



# Portfolio Strategy

Oops - I Hit my 10 Year Price Target with 8½ Years to Go...  
What Do I Do Now?

## Portfolio Strategy

# Portfolio Strategy: Oops - I hit my 10 year price target with 8 1/2 years to go... what do I do now?

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In 2019 two of Bernstein's strategists had a disagreement about whether the 10-year forward S&P target should be 4000 or 8000. Now that we are at the cusp of that lower target what should the forecast be? Simply adopting the higher forecast as the house view because we have passed the lower one might sound like an act of thesis creep of epic proportions. Yet can the emergence of a post-pandemic policy regime justify this?

We argue that we are in a very different policy environment. For the first time in at least a decade there is a plausible narrative for why inflation may rise. In addition, there are also reasons why rates may not respond as quick to inflationary signals. This leaves us with the prospect of persistent low real yields which can justify market valuations.

In absolute terms valuation appears to be an impediment to returns. The Shiller PE at 36x is at the top end of the 120-year range. But valuation has failed to be a guide for equity returns for over a decade. An investor who followed valuation would have sold equities years ago. Policy has trumped valuation. Moreover, the lack of other appealing assets that offer positive real returns means flows into equity are likely to continue, "TINA" is not enough to make a fundamental justification for returns, but it can beget significant flow.

A decomposition of returns into the constituents to real growth also suggests positive returns. However this points to one source of concern in the likelihood that corporate profit share of GDP may shrink as the policy pendulum swings away from shareholders.

We also present a very different way to get to a market return forecast which is to aggregate the idiosyncratic return of individual stocks, this is also positive.

We highlight the tactical sources of concern from extended sentiment and more strategic concerns should inflation become unanchored.

Finally, we note that even a bullish target for US equities does not obviate the need for a reform of broadly-accepted approaches to cross-asset investment. On this basis the real return from 60:40 is still likely to be sharply lower and with a significantly smaller return/risk ratio.

**8000 becomes our new end-decade target for the S&P.**

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## DETAILS

The rip higher in equities over the last year has made a mockery of many forecasts. Back in late 2019 Bernstein' strategists had an argument over two very different S&P forecasts. Inigo argued that the S&P would only get to 4000 over the next decade, while Alla argued for 8000. When two strategists have a 100% difference in their price targets it's probably worth writing about it in a research note rather than confining the discussion to the pub in Mayfair, [Portfolio Strategy: S&P 4000 or S&P 8000? Our strategists disagree.](#)

With the S&P now at the cusp of passing that lower of those forecasts we felt we should revisit this discussion. Should investors load up on equity beta or does the recent move higher portend a dire outlook?

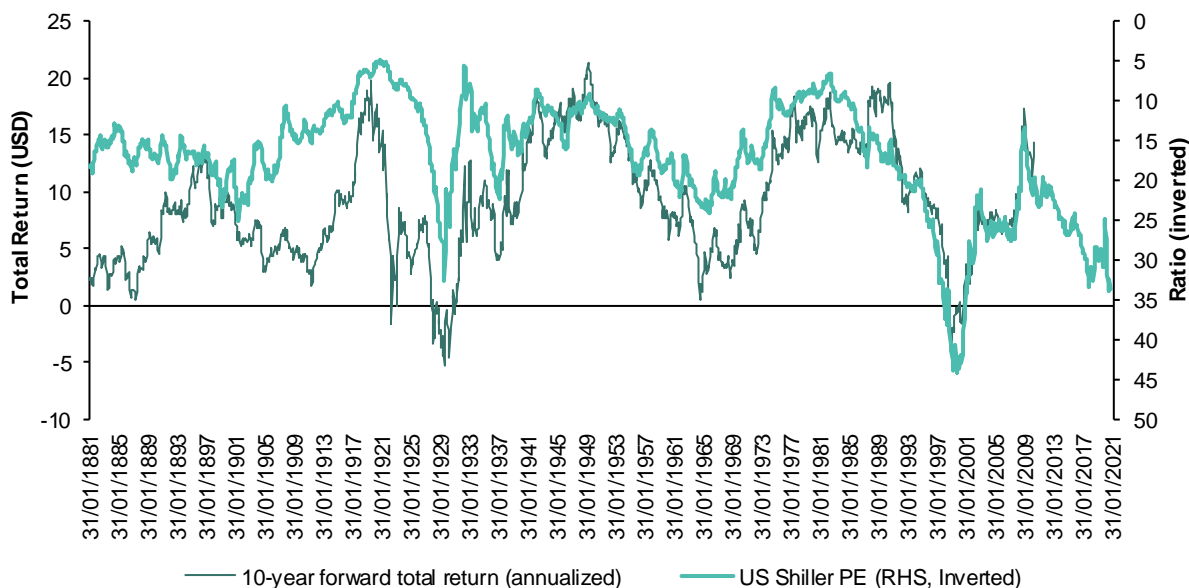
**Inigo:** So we are on the cusp of hitting my 10-year price target 8 ½ years too soon. This is one of those awkward things that happens when one is in the business of making forecasts. What should one do? Either I need to edge up my forecast in an act of potential thesis creep of truly epic proportions or take the view that we face the prospect of zero nominal returns from equities for 8 years. Given equities tends not to deliver flat, smooth returns that latter outlook more likely implies a large crash at some point, either preceded or succeeded by a rally.

Of course, having got to 4000 doesn't *necessarily* mean that I have lost the argument. But the idea that the nominal level of the S&P will be the same 8 and a half years hence seems too horrible an outcome to countenance. More importantly, I suspect that it is too horrible for politicians and other policymakers to countenance, at least if they want to persist in the notion that individuals need to carry the risk of saving for their retirement. Thus, given those alternatives I find it easier to accept that I was wrong, so I am belatedly changing my view to agree with that of my colleague and taking 8000 as our S&P target for the end of the 2020s.

