THOUGHT FOR THE WEEK
WHAT WILL THE MARKET DO THIS YEAR?

Global Financial Private Capital

SYNOPSIS

- Investors want to know that they are with a manager who is good at predicting annual returns
- Data indicate that this task is harder than it may seem
- Focus on fundamentals more than forecasts to prevent unnecessary risk creeping into a nest egg

ANNUAL FORECAST

The New Year is that special time when the media and investors anxiously await to hear predictions on how the stock market will perform over the next twelve months.

This desire is certainly understood given the events that have transpired over the last decade, and investors want to know that they are with a manager who is good at predicting annual returns because it feels safe to be invested with someone who has a "feel for the market."

The chart below goes back to 2000 and compares the average annual forecast of Market Strategists from some of the most prestigious institutions on Wall Street to the actual return of the S&P 500 at the end of the year.

The only discernable trend is that this cohort's forecasting track record has been completely and utterly abysmal. Take last year as an example. The average forecast was just over 5% for 2017, yet the index delivered a return four times this estimate.

These are highly-trained professionals that have access to more information that they can consume, carry PhDs from top universities, work so many hours that they no longer remember their kids' names, and are paid millions every year.

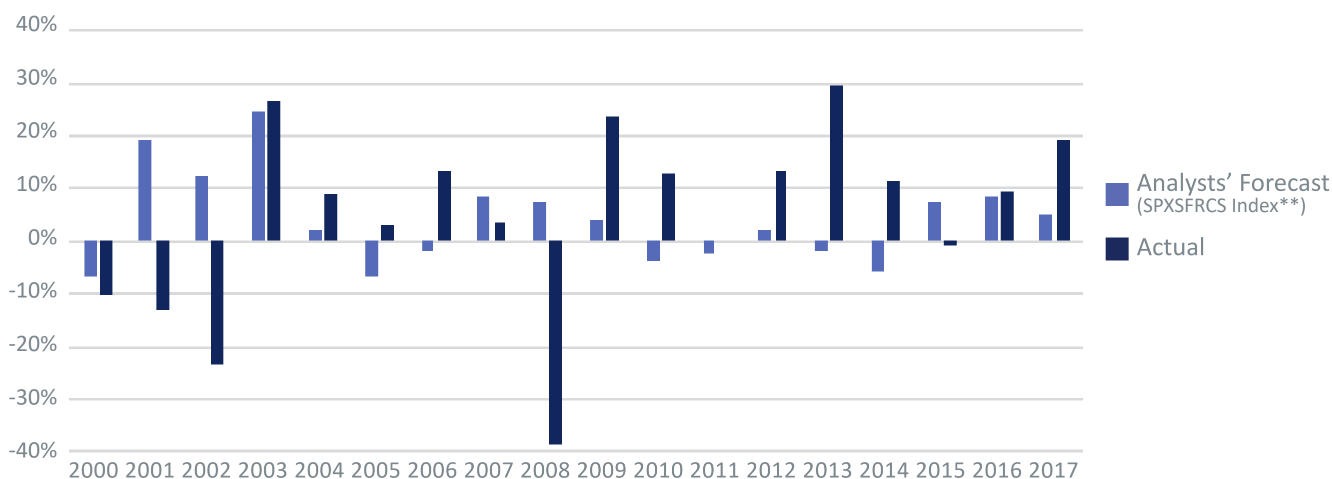
> **"Fundamentals are what drive the long-term returns in financial markets..."**

Yet they are apparently terrible when it comes to what is arguably the most important function of their job, which is forecasting annual returns. How could this be possible, and if the professionals are this bad, then where can the average investor go to get more reliable forecasts?

INEFFECTIVE TOOLS

I obtained undergraduate degrees in engineering and mathematics, and I remember my classes to be

WALL STREET STRATEGISTS S&P 500 FORECAST



Source: Bloomberg, Global Financial Private Capital analysis

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very structured and precise for a reason. As long as I accurately calculated all inputs, stuck to proven mathematical formulas, and obeyed the laws of science, prediction was possible.

Unfortunately, financial markets are not run on Newtonian physics. Think back to some of the events that rocked equity markets in 2017. It's implausible to assume that any investor could have accurately predicted that a single "tweet" from President Trump on North Korea back in August would have caused stock market volatility to spike over 40% in a day.

The fundamentals that grow our economy and the companies within do not move quick enough to warrant such volatility, so there must be something else driving these short-term swings. That something is the emotional component of markets, and no scientific process can forecast emotions.

Fear and greed are incredibly powerful and unpredictable forces that create dislocations in equity prices that often take months to normalize, and this can wreak havoc on short-term estimates. These 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 a toolkit that is ineffective. Using logic and reasoning to predict the mood of investors a year from now is akin to using antibiotics to cure a viral infection.

Therefore, my prediction for 2018 is the same as it is every year. I have absolutely no idea how the stock market will perform between now and December 31st.

IMPLICATIONS FOR INVESTORS

John C. Bogle is the founder and former CEO of Vanguard, and this visionary published the instant classic, "The Little Book of Common Sense Investing" back in 2007. In it, he wrote what could be one of the more powerful quotes in the history of financial markets:

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

To any long-term investor, these words should be gospel because the way to achieve your investment goals is to manage risk rather than take too much risk.

Within this context, if emotions dominate the short-term movements in stock prices, and emotions are viruses to portfolios, then relying on annual stock market forecasts only adds unnecessary risk to the investment process. There is simply no upside because forecasters are either lucky or wrong, and luck only lasts for so long.

Fundamentals are what drive the long-term returns in financial markets, so here are five drivers that I believe will impact asset prices in 2018 and beyond (properly diversified investors need to consider all asset classes):

1. The U.S. economy will begin to accelerate
2. The Federal Reserve could look a lot different by the end of 2018
3. The U.S. will soon become the world's largest energy producer
4. Diversification will become increasingly more important
5. The entrepreneurship and innovation has only begun to impact the global economy

This list is not much different than the one from last year because the drivers of fundamentals tend to move at a glacial pace. More importantly, markets do not operate on calendars, where the New Year commands a new set of forecasts (unless one's job is to provide continual market commentary).

Instead, they are event-driven, and despite a new Presidential administration and all-time highs in the S&P 500, the fundamentals continue to strengthen while the Fed continues to be accommodative to future economic

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growth.

Over the coming weeks, I will dive deeper into the five points above, but for now, do yourself a favor by ignoring annual forecasts and overcoming the urge to try to estimate where the stock market will end this year. If the smartest strategists with access to unlimited resources and multi-million dollar budgets can't get it right then neither can you, me, or anyone else.

THE BOTTOM LINE is that predicting annual returns from an asset class as emotionally sensitive as equities on a consistent basis is impossible, but since a year tells a long-term investor very little about the future of investment returns, it's best to ignore these predictions anyway.

SINCERELY,

Mike Sorrentino | CFA
Chief Investment Officer
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** S&P 500 Forecasts From Strategists Index (SPXSFRC) reflects the average year-end forecast for the S&P 500 Index, compiled from a survey of Wall Street strategists by Bloomberg reporters.

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