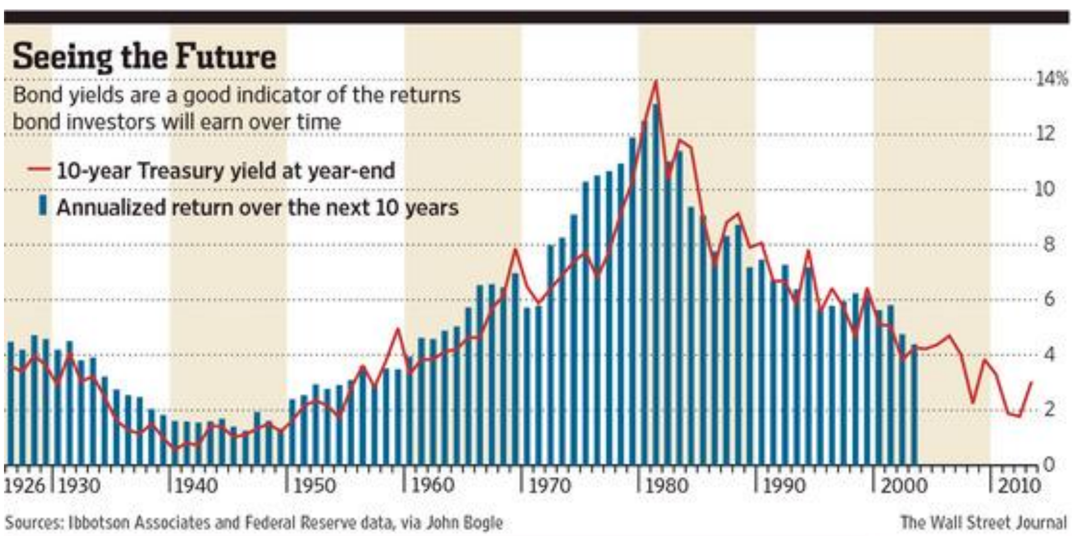
However, there is good news, sort of. **While still allowing for the possibility of significant variance, medium-horizon expectations, based on data and research, haven't been quite as disappointing.** More specifically, the S&P 500 Shiller cyclically-adjusted price to earnings ratio (CAPE) has been a reasonable indicator of the next 10 years of stock performance, and the 10-year treasury yield has been a reasonable indicator of, no surprise here, the next 10 years of treasury returns. In both cases, the horizons for even just somewhat useful forecasts were about a decade. Random noise dominates the short term; patience is a must.

Let's explore whatever success these two indicators have had in the past. The following graph shows the Shiller CAPE in orange, on the left-hand axis, vs. the next 10-year annualized return of the S&P 500 in blue, inverted on the right-hand axis. The return axis is inverted to illustrate the relationship: higher valuations, measured by the Shiller CAPE, have led to lower upcoming returns.



Data Source: Bloomberg and multpl.com

Next, we turn to treasuries. The following graph shows the 10-year treasury yield in red vs. the next 10-year annualized return of 10-year treasuries. At the time of this writing, the current 10-year treasury yield is only about 1.5%, even lower than it was when the chart was made.



Source: The Wall Street Journal, 2014 (current 10-year rates are lower)

In introducing these indicators, we stated there was "good news," "sort of." The "good news" is they have worked, to some extent. The "sort of" caveat comes from what that means today. **Visible in the above graphs, a Shiller CAPE of 30 has indicated a next 10-year annualized return for the S&P 500 of**

about 3%, and a 10-year treasury yield of 1.5% has indicated a next 10-year annualized return for those 10-year treasuries of about 1.5%.

What might investors, who have come to expect, or in some cases even need, 6%+ returns do? Unfortunately, a significant part of the answer is they can lower their expectations. Stock and bond returns since the March 2009 lows have been unusually high and cannot continue forever. And even since the 1980s, interest rates have been dropping, and equity valuations have been rising. Both trends have inflated core returns beyond what should be expected over the truly long-term (and, more importantly, beyond what might be expected over the next ~10 years).

However, there may also be more useful answers than just lowering expectations. This installment introduces a short series on some possibilities that investors, who have lowered their expectations to realistic outlooks for stocks and bonds over the next 10 years, may consider. Over the next 2-3 months, we will explore two subsets of strategies:

First, we will look at several strategies that have historically generated S&P 500-like return profiles, but with the potential for outperformance during a decade of lower S&P 500 returns. For that reason, they may warrant consideration as partial equity replacements for investors with lower expectations of stocks and bonds over the next decade.

Second, we will consider several diversifying allocations which may warrant additional consideration for two reasons. First, they have added value to portfolios over the long term. Second, investors with lower return expectations for stocks and bonds over the next decade face a lower expected opportunity cost associated with increasing their allocations to alternatives at the expense of their allocations to those stocks and bonds.

Next Week's Preview: Some short volatility strategies have outperformed the S&P 500 during decades of lower S&P 500 returns.

Notes/Disclosures

Some of the indices may contain some hypothetical results. There are inherent limitations to hypothetical results. Past performance does not guarantee future results. No index presented in this installment is representative of any strategy at ABR Dynamic Funds, LLC. It is not possible to invest directly in an index. The information presented in this installment does not constitute a complete analysis of any index or strategy, and this installment contains no recommendation to buy, sell, or hold any investment. All data was obtained from sources believed to be accurate; however, ABR Dynamic Funds, LLC cannot and does not guarantee the accuracy of such data.

The charts pertaining to CAPE ratios and interest rates contain highly autocorrelated data. Readers should not assume a certain level of statistical significance based on a chart.