So what has changed? I mean other than the obvious point that we have got to 4000 already. The charge of thesis creep is one that needs to be answered. I think that the answer lies in the way the policy environment has changed. Has the rally of the last year simply brought forward returns from future years? I think there is more to it than that. As we have discussed in recent research ([Portfolio Strategy: Six books for the post pandemic world](#)) we think that the policy environment has utterly changed in the wake of the pandemic. Not all of this will be positive for equities – a point that we will come back to in the context of margins – but the most important point is that for the first time in at least a decade there is a plausible case for inflation. If this became "unanchored" this could undermine the outlook, but we would argue that a moderate level of inflation would be positive. Moreover, it seems as if there is also a good case that interest rates may rise much more slowly in response to any inflation. The acceptance of semi-permanent higher debt and acceptance of massive direct fiscal measures (be it stimulus cheques, furlough schemes or infrastructure investment) is something that would have been much more unlikely if there had been no pandemic. So we think this is a case of "When the facts change, I change my mind. What do you do, sir?"

One can lay out the thesis for the higher index target, but also outline the risks and constraints. The key constraint is valuation. This cannot be dismissed lightly. There are a few distinct sources of return that can drive an investment. This could come from mean-reversion or a risk premium or as the result of a specific catalyst that is forecast to emerge. Forecasting catalysts is hard, so in this context mean-reversion has been one of the most powerful forces in investment. Long run market returns have tended to respond to valuations metrics such as the cyclically-adjusted or Shiller PE. While the Shiller PE tends to be relatively useless at guiding market returns over the next year, 10 years forward it is one of the best guides we have got. With the Shiller PE at 36x this is at the top end of the historical range. A "face value" reading of the link between it and 10 year forward returns over the last 140 years implies the S&P yields a return only in-line with inflation, Exhibit 1.

EXHIBIT 1: **Shiller PE and 10 year forward returns**



Shiller PE defined as price divided by 10-year average inflation-adjusted earnings, plotted against 10 year forward nominal total returns  
 Source: Robert Shiller's database, Global Financial Data, Bernstein analysis: Global Financial Data, Bernstein analysis

**Alla:** But valuation hasn't been a limit to equity returns in over a decade! This shows us that policy trumps valuation. The market is going up! If one had followed valuation – be it Shiller PE or another metric such as forward PE, market cap/GDP or Tobin's Q then one would have progressively reduced equity weight for the last five years, on some trading rules one would have even shorted equities. It would have been a disaster! If a metric is so wrong for such a long time isn't it time to stop using it?

Specifically, there are two arguments against valuation being a limiting factor. If real yields stay low then it can justify valuations on long duration assets like equities and then there is "TINA". In a low return world (in a cross-asset class sense) what else are investors going to buy?<sup>1</sup>

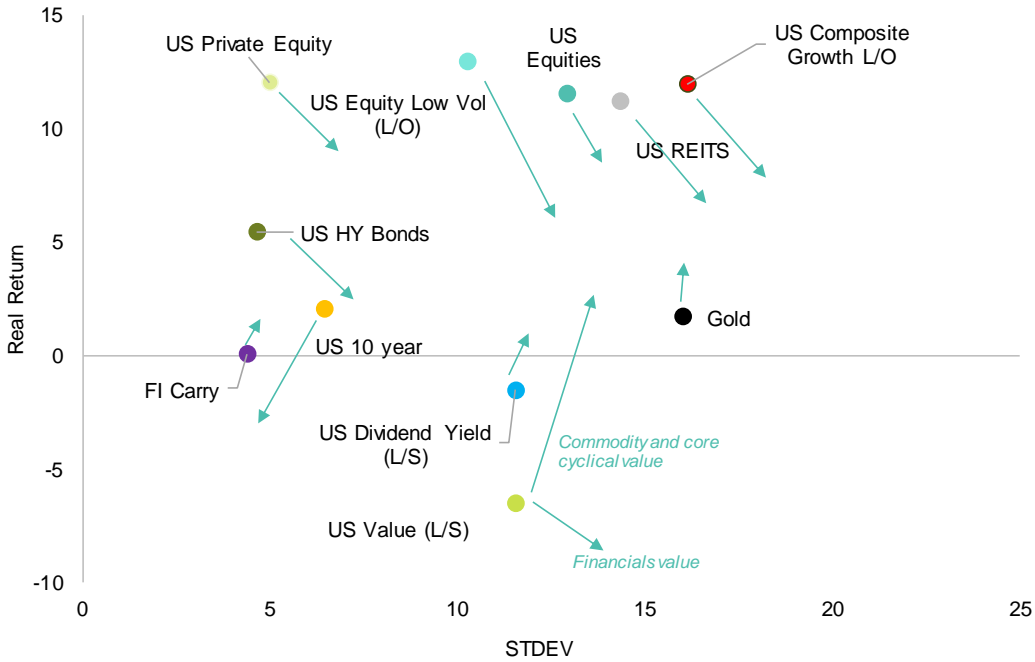
This note is about the long run return from equities, but this is in the context of other assets offering the prospect of lower returns than they have on average in recent decades. Yields on 10 year government bonds imply returns that are likely to be negative in real terms for the US – let alone European or Japanese bonds. There have been increasing allocations to private equity in recent years to make up for the anticipation of lower returns elsewhere. The best decile of private equity funds may indeed continue to deliver, but the build-up in dry powder and with lower credit costs seeming hard to achieve, it seems likely that the average return from private equity will be lower than that achieved in recent years, and one should note that the dispersion from private equity funds is much wider than for active public equity funds ([Fund Management Strategy: The folly of privacy?](#)). If we add in the likelihood that inflation could be at least slightly higher than in the past then real returns on many assets are likely to fall, Exhibit 2.

