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Old Bulls

It is no secret that the current bull market runs in stocks and bonds are long by historical standards. Counting from March 2009, this bull stock cycle, represented by the S&P 500 Index, is 8.8 years old today. According to InvesTech Research, this is more than twice the historic median of 3.6 years, and is 9 months away from setting a new record. The current bond bull market, represented by the U.S. 10yr Treasury bond yield, has outlasted the estimates of many market pundits with its 36.3 year run. This is the longest bond bull market we have seen in modern history. Either way you measure it, these bulls aren't getting any younger.

Stock returns have been very attractive. As of November, the five-year S&P 500 annualized return was 15.8% in US dollar terms. These returns are above the high single digit long run average and have benefitted from the strong tailwind of multiple expansion. Multiple expansion can be defined as the change in the price investors are willing to pay for each dollar of earnings. The other two components of stock returns are earnings growth and dividend yield. But the market's willingness to increasingly pay higher valuations has been the leading source of strong performance over the last five years. Extrapolating past returns would assume continued multiple expansion to levels that have rarely been achieved, so we are hesitant to rely on this component further. Our expectation for stock returns relies more so on earnings growth and dividend yield. Naturally this leads to a lower return than the double-digit numbers we have grown accustomed to. Instead, a conservative annualized return estimate of 6% to 8% from equities is reasonable (4%-5% from earnings growth plus 2%-3% from dividend yield).

Bond returns have not been as strong as stocks, but have been higher than expected given their low starting yields five years ago. The five-year annualized return of the FTSE TMX Canada Universe Bond Index was 3.1% as of November. Bond returns can be attributed to the interest income earned plus the capital gain/loss from price changes in the bond. Over three decades, investors and central banks have pushed bond yields to historically low levels, which in turn, pushes bond prices higher, creating a strong tailwind for returns. With the Canadian Government 10yr bond currently yielding 1.9%, and assuming interest rates and credit spreads remain unchanged, a reasonable estimate for annualized bond returns over the next few years could be around 2%-3%. This is also a lower return profile than the mid single digits that investors have earned over the last two decades.

We recognize these are conservative estimates and actual returns may vary. But investors should be aware that if valuations continue expanding and if bond yields keep declining, investors would be accepting lower prospective returns and inheriting greater amounts of risk. As long-term investors, we have a healthy respect for the cyclicality of markets. The inflection points are unpredictable but the ups and downs are inevitable. Instead of attempting to predict the direction of markets, paying close attention to the price we are paying and observing surrounding valuations can help us to assess overall market health. In our case, above average valuations suggest lower return expectations going forward, and this itself is a sign to exercise caution.

But bull markets do not die of old age. Valuations can stay expensive for a long time. The longest bull markets in history could be happening right before our eyes. Despite the US Federal Reserve hiking their target rate for the fifth time this cycle, accommodative monetary policies remain supportive of above average valuations.

Our investment teams continue to uncover pockets of opportunity, buying unloved businesses that have valuation support and reducing holdings that pose undue risk. We are also doing our homework ahead of time to gain the conviction necessary to buy when others are selling. Our caution in the midst of strong investor sentiment can be unnerving at times, but we have found this to be a key attribute in adding value for our clients over the long run.