Why we're in the early innings of a secular bull market

The S&P 500 could hit 10,000 by the mid-2030s

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IN BRIEF

- Stocks are widely viewed as expensive and over-owned. According to the current consensus, the market has had extremely strong returns and, as a result, future returns will be disappointing. We firmly reject that perspective.
- We believe that a new secular bull market for equities began in February 2016. Our analysis finds that annualized total returns should average in the double digits until 2033–2035.
- The historical pattern of equity returns, the relative valuation of equities to other assets, the pessimism reflected by the lack of flows into equities, and demographic and productivity tailwinds all argue for above-average equity returns.
- The S&P 500 could approach or exceed the 10,000 level by the early to mid-2030s.

Many investors take it as a given that—since returns on the S&P 500 have been strong for 10-plus years—stocks are expensive and over-owned. The demographic headwind from the aging of the baby boomers is widely viewed as another impediment to equity returns.

But conventional wisdom is often wrong, and we think this is one of those times. Here we make a contrarian argument: A secular bull market for equities began in February 2016. We believe that annualized total returns should average in the double digits until 2033-2035. The S&P 500 could hit 10,000 by the mid-2030s.

In the following pages we present our analysis, which draws on four key observations:

- The historical pattern of market returns suggests strong future returns.
- Equity valuation is attractive relative to other assets.
- A sustained period of weak equity inflows suggests high levels of investor pessimism, a bullish signal.
- Demographic trends in the labor force—mostly notably the rising ratio of middle aged (35- to 49-year-old) to young (20- to 34-year-old)—will be a tailwind for equities until the mid-2030s.

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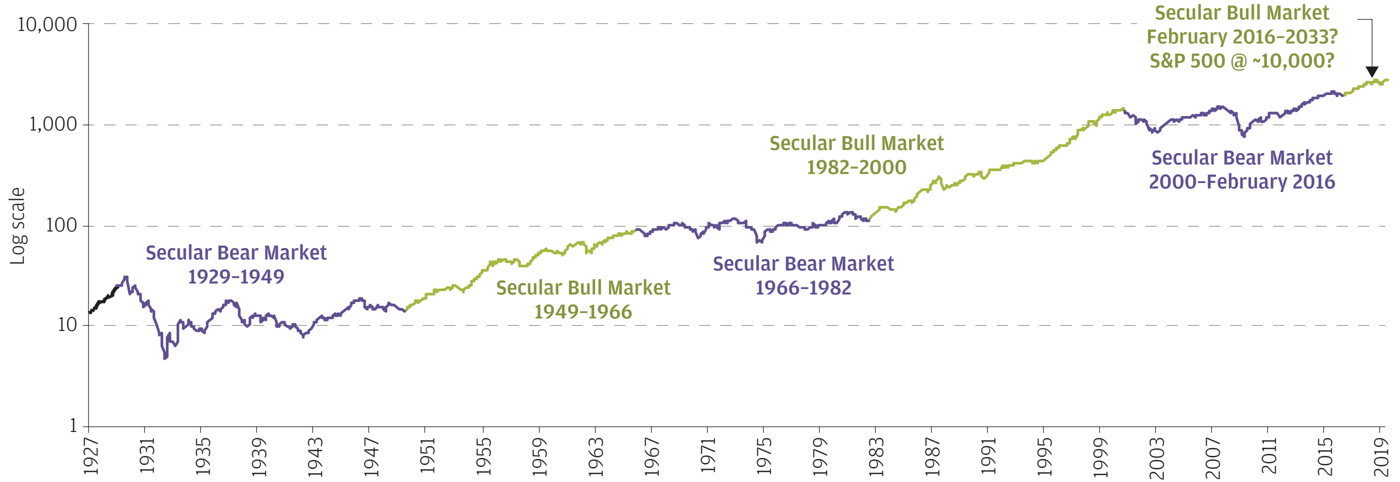
EXHIBIT 1: S&P 500 INDEX, LOGARITHMIC SCALE, 1927–JUNE 2019



Source: Robert Shiller, FactSet. Data shown in log scale to best illustrate long-term index patterns. *The performance quoted is past performance and is not a guarantee of future results.*

HISTORICAL PATTERN OF MARKET RETURNS

The S&P 500 has shown a pattern of alternating between SECULAR BULL MARKETS (a prolonged period of above-average total returns where drawdowns are relatively shallow and recoveries from pullbacks are relatively rapid) and SECULAR BEAR MARKETS (a prolonged period of below-average total returns where drawdowns are relatively severe and recoveries from pullbacks can take a long time). The current consensus is that the market has had extremely strong returns and, as a result, future returns will be disappointing. History indicates just the opposite as illustrated in **EXHIBITS 1** and **2**.

