Don’t Expect the Easy Market Gains of the Reagan Era

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Investors excited by the boost the US election gave to US stocks should recall that starting conditions matter. This is not 1981, the beginning of the Reagan era.

When Ronald Reagan took office 36 years ago, the US economy was in a deep recession induced by extremely high interest rates intended to wring out inflation. Back then, the S&P 500 was trading at around nine times depressed forward earnings, as the *Display* below shows.

When Donald Trump took office, the S&P 500 was trading at about 18 times forward earnings—and earnings were close to all-time highs. Yet, the fed funds rate was around 0.5%, and the 10-year Treasury rate, about 2.5%. While both interest rates are higher than a few months ago, they remain close to all-time lows, and are poised to go higher.

STARTING CONDITIONS MATTER

Market and Economic Conditions Just Before New President Took Office

	Trump	Reagan
Expansion/Recession	Expansion	Recession
Inflation	2.2%	12.5%
Fed Funds Rate	0.5%	18.9%
10-Year Treasury Rate	2.5%	12.6%
Unemployment Rate	4.6%	7.2%
Net US Debt/GDP*	77%	26%
S&P 500 P/E (forward)	17.9×	9.0×

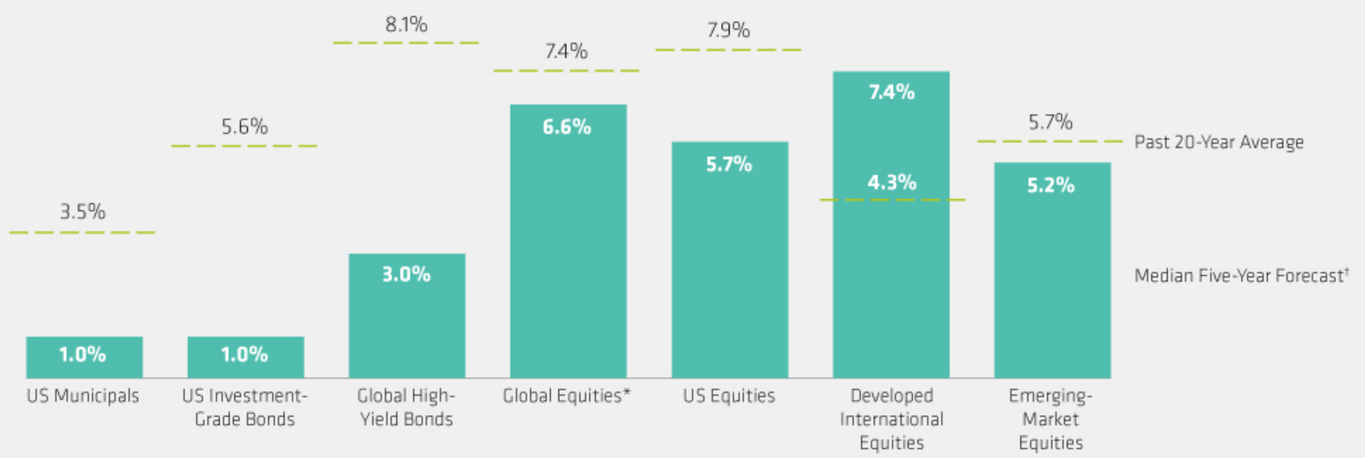
As of December 31, 2016, for Trump; December 31, 1980, for Reagan
*Net debt excludes debt the government owes itself.
Source: Congressional Budget Office, Haver Analytics, Tax Foundation and AB

We expect below-average returns for almost all asset classes over the next five years. Over the long term, bond returns are typically in line with starting yields: We expect bond returns of about 1% over the next five years, far below their 20-year averages, as the next *Display* shows, Rather than getting a huge boost from *falling* interest rates, as in the 1980s, bond prices are likely to be depressed by *rising* rates.

But returns will likely be positive for intermediate-duration fixed-income portfolios. While bonds may occasionally fall quickly in price, the increase in yield should replace market losses within a year or two.

EXPECTED RETURNS ARE LOW FOR ALMOST ALL ASSET CLASSES

Annualized Index Returns



Neither past nor forecasted performance is necessarily indicative of future results or a range of future results. There is no guarantee that any estimates or forecasts will be realized. Markets are represented by the Lipper Short/Intermediate Blended Muni Fund Average, Bloomberg Barclays US Aggregate Index, Bloomberg Barclays Global High-Yield Index, S&P 500 Index, Russell 1000 Growth Index, Russell 1000 Value Index, Russell 2500 Index, MSCI EAFE Index, and MSCI Emerging Markets Index.

*Global equities are represented by 21% US diversified, 21% US value, 21% US growth, 7% US small-/mid-cap, 22.5% developed international, and 7.5% emerging market.

†Median five-year forecast reflects Bernstein's estimates and the capital-market conditions as of September 30, 2016. See note on the Bernstein Wealth Forecasting System at the end of this post.

Source: Bloomberg Barclays, FactSet, Lipper, MSCI, Standard & Poor's and AB

Stock returns are also likely to be subpar: Our central case calls for US stock market returns of less than 6% annually over the next five years, below their nearly 8% average over the past two decades. Even if the new administration and Congress agree on policies that boost GDP growth and extend the economic cycle, earnings growth is likely to be limited and much slower than in the early years of the recovery. Why? Profit margins are close to record highs and could be hurt by protectionist trade policies.

A reduction in US corporate tax rates could add to after-tax earnings for some companies, however. This is an area where research-based stock selection will be critical. Overall, we expect modest gains from earnings growth and dividends to be somewhat offset by valuation contraction.

Global equity returns are likely to be somewhat higher, in our central case. Because the economic and earnings recovery in Europe and Japan has been slower and more fragile, there's far more potential for economic growth to surprise on the upside, and far greater support from valuations for non-US developed-market stocks. However, downside risks related to long-standing structural weaknesses in Europe's and Japan's economies and currencies remain.

Emerging-market stocks offer higher expected earnings growth and much lower valuations than developed-market stocks, but the potential for increased US protectionism and a strong dollar poses risks that vary widely by country and company.

Anxious reactions to political events that could disrupt growth may well propel more spikes in volatility, like those seen repeatedly in recent years. Just as the UK vote for Brexit and the US election briefly drove up volatility in 2016, elections in the Netherlands, France, and Germany could deliver shocks in 2017. We expect stock and bond market volatility to remain highly variable, as it often is near inflection points.

Low expected returns and higher volatility mean that investment success will make it hard for investors to reap the returns they desire. In our view, additional return through active management and effective risk management at every level of investment portfolios will be required.

The views expressed herein do not constitute research, investment advice or trade recommendations and do not necessarily represent the views of all AB portfolio-management teams.

The Bernstein Wealth Forecasting System seeks to help investors make prudent decisions by estimating the long-term results of potential strategies. It uses the Bernstein Capital Markets Engine to simulate 10,000 plausible paths of return for various combinations of portfolios, and for taxable accounts it takes the investor's tax rate into consideration.