Investing Is 90% Patience; The Other Half Is Compounding

Michael Friedman, CFA | Chief Investment Officer

In a Nutshell

The market has compounded a 58.0% total return over the past two years, reaching valuations last seen during the dot com bubble. The spread between unpalatable U.S. large-cap valuations and savory U.S. small-cap, international developed, and emerging markets valuations is among the widest on record. Historically, starting valuations have been a reliable gauge for returns over the subsequent ten years. Based on the current 22x forward P/E ratio for the S&P 500, the expected return over the next decade is no better than holding a 10-year Treasury note. Given this tradeoff, a sensible investor would not waste any time contemplating. However, contrary to popular belief, market participants are far from rational. While there is no way to foresee when investors will begin to appreciate the attractiveness of undervalued assets, I firmly believe investors who remain patient will be rewarded. And speaking of patience, the bonds are back in town. It has been over fifteen years since investors could pick up a 10-year Treasury note yielding 4.5%. Bond investors can now generate more income without taking on as much risk. Higher coupons will also benefit balanced portfolios by providing a more effective downside buffer and improving the risk/return profile; this is music to an asset allocator's ears.

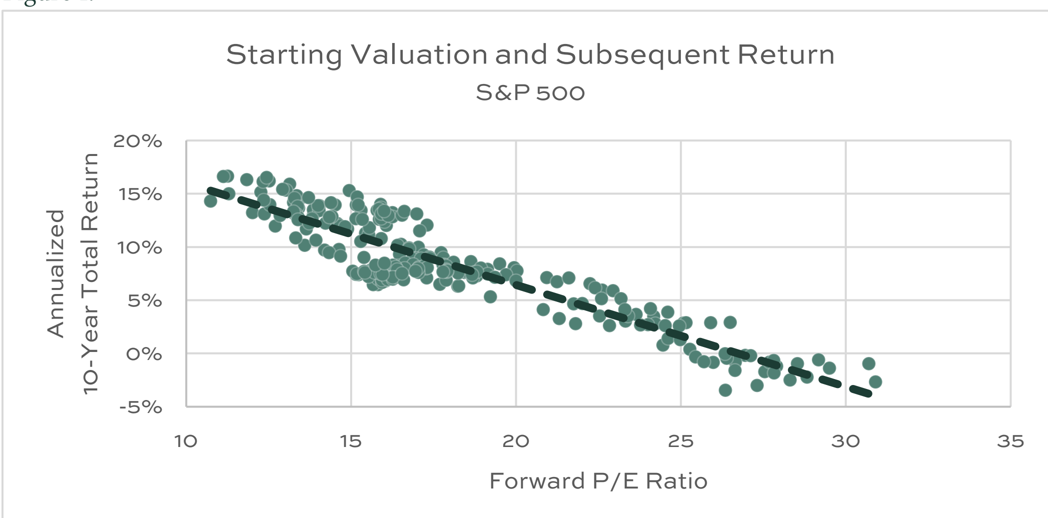
Avoid Loitering in Large Caps

2024 came in full of worry and went out with a vengeance, delivering a 25.0% total return, a spectacular encore to the 26.3% total return in 2023. As a refresher, we started 2024 with the most restrictive monetary policy in over fifteen years. Purchasing power has barely budged since 2019, with wages outpacing inflation by only 1%. And credit card balances were up 30% over the same time, as consumers were spending more and saving less. Three prominent recession indicators with perfect accuracy were signaling recession. And the S&P 500 was trading at a 21x forward P/E, 1.5 standard deviations above the 20-year average. What could possibly go wrong? Well, apparently nothing. Investors who de-risked their portfolios were left holding an empty bag, while those who crowded into stocks with the highest valuations were handsomely rewarded. Sometimes, it is better to be lucky than good. However, do not press your luck.

Investing is an art just as much as it is a science, although when it comes to starting valuations, there is no art about it. As asset allocators, we seek to identify undervalued asset classes, generally those market segments currently out of favor with investors. Historically, starting valuations have been the most reliable predictor of future results with a statistical significance beyond a random chance. Yes, I'm talking about valuations again, because it is simply that important.

The S&P 500 finished 2024 with a forward P/E of 22x. Outside of the cheap money bonanza from mid-2020 through the end of 2021, you must look to the early 2000s tech bubble to find another time when stocks were this expensive. Historically, the starting valuation has been a reliable predictor of returns over the subsequent ten years. The r-squared of this relationship is 84%, which means the P/E ratio at the beginning of the period explains 84% of the variation in returns over the following ten years. The correlation coefficient can confirm the strength and direction of the relationship, ranging from -1 (perfect negative correlation) to +1 (perfect positive correlation). The correlation between the two variables is -0.9, indicating a strong negative correlation, meaning the lower the starting valuation, the higher the return over the following ten years. Figure 1 depicts this relationship by plotting the starting P/E ratio and the resulting ten-year annualized total return since 1995. Historically, a P/E ratio above 20x is associated with low single-digit returns, while a P/E ratio below 15x corresponds to double-digit returns.

