The Capital Spectator

Investing, Asset Allocation, Economics & The Search For The Bottom Line

Are Recent S&P 500 Returns Excessive Relative To History?

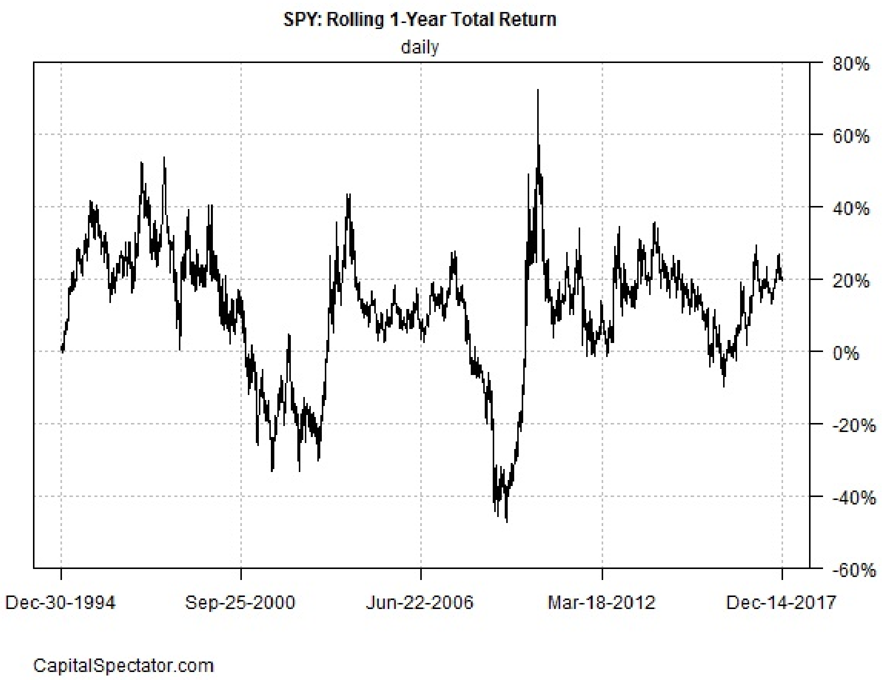
The US stock market has been on a tear lately. Has the party gone too far? A rising chorus of analysts say that caution is advised, citing several valuation metrics. The Shiller PE Ratio, for instance, is currently at its second-highest level since the late-1800s.

Valuations appear stretched, but history reminds that this form of excess can endure. And with the US economy posting ongoing signs of growth, the market's upbeat profile of late has macro support. Nonetheless, it's prudent to consider how performance stacks up in terms of history.

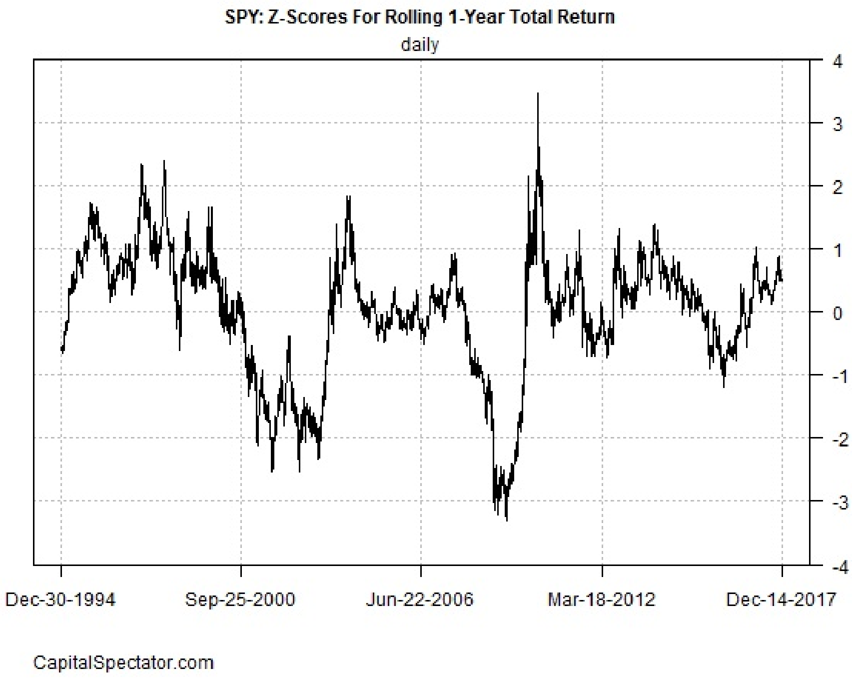
Some analysts note that the recent run of positive momentum implies that there's still room for prices to climb. Although every party ends eventually, momentum has an encouraging record of forecasting results for the short- and medium-term. But that argument may be tempered when returns move into nose-bleed terrain.

For some perspective, let's review the S&P 500's one-year and three-year returns in context with the past quarter century. As a proxy for the market, I'll use SPDR S&P 500 ETF (SPY), which has been trading since 1993.

