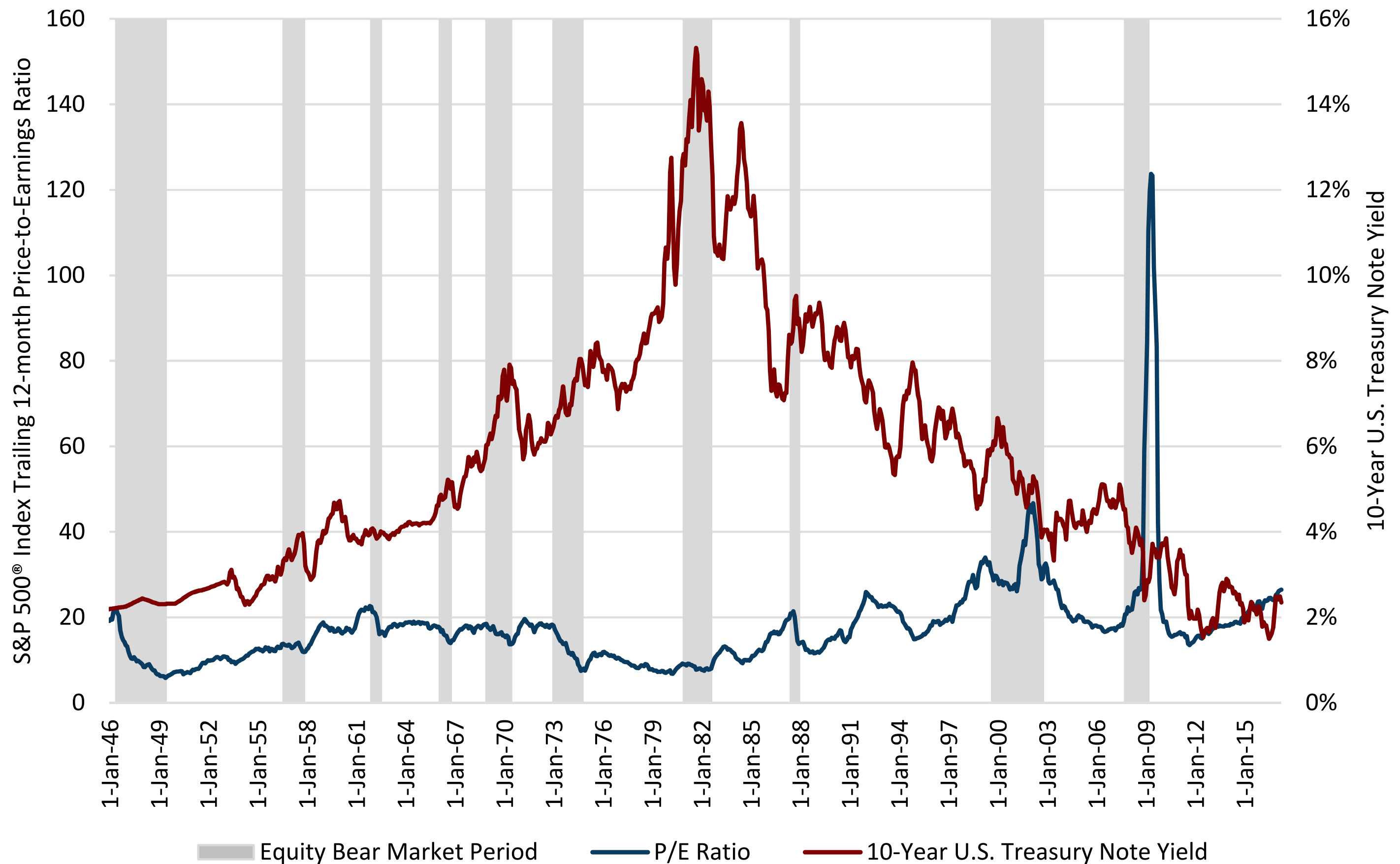
Despite high equity market valuations, cautious long-term investors should consider the possibility that equity investments may still outperform fixed income investments over their investment horizons. Although elevated equity valuations have persisted in the market landscape over the last 20 years, the current combination of very low bond yields and very high equity market valuations is historically rare. The last time interest rates were similarly low and equity market valuations were similarly high was the early 1960s. On January 1st, 1961, the yield on the 10-year U.S. Treasury Note stood at 3.84% while the trailing 12-month price-to-earnings ratio (P/E) on the S&P 500® Index was 18.60 and climbed to a high of 22.64 by November of that year. Those figures compare to a yield of 2.39% and P/E of 26.48 at the end of the first quarter of 2017.

