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HOW FAR CAN THE S&P 500 RISE?

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EXECUTIVE SUMMARY

It has become evident to technical analysts that the stock market has staged a convincing upside breakout. Not only has the major global averages broken out to the upside, the monthly charts of selected indices have flashed MACD buy signals. In the past, such buy signals have indicated significant price gains, with only minor downside risk.

In that case, what is the upside potential for stocks? We estimate targets using a variety of technical and fundamental techniques, and arrived at some different answers.

We found that price targets derived from technical analysis are highly ambitious and they call for upside potential of 25% or more. By contrast, valuation and longer-term projections point to highly subdued return expectations. Our Third Way scenario postulates that the S&P 500 could see a price appreciation potential of 10–13%, or 3380–3480 before suffering a downdraft of unknown magnitude.

Market Breaks Out, Now What?

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Exhibit 1: A Convincing Long-term Buy Signal

Source: Stockcharts

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Ambitious Technical Targets

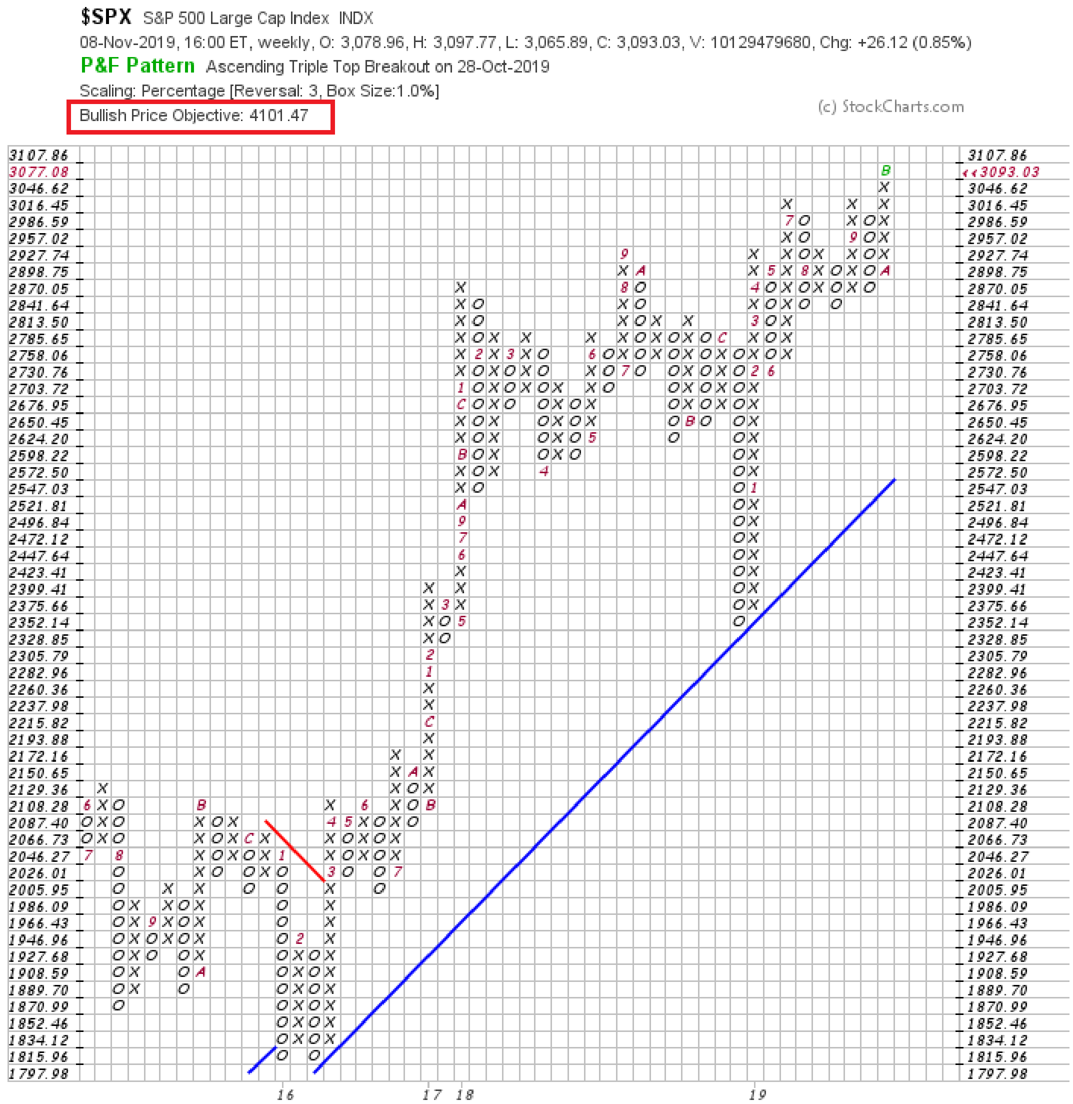
A brief survey of technical analysis revealed some astounding upside targets. [Callum Thomas] observed that Peter Brandt had projected an S&P 500 target of 3524.

