Quarterly Investment Update: *Four More Years!*[1]

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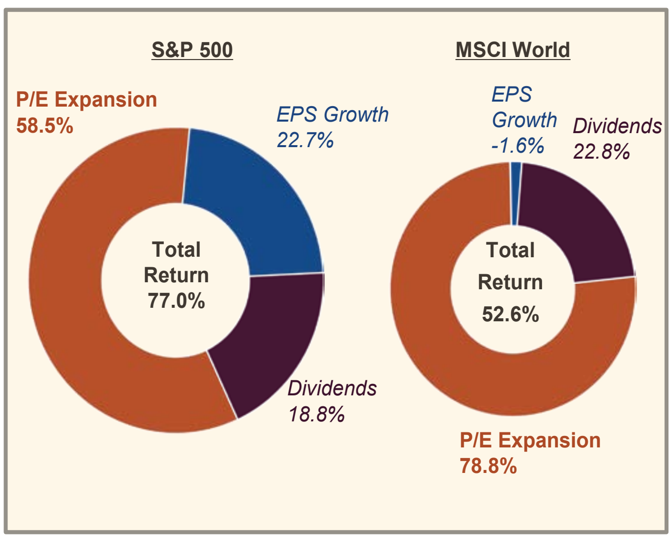
Are you better off than you were four years ago?[2] Equity investors certainly are. But that has little to do with the election cycle. The *peace and prosperity*[3] bestowed on shareholders is the result of a broad-based expansion of valuation multiples. But this *kinder, gentler*[4] market is unlikely to see a second term.

Equity returns from January 2012 through December 2015 can only be understood by examining the components of those returns — earnings, dividends, and P/E ratios. Figure 1 shows the four-year cumulative returns for the S&P 500 and the MSCI World Indices. The former rose 77%, while the latter gained nearly 53%.

FIGURE 1: CUMULATIVE CONTRIBUTION TO RETURN 2012 -2015



Source: Standard & Poor's; MSCI; Epoch Investment Partners; December 2015.

Look closely at the composition of returns for both indices. P/E expansion accounted for nearly 60% of the gain in the S&P 500 and almost 80% of the rise in the MSCI World Index! That is an amazing outcome considering earnings did not grow in the MSCI World Index.

Think of the contributions from the three drivers of returns this way (Table I):

TABLE 1: CONTRIBUTIONS FROM THE THREE DRIVERS OF RETURNS

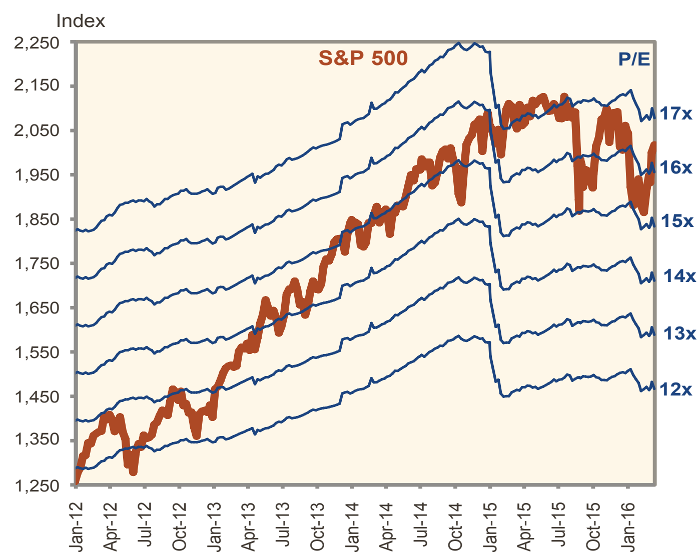
	S&P 500 (%)	MSCI World (%)
P/E Expansion	45.1	41.4
EPS Growth	17.4	(0.8)
Dividends	14.5	12.0
Total	**77.0**	**52.6**

If it were not for the earnings recovery in the U.S., imagine what the negative number for earnings in the MSCI World Index would be. No wonder the U.S. stock market was the place to be over the past four years.

Let us take a closer look at P/E expansion. In Figure 2, we show the P/E ratio for the S&P 500 based on the next twelve-month earnings forecast. The power of QE's effect on valuation metrics is highly visible. Forward earnings multiples on the S&P 500 rose from 12x in January of 2012 to 17x in the summer of 2015 before falling in Q3 as the Chinese stock market swooned and the earnings debacle about to befall the energy industry began to unfold. If we include the first quarter of 2016, the forward P/E on the S&P 500 recovered and approached its old high but remains below the peak touched in mid-2015.

