

[Commercial bankruptcies](#) are skyrocketing, oil prices have collapsed, profits have declined and Central Banks globally are pushing negative interest rates in hopes of keeping economies afloat. At any other point in history, such a combination of events would have investors scrambling for cover as market prices fell. Currently, however, the majority of the mainstream analysis continues to ignore past history as stock prices are just within reach of all-time highs. The assumption "*this time is different*" is based solely on a continued low-interest rate environment promulgated by the Federal Reserve. However, since I was long ago excised by the media for allowing the "*data to speak*," let me clarify why I still believe the "*bearish*" case will still likely come to fruition.

## Economic Hopes To Be Disappointed

Despite ongoing hopes of a resurgence of economic growth over the past six years, each year has only led to disappointment. As I discussed previously:

"If you are expecting an economic recovery, and a continuation of the bull market, then the economic data must begin to improve markedly in the months ahead. **The problem has been that each bounce in the economic data has failed within the context of a declining trend.** This is not a good thing and is why we continue to witness an erosion in the growth rates of corporate earnings and profitability. **Eventually, that erosion combined, with excessive valuations, will weigh on the financial markets which is potentially much of what we are witnessing now. The economy continues to ebb and flow between weak growth and no growth.** This puts the Federal Reserve at risk of a policy mistake that could trip the economy into an outright recession. **While there have certainly been positive bumps in the data, as pent-up demand is released back into the economy, the inability to sustain growth is most concerning.**"

This "*ebb and flow*" within a weakening trend can be most clearly seen in the [Economic Output Composite Index](#). As shown, recent hopes of a resurgence in economic growth have all but faded as the data has plunged to levels normally more associated with outright recessions.

[EOCI-050916](#) If we turn the index into a recession indicator by only looking at when the index falls below 35, we see the following.

*(The recession indicator uses a 6-month average to smooth out the month-to-month volatility caused by seasonal adjustment anomalies as we are currently witnessing.)*

[EOCI Index Indicator-042816](#)

## Not So Rewarding

Unfortunately, substantially weaker economic growth, both domestically and globally, will continue to weigh on future stock market returns particularly when coupled with already high valuation levels. While the majority of mainstream analysis continues to expect "*double-digit*" returns in the near term, the realization of near zero returns over the next decade (*after including taxes, inflation, and fees*) will likely be outright depressing. Ultimately, **stocks are not magical pieces of paper that provide double-digit returns over the long run.** In fact, we've just had a 15-year period of lousy (*less than 5% annualized*) returns, and it all has to do with valuation. While Wall Street, and

the financial media, continue to push individuals into the casino to increase revenues, **what is ultimately forgotten is that stocks are ownership units of businesses.** While that seems banal, **future equity returns are simply a function of the value you pay today for a share of future profits.** The chart below shows that rolling 20-year returns from current valuation levels have been substantially less optimistic. After fees, taxes and inflation, it is substantially worse.  
[SP500-Real-RollingReturns-20-Years-051916](#)

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## The Fed Can't Raise Rates

The recent rally in the dollar has been primarily been a function of anticipation the Fed would continue hiking interest rates. Of course, further rate hikes would be taken as a sign of a stronger economic backdrop which would be supportive of a stronger dollar. Well, that is what was hoped. The reality, as I have been discussing for over two years, is the Fed is *"caught in a liquidity trap"* and can not raise rates for the foreseeable future. To wit:

**"The problem for the Federal Reserve is that getting caught in a liquidity trap was not an unforeseen outcome of monetary policy, but rather an inevitable conclusion.** As shown in the chart below of GDP, inflation, and interest rates, **each time the Fed has intervened with monetary policies it has lead to lower rates of economic growth and lower rates of inflation and interest rates**As stated, the current low levels of inflation, interest rates, and economic growth are the result of **more than 30-years of misguided monetary policies that have led to a continued misallocation of capital.**

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For several years, there have been repetitive screams that inflation was imminent due to deficits, a fiat currency and expanding debt levels. Yet, the opposite has been true.