EXHIBIT 1 illustrates the level of the S&P 500 on a log scale from 1927-present categorized into secular bear markets, when the market made little to no progress for 16-20 years, and into secular bull markets when the market went up on the order of 1000% or more in price over roughly 17 years. Returns during the 1929–1949 secular bear market were impaired by the Great Depression and World War II. During the 1966–1982 secular bear market, returns were depressed by the Nifty Fifty Crash, the Energy Crisis and stagflation. We put forth that March 2000 through February 2016 was another secular bear market with the S&P 500 gaining ~1% per annum during that 16-year

EXHIBIT 2: ANNUALIZED S&P 500 20-YEAR TOTAL RETURNS, 1927 THROUGH JUNE 2019

Source: Ibbotson, Empirical Research Partners Analysis, J.P. Morgan Asset Management, Bloomberg L.P. as of June 30, 2019. *The performance quoted is past performance and is not a guarantee of future results.*

stretch. Returns during this period were dampened by the bursting of the Tech Bubble, the Great Financial Crisis, and a series of European Sovereign Debt Crises.

We assert that a new secular bull market started in February 2016. If this secular bull market is similar in duration and magnitude to the prior two secular bull markets, annualized total returns should average in the double digits until 2033–2035 and the S&P should approach or exceed the 10,000 level.

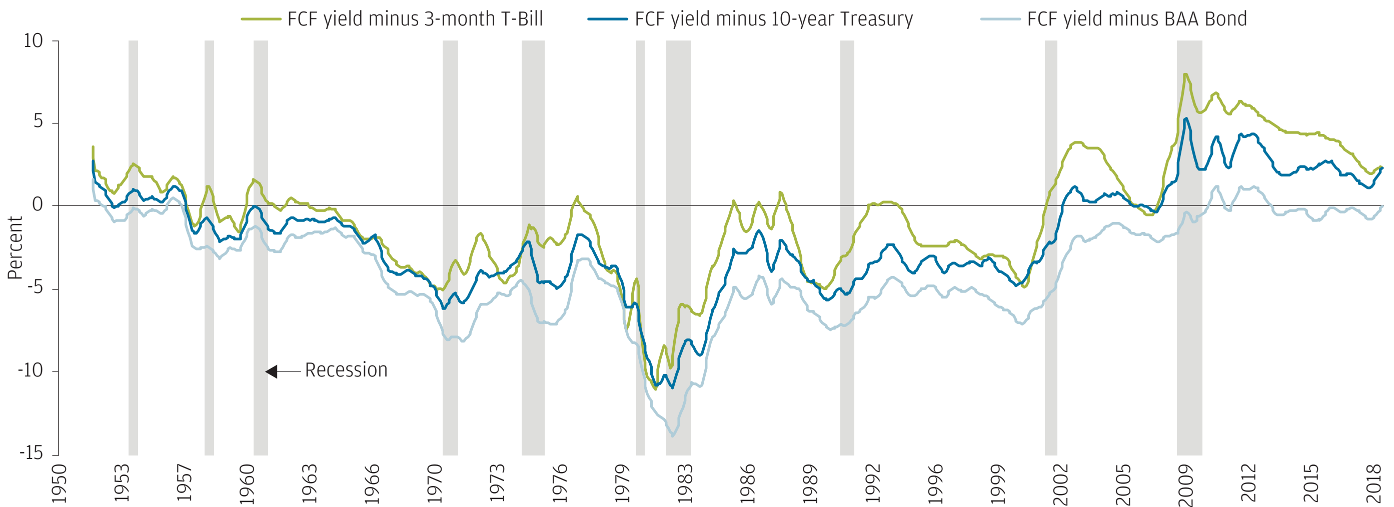
EXHIBIT 2 tells a similar story in a different way. This chart illustrates the rolling 20-year total returns for the S&P 500. We use total returns to account for changes in dividend policy and 20-year rolling periods because they most closely mimic the length of secular bull and bear markets. While most investors believe that it has been a very strong environment for stocks, this chart presents a different perspective. Over the most recent 20-year period, the S&P 500 total return of 5.9% ranks in the bottom 5% of observations going back to 1947. The only periods with similar trailing 20-year total returns (late 1940s and early 1980s) occurred during the early stages of the previous two secular bull markets, and were followed by 10+ years of double-digit returns.

