The Financial Market Forecast

Robert S. Neal

Associate Professor of Finance, Kelley School of Business, Indiana University-Purdue University, Indianapolis

William L. Sartoris

Professor of Finance and Director, Investment Banking Academy, Kelley School of Business, Indiana University, Bloomington

A noted economist once said, "The five most dangerous words for investors are: This time really *is* different". So before trying to gaze into the crystal ball let's look backward and put the recent market performance in historical perspective. The S&P 500 generated annual total real returns (after accounting for inflation) of slightly less than 15 percent over the last 15 years (1986-2001),with the average over the last five years being just over 20 percent per year. This was much higher than the five percent real return on the S&P during the fifteen years from 1971-1985. Productivity growth, the expansion in global trade and the technological revolution were clearly important factors for the recent performance. However, two other factors emerged in the latter half of the 1980s and the 1990s.

The first factor was the level of inflation and interest rates. In the early 1980s interest rates on long-term government bonds and inflation were both around 14 percent. By the mid-1980s inflation had dropped to about five percent but the government bond rates were still in double digits. The mid-1980s saw the start of a fairly steady decline in interest rates that has continued to this date. Since rates and prices move in opposite directions, the drop in rates caused an increase in asset prices—stocks as well as bonds. To see this effect, think of a security that was paying out $100 per year. At a rate of 15 percent, this security would sell for $667. If the rates drop to 10 percent the security price increases to $1,000. If the rates further drop to 5 percent, the price increases to $2,000. This is without any increase in the payout from the security!

Can we expect more normal rates of return next year?

The second factor is a change that occurred in the risk premium—the extra return that investors demand to bear higher risks. In the early 1980s Baa corporate bonds (the lowest investment grade bonds) were commanding a risk premium of about 3.5 percent above government bonds. By the late 1990s this risk premium had declined to about 1.25 percent. While the risk premium on common stocks is hard to estimate, without question it followed a similar pattern. This drop in risk premium magnified the decline in overall interest rates, with a consequential increase in stock prices.

The net result is that these two factors enabled investor's returns in stocks to outpace the growth in profits. In looking to the potential returns for the next year and beyond, we have to recognize that these factors will not be duplicated. First, there is no room for interest rates to drop much more. Second, there is some evidence that the risk premium has risen recently. The spread of Baa bonds over governments rose to the 2 to 2.5 percent range in 2000 and 2001. It is unclear what the economy sliding into a recession and the terrorist activity is having on the risk premium for stocks, but it is not likely to cause the premium to fall.

While the market has recovered the losses following September 11th, the next year is likely to be a time of substantial uncertainty. Third quarter earnings for the S&P 500 are now expected to decline about 22 percent from year ago levels and an unusually large number of companies have pre-announced lower future earnings. This pattern is gradually expected to improve with a forecasted 14 percent decline in the fourth quarter (year-to-year) and a 2 percent decline in the first quarter of 2002. Positive earnings growth is expected to return in the second or third quarter of 2002, with an approximately 5 percent growth rate for the year.

Much of this free fall in earnings is associated with the September 11th attack. In the five weeks after the attack, earnings forecasts plummeted 11 percent for the fourth quarter and 10 percent for the first quarter of 2002. Economically sensitive sectors such as technology and airlines were especially hard hit.

Over the very long horizon, the return to stocks has averaged about 7 percent more than the inflation rate. Does this mean that we can expect normal rates of return for the next year? Unfortunately, there are two red flags on the horizon. First the price/earnings ratio of stocks is currently about 21, well above the historical average of 14. While the prospect of low inflation and strong savings from 401k plans contribute to a higher than average price/earnings ratio, reversion towards its historical average will likely come from lower stock prices. Second, there can be long periods when stocks remain poor investments. For example, from 1966 to 1981, the average return on stocks was about the same as the inflation rate.

On the upside, many analysts believe that the September lows have signaled the bottom of the market. For the first time in several years, corporate insiders were net buyers of stocks and surveys of corporate technology spending suggest

that IT investment has stabilized after months of sharp declines. The downturn of the past 18 months has essentially erased the run-up of stock prices in the 1990s. Since the recession of 1991, if stocks had simply averaged 7 percent above inflation per year, then the stock prices would be close to current levels.

Over the next year we expect to see market returns more closely related to expected growth in corporate profits and the growth in the economy in general. Once the recovery is under way we are likely to see economic growth in the 2 to 3 percent range, inflation of 1 to 2 percent and corporate profit growth in the 5 to 6 percent range. Price/earnings ratios will shrink somewhat, but remain above their historical average. Overall, expectations of stock market returns are more likely to be in the high single-digits than the double-digit rates of the mid-1990s. We appear to be gradually returning to more "normal" times.

Short-term government rates are currently about 2 percent, and should remain at these low levels over the near term. Since the start of the year, the Federal Funds rate has been cut by 450 basis points and short-term Treasury Bills have shown a similar decline in yields. Despite the lowest short-term rates in 40 years, the yield on 3-month T-bills is lower than the Federal Funds rate, suggesting that additional interest rate cuts are forthcoming. Overall, short-term rates will remain in the 2 percent range until there is clear evidence that recovery is underway. The bank prime rate is expected to continue a slight decline and be around 5 percent until loan demand increases with an increase in economic activity.

Long-term Treasury rates have also declined, although much less than the short-term rates. The 10-year Treasury rate is about 4.25 percent, a reduction of 85 basis points since the start of the year. Since short-term rates have fallen by more than long-term rates, the yield curve has become steeper. This development is a favorable indicator for the economy because a steepening of the yield curve is associated with higher growth in the future. As growth picks up, short-term rates will rise as the Federal Funds rate reverts to a more balanced target.

The Outlook for Housing

Jeffrey D. Fisher

Director, Center for Real Estate Studies and Charles H. and Barbara F. Dunn Professor of Finance and Real Estate, Kelley School of Business, Indiana University, Bloomington

Activity in the nation's home building industry is expected to hold up fairly well against a general decline in economic growth during the final two business quarters of 2001. While the terrorist attack on America on September 11th has had a negative impact on consumer confidence, it appears that a healthy number of prospective homebuyers remain in the marketplace, and that low mortgage interest rates are helping to moderate the housing slowdown that is now occurring.

For the past year, the role of housing has been anything but typical, as it remained strong as the economy weakened, preventing growth of the Gross Domestic Product from turning negative. New residential construction alone accounts for 5 percent of the GDP on average and 14 percent when related financial and other activities are included.

The drop in mortgage rates from a peak of 8.7 percent in May of 2000 is helping to support the industry by making home buying more affordable. Interest rates are around 6.5 percent for fixed-rate mortgages and close to 5 percent for adjustable-rate mortgages. According to Freddie Mac, the national average commitment rate for a 30-year, conventional, fixed-rate mortgage was 6.82 percent in September, down from 6.95 percent in August; it was 7.91 percent in September 2000. Rates for fixed-rate mortgages had increased slightly at the time of this writing, but remain near historic lows, which allows homebuyers and people refinancing their homes probably the best mortgage financing terms since the 1960s.

There are some reasons to believe that the next significant move in long-term mortgage rates will be up from current levels. For one, the rate on the 10-year Treasury Note, a bellwether bond used to help price mortgages, has kicked up recently. It stands now at 4.57 percent—not that much higher than its recent low of 4.48 percent on October 3rd, but it is not falling, either.

Second, the housing market may be holding up better than most had expected following September