What's the Forecast for Stocks this Year?

SYNOPSIS

- The New Year is the time when Wall Street strategists attempt to answer the number one question on the minds of investors.
- Markets move on events, not calendars, and equities are far too volatile to conduct an annual forecast with any level of statistical accuracy over such a short time horizon.
- Annual predictions for the stock market are almost always wrong, and the ones who get it right are nothing more than lucky.

EVERYONE WANTS TO KNOW

The New Year is that special time when the media and investors anxiously await to hear predictions on how the stock market will perform this year.

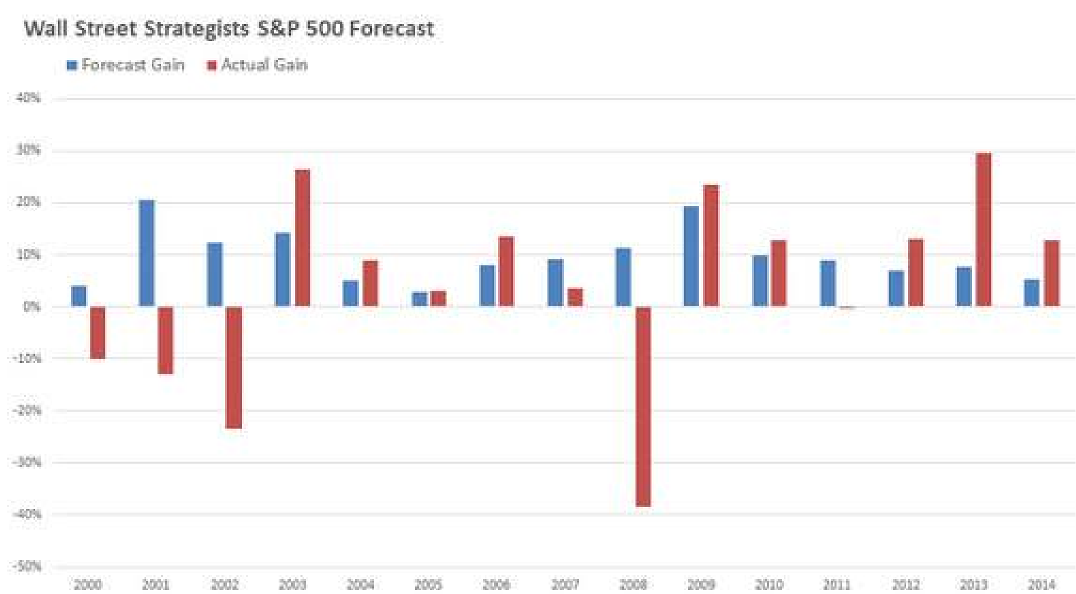
This desire is certainly understood given the events that have transpired over the last decade, and investors want to know that they are with a manager who is good at predicting annual returns because it feels safe to be invested with someone who has a "feel for the market."

Investors also tend to purchase more stocks in January than other months of the year, so buyers want to know if now is a good time to get in the market. If predictions are less than sanguine, then investors may choose to wait for a better entry point.

Using logic and reasoning to predict the mood of investors a year from now is akin to using antibiotics to cure a viral infection.

According to the Wall Street Journal, a group of 15 strategists expect the S&P 500, on average, to finish the year at 2356, which is a gain of right around 5% from the end of 2016. Given the long run average of the stock market is close to twice this amount, one may assume that 2017 is shaping up to be less than stellar.

Before we jump to conclusions, take a long look at the chart below:



Source: S&P Capital IQ.

This chart compares the average forecast at the beginning of the year for the S&P 500 (blue bar) to the actual gain at year end (red bar). On average, the forecast was off by close to 15% per year, which is a huge margin of error.

There are over 20 "chief market strategists" at Wall Street's biggest and most prestigious firms. They have access to the best information, carry PhDs from top universities, work so many hours that they no longer remember their kids' names, and are paid millions every year.

Yet they are clearly terrible when it comes to what is arguably the most important function of their job, which is forecasting annual returns. How could this be possible, and why do so many investors continue to rely on these abysmal predictions?