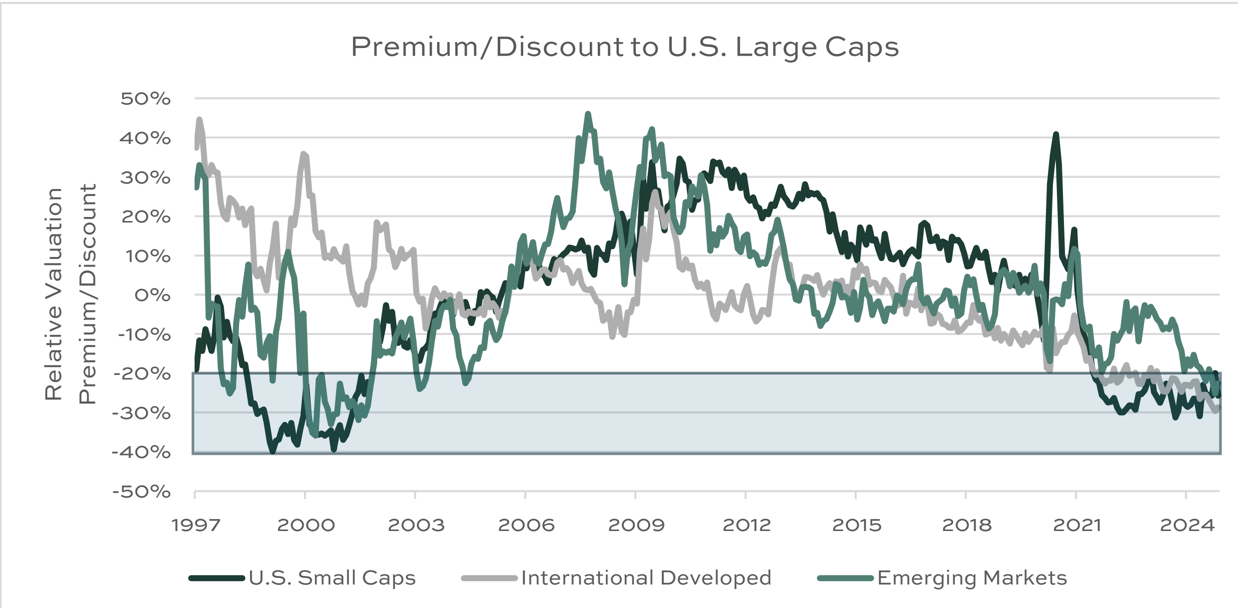
Figure 1.



Taking the analysis one step further, we can use the equation for a line of best fit to estimate the return for a given starting P/E ratio. The line of best fit is a mathematical equation and is depicted visually as the dashed line through the individual data points in Figure 1. Plugging in the 22x P/E where the S&P 500 finished 2024, we get an estimated annualized return over the next ten years of 4.5%. A far cry from the 13% annualized total return over the past ten years and less than half the long-run average return of about 10%. It is noteworthy to mention you can pick up a 10-year Treasury note currently yielding 4.5%. If held to maturity, it will produce a 4.5% annualized total return over the next ten years sans the U.S. government defaulting on its debt payments. No rational investor would take on the added risk of the S&P 500 given this alternative. However, no one said investors are rational outside of a textbook.

Based on this analysis, the implied fair value for the S&P 500 is 4,100, a whopping 30% decline from the 5,882 level at the end of 2024. A correction of this magnitude is not the base case, but it would certainly be a reasonable outcome. However, since we operate outside of a textbook, we know the rational outcome is not typically Mr. Market's modus operandi. While a swift decline to fair value followed by more normalized returns is preferred over ten long years of subdued performance, either is an undesirable outcome. To this end, we remain underweight U.S. large caps in favor of smaller capitalization stocks in the U.S. and international developed and emerging markets stocks. All three asset classes are trading below fair value and at significant relative valuation discounts to U.S. large caps. For U.S. small caps and emerging markets, the last time relative valuations were this attractive was during the dot com bubble. For context, from 1/1/2000 to 12/31/2009, U.S. small caps and emerging markets produced annualized total returns of 6.4% and 10.1%, respectively, while U.S. large caps generated an annualized total return of -1.0%.

Figure 2.



An important caveat is that although the relationship between starting valuations and future results is meaningful, it is not necessarily a good timing tool. Since investors are not rational, assets can remain mispriced for extended periods before correcting. Although the waiting game can be discouraging, I steadfastly believe investors who remain patient will be rewarded.

What Goes Up, Must Come Down?

