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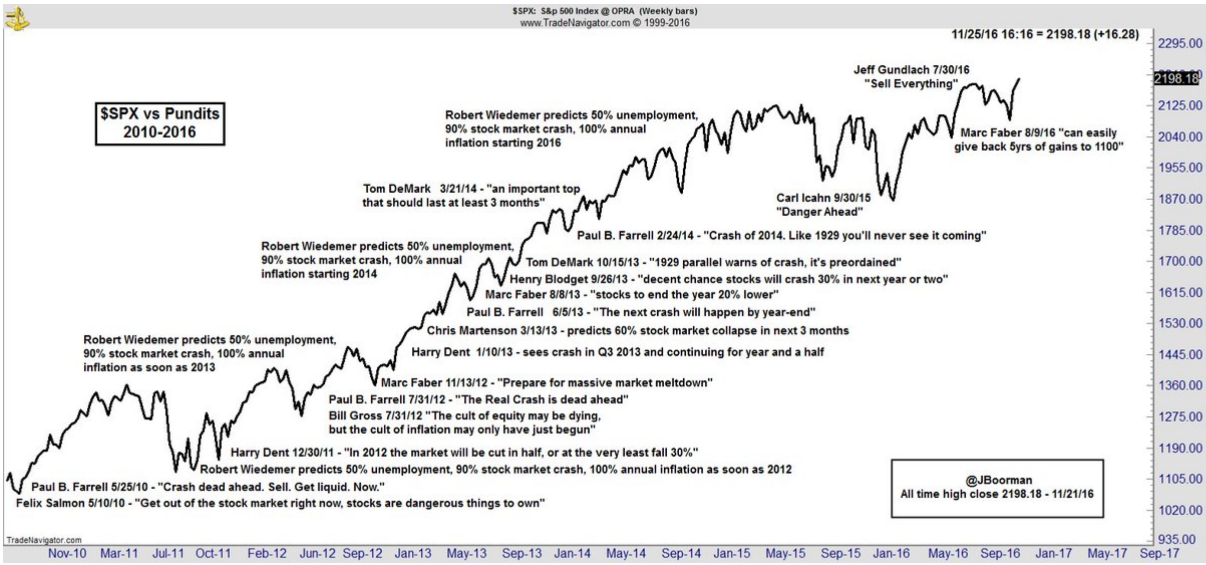
The Wall

"The fact that there's a highway to hell and only a stairway to heaven says a lot about anticipated traffic numbers."

- Bill Murray.

The most expensive wall in the world isn't the one being considered by Donald Trump across the Mexican border. Rather, it's the Wall of Worry that investors are climbing in the US stock market. Trend follower Jon Boorman has compiled the following chart of the S&P 500 stock index versus pundits over the last seven years, which will likely dissuade many aspiring talking heads from flapping their lips on CNBC in the future:

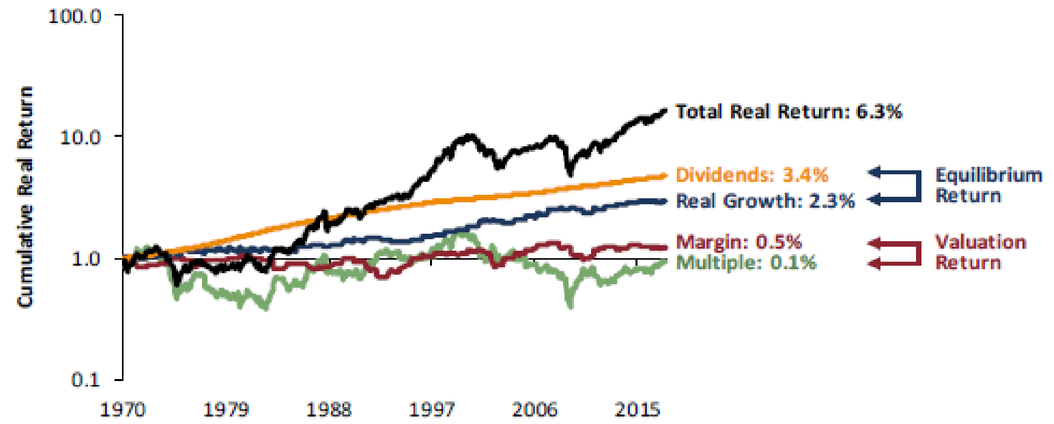


Assigning one reason (super-accommodating monetary policy) or even several reasons (QE, ZIRP and continually swelling ETFs) for the rally makes for an intriguing parlour game, but it doesn't change the fundamental problem: US stocks are already expensive by historical norms, and yet the rally could still last another seven years, or it could end tomorrow.