Exhibit 2: S&P 500 Target of 3524

Source: Peter L. Brandt, Twitter

Point and figure charting yielded a series of different results, depending on the parameters set in the charts. We tried daily, weekly and monthly charts, with traditional and 1% boxes, and 3-box reversals. The upside target ranged from 3750 to 4100, with most clustered in the 3900 to 4000 range. These are all aggressive targets with upside potential of 22% or more from current levels.

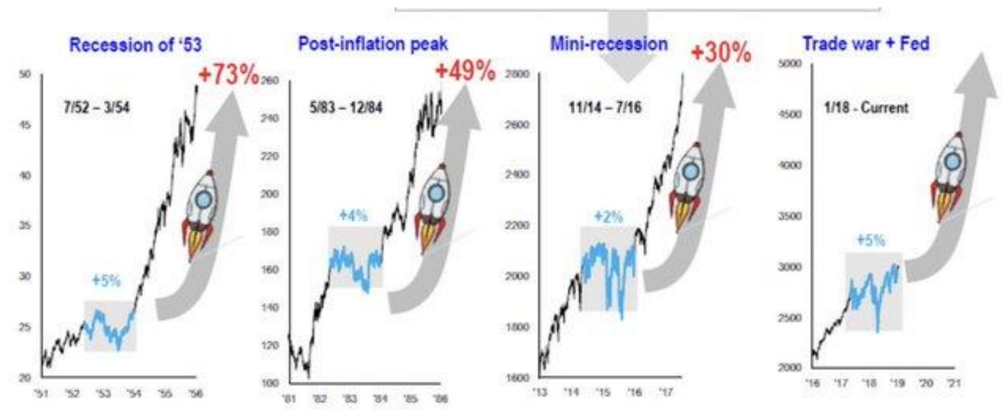
Exhibit 3: Point and Figure Targets from 3750 to 4100



Source: Stockcharts

While these are not purely technical targets, [Callum Thomas](#) also highlighted the bullish analysis from perennial bull Tom Lee of Fundstrat, who projected even more upside potential for stock prices.