We have made the case<sup>2</sup> that part of the answer to this is to use factors in strategic asset allocation and also to more explicitly rely on idiosyncratic alpha blended with asset class betas. But in addition to those broader changes to the methodology of asset allocation, investors may have little choice but to buy more equities.

<sup>1</sup> [Portfolio Strategy: Valuation Rhapsody](#)

<sup>2</sup> We outlined our preferred approach to asset allocation in the Blackbook: [A New Paradigm for Investing](#)

EXHIBIT 2: **Return-risk trade off to deteriorate**



The dots represent the last 10 years of real returns and volatility for the major return streams that investors can buy. The arrows represent Bernstein portfolio strategy team's forecasts for the next 5-10 years.

Note: The US Private Equity data is compiled from 1,562 funds, including fully liquidated partnerships, formed between 1986 and 2019. All returns are net of fees, expenses, and carried interest. Data is provided at no cost to managers. Data provided as of 2020 Q1.

Source: Cambridge Associates, Ken French, Factset, Datastream, FRED, Bernstein analysis

The allocation of US households to equities is *towards* the top end of the post war range, but remarkably it is not yet quite *at* the top of that range. Given the outlook for inflation and rates and given the starting level of yields for fixed income, we would argue that the equity allocation should be above the top end of its historical range.

**EXHIBIT 3: US Household: Total Equity share of Total Financial Assets (%) – including pension assets and private equity**

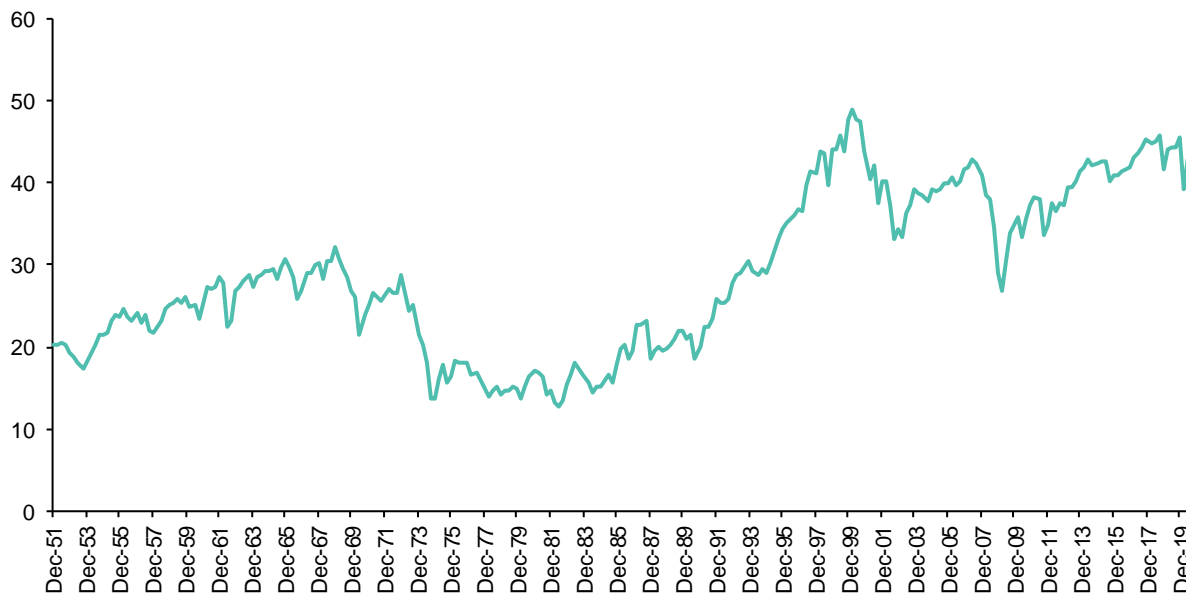


Chart shows the portion of US Household and Non-profit sector total financial assets allocated to equities. Equities is defined here as directly held Corporate equities + mutual fund shares (includes ETFs) + Non Corporate (i.e. Privately held) equity + the equity portion of Public and Private pension fund assets. The data is quarterly. The latest data point is Q3 2020.

Source: Bernstein analysis

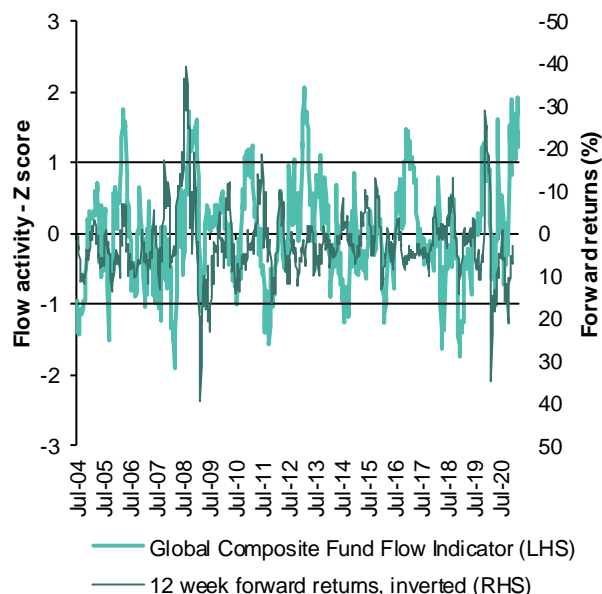
**Inigo:** This debate is all very well, but it is very strategic and linked to how policy may evolve. Can I just mention that there are some tactical concerns that investors should have as well. The market has become highly sensitive to shifts in bond yields and inflation. As we have discussed in other research, we think there is likely to be a lot of volatility in inflation in 2021. In part this stems from the likelihood of a "blip" in inflation as economies reopen and increasing demand hits tight supply. In addition to this the measurement of inflation is going to be more complicated than normal this year as whole swathes of the baskets of goods used for computing inflation have been things that citizens have been unable to buy. On top of this there is a high degree of uncertainty about the policy response to inflation. All this amounts to higher than usual scope for volatility in equities being driven from the flow of inflation data in coming months.