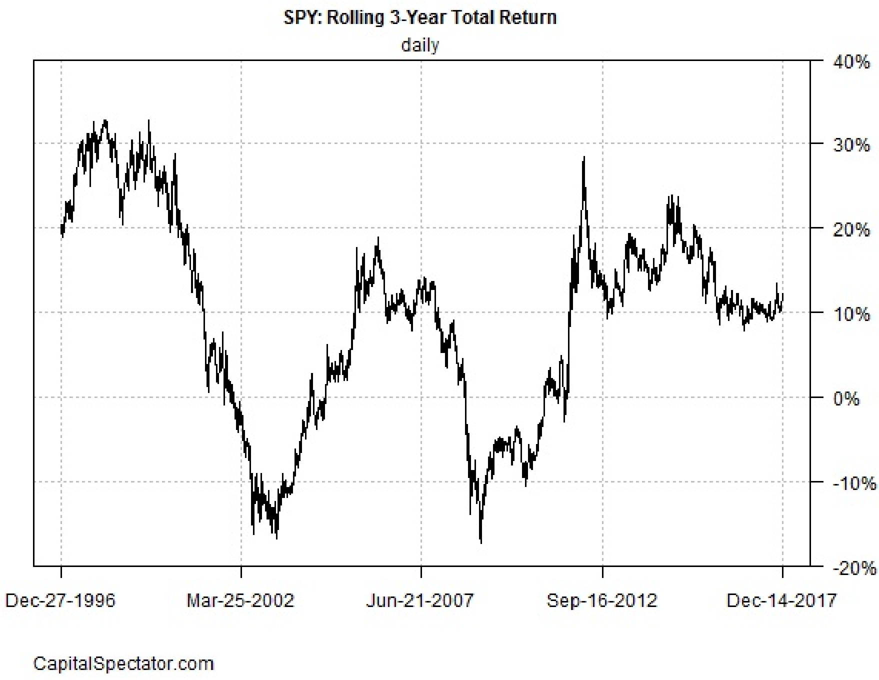
On a rolling one-year basis (252 trading days), performance is certainly impressive. SPY's 20% one-year gain is well above the long-run average, although in context with the last 25 years this healthy advance is still well below peak performance. That alone doesn't ensure that the good times will continue, but it's clear that even higher returns aren't unprecedented.



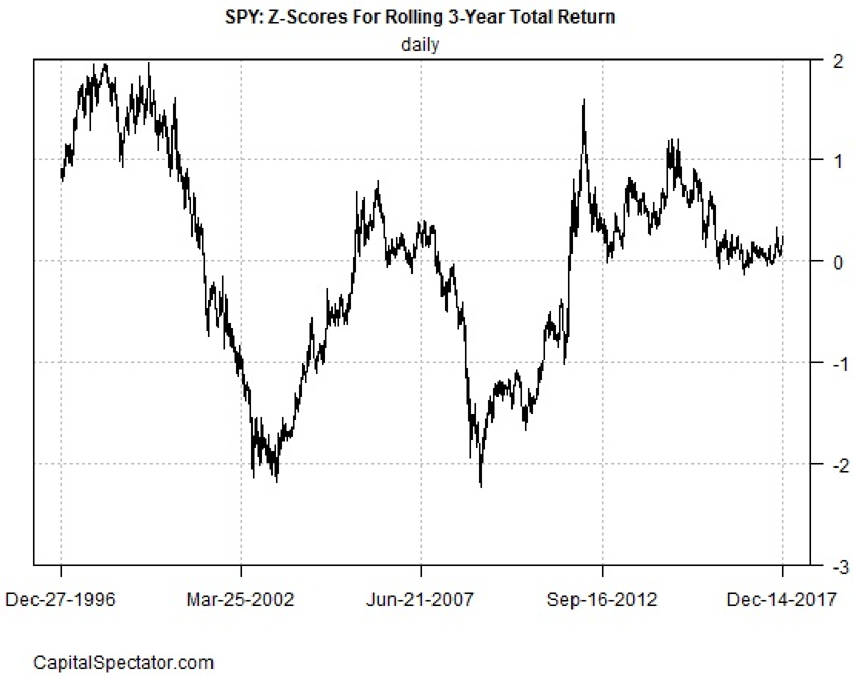
Let's review the one-year data through the lens of Z-scores, which converts the performance history to a scale that shows how returns compare as standard deviations from the mean. Based on the past quarter century, the current 20% one-year gain is less than one-standard deviation above the mean. The implication: the one-year performance at the moment isn't particularly unusual based on results since the 1990s.



One might argue that one-year returns are too noisy to develop useful perspective. As an alternative, let's lengthen the trailing window to three years (756 trading days). As the next chart shows, the current 12.3% annualized total return for the past three years is elevated but it's still well short of the extremes that SPY has generated since the mid-1990s.



Translating the three-year performances into Z-scores reveals that the current 12.3% annualized performance is close to the mean (a zero reading) since the mid-1990s. In other words, a comparatively middling return.



The caveat in the analysis above, of course, is that the last 25 years is a relatively short sample period. The key question: how might the results change by looking at a longer and arguably more robust time series for the S&P 500? For example, we can crunch the numbers using Professor Robert Shiller's database, which provides S&P history dating to 1871. I'll update the analysis using that longer data set in a future post.

By James Picerno | Dec 15, 2017 at 07:43 am EST [http://www.capitalspectator.com/are-recent-sp-500-returns-excessive-relative-to-history/] | 5 Replies

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