NOTE: Go back to the chart above and try to find a year where strategists collectively forecasted a down year. Could it be that Wall Street firms who make money when customers buy stocks are slightly biased to convince people to buy more stocks?

A COMMON MISCONCEPTION

Putting my conspiracy theory on the eternal optimism of Wall Street aside for a moment, I believe the answer to the questions above lies in a common misconception that investing operates similarly to engineering and other scientific disciplines.

I obtained undergraduate degrees in electrical engineering and mathematics, and I remember my classes to be very structured and precise for a reason. As long as I accurately calculated all inputs to a circuit, I was sure to know the output ahead of time via a few complex mathematical formulas. Follow the steps and obey the laws of science, and prediction is possible.

Unfortunately, financial markets are not run on Newtonian physics or any other predictable force. Think back to some of the events that rocked equity markets in 2016. It's implausible to assume that any investor could have accurately predicted that the S&P 500 would fall over 6% the first week but then end the year up double digits.

The fundamentals that grow our economy and the companies within do not move quick enough to warrant such volatility, so there must be something else driving these short-term swings. That something is the emotional component of markets, and no scientific process can forecast emotions.

Fear and greed are incredibly powerful and unpredictable forces that create dislocations in equity prices that often take months to normalize, and this can wreak havoc on short-term estimates. These strategists may as well publish quarterly, monthly, or even daily forecasts because they are just as arbitrary as a single year.

The reality of their job is that they are being paid to do the impossible armed with a toolkit that is completely ineffective. Using logic and reasoning to predict the mood of investors a year from now is akin to using antibiotics to cure a viral infection.

Therefore, my prediction for 2017 is the same as it is every year. I have absolutely no idea how the stock market will perform this year, and I proclaim this forecast with the utmost pride and confidence.

IMPLICATIONS FOR INVESTORS

John C. Bogle is the founder and former CEO of Vanguard, and this visionary published the instant classic, "The Little Book of Common Sense Investing" back in 2007. In it, he wrote what could be one of the most powerful quotes in the history of financial markets:

> "The stock market is a giant distraction to the business of investing."

To any long-term investor, these words should be gospel because the way to achieve your investment goals is to manage risk rather than take too much risk.

Within this context, if emotions dominate the short-term movements in stock prices, and emotions are viruses to portfolios, then relying on annual stock market forecasts only adds unnecessary risk to the investment process.

There is simply no upside because forecasters are either lucky or wrong, and luck only lasts for so long.

Fundamentals are what drive the long-term returns in financial markets, so here are a few predictions that I believe will impact far more than just stock prices (properly diversified investors need to consider all asset classes):

- The returns in stocks and bonds will be lower than historical averages because world economic growth is slower today than in prior decades.
- Cash will continue to lose money safely because the returns on bank CDs and money market funds will not exceed inflation for many years to come.
- The U.S. economy will continue to benefit from the same entrepreneurism and innovation that is changing our lives on a near daily basis.
- Generating income from investments is still very possible, but it will become more difficult and will require investors to be even more patient.
- Gold will continue to generate no sales, earnings, or cash flow. Nor will it pay dividends or buy back any shares. In short, it will remain to be nothing more than a shiny pet rock.
- Interest rates will rise very slowly, which makes investing in fixed income far more challenging than over the last 35 years.
- The risk of a recession in the U.S. remains low.

This list looks nearly identical to my list from last year because the drivers of fundamentals tend to move at a glacial pace. More importantly, markets do not operate on calendars, where the New Year commands a new set of forecasts (unless one's job is to provide continual market commentary). Instead, they are event-driven, and despite a new President, all-time highs in the S&P 500, and the Cubs pulling it off, the fundamentals have not changed much.

Add it all up and even though I may not know where the year will end for the S&P 500, I do believe that those who are comfortable owning a diversified portfolio of stocks should do so but for far more than just a single year. This bull market is being fueled by fundamentals that are showing no sign of slowing down anytime soon.

The bottom line is that predicting annual returns from an asset class as emotionally sensitive as equities on a consistent basis is impossible, but since a year tells a long-term investor very little about the future of investment returns, it's best to ignore these predictions anyway.

Sincerely,

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