In addition there are potential signs of exuberance. Analysts covering US companies have been upgrading their estimates at the fastest rate in 30 years. OK fair enough – the "cycle" (if we can even use such a term anymore) has been the biggest in many centuries. But it does imply that the recent pace of upgrading cannot be maintained.

Investors have been buying equities at a record rate too. Since the beginning of November last year we have witnessed 11 of the 15 largest weekly equity fund inflows in history. Specifically, this has pushed our tactical flow-based sentiment indicator to +1.65 standard deviations, close to its highest level in 8 years, Exhibit 4. We have pointed out in recent research that we have been choosing to ignore the fact that this is technically telling us to tactically sell equities because the amplitude of the current cycle implies there will be large flows into a reflation trade, and also a recurring theme in this note is that investors should be buying more equities.

A slower-moving measure of flow-based sentiment is not as extended. If we track total cross-border flows then this has picked up, but is suggesting that total purchases of equities by investors not in the same region (ie US buying of Asia and Europe and Asian buying of US and Europe etc) is running at an annual rate of 0.3% of market cap which is consistent with positive forward returns, Exhibit 5.

EXHIBIT 4: Global Fund Flow Sentiment Indicator



Source: EPFR global, Bernstein analysis

EXHIBIT 5: Global Cross-Border Equity Flow Indicator

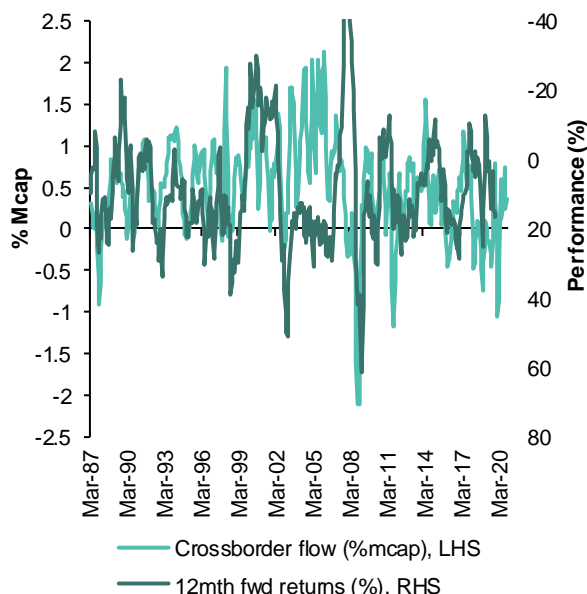


Chart shows the combined net purchases of overseas equities for US, UK, Euro area (post 1997), Germany (1987-1997), France (1993-1997) and Japan (post 1997). Data derived from external sector portfolio investment data published in the financial accounts of central banks. The series is monthly flows smoothed over 3 months, annualised and normalised by the market cap of the Datastream World index. Source: US Fed, ECB, UK ONS, Japanese MOF, Bundesbank, Banque de France, Datastream, Bernstein analysis

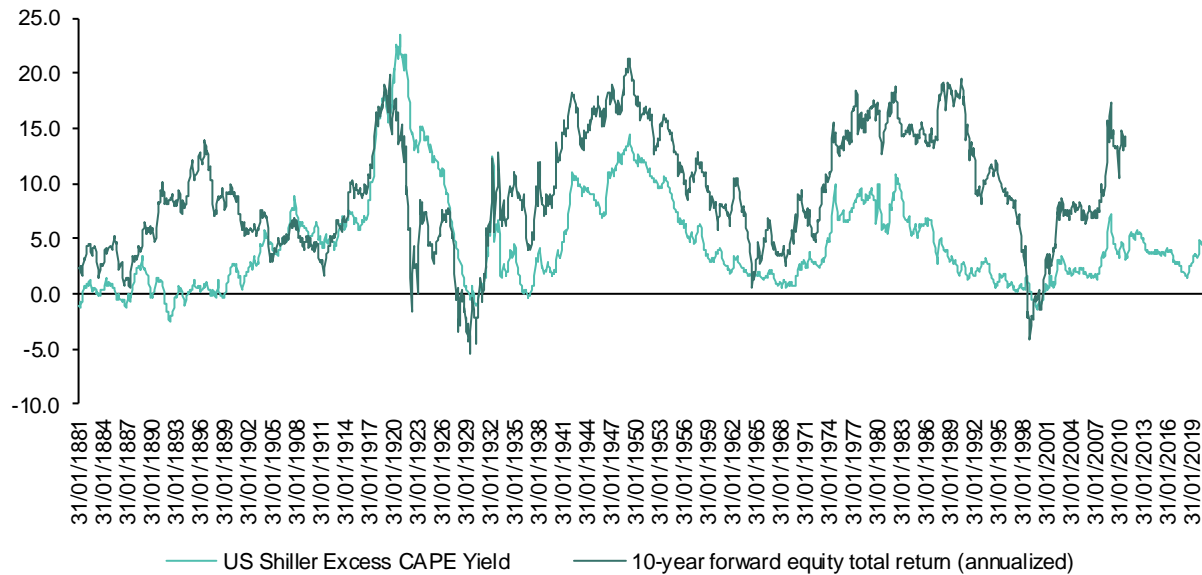
**Alla:** The obvious rejoinder on these tactical points is that we are, at the same time, seeing a \$1.9tn fiscal package being unleashed in the US. At the same time the global debate about fiscal support has been evolving and indicates a likely more relaxed approach to deficit levels. It's not MMT, but it borrows some of the MMT language. But anyway, this is not even a discussion about timing, it is about expected returns in the long run given the policy environment and capital market outlook.

