RIVERFRONT INVESTMENT GROUP

From the Chairman's Desk

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SUMMARY

- The period from 1956-1966 offers lessons we can learn from today.
- Similarities include technological progress, market fundamentals and geopolitical instability.
- If we are right, stocks will likely remain above trend and returns will be more muted.

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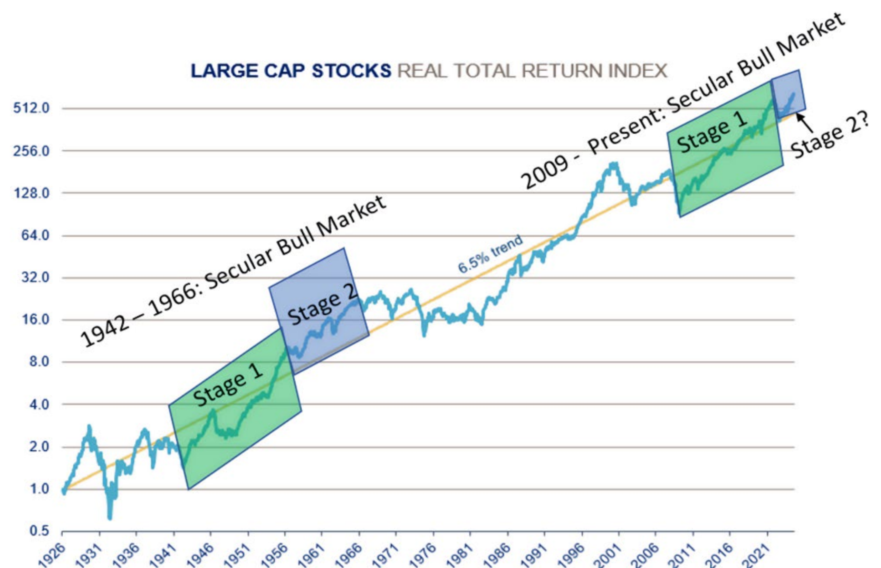
Lessons from a 'Mid-Century Modern' Market (Updated from June 2022)

What Was Old May be New Again, Offering Possible Clues About the Bull Market's Next Stages

Last week the S&P 500's advance marked the 47th time this year that the index has hit a new all-time high. The secular bull market that investors are currently enjoying began in 2009 and is now nearly sixteen years old. Over this period the S&P 500 has risen nearly 9x from its March 2009 bottom of 666. Naturally, each advance leads to the obvious question: 'what's next?' In June of 2022 we attempted to answer that question in a *Weekly View* with a comparison between today's secular bull market and one in the past. Our current *Weekly* is an update to that piece and a reaffirmation that this bull market has more room to run, albeit at a different gait.

The Mid-Century Modern Market

Although history rarely repeats itself, it does often rhyme, and we believe it makes sense to review prior secular bull markets to look for patterns that feel familiar. In our view, the most similar may be the secular bull market, which



Source: RiverFront Investment Group, calculated based on data from CRSP 1925 US Indices Database ©2024 Center for Research in Security Prices (CRSP®), Booth School of Business, The University of Chicago. Data from Jan 1926 through September 2024. RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation. Blue line represents the Large Cap Real Return Index. Yellow line represents the Annualized Real Trend Line of Large Cap Real Total Return Index according to Price Matters®. Information or data shown or used in this material was received from sources believed to be reliable, but accuracy is not guaranteed. The chart above uses a logarithmic scale. Line movements will be dampened/subdued based on the exponential y-axis. Chart shown for illustrative purposes only. Past performance is no guarantee of future results.

occurred between 1942 and 1966. Architects, designers, and fashionistas may recognize that as the 'mid-century modern' period, which explains our title.

The 1942-1966 bull market progressed in two stages, as shown in the chart above. The first stage, which lasted 14 years (1942-1956, green box) was defined by high returns where US Large-cap stocks rose from well-below trend to well-above trend. It was also a period where low interest rates prevailed. The second stage, where valuations started and ended above trend, lasted 10 years (1956-1966, blue box) and delivered more muted returns. **It is this second stage that we believe could provide some insight into how the next few years may unfold for US equity investors.**

We believe that there were at least three defining characteristics of that second stage of the 1942-1966 secular bull market that share similarities with today's investment environment. **They include: 1) Economic progress fueled by innovation and demographic consumption, 2) Less favorable valuation and a higher interest rate backdrop, and 3) Macro challenges and conflict.**

Economic Progress

Then:

- **Innovation:** The 1950s and 1960s were viewed as the beginning of the **Third Industrial Revolution**. Examples include the first commercial computer (1951), first color TV broadcast (1954), first optical fiber (1956), first interstate highway (1956), first satellite: *Sputnik* (1957), first microchip (1958) and the first modern photocopier (1959). This period of revolutionary innovation spurred consumer desire and business investment, which led to strong economic growth.

- **Demographic Consumption:** Pent-up consumption was unleashed after WWII with returning soldiers quickly trying to progress through life's stages: 1. getting jobs, 2. marrying, 3. Buying a home and 4. having children (baby boomers). As this wave of Americans progressed en masse, the demand for goods and services was amplified and the economy enjoyed a strong tailwind.

