

Raymond Capital Advisors, LLC

October 17, 2021

Stock & Bond Benchmark Total Returns (%)						
For Periods Ending September 30, 2021						
	QTR	YTD	1-Year	3-Years	5-Years	9-Years
S&P 500	0.58	15.92	30.01	15.99	16.90	15.22
Bloomberg Barclays U.S. Aggregate Bond	0.05	-1.56	-0.90	5.36	2.95	2.78
60/40 TAA Composite Index	0.37	8.93	17.64	11.74	11.32	10.24
3-month Treasury Bills	0.01	0.03	0.05	0.97	1.06	0.63

Returns (%) include capital gains, dividends and interest, and are **annualized** for periods greater than one year.
Sources: S&P Dow Jones Indices, Morningstar, Federal Reserve.

Market Review: Modest Gains

Modest positive returns were produced by both stocks and bonds in Q3:2021. Stocks (S&P 500 Total Return) produced a 0.58% return for the quarter, chalking up their seventh consecutive quarter of gains. Within equity styles, large-cap Growth outperformed Value as investors debated the strength of the economic recovery, concerns over the Covid Delta variant, inflation, rising interest rates, Fed tapering, a fiscal cliff, and an infrastructure bill. A pullback in stock prices just shy of 6% occurred late in the quarter, although they are currently just 3% below their all-time highs. Bonds (Bloomberg Barclays U.S. Aggregate Bond Total Return) returned 0.05%, and have underperformed stocks for six consecutive quarters. **Over longer holdings periods, stocks have far outpaced bonds as is often the case (see table above, 1 to nine years).**

Outlook: The Next Decade? A Long-Term Fundamental Forecast

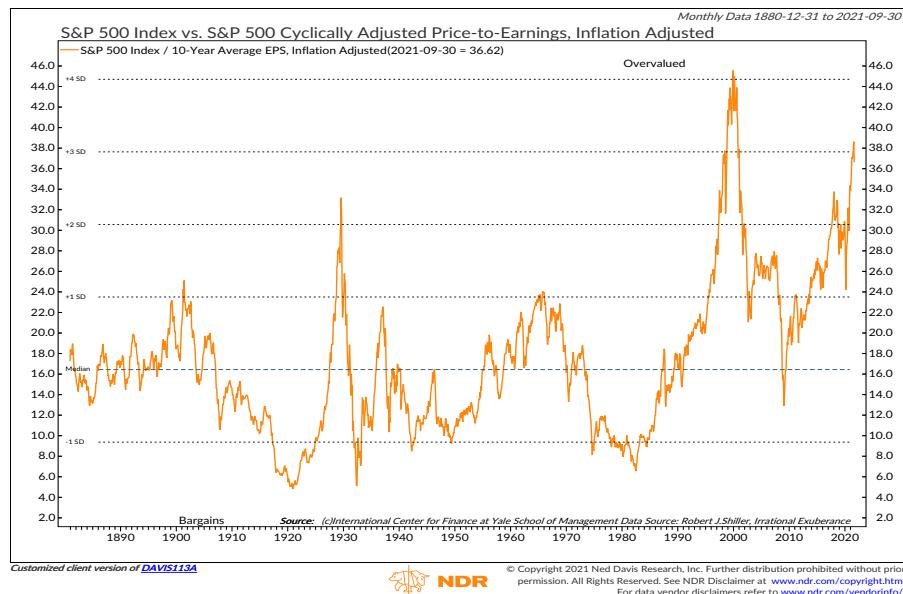
“Forecasting is very difficult, especially when it involves the future.” -- Yogi Berra

“Who-da-thunk-it?”... It’s been a great environment for investing over the past 18 months, with stocks having nearly doubled in price as liquidity flows, declining interest rates, and economic recovery replaced fears of economic recession from the Covid virus. But while the outlook for stocks is not a bearish one, they cannot go up at this pace forever, and they rarely go up in a straight line. A review of where valuations stand and what they may mean for long-term returns is in order...

According to the theory proffered forth by Columbia professors Graham and Dodd in the 1930’s, stocks have an “intrinsic value.” There are multiple ways one can derive a valuation for stocks, but price, earnings, and interest rates are the common elements. Earnings (i.e. corporate profits) tend to follow economic growth, and stock prices tend to follow earnings over the long-run. So, as long as we’re not facing a prolonged recession, downside risks to earnings and therefore stock prices should, in theory, be limited. Along these lines, the economy grew at a barn-burning 6.7% annual pace in Q2:2021, which is almost assuredly going to be the peak growth for this cycle. We may well see some further increased volatility in stock prices coming off peak growth as liquidity flows taper off, but the long-run economic growth projections remain in positive territory at 1.8%, according to the Federal Reserve.

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The Price to Earnings (P/E) ratio is perhaps the most popular stock valuation metric, but using just one year of earnings as it prescribes subjects it to the volatility of the business cycle. To correct for this flaw in the P/E ratio, a “CAPE” ratio (Cyclically Adjusted P/E), which averages inflation adjusted earnings over a 10-year period, can be used for long range valuation forecasts. Currently, the CAPE ratio is at 36.6, meaning it now takes that many years of average annual inflation adjusted earnings to equal the price of the S&P 500. For perspective, that’s well above its historical median of 16.5, and has only been exceeded during the tech bubble period in 2000. Then again, these higher valuations also reflect today’s record low interest rates.