**Inigo:** I agree that the outlook for real rates remaining low means that the equilibrium level of valuations has likely changed. Yes, the ultimate point of a valuation metric is mean-reversion, but for extended periods of time (eg a decade) the mean that one is "reverting to" can change. In order to account for the low discount rate that we face today a more appropriate model is perhaps the equity risk premium, here defined as the excess yield of equities over bonds. As we are making a long term forecast here we use a risk premium with a cyclically-adjusted earnings level to remove the (sizable) uncertainty about 2021-2022 earnings.

Using cyclically-adjusted earnings, the US equity risk premium implies an excess return of stocks over bonds of 3.5% pa for the next decade, Exhibit 6. I would also add that relative valuation might be more appropriate anyway as I am not sure there is any such thing as a risk free rate anymore, in which case any notion of absolute valuation may no longer be possible.<sup>3</sup>

<sup>3</sup> [Global Quantitative Strategy: The end of Pax Americana and what it means for the market](#)

EXHIBIT 6: **Cyclically-adjusted equity risk premium and forward excess returns**



Risk premium defined as cyclically-adjusted (ie 10 year average inflation-adjusted) earnings yields less real yields on government bonds.  
 Source: Robert Shiller's database, Global Financial Data, Bernstein analysis

But if we want to attempt an absolute return forecast, one way is to decompose the various sources of return or shareholders. We can write:

$$\text{Real equity return} = \text{dividend yield} + \text{buyback yield} + \text{real growth per capita} + \text{population growth} + \text{change in profit share of GDP} + \text{multiple expansion/contraction}$$

Here we are subsuming margin expansion/contraction as part of the broader measure of profit share of GDP, as we see the pressures on the two as being related.

Let's assume – for the purposes of argument – that the multiple and margin remain constant. The issue with the multiple we have already discussed, it is high but could maybe be maintained through a combination of low real yields and TINA-type arguments on the part of investors begetting more flow (we recognise that the latter argument is somewhat circular). Profit share of GDP has been elevated, Exhibit 7, and it seems more likely that it falls rather than rises which we discuss later. But let's be generous for now and assume flat margins and profit share as our base case.



EXHIBIT 7: **Corporate Profit share of GDP**



Source: FRED, Bernstein analysis

This also depends on the prognosis for buybacks. For the last 10 years corporates have been by far the biggest buyers of equities, far out-stripping investors. The last decade has also been an environment that has encouraged levering up corporate balance sheets and issuance of debt to undertake buybacks. We think that there are limits to how long this can be maintained, there is a growing chorus that it leads to greater inequality and also that it constitutes a governance failure – ie that corporate management teams are measured on too short a horizon that leads to lower capex and greater debt issuance to complete buybacks. Again, in our base case let's assume the future is like the recent past, but then see how this could change the result.

The UN population growth projection for the US is 0.6% per year; The achieved real GDP per capita average growth over the last 30 years has been 1.5% pa (and long run consensus forecasts have tended to be in a similar range). The US Dividend yield is 1.5%. The 10-year average net buyback yield (ie buybacks less issuance as a percentage of market cap) has been 1.5%, (although given the last 12 months of pandemic-influenced markets it has been only 0.3%.)

With no change in multiple or profit share the decomposition of returns simplifies to:

$$Real\ equity\ return = dividend\ yield + buyback\ yield + real\ growth\ per\ capita + population\ growth$$

So what does this imply in terms of real return? Plugging in numbers to the above equation we get:

$$Real\ return = 1.8\% + 1.5\% + 1.5\% + 0.6\% = 5.4\%$$

This is in real terms, if we assume inflation at 2% pa over the forecasting horizon this leaves us with 7.4% pa nominal return.