Exhibit 4: Tom Lee Projects Enormous Upside Potential

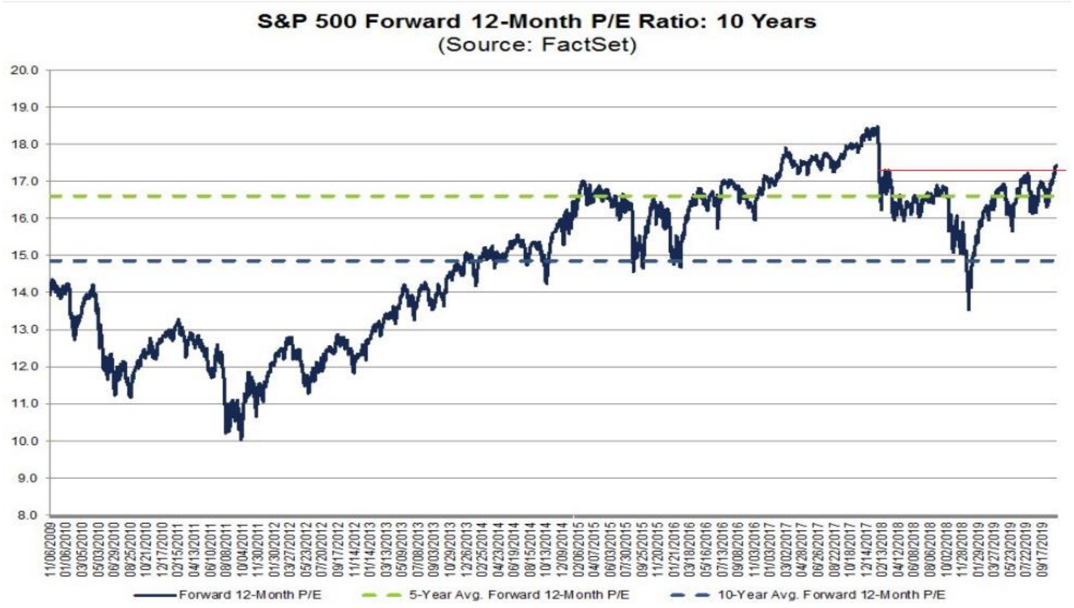


Source: Fundstrat

Valuation Headwinds

The sunny technical forecasts are tempered by market valuation headwinds. The S&P 500 trades at a forward 12-month P/E ratio of 17.5, which is nearing the nosebleed zone. The E in the P/E ratio would have to improve considerably to justify these multiples.

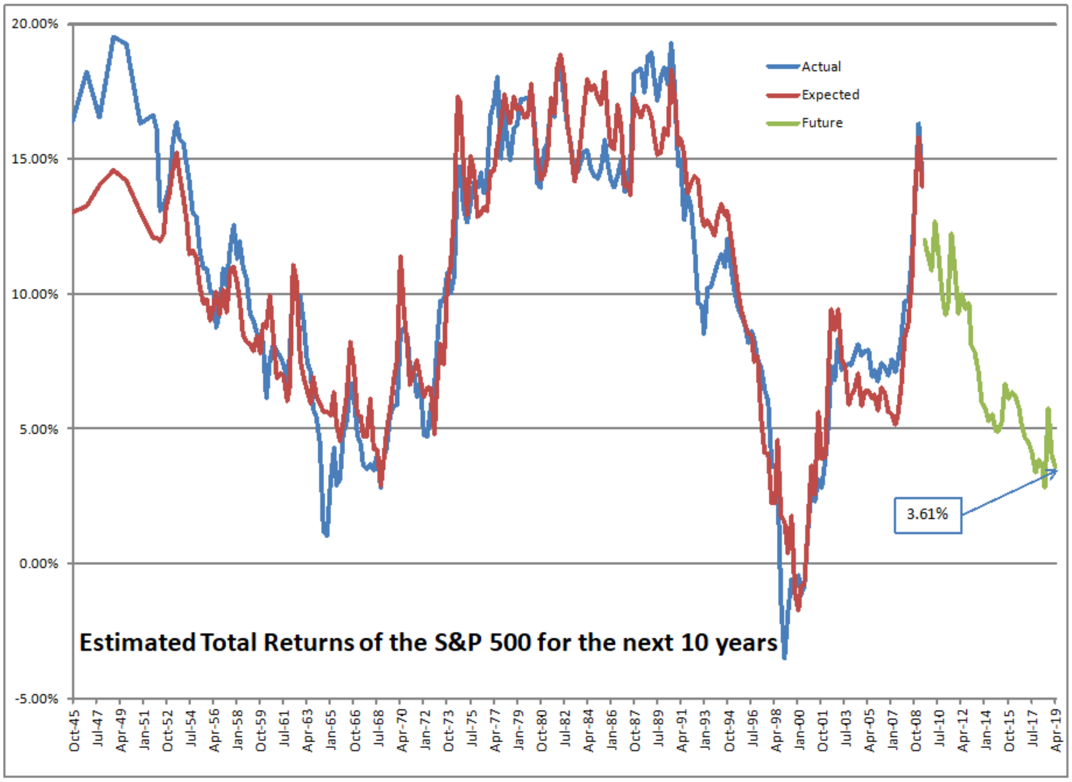
Exhibit 5: The Market Is Richly Priced



Source: FactSet Information Systems

From a longer-term fundamental perspective, David Merkel projected a 10-year total return of only 3.6% on September 21, 2019, when the S&P 500 stood at 2990. These forecasts have been remarkably accurate. If 3.6% return were to be realized, it would either mean that the uber-bullish technical targets are pure fantasy.

