Have the Financial Markets Given a Once-in-a-Generation Signal?

One of the principal decisions investors have to make is how to allocate their assets between stocks and bonds. Although stocks generally provide a higher rate of return than bonds, stocks are also more volatile, and investors run the risk that when they need to take money out of their portfolio, stocks might be in a bear market, reducing the amount of money available to them. One of the indicators we look at to determine the optimal allocation between financial assets, is the relative returns between stocks and bonds, and in particular, the 10-year and 20-year rates of return for stocks and bonds. We have found these to be one of the most effective indicators for allocating assets. Five-year rates of return have too much noise in them to provide useful signals, and thirty-year rates are too stable to provide important signals on the relative returns on stocks and bonds. We use the return on the S&P 500 for stocks and the GFD's index of returns on 10-year government bonds for bonds. As most investors know, stocks generally outperform bonds over time because equities are riskier than bonds and investors must be compensated for this risk with a higher rate of return. However, this is not always true. Occasionally, though rarely, bonds outperform stocks over a period of 10 or 20 years. This only happens once in a generation, and the Financial Crisis of 2008 created one of those rare events. As a result of the financial crisis, for the first time since the 1970s, stocks underperformed bonds over the previous 10 years, and for the first time since the 1940s, stocks underperformed bonds over the previous 20 years. Typically, investors look at the annual returns to stocks, bonds and bills and the volatility of returns to determine the level of risk they face in choosing between assets. In reality, investors don't look at one-year time periods in making their long-term investment choices, but want to look at periods of ten, twenty or more years in order to prepare for their retirement. Without a long set of data, there is insufficient evidence to make informed decisions about how to allocate investment resources between different asset classes. Global Financial Data has over 150 years of history on the interaction between the 10-year and 20-year returns on stocks and bonds in the United States. This amount of data provides a more realistic view of the information investors need to make long-term investment decisions. The 10-year total returns to stocks and bonds are illustrated in the graph below with stocks represented by the blue line and bonds represented by the red line.

The graph illustrates that stocks generally outperform bonds over time, and that stock returns are more volatile than bond returns. What is more interesting than these well-known facts are the periodic, but rare, occasions when bonds outperform stocks over a ten-year period. The primary periods when stock returns fell below bond returns were in the 1880s and 1890s, the 1930s, the 1970s and the 2000s. Over the past 150 years, these have been once-in-a-generation events that are followed by periods of several decades in which stocks consistently outperform bonds, in some cases by wide margins.

Several important facts should be noted about this graph. In most cases, increases in the rate of return to stocks at the beginning of each cycle were accompanied by decreases in the rate of return to bonds, as was true from around 1900 to 1930 and from 1940 to 1970. This occurred when nominal interest rates were low at the beginning of a cycle. The period between 1980 and 2005 was different from the other periods because the cycle began when inflation rates, and thus nominal interest rates, were relatively high. Consequently, as inflation and nominal interest rates fell, these changes generated capital gains which increased the long-term return to fixed income investors. Once inflation fell to normal levels, the 10-year return on bonds began to fall. Yields on 10-year bonds have been declining consistently since 1981 which means that over the next few decades, the graph is more likely to look like the 1940s and 1950s than the 1980s. It should also be noted that the 10-year relative returns to stocks and bonds cross over several times before stocks begin to consistently outperform bonds for a period of 25 years or more. Although it is impossible to know the returns this graph will show over the next 30 years, stock returns will probably fluctuate dramatically over the rest of the decade, and during the next bear market, 10-year returns to stocks will temporarily fall below the returns to bonds before rebounding. Nevertheless, the 10-year returns to stocks and bonds have begun to show a divergence which is likely to continue in the future. Below is the graph for the relative 20-year returns on stocks and bonds over the past 150 years. As can be seen, there have only been three times in the past 150 years when bond returns exceeded stock returns over a 20-year period: at the bottom of the bear market in 1932, during 1949, and during the financial crisis in 2009 and 2010. Since long-term bond total returns probably will continue to decline, 20-year stock returns are unlikely to drop below 20-year bond returns again for decades. As is true of the 10-year graph, stock and bond returns are beginning to diverge. Although there is no guarantee financial markets will repeat their past performance, there are several possible implications of this once-in-a-lifetime signal from financial markets.

1. Stocks should generally outperform bonds over the next 30 years because a new cycle in the relative rates of return began a year ago.
2. When the current bull market runs into trouble sometime in the next few years, the relative 10-year return on stocks will temporarily fall below the return on bonds, but will soon recover.
3. The 10-year rate of return on bonds is in long-term decline, and is likely to continue. Because, unlike in the 1980s, inflation rates are not excessively high, during the initial phase of this cycle, long-term return to bonds should decline not only in relative terms, but in absolute terms as well, before reversing about half-way through the cycle.
4. At the height of the cycle, stocks will have returned 15%-20% over the previous ten years. This peak should be reached sometime in the 2020s.
5. This cycle reinforces the conclusions I made in my paper, Are You Ready for the Bubble of the 2020s which discusses the convergence of long-term factors which favor a strong bull market in the 2020s. The stock market could fluctuate for the rest of the decade before breaking into a secular bull market in the 2020s.

One possible conclusion to draw from these graphs is that long-term investors should consider allocating more of their assets toward stocks, and take advantage of market downturns during the next few years to reallocate money from bonds into stocks. Of course, past performance is no guarantee of future returns, but as anyone who looks at these graphs should realize, events such as these only happen once in a generation.