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Market Observations
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WHAT COMES NEXT?

Conventional wisdom holds that past outcomes in financial markets are unreliable indicators of what comes next. Yet when trying to plan for an uncertain future, the past can provide useful guidance. The need for guidance increases when recent outcomes push the limits of past experience. Such is the current predicament for investing either in the stock market, with prices at record highs, or in the bond market, with yields near record lows. Even with reliability in question, past market experience can be looked to for some perspective.

Perspective

The strong uptrend in the U.S. stock market (as measured by the Wilshire 5000 Index) continued through September with a trailing twelve-month return of +18.6%. Eleven months have passed since the last one-month loss. Chart I shows the frequency of one-month stock market returns and rolling twelve-month returns. Historically, one-month stock market returns have varied within a narrow ±1% range 72% of the time. In addition, one-month returns outside of ±5% have been rare indeed. The stock market has been driven higher over time by positive one-month returns 63% of the time. The cumulative outcome for twelve-month periods, as seen in Chart I, has been a gain 74% of the time with 58% of all twelve-month returns in excess of +10%.

With a stock market gain in the last twelve months, what outcome can be expected in the next twelve months? Chart II shows past relationships. The frequencies here reflect the reality that stock market gains have occurred more frequently than losses. When the stock market return has been positive in the last twelve months, the return has been positive again in the next twelve months 77% of the time. Next-year returns following all last-year gains have been lower on average.

Diversification is the preferred strategy for reducing portfolio risk amid ever-present market uncertainties. The different return frequencies between stocks and bonds shown in Chart III provide some explanation. Bonds clearly have been less risky with twelve-month gains experienced 93% of the time and losses greater than -5% exceedingly rare.

Investment Implications

Past outcomes can provide but guidance to what comes next for market returns. Recent stock market gains make certain neither future gains nor losses even though the frequency of gains has exceeded by far the frequency of losses. Portfolios diversified among stocks and bonds can reduce but not eliminate risk. Nevertheless, it is essential that portfolios be diversified to risk levels consistent with clearly identified goals and time horizons, and individual tolerance for risk.

Chart I

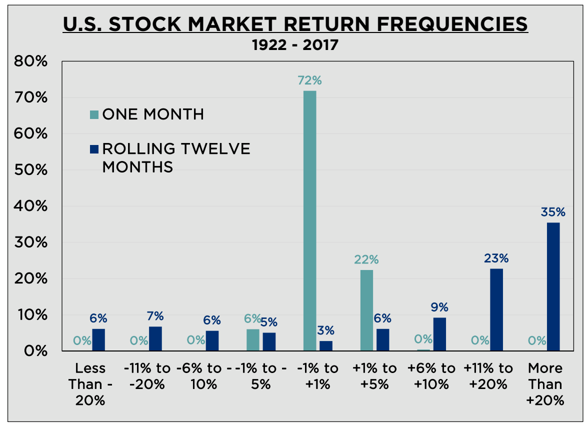

Chart II

U.S. STOCK MARKET
Year-Over-Year Frequencies
Rolling Twelve-Month Returns
1922 - 2017

		LAST TWELVE MONTHS: LOSS	LAST TWELVE MONTHS: GAIN
NEXT TWELVE MONTHS	GAIN	18%	57%
	LOSS	8%	17%

Chart III