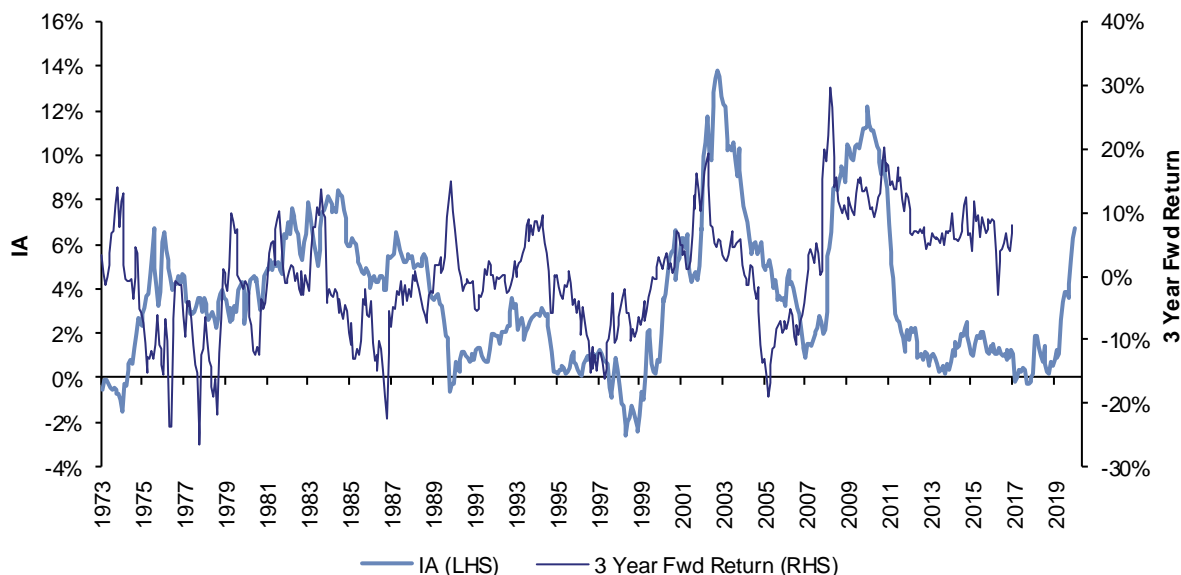
A move to restrict buybacks could dent this return. Though actually in the long horizon context of this note that might not be a bad thing. We have argued in recent research that there has been a governance failure in recent years that has encouraged buybacks at the expense of capex. For long-run returns any potential increase in the real growth rate resulting from increased capex could be a more sustainable source of returns. There is the potential for inflation to be slightly higher than this 2% level given the evolution of the policy framework in the light of the pandemic and the desire of politicians to inflate out of the current debt level.

**Alla:** There is also an alternative, very different route to getting to an expected market return. From the point of view of the asset owner, the investment choices have been revolutionised by the acceptance of passive as the dominant vehicle for investing new funds. On the one hand this is very helpful for lowering the overall fee paid for investing, but it reveals a deeper point about investing too. The emergence of cheap vehicles for market and factor beta allows investors to genuinely separate cheap beta

from alpha. We recently laid out in detail what this means at the individual stock level (as opposed to the fund level), [Alphalytics: Which stocks carry Alpha?](#)

Every stock brings with it a bundle of exposures, to asset classes, sectors, factors and idiosyncratic returns arising from what that company alone has done. We can strip individual stock returns of simple factor exposures such as Value, profitability, etc leaving an idiosyncratic return for each stock. We can show that there is a persistent link between the average trailing idiosyncratic alpha of stocks and the forward return on the market, Exhibit 8. We can understand this in terms of the ability of stocks to generate idiosyncratic returns as being a more persistent feature of the stock rather than the overall return which includes factor exposures that may be more prone to macro influence over the course of the cycle. On this basis the 10-year trailing average idiosyncratic alpha of US stocks implies a forward return of 10.9% pa (on a total return basis as an excess return over cash).

**EXHIBIT 8: 3 year trailing IA vs 3yr forward return (vs 1m T Bill), equally weighted across c.1000 large Cap US stocks**



Source: Fama French factor library Factset Bloomberg, Bernstein analysis. The universe is the 1000 large cap US stocks; rebalanced annually

**Inigo:** Can I be a misery guts and just lay out what can go wrong with this thesis please? Not that I'm trying to back away from it at all, but just so that we are going in eyes-open and to pre-empt some obvious questions. The message that high valuations are OK presupposes that a lot of things go right.

The biggest risk is that yields rise further than we expect. This is where tactical and strategic concerns coalesce. The move higher in bond yields in the last week has been the main tactical threat to the market and this is also the biggest strategic concern looking one year forward. We addressed this in [Portfolio Strategy: Paths of Policy - or can the market survive 2% yields?](#)

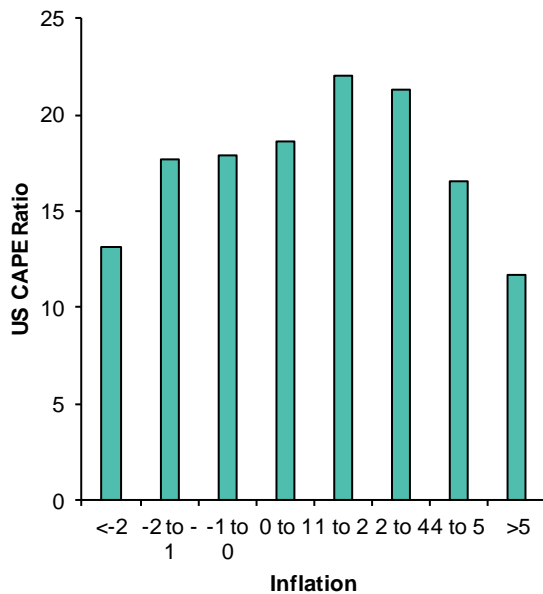
Can the economy be steered with enough precision? We have never been in a situation remotely like this before with a reopening of the economy and full fiscal and monetary support to such a degree. Moreover, in the background we have a political discourse that is inching towards using MMT as a description, even if not adopting it as a policy goal. Our central case is that inflation finds an equilibrium level in 2022 that is somewhat above the pre-pandemic level but that it remains under control. Underlying this we assume a balancing of the pro-inflationary forces of political desire to keep cost of debt low and the tolerance of a much more proactive fiscal policy vs the deflationary forces of unemployment, lower velocity of money, automation and the risk of zombie companies. However, we freely admit that it would be hard to claim that we can know with a high degree of certainty what coefficients to put on these various forces. Thus, the risk of an inflation overshoot is non-negligible.