**The lack of inflation has been a construct of the underlying structural dynamics of the economy. Home ownership rates have plunged, technological advances and productivity increases have fostered wage suppression, and high levels of uncounted unemployed (54% of the 16-54 aged labor force) drag on economic strength."**

As I predicted the, the Federal Reserve has now become trapped by its own "data-dependent" analysis. **Despite ongoing commentary of improving labor markets and economic growth, their own indicators are suggesting something very different.** This is why they have now instituted [their new "perma-excuse" of global instability](#) as the rational for not hiking rates. While I stated previously the Federal Reserve may hike interest rates simply to "save face," it is now quite apparent they can not do so particularly as we head into a political election. The reality has always been that organic economic growth was far too weak to tighten monetary policy. Of course, the Fed knows this which is why they have remained on hold and even floated the idea of "negative interest rates." In other words, they already likely realize the trap they are caught in.

## Staying Bullish

With the current economic cycle already long by historical standards, economic data continuing to

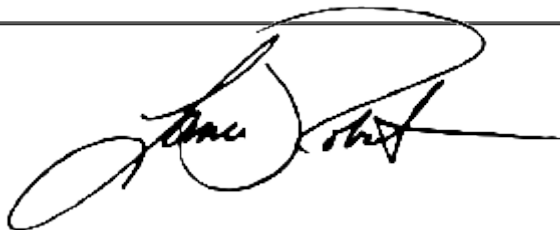
remain weak and profit margins on the decline, **there is an increasing possibility that "risk" outweighs reward" in the near term.** As we now exit the "best 6-months" of the year, any rally from the recently oversold conditions is likely a good opportunity to "de-risk" portfolios particularly as we head into two of the weakest years of the decennial cycle. In simpler terms, while Wall Street continues to flood the media with "bullish spin" to keep individuals invested in order to collect "fees," the actual data suggests that "odds are heavily stacked in favor of the house." **The inherent problem of "eternal bullishness" is the "willful blindness" to the underlying data in an effort to chase short-term returns.** This leads to the unfortunate problem of being "all-in" on every hand which has a devastating consequence when a mean reverting event occurs. [John Hussman](#) once penned an excellent piece on the full-market cycle:

**"Regardless of very short-term market direction, it is urgent for investors to understand where the equity markets are positioned in the context of the full market cycle.** While the most extreme overvalued, overbought, overbullish, rising-yield syndrome we define has generally appeared only at the most wicked market peaks in history, and investors have ignored those conditions over the past year. We can't be certain when the deferred consequences will emerge. **But a century of market history provides strong reason to believe that any intervening gains will be wiped out in spades.** It's instructive that the 2000-2002 decline wiped out the entire total return of the S&P 500 in excess of Treasury bills all the way back to May 1996, while the 2007-2009 decline wiped out the entire excess return of the S&P 500 all the way back to June 1995. **Overconfidence and over valuation always extract a terrible payback."**

In the end, it does not matter IF you are "bullish" or "bearish." **The reality is that both "bulls" and "bears" are owned by the "broken clock" syndrome during the full-market cycle.** However, what is grossly important in achieving long-term investment success is not necessarily being "right" during the first half of the cycle, but by not being "wrong" during the second half. That second half of the equation will come as recently stated by Stan Druckenmiller of Duquesne Capital:

**"If we have borrowed more from our future than any time in history and markets value the future, we should be selling at a discount, not a premium to historic valuations.** It is hard to avoid the comparison with 1982 when the market sold for 7x depressed earnings with dozens of rate cuts and productivity rising going forward vs. 18x inflated earnings, productivity declining and no further ammo on interest rates. **The lack of progress and volatility in global equity markets the past year, which often precedes a major trend change, suggests that their risk/reward is negative without substantially lower prices and/or structural reform.** Don't hold your breath for the latter. **While policymakers have no end game, markets do."**

The problem of excessive optimism is the inevitable reversion to excessive pessimism. It is just a matter of timing.



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