Exhibit 6: Projected 10-Year S&P 500 Total Return of 3.6%



Source: David Merkel

There are many ways of estimating long-term returns. Merkel explained that he tried using a variety of valuation techniques, which explained "60–70% of variation in stock returns". He settled on a technique he found at the blog Philosophical Economics,

> *The basic idea of the model is this: look at the proportion of U.S. wealth held by private investors in stocks using the Fed's Z.1 report. The higher the proportion, the lower future returns will be.*
>
> *There are two aspects of the intuition here, as I see it: the simple one is that when ordinary people are scared and have run from stocks, future returns tend to be higher (buy panic). When ordinary people are buying stocks with both hands, it is time to sell stocks to them, or even do IPOs to feed them catchy new overpriced stocks (sell greed).*
>
> *The second intuitive way to view it is that it is analogous to Modiglani and Miller's capital structure theory, where assets return the same regardless of how they are financed with equity and debt. When equity is a small component as a percentage of market value, equities will return better than when it is a big component.*

Bottom line: Both equity valuation and a survey of private investor positioning suggests sub-par U.S. equity returns. The gains of 20% or more appear way too ambitious.

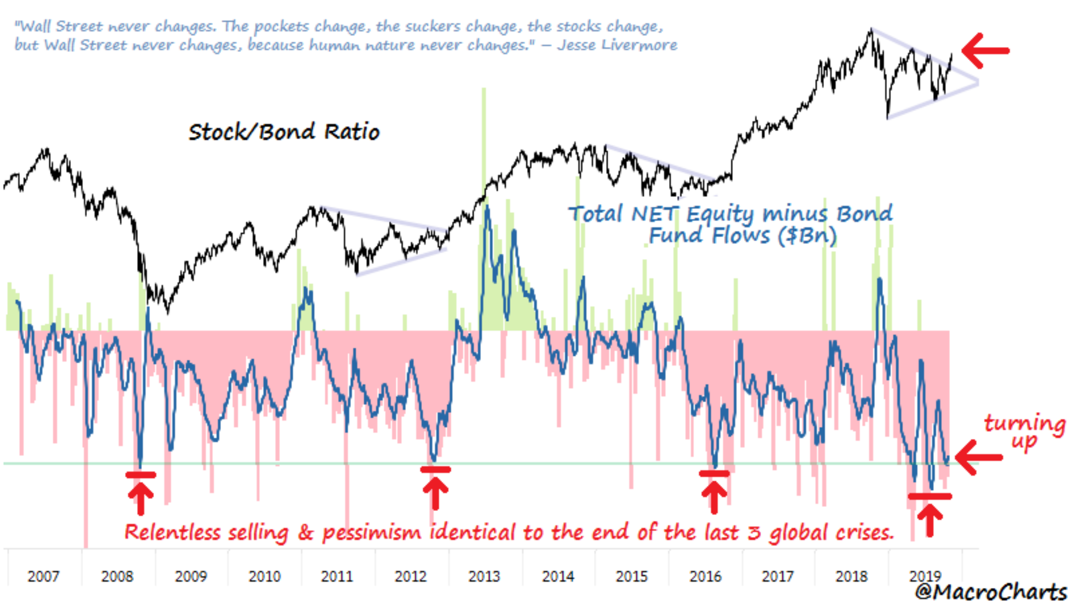
A Third Way Market Scenario

How can we square the circle of these contradictory views?

Investors can resolve this dilemma by recognizing that there are different time frames to the two schools of thought. The analysis of short-term macro outlook, institutional positioning and valuation suggests that both are right. ***A more reasonable scenario is a bubbly market melt-up, followed by a downdraft, all in a 2–3-year time frame.***

Let us first consider the issue of institutional positioning. Macro Charts analyzed stock and bond fund flows and found that investors had become excessively cautious. The latest upside breakout in the major global equity markets is a signal that stock prices are ready to soar as sentiment changes from fear to euphoria.