In Exhibits 9 and 10 we show that for inflation levels up to around the 4% mark have been consistent with equity multiples being maintained, but at levels beyond that then multiples fall, though the speed with which yields moves matters as well and a rapid move up would likely be destabilising.

In the next 3-6 months it is likely that inflation will move a lot higher. The market needs to be able to distinguish between an inflation "blip" on the back of a reopening trade and a mismatch in supply and demand, vs a move higher in inflation due to a policy error. Will investors be able to distinguish between these two? What complicates this is that the measurement of inflation is likely to be impaired by the uncertainty about composition of the baskets of goods used – given restrictions on how money could be spent on many of them over the last year.

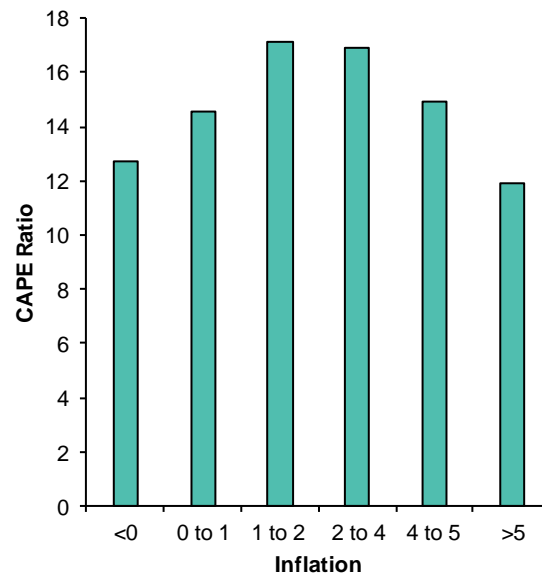
A rapid move in inflation and yields is the event most likely to destabilise the bullish thesis.

EXHIBIT 9: **US CAPE vs inflation regime**



Source: GFD, Datastream, Robert Shiller's database, Bernstein analysis

EXHIBIT 10: **UK CAPE vs inflation regime**

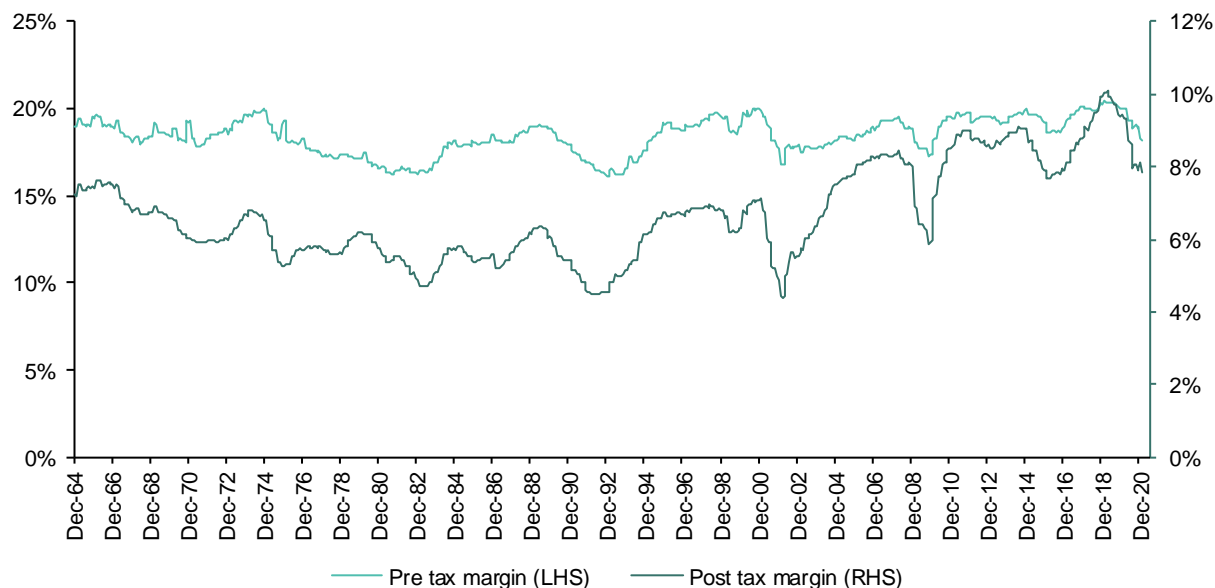


Source: GFD, Datastream, Robert Shiller's database, Bernstein analysis

Another strategic concern that is particularly relevant when it comes to justifying current valuations is the medium-term outlook for corporate margins. Pre-tax and post-tax margins have been generally higher in recent years, this has been most pronounced for post-tax margins which for the last decade have averaged levels not seen in the last 60 years, Exhibit 11. We think that a general policy shift in favour of labour at the expense of capital will decrease pre-tax margins<sup>4</sup>, and at the same time taxes are likely to rise.

<sup>4</sup> [Portfolio Strategy: Six books for the post pandemic world](#)

EXHIBIT 11: US pre and post-tax margins



Source: Factset, Bernstein analysis

More generally we can place this pressure on margins in the context of the cost of compliance with ESG in the broadest sense of that term. Improved environmental standards and properly pricing in negative externalities on the environment lead to a medium-term increase in costs for corporates. But the policy-driven upward pressure on wages and taxes can be seen in the light of the cost of complying with a broader macro interpretation of the 'S' and 'G' aspects of this. In this context there could also be pressure on buybacks, hence influencing the return calculation we presented earlier in this note. It is both 'micro' ESG in terms of the cost of compliance at the individual corporate level and 'macro' ESG in the sense of how this influences policy that amount to a compression in margins.