Investors looking for lessons from the early 1960s will find a mix of good and bad news. Economic growth was above average. Corporate earnings were above average and outpaced the market's return, which was below average. The S&P 500® Index had a cumulative total return of 38.24% (5.54% annualized) from December 31st, 1960 to December 31st 1966 while the cumulative growth of S&P 500® Index earnings was 53.72% (7.43% annualized). The high market valuation at the beginning of the period was a signal that significant earnings growth was already priced into the market. But the below average market return wasn't the only evidence that earnings growth did not meet expectations—there were also two bear markets in the six-year span.[1] Remarkably, despite below average returns and two bear markets, investors who remained in the equity market from 1961 through 1966 fared better than intermediate government bond investors who earned an annualized return of just 3.12% as the yield on the 10-year U.S. Treasury Note climbed from 3.84% in January 1961 to a high of 5.16% in November 1966.

[1] From December 12th, 1961 to June 26th, 1962 the S&P 500® Index lost 27.97% and from February 9th to October 7th, 1966 the S&P 500® Index lost 22.18%.



Source: Bloomberg, L.P. **Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results.**

Historically, bear markets materialized in 1946, 1961 and 1987[2] – soon after the trailing 12-month P/E ratio on the S&P 500® Index climbed above 20. At other times, however, high equity valuations were normalized through earnings growth rather than deep market declines. The early 1990s was one such time, when earnings growth was sufficient to catch up to the market price and significant downside volatility was avoided.

Specifically, from December 31st, 1991 through December 31st 1994, S&P 500® Index earnings grew more than 20% annualized. The trailing 12-month P/E began the period at 15.35, climbed above 20 by mid-1991 and stayed above that threshold until the first quarter of 1994. Due in part to the market's high starting valuation, however, the annualized total return of the S&P 500® Index was only 6.25% over that three-year period. Despite this below average return, robust earnings growth appeared to have contributed to keeping significant downside volatility out of the market. The worst peak-to-trough decline in the S&P 500® Index over this period was a drawdown of 8.47% from February 2nd to April 4th, 1994.

[2] S&P 500® Index bear market returns and dates: May 29th, 1946 to June 13th, 1949: -29.61%, August 25th, 1987 to December 4th, 1987: -33.51%, See Note 1 for bear market returns in 1961 and 1966.

GATEWAY INVESTMENT ADVISERS, LLC

Interestingly, earnings growth forecasts for 2017 are similar to the earnings growth rate of the early 1990s. Consensus bottom-up estimates as of March 23rd for S&P 500® Index operating profits are currently about $130, an increase of more than 20% over S&P 500® Index operating earnings as of December 31st, 2016. Earnings growth and market action of the early 1990s suggest S&P 500® Index companies may need to sustain that level of earnings growth for more than one year if equity investors are to avoid a significant downside event. Optimistic equity investors may want to temper their outlook with the possibility that robust earnings growth going forward may only serve to keep downside volatility out of the market, rather than drive average to above-average equity market returns.

It is also worth noting that, despite higher yields on investment grade bonds relative to today and the 1960s, the stock market still performed better than the bond market from 1991 through 1994. The Bloomberg Barclays U.S. Aggregate Bond Index returned just 4.60% annualized over the three-year period, underperforming stocks by more than 1.5% per year on average. This happened despite the 10-year U.S. Treasury Note yielding over 8% at the beginning of 1991 and total-return boosting rate declines over the next two years. Rising rates during 1994 drove losses in the bond market that erased a portion of the gains generated in the first two years of the period.

Analyzing equity and bond market returns in these high valuation periods illustrate that while high market valuations don't always presage bear markets, neither does above average earnings growth always result in above average equity market returns. This is especially true when high valuations are an indicator of priced-in future earnings growth. Moreover, bear markets can occur even during a period of expanding earnings. The early to mid-1960s period shows that, perhaps surprisingly, equities can outperform bonds over multi-year periods even when equity market returns are below average and the period includes a bear market. Low and/or rising bond yields can be a key contributor to such outcomes.

Long-term investors face an asset allocation conundrum over high equity market valuations and the possibility that interest rates may soon rise. Namely, exposure to equity market risk may not be rewarded with typical equity market returns, and an overweight position in bonds could mean sacrificing long-term equity returns. Realizing this conundrum is only a small step toward solving it.

Long-term investors may benefit from seeking approaches beyond just blending traditional asset classes to achieve the optimal middle ground between stocks and bonds. Adding equity correlated investments that combine reliable downside protection and greater long-term return potential than bonds may be particularly beneficial.