One reason for inclining towards scepticism about the likely duration of the rally came at this year's Jackson Hole gathering of the hubristic. "Look at their works, ye mighty, and despair !" Messrs Yellen and Draghi, against expectations, said precisely nothing about the future direction of monetary policy rates. This could be because Messrs Yellen and Draghi have painted themselves into a corner. They can't realistically cut rates any further, and indeed the Fed has already started to make baby steps in the direction of some kind of what Ray Dalio called a "beautiful normalisation" of interest rate policy. But neither can they raise rates dramatically, not least because it would trigger a collapse in the property (and bond, and stock) prices that they've just spent the last decade desperately reflating. The pragmatic expectation, then, is that interest rates are likely to spend some time at close to zero – at least as far as central banks are capable of successfully suppressing them there.

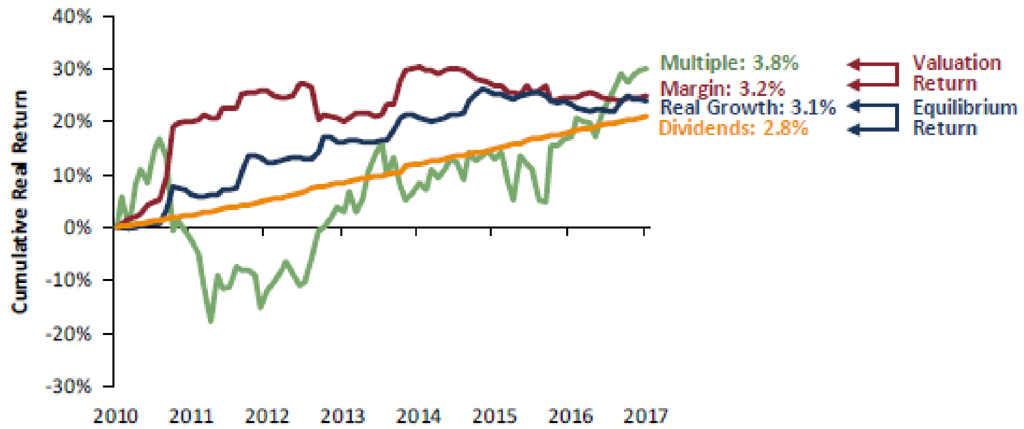
We now know that in a world of zero interest rates, and no shortage of other forms of government market intervention, the prices of financial assets, including stocks, get bid up to giddy multiples. In their recent white paper The S&P 500: Just Say No, GMO's Matt Kadnar and James Montier crunch the numbers for the US stock market over two periods, 1970-2017 and 2010-2017. The results are shown below.

Exhibit 1: S&P 500 Return Decomposition



As of 6/30/17
Source: GMO, Worldscope, Compustat, MSCI
Note: The "Multiple" driver includes a rebalancing effect (essentially the impact of more expensive companies entering the index and cheaper companies exiting).

Exhibit 2: S&P 500 Return Decomposition—Total Real Return of 13.6% for the Last 7 Years



As of 6/30/17
Source: GMO, Worldscope, Compustat, MSCI
Note: The "Multiple" driver includes a rebalancing effect (essentially the impact of more expensive companies entering the index and cheaper companies exiting).

In the long first period, the market's annualised real return was 6.3% - like its very long run average over 200 years.

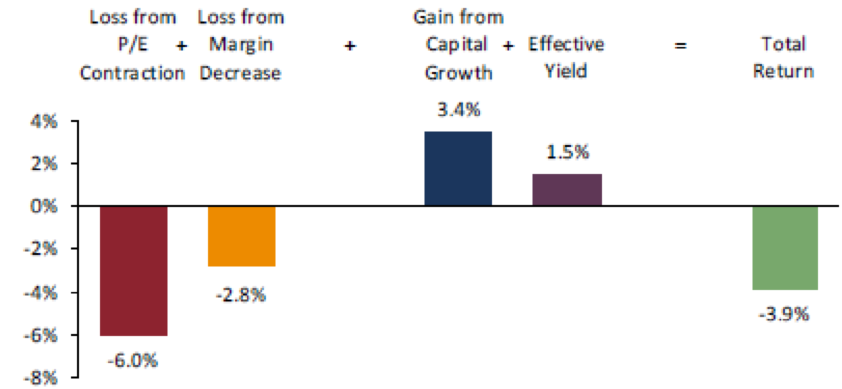
In the second shorter period, 2010-2017, the market's annualised real return was dramatically higher, amounting to 13.6%.