RELATIVE VALUATION OF EQUITIES

A truism of financial markets is that capital goes where it is treated best. We are primarily interested in comparing stocks, bonds and cash (the three biggest and most liquid pools of assets). With central banks around the world pushing yields on short-term instruments down to very low or even negative rates, returns on cash are near the bottom-end of historical levels and are quite low relative to the free cash flow yields available from stocks (**EXHIBIT 3**).

The relative free cash flow yield of stocks to both government and corporate bonds is even more pronounced in the context of history. In particular, the free cash flow yield of stocks relative to BAA bonds is the most revealing. Investors are willing to accept the same free cash flow yield on corporate bonds as on equities—a situation that has existed only 6% of the time over the past 66 years. These time periods (the early 1950s and since the Great Financial Crisis of 2009) have led to very strong equity returns. We expect history to repeat itself and the high level of fear implied by this spread will normalize as a result of above-average returns in equities.

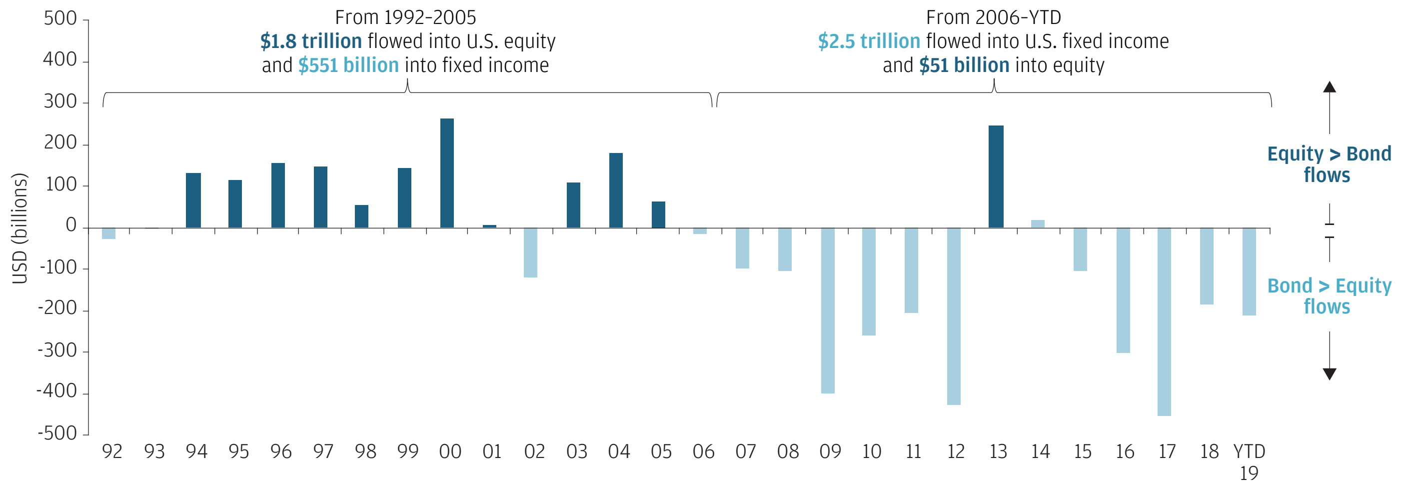
EXHIBIT 3: EQUITY FCF YIELD VS. 3-MONTH T-BILL, 10-YEAR TREASURY AND BAA BOND YIELDS* (SMOOTHED ON A TRAILING 6-MONTH BASIS)



Source: Federal Reserve Board, Corporate Reports, Empirical Research Partners Analysis.