We'll footnote the math, but to derive our long-term forecast, we simply convert the CAPE ratio to a yield and then adjust for interest rates by subtracting the corporate bond yield and inflation (bonds being a competing investment for stocks). Doing so leads to a long run inflation adjusted forecast of 2.47%. Meaning that by the end of the 10-year period, stocks would have been expected to return 2.47% *every year more than the rate of inflation*. We then add back in the implied inflation rate to derived our long-term expected return that most of us can better relate to. That final number is 4.91%.¹

Granted, a 5% return may not sound like much, as it's only half the historical annualized return for stocks of 10%. But it's also a higher return than what one gets for quality corporate bonds (i.e. Moody's Aaa Bond yield = 2.70% - 2.44 = .26% after inflation). So, for investors that need liquidity, with an exposure to economic growth, stocks still remain the asset class of choice.

Of course, such pinpoint forecasts should also include a good amount of “Kentucky windage” as much can go wrong with them. Just think how different things were 10-years ago! Earnings can be higher or lower, interest rates could rise (hard to see them going down much). Inevitably, the world will be changing a lot over the next decade and investors are also going to be adjusting their “risk appetite” for stocks (some simply won’t be willing to pay for such high P/E ratios, and then again perhaps some will be willing to pay even more depending on their outlook and personal circumstances). In the table below, we offer several “stress-test” scenarios to see how macro conditions would change our base forecast. For example, under Scenario A, if inflation and bond yields were to *both* rise by two percentage points, inflation adjusted returns would stay the same, while nominal returns would actually rise. **Such a scenario would work out very well for the fiscal and monetary authorities as the higher inflation would help to reduce the real value of our increased debt burdens, while the higher portfolio values would also mean higher taxes would need to be paid. Might not this be our government’s desired heading for us?**

¹ 9/30/2021 10-Year S&P 500 Return Forecast based on “CAPE” Ratio’s yield ($1/36.62 \times 100 = 2.73\%$), Moody’s Aaa Bond yield (2.70%), and Implied Inflation from 10-Year Treasury Inflation Protected Securities (2.44%): $(2.73\% - (2.70\% - 2.44\%)) + 2.44\% = 4.91\%$. A study by Ned Davis Research finds that the excess CAPE yield has had a 73% correlation with S&P 500 10-year forward returns.

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Forecasted 10-Year Annualized Stock Market Returns						
CAPE Yield	Bond Yield	Inflation Expectations	Inflation Adj. Forecast	Nominal Forecast	Scenario	
2.73	2.70	2.44	2.47	4.91	Current market based assumptions	
2.73	4.70	4.44	2.47	6.91	Scenario A... Bond yields and inflation both rise by 2 percentage points	
2.73	4.70	2.44	0.47	2.91	Scenario B... Bond yields rise 2 percentage points, but no increase in inflation	
2.73	0.70	2.44	4.47	6.91	Scenario C... Bond yields fall 2 percentage points, but no increase in inflation	
2.73	2.70	4.44	4.47	8.91	Scenario D... Inflation rises by 2 percentage points, but no change in bond yields	
2.73	0.70	0.44	2.47	2.91	Scenario E... Bond yields and inflation both fall by 2 percentage points	
3.41	2.70	2.44	3.15	5.59	Scenario F... Stocks fall by 20%, but no change in inflation adjusted earnings	
2.28	2.70	2.44	2.02	4.46	Scenario G... Stocks rise by 20%, but no change in inflation adjusted earnings	

Data as of September 30, 2021: S&P 500 CAPE Ratio = 36.63, Moody's Aaa Corporate Bond Yield = 2.70%, 10-Year Implied Inflation (TIPS) = 2.44%. Inflation Adj. Forecast = 1/CAPE Ratio - (Bond Yield - Implied Inflation)

In all, while valuation indicators aren't great timing tools, especially in the short-run, **stock prices are likely to have lower rates of return in the years ahead. And frankly, after 40-years of declining interest rates, every asset class is likely to experience lower returns.** Stocks, however, still have an important place in the portfolio. They are flexible operating companies that can adapt to new environments and find new markets, innovate, adjust their product mixes, prices, and cost structures. They can help to hedge inflation risks, and have a liquidity advantage over real estate. Bonds, on the other hand, are inflexible and have fixed returns. Inflation is a threat to bonds. Yet for retirees, bonds also continue to have their place in the portfolio as a source of stable returns and reserve funding, and also often to help offset stock market declines. And for "well-funded" retirees, they can be an important source of funds for rebalancing portfolios should stocks decline.

But how much of each? **The appropriate mix of stocks and bonds for you depends on your goals, your retirement fundedness, and your personal risk tolerance. We are always glad to review these items for you, and there is no charge for doing so.**

Thank you for your continuing support,
Geoff & Lance
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