PRIVATE ASSET MANAGEMENT, INC.
WEALTH STRATEGY ADVISORS
PARADIGM

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This is the third part of our series. This month's Paradigm focuses on future returns. Individuals need to prepare for lower returns than in the past. Each person should review their goals and strategy to ensure that lower returns do not derail the main components of their long-term financial success.

There are two main reasons behind our thoughts that future returns will be lower than past returns: slower economic growth and current valuations for both stocks and bonds.

Slower Economic Growth

Slower economic growth is mainly due to long-term trends that were tailwinds in the past, but are likely to be headwinds or neutral in the future. These factors will cause earnings growth, the main driver of returns, to be lower in the future.

Think back over the past 30-40 years ago. The baby boomers were getting established in their careers. More women were entering the workforce. Global markets were opening up to U.S. companies. Technological progress boosted productivity. The birthrate in the U.S. was higher than today. These factors help fuel a nearly 7% annual earnings growth rate for the S&P 500 over the past 30 years.

Going forward, the trends referenced above will not aid economic growth as much as in the past. The main issue is the slowdown in the growth of the labor force. Baby boomers are retiring. The working age labor force participation rate (male and female) is not going up as in the past. Productivity growth is forecasted to be lower in the future than the past. Finally, the birthrate remains below past rates.

These trends mean economic growth will be slower. The decrease may be only 1% per year, but this will affect earnings growth. Forecasting 5% earnings growth for the S&P 500 over the next 30 years versus the nearly 7% of the past 30 years appears reasonable.

Past Returns

Understanding the magnitude and composition of past returns helps in understanding the starting point and potential for future returns.

For the 30 year period ending December 31, 2016 the S&P 500's total return was 10.2% per year. The composition of this return is 6.9% per year from earnings growth, 2.3% per year from dividends and 1% per year from increasing P/E ratios. At the end of 2016 the P/E for the index stood at roughly 18 times trailing earnings, high by historical standards, but not at bubble levels given current interest rates.

For the 30 year period ending December 31, 2016 bonds, using the most widely quoted U.S. bond index, returned 6.6% per year. Interest rates declined dramatically during this period, causing bond prices to rise. For example, the yield on the 10-year U.S. Treasury fell from 7.1% on January 1, 1987 to 2.5% on December 31, 2016.

Current Valuations and Projections

Let's look at how the S&P 500 might perform over the next 30 years. We have already forecast earnings growth of 5% per year.

Current dividend yields on stocks approximates 2.0%, slightly lower than the past and likely to remain at roughly this level.

The bull market in both stocks and bonds has continued in 2017. The S&P 500 is up nearly 15% so far in 2017. This means the current P/E ratio on 2017's estimated earnings is over 19 times. This is well above historical averages. We believe that a slight negative contribution, say 0.4% per year, from changing P/E ratios is a good starting point for looking at the next 30 years. This still implies a P/E ratio 30 years hence of 17 times.

Adding the three components of stock returns we estimate future returns of 6.6% to 7.0 % depending on whether you use October 15, 2017 or December 31, 2016 as your starting point, respectively.

For bonds, interest rates are expected to slowly rise from current levels, but not to the back to the levels experienced in 30 years ago. As rates rise, prices decline, though the total return is expected to be positive. Most forecasts call for 30 year returns to be 3.5% to 4% per year, with the likelihood of lower returns in the early part of the period and higher returns in the late years.

Expected returns for both stocks and bonds are materially lower than past returns. Our projections are just that, projections. However, we do believe these projections requires individuals to review their goals and strategy to ensure they experience long-term financial success.

A future of lower returns will be challenging. We encourage individuals to accept this and plan accordingly. We can help.

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