*Large-capitalization stocks excludes financial and utilities; capitalization-weighted data smoothed on a trailing six-month basis. Data as of June 2019.

EXHIBIT 4: ANNUAL SPREAD OF U.S. EQUITY NET FLOWS AND FIXED INCOME NET FLOWS



Source: Strategic Insight, Empirical Research Partners Analysis, Data as of May 2019.

WEAK EQUITY FLOWS IMPLY OPPORTUNITY

Investment trends that last for a prolonged period often create new dogma. Investors have seemingly come to believe that bonds offer competitive returns relative to stocks with lower volatility. Presumably acting upon this view, investors have voted with their wallets as flows into bonds have outpaced flows into equities by a wide margin since the mid-2000s (**EXHIBIT 4**). Of course, the accepted dogma was different from 1992–2005. By the mid- to late-1990s, the accepted wisdom was that equity returns would dominate bond returns. This led to equity flows that were three times greater than bond flows during that period, with the peak in equity flows coinciding with the top of the secular bull market in 2000. Whether the current pessimism regarding stocks is warranted or not will only be revealed in the fullness of time. However, if history is a guide, it is better to buy an asset class after a sustained period of low inflows rather than after a prolonged period of massive inflows.

DO DEMOGRAPHICS POSE A HEADWIND TO EQUITIES?

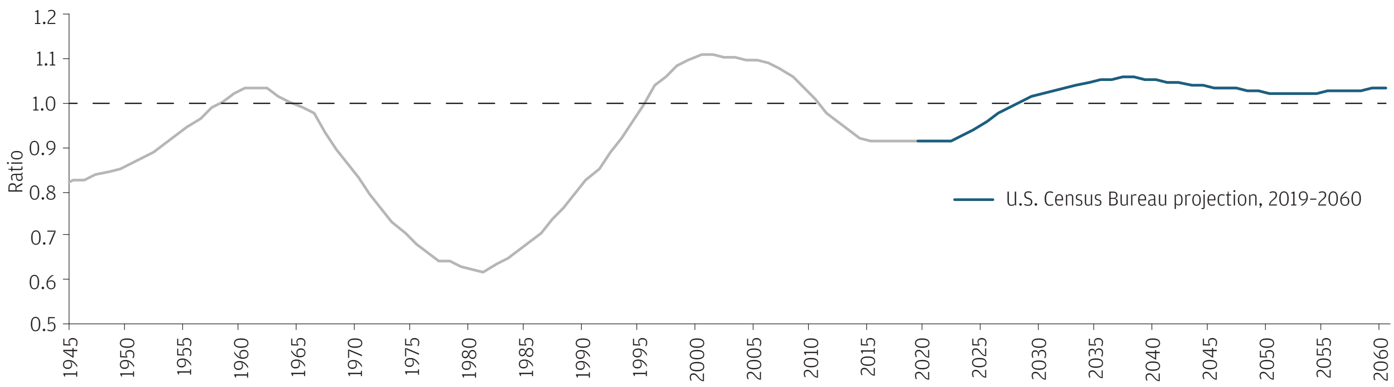
There is a widespread belief that as more baby boomers reach retirement age, demographics present a headwind for equity performance. As with the other widely accepted views discussed in this paper, we disagree with the consensus. Data suggest that rather than being a headwind, demographic trends may be quite supportive of equity returns. According to a research paper by the Brookings Institute,[1] there has been a strong correlation of above-average equity returns when the ratio of 35–49 year olds is increasing relative to 20–34 year olds (the "middle-young" or MY Ratio) and below-average equity returns when the MY Ratio (**EXHIBIT 5**) is decreasing. The MY Ratio has only recently started to rise and is set to continue rising until the mid-2030s.

The main premise in the Brookings paper is that middle-aged people have a somewhat inelastic demand for equities given their need to save for various long-term goals. The variation in birth rates related to the baby-boom following World War II, the baby-bust of the 1970s, and the birth of millennials is viewed as an explanatory cause for the variation of stock market cycles (the secular bull and bear markets, which we described earlier). The increase in demand for equities due to demographic trends combined with the reduced supply of equities (high level of buybacks and modest level of stock issuance) could lead to an even more pronounced boost in equity prices in this cycle.

