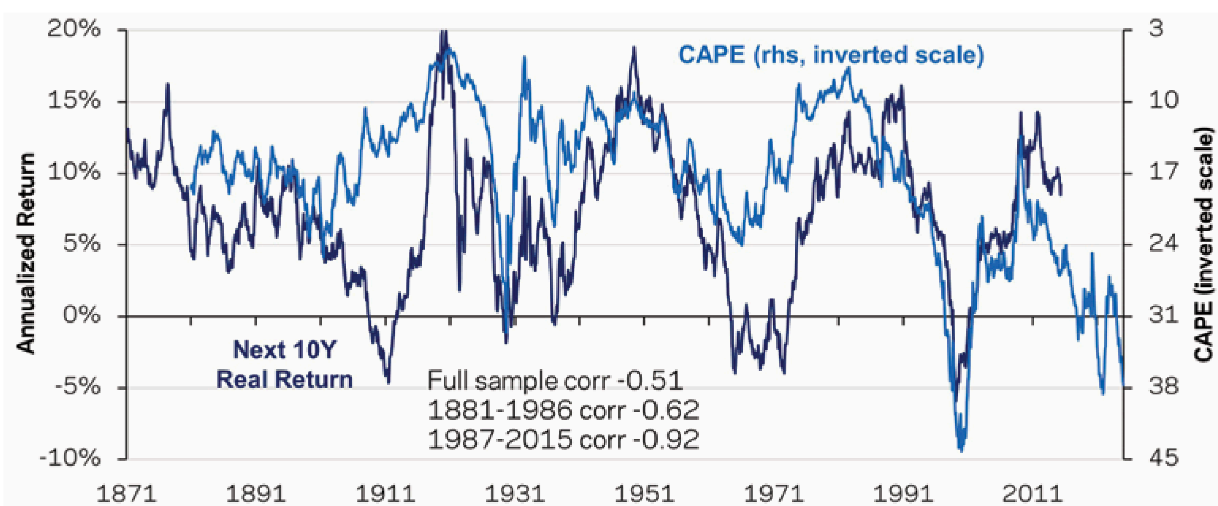
A Decade of Low Returns

If history is a guide, we are at significant risk of low market returns over the next decade.

AQR, a $100 billion asset manager well-regarded for its quantitative research, recently published a paper showing the relationship between market valuations and future returns.

While not perfect, the *Cyclically Adjusted P/E (CAPE)* ratio provides a decent guide for future market returns.

Exhibit 3. CAPE Imperfectly Predicts Next 10-Year Market Return



Source: Professor Shiller's website and AQR. Return and CAPE are for S&P 500.

As *AQR* points out, the period between 1990 and 2010 was highly accurate in predicting future 10-year returns (see how tight the dark blue and light blue lines are?).

Short-term projections are less impressive. That makes sense to me, as anything can happen in the short term. But, over more extended periods of time, economic reality sets in.CAPE is in its cheapest quintile, with a 10-year forward return of 11% compounded annually.

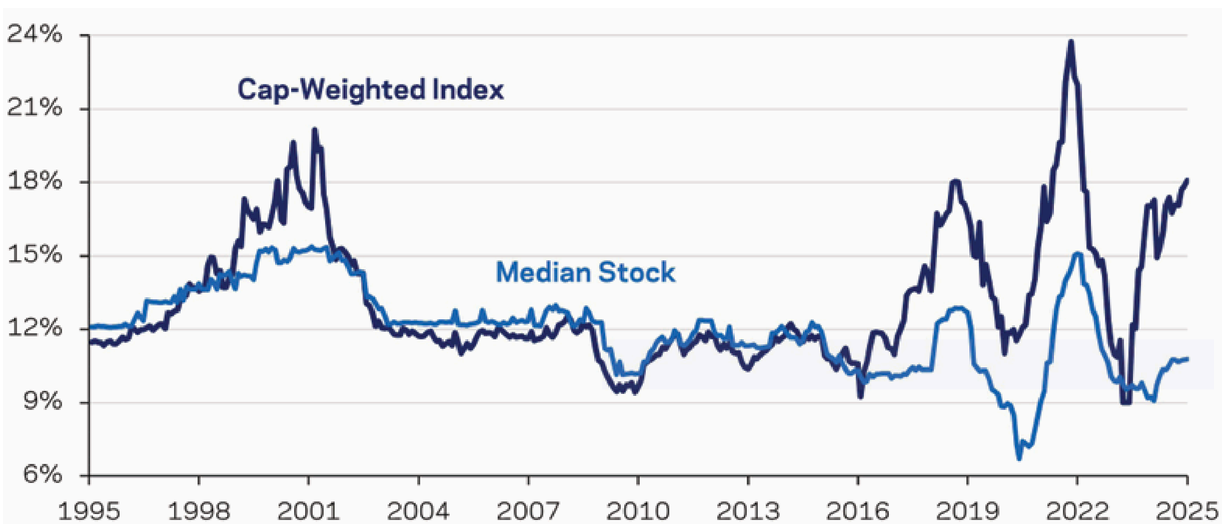
Conversely, the richest quintile yields just 3% annual returns. Unfortunately, that's where we reside. As I've noted in the past, we are in the nosebleed section when it comes to valuations.

The U.S. also has the highest CAPE ratio of any major market in the world.

One of the more interesting charts in the report came at the end of the appendix.

As the chart below shows, there's a massive spread between the 3-5 year EPS growth of the mega-cap companies and the median stock.

Exhibit A2. Mega-Optimism: Analysts' Long-Term Earnings Growth Forecast for US Cap-Weighted Market and the Median Stock
Jan 1, 1995 - Dec 31, 2024



Source: IBES. Chart shows equity analysts' long-term (3-5 year) EPS growth forecast for stocks in the Russell 1000..

As I have pointed out, the market's surge has been driven by mega-caps. Only a handful of stocks account for nearly 50% of the index weight. If (when?) these companies disappoint, the market-cap-weighted S&P 500 is vulnerable.

I am starting to see activity related to late-cycle shenanigans. Companies like Nvidia are financing customers, and it looks iffy that those "investments" may come back as revenue.

There are also companies such as Strategy (MSTR) that essentially have no business model other than Bitcoin accumulation, resulting in paltry revenue growth, incredible leverage, and massive dilution to keep the game going.

It's not what you want to see!

For now, I continue to wait for my next opportunity to pounce. We are nowhere near that point.

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