To combat the highest inflation in more than 40 years, the Federal Reserve hiked the Fed Funds rate to 5.25% from 0% over sixteen months starting in March 2022. The most restrictive policy since 2007 resulted in higher borrowing and savings rates across the economy. The yield on short-term Treasuries soared from nearly 0% to 5.5% at the peak. The yield on money market funds followed suit. However, borrowing costs rose rapidly as well. The 30-year mortgage rate surged from a low of 2.7% to a peak of 7.8%, and financing a new auto purchase over 60 months rose to 8.4% versus 4.5% before the rate hikes.

The Fed began cutting rates in September 2024, lowering the Fed Funds rate to 4.25% from 5.25% by the end of December 2024. However, it was hard to ignore two key rates moving in the opposite direction. Just before the first rate cut, the 30-year mortgage rate was 6.2%. By the end of December, it reached almost 7.0%. Similarly, the 10-year Treasury yield stood at 3.7% just before the September 2024 rate cut, moving to 4.6% by the end of the year. Although not a typical reaction, truth be told, the market is functioning normally.

The Fed Funds rate is the rate banks charge each other for overnight loans. Hence, it is a very short-term rate. While the Fed can use this tool to influence short-term borrowing and savings rates, they have a much smaller influence on longer-term yields. Maturities further down the yield curve, like the 10-year Treasury note, are primarily set by the market. Just as stock prices fluctuate based on investor expectations, the yield on Treasuries is a function of supply and demand for the various maturities. Less demand for a particular maturity will cause its yield to rise, and vice versa. Remember, bond yields and prices have an inverse relationship. The fundamental law of economics says if supply is greater than demand, then prices will fall. For bonds, that means yields are moving higher.

Concerning mortgages, the 30-year mortgage is priced with a spread over the 10-year Treasury yield to reflect the additional risk of a mortgage loan. Like stock investors expecting a higher return than investing in bonds as compensation for the added risk, mortgage lenders are compensated for the additional risk through the spread over Treasuries. So, the rise in the 30-year mortgage rate is a function of changing investor expectations, causing the 10-year Treasury yield to rise.

Economic growth has hung in there much better than many feared. When investors expect an economic downturn, they buy Treasuries for safety. However, if the sun is shining, investors are willing to take on additional risk, so they sell Treasuries to buy risk assets. A string of positive economic data during the fourth quarter provided just that. Investors now expect higher growth and higher inflation, making Treasuries less compelling. And, the massive and growing U.S. debt, a not often talked about issue but a real long-run concern, may place upward pressure on yields. If the government does not intervene by reducing spending or increasing revenue, interest payments will become the largest expense in the federal budget in 25 years. I wrote about this highly underrated issue in much greater detail in my first quarter 2024 letter[1] for those interested in a deeper dive. But for our purposes here, we need to know as the amount of debt increases, investors will demand a higher yield. In aggregate, this means interest rates will likely stay higher for longer.

While higher interest rates mean elevated borrowing costs, there are two sides to every coin. Higher yields are welcome news for bond investors after a drought spanning more than a decade where the 10-year Treasury yield averaged just 2%. Investors with a balanced portfolio and those seeking income in retirement will all benefit from higher yields. Individuals in retirement may not have to assume as much risk to achieve their income needs, and bonds with higher coupons provide a more effective downside buffer in a balanced portfolio. Although not flashy, improving a portfolio's risk/return profile is always in vogue.

[1] The Wall of Worry – Q1 2024 is available at vinitygroup.com/market-commentary

Figure 1. Annualized ten-year total returns, on a rolling monthly basis, from 12/31/1994 to 12/31/2024. The forward P/E ratio represents the price at the start of the period divided by the next twelve months' earnings per shares estimates. **Figure 2.** U.S. Large Caps represented by the S&P 500, U.S. Small Caps represented by the S&P SmallCap 600, International Developed represented by the MSCI EAFE Index, and Emerging Markets represented by the MSCI Emerging Markets Index. Relative Valuation Premium/Discount (RV P/D) is calculated monthly for each asset class versus U.S. Large Caps. Relative Valuation (RV) equals the reference index forward P/E ratio divided by the S&P 500 forward P/E ratio. The Premium/Discount (P/D) represents the monthly RV percentage change from the long-term average RV [RV P/D = RV / LT Avg RV - 1].

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Diversification does not guarantee a profit or protect against loss.

MSCI EAFE Index: Measures the performance of large- and mid-cap equities across 21 developed markets countries, excluding the U.S. and Canada, and covers approximately 85% of the free float adjusted market capitalization in each country. **MSCI Emerging Markets Index:** Measures the performance of large- and midcap equities across 26 emerging markets countries and covers approximately 85% of the free float-adjusted market capitalization in each country. **S&P 500:** Measures the performance of U.S. large-cap equities and is comprised of 500 companies across sectors and covers approximately 80% of available market capitalization. **S&P SmallCap 600:** Measures the performance of U.S. small-cap equities and is comprised of 600 companies across sectors.

Sources: WisdomTree, YCharts.