Now:

- **Innovation:** Today, it is believed that we are at the dawn of the **Fourth Industrial Revolution**, which will be defined by technology actively intervening in more aspects of our life. The most talked about example is artificial intelligence, however other technological advances like autonomous vehicles, 3-D printing, customized medicine, and functional robotics are also important components. Similar to the Industrial Revolution that preceded it, we anticipate these advances will further spurn consumption and investment.

- **Demographic Consumption:** We see two impactful demographic waves driving economic demand. First, there are the 72 million Millennials (age 28-43*), who have moved through life's stages more slowly than prior generations. They are now in their 'prime spending' years and trying to catch up quickly, which helps explain the growing number of baby strollers around town and the high prices of homes. Second, aging baby boomers (ages 60-78*) are beginning to transition their massive wealth to their children and grandchildren, providing some of the fuel to fund Millennial spending.
  **According to Pew Research*

Less Favorable Valuation and Interest Rate Backdrop

Then:

- **More expensive valuations:** When the secular bull market began in April 1942, US Large-cap stocks were attractively valued at nearly 50% below trend, according to our *Price Matters* methodology. By the end of that bull market's first stage (March 1956) stocks were more than 50% above trend and thus no longer cheap. However, stocks continued to rise in value throughout the bull market's second stage, albeit at a slower pace, and peaked at roughly 90% above trend in October 1965.

- **Rising rates:** From 1942 to 1951 the Federal Reserve kept interest rates artificially low, effectively pegging the Fed Funds rate at 0.375% and 10-year rates at 2.5%. After the peg was removed, rates were allowed to rise, and 10-year yields oscillated between 3% and 5% from April 1956 to February 1966.

Now:

- **More expensive valuations:** The first stage of the current secular bull market began with US large-cap stocks 47% below trend in February 2009. As of September 2024, those same stocks have risen to nearly 40% above trend.

- **Rising rates:** Except for a 3-year period, which ran from mid-2017 to mid-2020, the Fed held the Fed Funds rate under 1% from 2009 until 2022. Over that time 10-year yields also remained low, oscillating largely between 1% and 3%. However, beginning in March 2022, the Fed raised rates eleven times, effectively ending this period of artificially low interest rates. As of 10/18/24, the Effective Fed Funds rate now hovers around 4.8% and the 10-year Treasury yields 4.09%.

Macro Challenges and Conflict

Then:

- **Economic Challenges:** Despite real GDP growth of 3.8% between 1956 and 1966, the economy experienced two monetary policy-induced recessions in 1958 and 1960-1961.

- **Social Division:** The seeds of social division may have first been sown by Senator Joe McCarthy in the early 1950's, with what has been labelled as *McCarthyism* or *The Red Scare*. Further division followed throughout the Civil Rights Movement, which lasted from 1954 to 1968.

- **Geopolitical Conflict:** Challenge and conflict defined this period as the Cold War with the Soviet Union intensified with the Cuban Missile Crisis (1962) and President Kennedy was assassinated in 1963.

Now:

- **Economic Challenges:** The US economy is still growing at real rate of around 3% but much is dependent on the Fed and their ability to execute a 'soft landing'. A policy misstep by the Fed (not lowering rates fast enough) or a pick-up in inflation could quickly slow the economy, in our view. Additionally, we believe the economic divide between the 'haves' and 'have nots' appears to be growing with the 'have nots' possibly already experiencing a mini recession as companies catering to this demographic have recently started to struggle.

- **Social Division:** As the Presidential election draws near, disagreements between progressives and conservatives seem to grow in frequency and magnitude every day. These fissures have not just appeared between parties, but within parties as well.

- **Geopolitical Conflict:** Eerily like the 1950s-60s, we believe the US is in the early stages of a new 'Cold War', this time with China. 'Hot' wars in Eastern Europe and the Middle East have also broken out and tensions appear to be rising between China/North Korea and Japan/South Korea.

Conclusion

History provides clues regarding how investors may respond to different market environments. Perfect corollaries are rare, and unexpected factors could create some very different outcomes. However, we believe that the 'mid-century modern' bull market can offer some clues as to how the next leg of the current bull market unfolds. Assuming our views are correct, we see three take-aways investors should prepare for.

- **Uncertainty is here to stay:** Without cheap valuations to buffer bad news, anxiety will remain as it did in the second stage of the 'mid-century' bull. While we continue to expect stocks to advance, we anticipate that the 'ride' will continue to be uncomfortable.

- **Stocks and bonds remain attractive and may not get cheap:** US large-cap stocks remained relatively expensive throughout the second stage of the 'mid-century' bull, averaging nearly 57% above trend and remaining at least 18% above trend throughout, according to *Price Matters*. Bond yields were higher too, averaging 3.93%. Going forward we anticipate normal pullbacks of 5-15% but are not expecting the 'fire sales' that appeared after the Tech bubble, the Financial Crisis or COVID.

- **Lower, more normal returns on stocks:** Returns during the first stage of the 'mid-century' bull market were significant before normalizing in its second stage. We anticipate a similar path for returns in the current secular bull market, meaning that returns should be more normal relative to the much higher returns experienced from 2009-2021.

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Standard & Poor's (S&P) 500 Index TR USD (Large Cap) measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

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Current yield is a bond's annual return based on its annual coupon payments and current price (as opposed to its original price or face). The formula for current yield is a bond's annual coupons divided by its current price.

In a rising interest rate environment, the value of fixed-income securities generally declines.

Definitions:

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