The trillion dollar question posed by GMO's Jeremy Grantham is: has reversion to the mean ended for some reason ? We think not, but we acknowledge that the one special factor that has surely helped drive market returns between 2010 and 2017 is the most aggressive monetary stimulus in history. So if you think that QE and ZIRP can last or even accelerate over the next seven years, it makes sense to keep climbing that wall. Messrs Kadnar and Montier simply do the maths, and issue their own forecast of likely market returns, after inflation, over the next seven years: an annualised loss of 3.9% for the S&P 500. Try and contain your enthusiasm.

Exhibit 3: S&P 500 - Building a 7-Year Forecast

	Valuation	
	P/E	Margin
Normal	16.0	5.7%
Current	24.4	6.9%

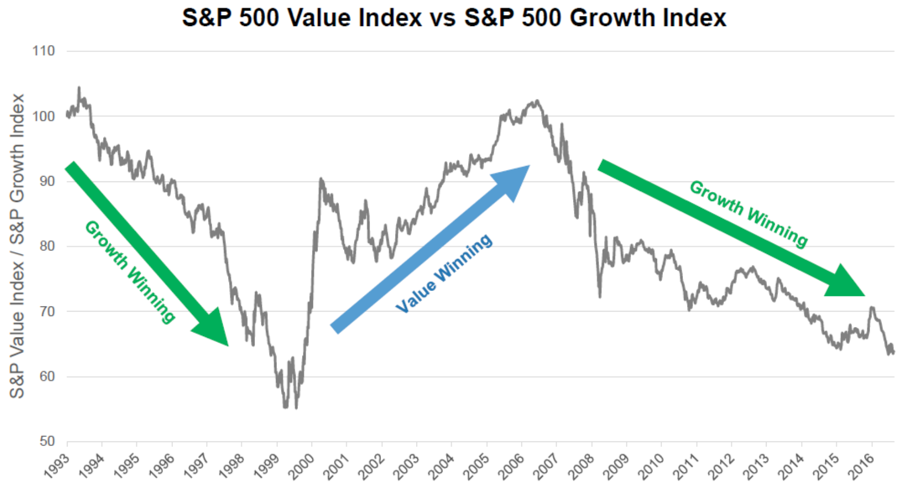
	Growth and Income	
	Capital Growth	Effective Yield*
Normal	2.9%	2.9%
Valuation Adjustment	0.6%	-1.3%



As of 6/30/17
Source: GMO
*Effective yield represents total payout including cash dividends and share buybacks. Current cash dividend yield for the S&P 500 is 2.0%.
Note: The chart represents a real return forecast for the above-named asset class and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from the forecasts above.

We mention US stock market valuations not because we have any meaningful exposure to US stocks – quite the opposite – but rather because we simply acknowledge the US stock market's primacy as the largest in the world by capitalisation.

What is clear is that ‘growth’ strategies, at least in the US, have outperformed ‘value’ strategies for the last decade or so:



Source: FactSet, Arbrook Investors July 2017

But there are two big caveats. One is that we still believe in reversion to the mean, so in this regard the duration of the outperformance by ‘growth’ could amount to a significant buying opportunity for ‘value’. The second is that these terms may be less meaningful than they sound. The Dow Jones stalwart General Electric, for example, is a component in 177 ETFs, including Vanguard S&P 500 Value; iShares S&P 500 Value and SPDR S&P 500 Value. GE also happens to be a component of Vanguard S&P 500 Growth; iShares S&P 500 Growth, and SPDR S&P 500 Growth. How to explain this apparent magic ? Either General Electric shares have mastered the physics of quantum superpositioning. Or venal ETF providers are perfectly happy to launch all kinds of product to their quacking duck customers, style drift and investment consistency be damned.

We don’t spend too much time worrying about US market overvaluation when we can find perfectly investible and sensibly priced companies in listed markets elsewhere. (Primarily throughout Asia, since you ask.) And there is something rather wonderful about finding highly profitable and cash generative companies in economies set to grow faster than the US and Europe while their shares simultaneously trade on far lowlier valuations. It’s almost as if the Efficient Market Hypothesis that underpins continued ETF buying of the US stock market was actually nonsense. Expensive nonsense. As expensive as climbing that wall.

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Important Information

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