The paper also suggests that 35–49 year olds are more productive than other cohorts in the working population. This assessment makes intuitive sense as 35–49 year olds are likely to have finished their training and gained relevant experience in their chosen professions. The potential for higher-than-anticipated productivity is supported by two additional factors.

[1] Brookings Papers on Economic Activity, 1:2004 "Demography and the Long Run Predictability of the Stock Market" by Geanakoplos, Magill & Quinzii, United States Census Bureau, J.P. Morgan Asset Management.

EXHIBIT 5: MIDDLE-YOUNG RATIO OF U.S. POPULATION AGED 35–49 VS. 20–34



Source: Brookings Papers on Economic Activity, 1:2004 "Demography and the Long Run Predictability of the Stock Market" by Geanakoplos, Magill & Quinzii, United States Census Bureau, J.P. Morgan Asset Management.

Given the low level of unemployment in the U.S., it will be uneconomic for corporations to increase output by hiring relatively scarce and expensive employees. Instead, they have a strong incentive to boost productivity by increasing capital expenditures. Second, several trends in technology (industrial automation, artificial intelligence, self-driving vehicles, democratization of software, genetic sequencing, etc.) have achieved sufficient scale and are set to modestly boost productivity in the medium-term.

Demographic trends support a greater demand for equities through 2035. These demographic patterns along with greater capital investment and technological innovations support the case for stronger productivity growth. The combination of greater demand for equities, higher productivity, and low net equity issuance creates a positive backdrop for equities.

CONCLUSION

The pervasive belief in markets appears to be that equities are relegated to below-average returns for a litany of reasons. These reasons do not stand up to scrutiny. The historical pattern of equity returns, the relative valuation of equities to other assets, the pessimism reflected by the lack of flows into equities, and the demographic and productivity tailwinds argue for above-average equity returns. Taken together, there is a strong case to be made for approaching or exceeding the 10,000 level on the S&P 500 by the early-to-mid 2030s.

Frequently asked questions

Are you implying that the market will go up continuously from now until the early-to-mid 2030s?

The answer is a definitive "No!" It is important to highlight that secular bull markets encompass cyclical bear markets while secular bear markets will have cyclical bull markets. We define cyclical bull and bear markets as upward or downward price movements which are much shorter in duration than secular bull and bear markets. A secular bull or bear market is comprised of a series of cyclical bull and bear markets.

The market will not move monotonically up or down for 16–20 years. The secular bull market from 1949–1966 occurred despite three recessions, the Korean War, the Cuban Missile Crisis and the assassination of President Kennedy. The secular bull market of 1982–2000 occurred despite the 1987 crash, the Savings and Loan crisis, the First Gulf War, the Asian Financial Crisis, the Russian Debt Crisis and the implosion of the Japanese stock market in the 1990s. We fully expect market downturns and negative geopolitical events to transpire during the remainder of the current secular bull market. We expect that these drawdowns will be made up for quickly and will present excellent buying opportunities.

After a 10-year bull market, aren't we due for a bear market?

There is a widely held view that the S&P 500 has been in a bull market for 10+ years and, as a result, investors should be cautiously positioned and wait for the "overdue" bear market

before increasing equity exposure. The claim that the S&P 500 has not entered into an "official bear market" (S&P 500 closing 20% below a prior close) since March 2009 is technically true. However, during the past 10 years, there have been three severe corrections, which bottomed in October 2011, February 2016 and December 2018. These three periods were bear markets in all but name. In fact, in October 2011 and December 2018, the intraday peak-to-trough losses on the S&P 500 exceeded 20% (though the peak close to trough close was less than 20%). We believe that these severe corrections during the past 10 years have effectively functioned as bear markets in re-setting fear levels among investors. We argue that the evidence suggests this cyclical bull market started in December 2018 rather than in March 2009.

Are you implying that 10,000 is fair value for the S&P 500 by the early-to-mid 2030s?

Again, the answer is a definitive "No!" This paper lays out a framework for identifying a plausible path for the S&P 500 based on historical parallels. This approach is focused on trying to identify what the market is likely to do rather than what it "ought" to do. If this framework plays out as detailed and the S&P 500 reaches 10,000 by the early-to-mid 2030s, the implications for future returns at that time will be bleak. In other words, if this paper is accurate in describing market returns, the S&P 500 is likely to have below-average total returns for the period from the mid-2030s until 2050 or so.