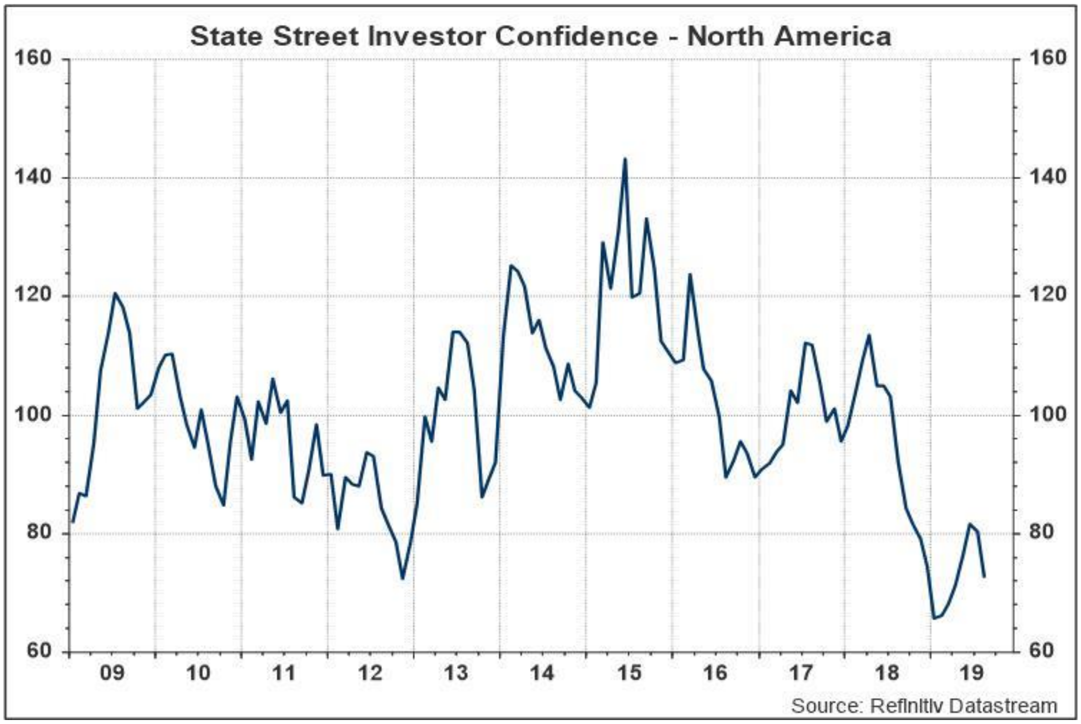
Exhibit 7: Ongoing Risk-on Reversal from Excessively Defensive Positioning



Source: Macro Charts

A variety of institutional sentiment indicators all point to excessively cautious position. The latest Barron's Big Money Sentiment Poll revealed a high degree of bearishness among U.S. institutions. The State Street Confidence Index, which measures the actual custodial institutional holdings, also shows a below-average market beta exposure.

Exhibit 8: State Street Confidence Shows Low Risk Appetite



Source: Datastream

The latest BAML Global Fund Manager Survey reveal a more nuanced view. The average global manager holds a below-average equity weight while overweighting defensive sectors and underweighting cyclicals. That said, they were overweight U.S. equities, as the U.S. economy was the last bastion of growth in a growth-starved world.

The Cycle Turns Up

The combination of an overly defensive institutional positioning and a cyclical turnaround could be the spark for a risk-on stampede. Indeed, we are starting to see signs of a cyclical revival. Robin Brooks of IIF observed that global PMIs are rebounding, indicating excessive overshoot to the downside.

