PRIVATE ASSET MANAGEMENT, INC.

WEALTH STRATEGY ADVISORS

PARADIGM

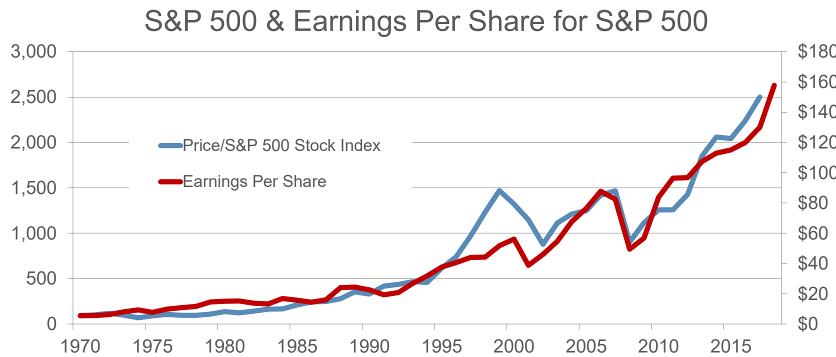
October 2018

The first part of our series focused on why interest rates will rise. This month, we focus on stock returns while including thoughts about current valuations and volatility. Next month, we will focus on increasing taxes. The final part of the series will focus on actionable items you control to achieve your financial goals.

Earnings Growth Will Fuel Stock Returns

The graph shows that over long time periods, the stock market is fueled by earnings growth.

Company earnings and stock prices move together



6 Source: Standard & Poor's

Data from the last 50 years shows that the price of the S&P 500 increased roughly 28-fold. Amazingly, earnings per share (EPS) increased virtually the same amount. Both figures represent an annual growth rate just shy of 7%.

We do not expect growth rates to be as high in the future. Demographics are changing, companies greatly expanded their foreign operations in the past 50 years, and our economy started from a much smaller base 50 years ago. All three factors suggest that future growth will be less. A reasonable estimate of future earnings growth is 5% annually.

Dividends and P/E Ratios Matter, Too

Over the past 50 years, dividend yields averaged roughly 3%, versus the current 2%, and changing P/E ratios had minimal effect on returns.

As a reminder, total return is a function of earnings growth, the average dividend yield, and changing P/E ratios. The data explains why the S&P 500 earned 9% to 10% per year over the past 50 years: annual earnings growth of nearly 7%, annual dividend yield of nearly 3%, and a very slight decline in the P/E ratio.

Combining future annual earnings growth (5%) with average dividend yield (2%) and no material effect from changing P/E ratios, **an expected future annual return of 7% appears reasonable.**

Current Valuations

Almost by definition, the market is fairly valued. This is because we are not expecting a material impact on future returns from changing P/E ratios.

Investors need to appreciate the material bump earnings received from the 2017 tax reform. This means that the market rise of the past 18 months has been fueled by earnings growth.

Current Volatility

Short-term volatility is best dealt with by accepting its presence and adhering to your established strategy.

Over a 20-year period, "current" could mean any time in 2018. Markets dropped over 10% in February and nearly that much recently. These drops can be mentally challenging due to short-term monetary losses. Also, the magnitude is material because markets can drop more in a few weeks' time than earnings can grow in a year. A 10% drop is nearly two years of 5% earnings growth.

Future stock returns are expected to be modest by historical standards. However, 7% per year need not derail your financial future. This is especially true if you do not let market volatility lead to poor decisions.

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