Aren't we "due" for a recession that will precipitate a terrible bear market?

This paper has focused on market cycles as opposed to economic cycles. We are not making claims about the economic cycle or when the next recession will occur. However, we believe that market participants have been scarred by the Tech Crash and the Great Financial Crisis and are anchored into thinking that recessions necessarily result in 50% plus drawdowns. The two most recent recessions and the magnitude of loss in the accompanying bear markets are the exception, not the rule. In the secular bull market from 1949–1966, there were three recessions, and in the secular bull market from 1982–2000, there was one recession. The average market decline for these four recessions was 17.3% with the greatest decline being 20.6%.

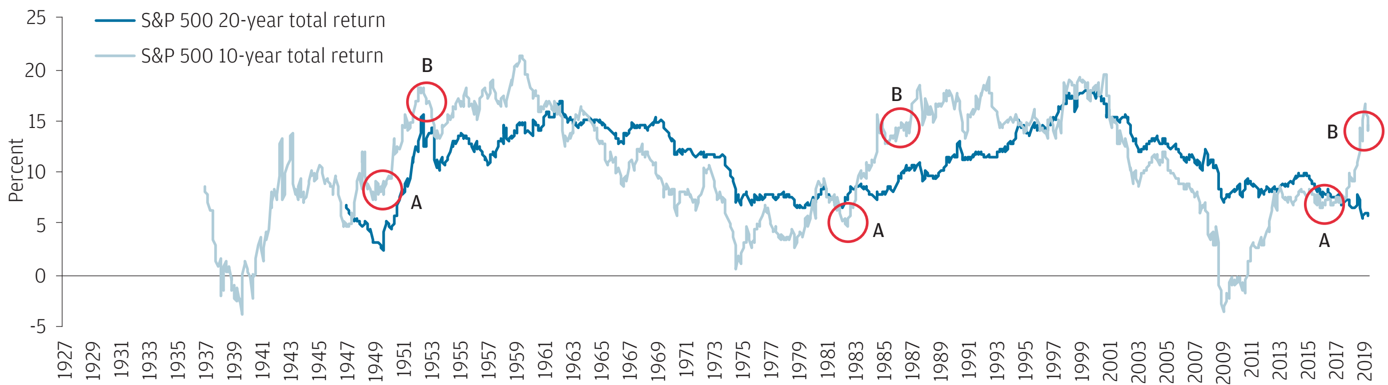
Why are you using 2016 as the start of the secular bull market rather than 2009?

There are a number of reasons we picked 2016 as the start of the secular bull market instead of 2009. The prior two secular bear markets lasted between 16–20 years, which would point to 2016 rather than 2009 as the end of the secular bear market. We propose that both secular bull and secular bear markets last 16–20 years in order for the psychology of a generation of investors to move to extreme fear/apathy after secular bear markets or to extreme greed after secular bull markets. This prevailing psychology then persists despite a change from a secular bear market to a secular bull market or vice versa. Investors remain fearful (greedy) for an extended period of time despite a pronounced change in the return potential of the equity market.

In the two previous secular bear markets, the 20-year total returns languished at below-average levels for 8-10 years before the start of a secular bull market. This again points to 2016 versus 2009. In the prior two secular bear markets, the psychological lows or peak fear points of the bear markets of 1942 (following Pearl Harbor) and 1974 (Nifty Fifty crash plus recession) preceded the start of the secular bull market by seven and eight years, respectively. This too is consistent with past cycles in pointing to 2016 as the start of the secular bull market.

It does not matter whether one chooses 2016 or 2009 as the start of the secular bull market as long as the framework is consistent with past cycles. If we chose 2009 as the start of the current secular bull market, we would have used 1942 and 1974 as the starting points of the prior secular bull markets. We could have argued that secular bull markets last 24–26 years (1942–1966 and 1974–2000) and that the market anticipates the turning of the MY Ratio by approximately eight years. This would still lead to the same conclusion with the current secular bull market projected to last until 2033–2035. We feel there is a stronger rationale for choosing 2016 rather than 2009 but it has no impact on the conclusions.