Exhibit 9: PMIs Have Overshot to the Downside

Source: IIF

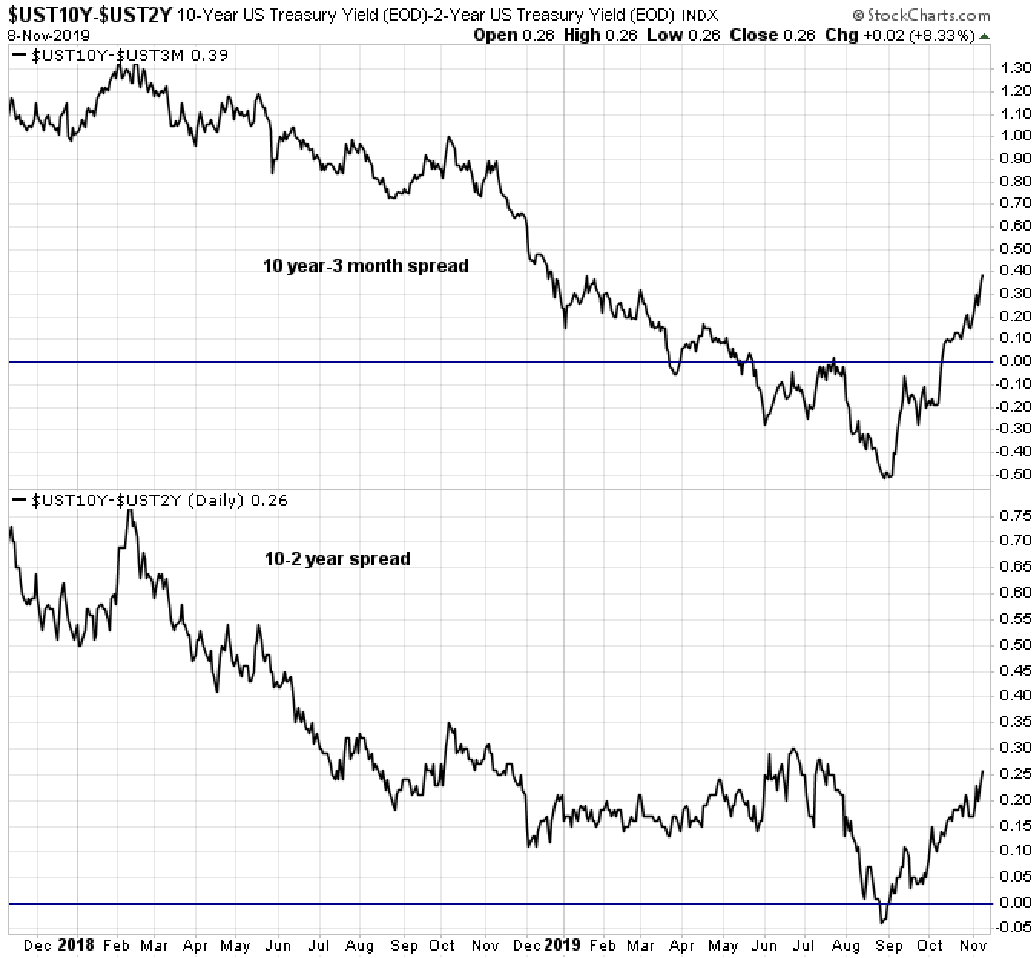
There are signs of stabilization in Europe. German exports rose 1.5% month-over-month and it was the biggest increase since November 2017. As Germany has been the locomotive of growth and exports in the eurozone, this latest reading gives some relief to recession fears.

Exhibit 10: German Exports Recover

Source: Bloomberg

Real-time market data is also supportive of a turn in the cycle. The yield curve is steepening, which is a signal that the bond market expects better economic growth.

Exhibit 11: Steepening Yield Curve = Better Growth Expectations



Source: Stockcharts

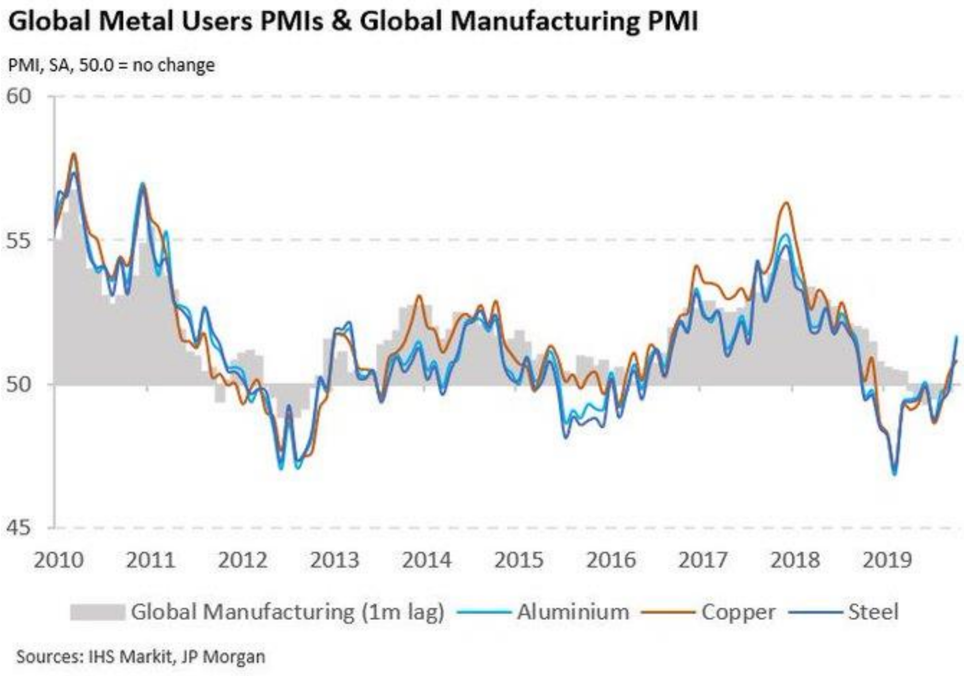
The relative performance of cyclically sensitive industries, such as global industrial stocks and global auto stocks, have bottomed and they are starting to turn up.

