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How Will The Market Do Next Year?

It's that time of year when investors anxiously await predictions from the brightest minds on Wall Street. What can we learn from this prestigious group, and will they bring good fortune?

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Crystal Ball

It's that time of year when investors start asking how the stock market will perform next year. Before we turn to some of the brightest minds on Wall Street, let's analyze their track record.

The chart below compares the average annual *forecast* for the S&P 500 (red bars) to the *actual* result at year end (blue bars). These estimates were compiled by averaging the individual forecasts from Market Strategists employed by some of the most prestigious institutions on Wall Street.

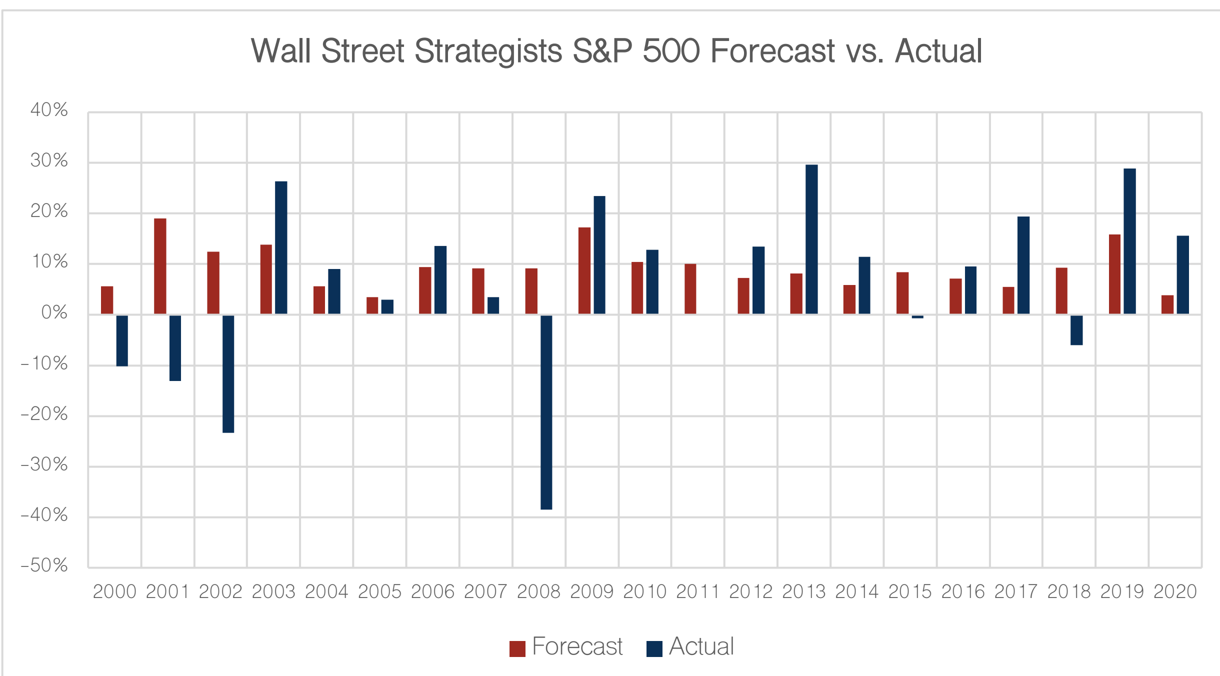
The only discernable trend is that this cohort's forecasting track record has been consistently abysmal. There were only three years when this very well-informed estimate came within 25% of the actual return (2005, 2010, and 2016).

These are not dumb people. They earned PhDs from top universities, work so many hours that they no longer remember their kids' names, and are paid millions. They also have unlimited budgets, access to more data than they can consume, and an army of geniuses working for them to crunch the numbers. Yet they appear to be terrible at forecasting annual returns.

How is this possible? Furthermore, if the professionals can't get it right, where can investors go to get more reliable forecasts?

Getting Emotional

I obtained undergraduate degrees in electrical engineering and mathematics. The curricula were very structured and precise for a reason. As long as I accurately calculated all inputs, stuck to proven



Source: Bloomberg, 2020 Actual return is through 12/9/2020 mathematical formulas, and obeyed the laws of science, prediction was possible.

However, financial markets do not operate on Newtonian physics. Think back to the events that impacted equity markets in 2020. There is zero chance that anyone could have predicted a global pandemic, subsequent shutdown of the U.S. economy, and the most aggressive policy response in the history of the Federal Reserve in just the first six months of the year.

Fear and greed are unpredictable forces that create dislocations in equity prices. These often take months to stabilize, which can wreak havoc on short-term estimates. Strategists may as well publish quarterly, monthly, or even daily forecasts because they are just as arbitrary as a single year.

The reality of their job is that they are being paid to do the impossible armed with an ineffective toolkit. Using process and logic to predict the mood of investors a year from now is like using antibiotics to cure a viral infection. What they really need is a crystal ball, and those are hard to come by.

But that's not to say forecasting is a waste of time. Most business owners would agree that projecting sales and expenses at the beginning of each fiscal year is a valuable exercise. These estimates are almost always wrong, but doing so forces them to think about what could impact their business.

The same applies to the research these strategists publish. They might uncover investment themes and risks that a reader may not have considered. Incorporating the viewpoints of those who think differently or that have specialized expertise might help them avoid costly mistakes. That's why I try to read as many of them as I can.

Simply put, it's ok to follow market forecasts from smart people, but take them with a grain of salt. Forecasters are either lucky or wrong, and luck usually runs out.

The Bottom Line

John C. Bogle, the founder of Vanguard, published the instant classic, *"The Little Book of Common Sense Investing"* back in 2007. In it, he wrote:

> *"The stock market is a giant distraction to the business of investing."*

These words should be gospel to long-term investors because the way to achieve investment goals is to manage risk rather than take too much of it.

Within this context, If emotions dominate the short-term movements in stock prices, and emotions are unpredictable and fleeting, then their impact is also temporary. If so, relying too heavily on annual forecasts could add unnecessary risk by shifting focus away from what can get you to your financial goals.

Revenue, earnings, cash flow, and other fundamentals drive long-term returns in financial markets. Therefore, rather than offer an estimate for the S&P 500 in 2021 (which would probably be wrong anyway), here are five themes that I believe will drive stock prices higher in 2021 and beyond:

1. The U.S. economy will continue to recover but at a slower pace.
2. The Federal Reserve will not raise interest rates for several years.
3. Inflation is coming.
4. Entrepreneurship and innovation should continue to change the world.
5. There is nowhere else to go to get equity-like returns.

This list hasn't changed much over the last six months, and it probably won't when the ball drops in Times Square in a few weeks. Markets do not operate on calendars, where a New Year acts as a reset button. Instead, they are event-driven, and the events that fuel fundamentals develop over time and are rarely derailed from the emotional effect in the short term.

Hence, despite risks to the vaccine rollout, a new presidential administration, the runoff in Georgia, murder hornets, toilet paper shortages, and whatever else causes investors to temporarily panic in 2021, these themes should mostly remain intact.

The bottom line is that if the most experienced strategists with access to unlimited resources can't get it right, then neither can you, me, nor anyone else. But since a year tells us little about the future of investment returns, remain focused on what will drive stocks over the next several years rather than the next few months.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer

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