EXHIBIT 6: S&P 500 ANNUALIZED TRAILING 10 & 20 YEAR TOTAL RETURNS, 1927 THROUGH JUNE 2019



Source: Ibbotson, Empirical Research Partners Analysis, J.P. Morgan Asset Management, Bloomberg L.P as of June 30, 2019. *The performance quoted is past performance and is not a guarantee of future results.*

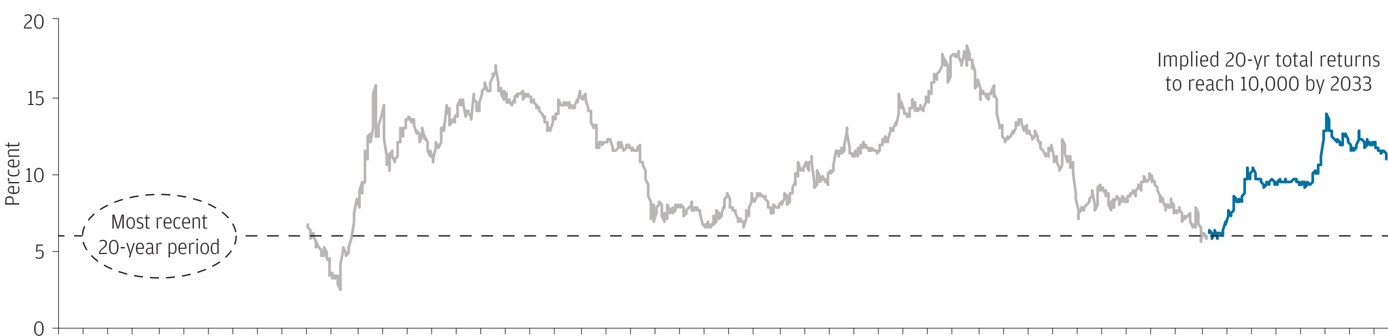
The 10-year total returns since 2009 are very high. Is this different than past cycles and does this imply returns during this secular bull market will be lower?

There is no difference in this cycle from the past two secular bull markets. **EXHIBIT 6** illustrates the rolling 20-year total return chart overlaid with the rolling 10-year total return chart. In each cycle, point A indicates the beginning of the secular bull market and point B is 40 months later (the period of time from February 2016-June 2019), which is how far in duration we are into the current secular bull market. The rolling 10-year return after 40 months in the current secular bull market is strikingly similar to the rolling 10-year returns after 40 months in the past two secular bull markets. In both prior instances, there were still tremendous market gains before the secular bull markets peaked. From 1952 to the peak of the secular bull market in 1966 and from 1985 to the peak in 2000, the cumulative total returns were 525% and 992%, respectively. As a point of reference, if the S&P 500 reached 10,000 in 2033, the total return would be 320% (starting 6/30/2019 through 12/31/2033 and assuming an annual dividend of 2%).

From mid-2000 to March 2009, S&P 500 returns were very weak. Won't the 20-year total returns be excessive relative to history as those nine years roll off?

Again, the answer is "No!" **EXHIBIT 7** illustrates the path of rolling 20-year total returns assuming that the S&P 500 will reach 10,000 by the end of 2033 while keeping the dividend yield flat at the current 2% rate. This implies a 9% annual price return for a total return of 11% per annum. Despite the fact that the very weak returns of 2000-2009 will roll off over the next nine years and that price returns are assumed to be 9% for the next 14 years, the rolling 20-year total returns for this secular bull market look lackluster compared to the past two secular bull markets. If anything, our expectation that the S&P 500 will reach 10,000 appears to be conservative.

EXHIBIT 7: S&P 500 ANNUALIZED TRAILING 20 YEAR TOTAL RETURNS, 1927 THROUGH JUNE 2019



Source: Ibbotson, Empirical Research Partners Analysis, J.P. Morgan Asset Management, Bloomberg L.P as of June 30, 2019. From June 30, 2019 through 2033, an assumed index level of 10,000 by December 31, 2033, would imply a compound annual growth rate of 9.0%. Future rolling 20-year total returns captured using the 9.0% implied annual price return from the top chart and assumed 2% annual dividend. *The performance quoted is past performance and is not a guarantee of future results.*

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