Exhibit 12: Global Cyclical Relative Performance Bottoming

Source: Stockcharts

Chinese growth may also be bottoming. IHS Markit reported that "Global Metal Users PMIs soar into expansion territory in October, as boosts to the Chinese manufacturing sector encourage strong production uplifts at global users of key metals."

Exhibit 13: Global Metal Users PMIs Surge Upward



Source: HIS Markit

Even the relative performance of Chinese property developers is constructive for the bull case. This is a highly leveraged and vulnerable sector in China. Beijing has done little to support to support these companies as growth has slowed. The revival in relative performance of these stocks is an encouraging sign that the worst of the tail-risk is behind us.

Exhibit 14: China's Property Developers Are Recovering

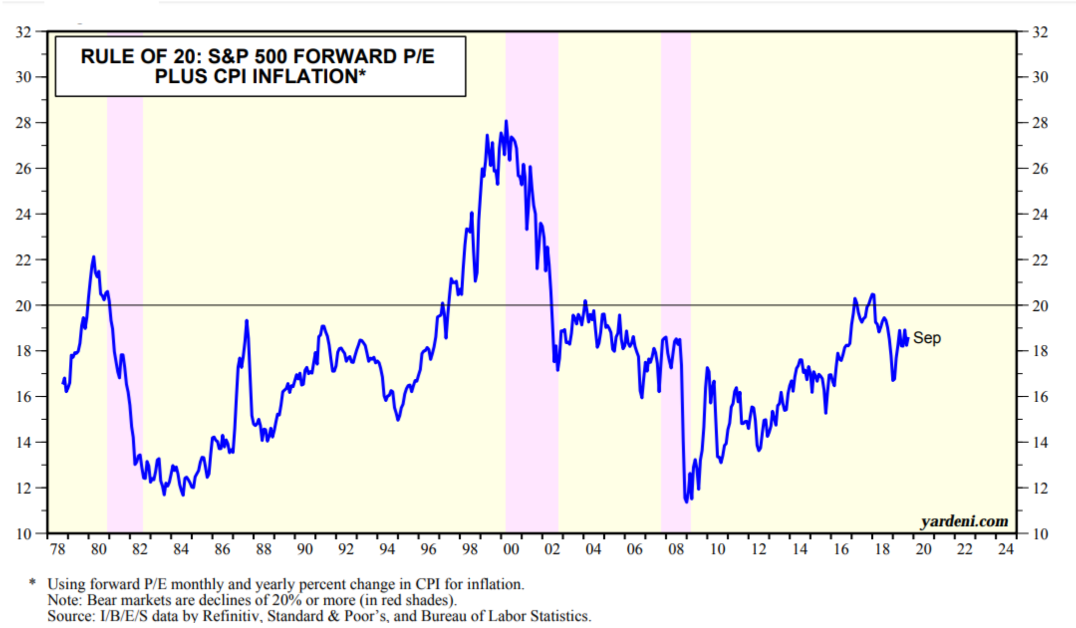
Source: Stockcharts

The Rule of 20

We began this exercise by trying to square the circle of highly bullish technical targets with cautious fundamental equity targets. The scenario we sketched out is an overly defensive institutional investor community that is caught offside by a cyclical revival, and chases equity market beta in a FOMO (Fear of Missing Out) rally.

While S&P 500 valuations are somewhat elevated, they are not yet at bubbly levels just yet. We refer readers to Ed Yardeni's "Rule of 20", which states that investors should be cautious when the sum of the forward P/E and inflation rate exceeds 20. With the forward P/E at 17.5 and CPI inflation at 1.7%, we are not there yet.

Exhibit 15: Yardeni's Rule of 20



Source: Yardeni Research, Inc.

Looking out 12 months, if we were to pencil in a growth rate of 5–8% to forward earnings, and assuming that CPI remains at 1.7%, the S&P 500 would have an upside of 300–400 points, or a price appreciation potential of 10–13% before the Rule of 20 warning is reached. As history shows, the Rule of 20 is not a hard and fast rule.

In summary, price targets derived from technical analysis are highly ambitious and they call for upside potential of 25% or more. By contrast, valuation and longer-term projections point to highly subdued return expectations. Our Third Way scenario postulates that the S&P 500 could see a price appreciation potential of 10–13%, or 3380–3480 before suffering a downdraft of unknown magnitude.

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