The likelihood of four more years of P/E multiple expansion in the stock market of the magnitude we experienced over this period, well over 35%, is near zero in our estimation. It would require a P/E multiple increase of one-third from current levels to nearly 22x. While

FIGURE 2: S&P 500 NEXT TWELVE MONTHS EARNINGS MULTIPLES



Source: Standard & Poor's, Yardeni Research, Epoch Investment Partners; March 2016

1 Four more years!, Richard Nixon, 1972
2 Are you better off than you were four years ago?, Ronald Reagan, 1980
3 Peace and prosperity, Dwight Eisenhower, 1956
4 Kinder, gentler nation, George Bush, 1988

not impossible, that would be unlikely in a world characterized by low real growth and low interest rates.

QE is over in the U.S. and the U.K. and it has lost its influence on valuation measures in the euro zone and Japan, in our view. Recall also that China has accounted for 45% of global GDP growth over the past five years. China's growth rate, while still positive, will likely decline significantly from its recent past, lowering global growth expectations. So there will be no valuation help from these sources.

We expect a positive but low rate of return for equities over the next few years. Indeed, if we had to pick a number for the coming year it would be in the plus 5%-to-7% area and that assumes P/E multiples stay where they are. Our 5%-to-7% range reflects the sum of the current dividend yield of about 2% and an earnings growth rate assumption of 3% to 5%. The latter estimate assumes corporate profit margins hold steady and revenues rise at a rate equal to nominal GDP. With rising unit labor costs, the margin outlook could well prove optimistic.

Our number is well below the 9.8% average return for the S&P 500 over the last 85 years but is similar to the past if we consider "real" returns — equity returns after taking inflation into account. Inflation has averaged about 3% over most of the historical return periods whereas today it is barely over 1%. Nevertheless, real returns may still turn out to be lower than historical levels — somewhere between 4% and 6%. However, real returns of this magnitude would be absolutely terrific compared to bonds, which are likely to generate returns that are barely positive. (Indeed, six countries now have negative sovereign bond yields.)

The problem with our forecast (and that of any other forecast) is that it is often a single-point estimate within a wide range of possibilities. A better question is to ask the forecaster (including us) is this one: "what is the confidence interval surrounding your estimate?" That is, if I wanted the mid-point expected rate of return to fall within a range that captured 95% of the possibilities, what would that range be?

Let us define a confidence interval utilizing a statistical term: standard deviation. A two-standard-deviation range would encompass 95% of the possibilities. If we use the historical VIX number as the measure of the standard-deviation (about 17.5 percentage points), our forecast would be 5%–7% plus or minus 35 percentage points! This is not what investors want to hear, but it is the right perspective. If one wanted a range that encompassed only two-thirds of the possibilities, it would be 5%–7% plus or minus 17 percentage points.

What this framework highlights is the interaction of two elements — the mean return expectation and the range of outcomes. It also introduces a third element, that of the "holding period." It cannot be a short-term one. Indeed, a minimum holding period for equity ownership needs to be in the three-to-five year range. It is the only way one can capture the compounding effect generated by the average return to offset the annual volatility inherent in equities and reflected in our range of return outcome possibilities.

To summarize, we doubt the outsized absolute returns of the past four years will be repeated. The broad-based expansion of valuations, which lifted profitable and unprofitable companies alike, is in the past. The quantitative easing that fueled the expansion is finished in the U.S. and U.K., at least for the moment. And while the euro zone and Japan may continue to pursue highly accommodative monetary policies, their influence on equity valuations has waned.

Equities, however, should have positive real returns that are substantially better than bonds as long as the global economy does not slide from its current low-inflation state to outright deflation. We expect single-digit equity returns, most of which will be "real" returns (after inflation) accompanied by volatility measures similar to the past. These returns will be driven more by events in the real economy rather than monetary policy actions.

This should be an environment where active managers focused on company fundamentals stage a comeback. Operating cash flow, the parent of earnings and dividends, will dominate the sources of equity returns going forward. With this *return to normalcy,*[5] free-cash-flow growth will determine the equity winners, not higher valuation metrics.

That might fall short of putting *a chicken in every pot,*[6] but it's *not just peanuts.*[7]

5 A return to normalcy, Warren G. Harding, 1920
6 A chicken in every pot and a car in every garage, Herbert Hoover, 1928
7 Not just peanuts, Jimmy Carter, 1976