If we zoom out from this there is another risk in the background: low growth means need for more debt for every unit of growth, but that is ok as rates are low, but rates are only low because growth is low. This pushes the amount of debt up in a secular way as it has since the 70s. But hang on, is this circular? Does it prompt inter-generational issues? Is it sustainable? To address that requires an even broader debate on policy choices and the funding of retirement. A topic we will return to in a future essay.

However, despite these risks, 8000 becomes our 8 ½ year forward price target,

**Team:** So if we bring all this together, and revert to speaking as a team, what does it mean for a multi asset portfolio implications? We have been arguing in recent notes that the whole model of 60:40 portfolios is wrong<sup>5</sup> and needs to be replaced with a blending of asset classes and factors and a structure based on a split between idiosyncratic alpha and beta<sup>6</sup>. Such a portfolio will likely have to rely more on long-short returns such as value and carry, have a higher allocation to real assets and also likely include a greater allocation to non fiat currency such as gold and potentially crypto.

But to use 60:40 as a guide for now, what does this imply. If we set the 10-year forward target on US bonds as the level of the 10-year yield and 8000 as the S&P target then it implies a 10-year forward annualised return of 60:40 of 5% pa in nominal terms. We argue that for most asset owners the true benchmark is inflation. In Exhibit 12 we show that relative to inflation 60:40

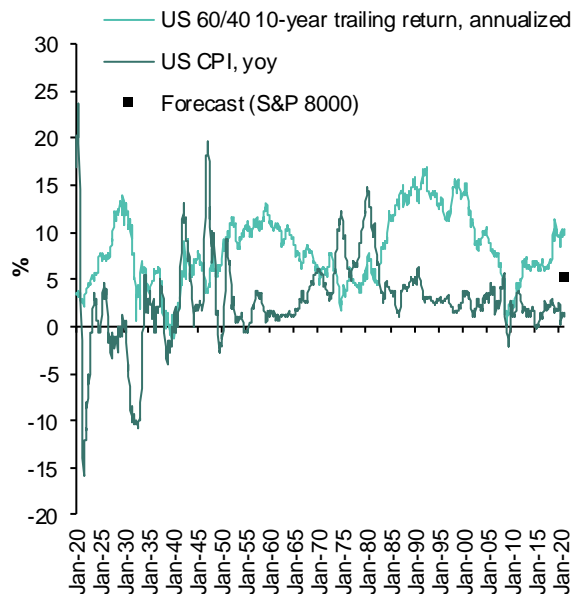
<sup>5</sup> [Portfolio Strategy: Duration in equities good, duration in bonds bad](#)

<sup>6</sup> [A New Paradigm for Investing](#)

has done very well for the last 40 years, but even this somewhat bullish equity target implies lower spread over returns from 60:40 in future<sup>7</sup>.

This impact is more stark on a risk-adjusted basis, Exhibit 13. Even the marked increase in equity vol since the global financial crisis did not significantly increase the volatility of 60:40 because the correlation of stocks and bonds became more deeply negative. To the extent that rising inflation and rising volatility of inflation threaten this, then the return/risk ratio of 60:40 would fall. Even with our bullish equity target, but assuming an increase in stock-bond correlation to +0.1, then the return/risk ratio of 60:40 would fall to 0.4. This compares to a return/risk ratio of 1.0 since 1982. The bottom line is that a bullish equity view does not obviate the need to reform broadly-held assumptions about cross-asset investing.

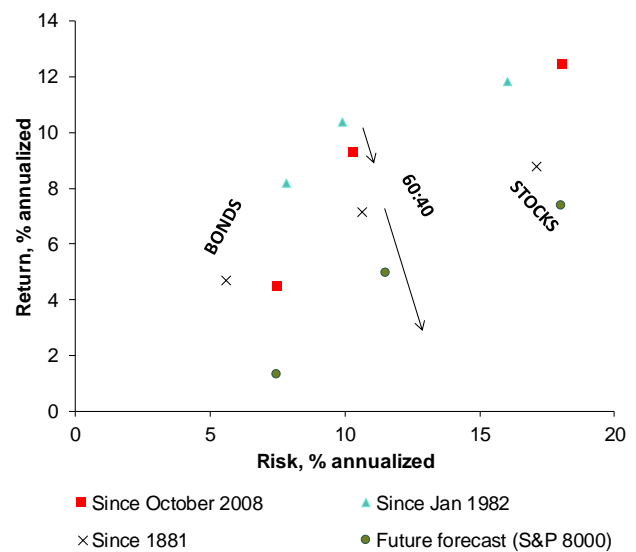
EXHIBIT 12: **60/40 portfolio vs inflation**



The black square represents a scenario for 60:40 returns based on the outlook for equities where S&P is projected to rise by 7% pa over the next 10 years. The forward return to Bonds is assumed to be equal to the current rate of US 10-year yield.

Source: Datastream, Bernstein analysis

EXHIBIT 13: **Risk / Return trade-off of 60:40 portfolio**



The chart shows annualized total return and risk for US equities, US bonds and a 60/40 eq/bond portfolio. Future forecast is assuming same volatility for stocks and bonds as since October 2008 and 0.1 correlation coefficient. Future equity forecast is modelled based on two scenarios - of S&P 500 reaching 4000 and 8000 level in the next 10 years. The 10-year annualized bond return is assumed to be equal to current US 10-year yield.

Source: Datastream, Robert Shiller's database, Global Financial Data, Bernstein analysis

<sup>7</sup> We recently discussed how the new policy environment implies a need to change asset allocation assumptions [Portfolio Strategy: Six books for the post pandemic world](#)

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