

The Gazette

The Dow Jones at 17 000 in Five Years!

Very rarely do I play the prediction “game” so popular on Wall Street. But I’ll make one this week. In 1999, I wrote an article stating that the S&P 500 was very expensive and the next decade returns could be modest (it turned out to be an understatement). In 1999, stocks were expensive: the Price to Earnings ratio (P/E) of the average stock of the S&P was around 27 times, way higher than what interest rates at that time (6%) would have justified (something like 16-17x). How did investors react to high prices? They were buying index funds at record pace and were more optimistic than ever. A poll of investor’s sentiment revealed that the expected return for the future was 15% per year. It turned out that they were dead wrong: since then, the average yearly return has been around 2%, including dividends (0% without).

Today, the situation is the total reverse of 1999. Stocks are cheap: the P/E ratio of the S&P 500 is only 12 times. Long term interest rates are much lower than in 1999 (3.5%). But after a decade of poor returns, brought by shrinking P/Es, investors are now more pessimist than ever. Most of them don’t want to hear about the stock market for the rest of their lives. No one would dare to expect 15% a year from stocks... Believe it or not, this is highly positive for long term investors.

I only look at fundamentals and try to remove emotions from the process of rational analysis. So based on valuations, the timing seems almost perfect to invest in the stock market. In fact, I will dare to predict that within the next five years, the Dow Jones Industrial Average will reach at least 17 000 (up from 11 280 today).

Market levels depend on two things: earnings and P/Es. The later part is usually linked to interest rates but can be altered by investor sentiment. These sentiments are always short term oriented in nature. Over the long run, market levels reflect the intrinsic value of underlying companies.

The 30 companies that make up the Dow Jones should earn around 975 in profits this year. If we go back to 1999, the Dow earned 455 and its average level was 10 500. So the growth rate of earnings was almost 6.5% a year (almost in line with historical figures of 7%). But the P/E ratio has come down from 23x to 12x.

Now, let's assume that earnings continue to grow at 6.5% a year: they would reach the level of 1 336 in 2016. If P/Es go back to their historical average of 16x, this would translate into a level of 21 373 for the Dow Jones! Including dividends (2.5%), this would translate into a 16% annual return for the Dow.

Let's be a little more pessimistic. I'll assume that earnings only grow 5% per year in the next five years. And that the P/E of the Dow reach only 14x in 2016, which would be higher than today's level but still lower than the historical average. Earnings would reach 1 244 and the Dow would be at 17 421. I'll round it to 17 000 (I like nice round numbers). Including dividends, this would translate into an 11% annual return for the Dow.

So my range for the Dow in 2016 is 17 000 to 21 000, the equivalent of an 11%-16% annual return from today's level. And you also have a little potential bonus: the Canadian dollar is probably overvalued by 15-20%. So a return to a more normal level for the loonie (the OECD estimates Purchasing Power Parity at \$0.82) would add a few percentage points to these returns.

Anyway, at the very least, double digit returns for US stocks are – in my opinion – highly probable in the next five years. Based on my analysis, I can predict – with a nice margin of safety – that the Dow Jones will reach at least 17 000 before the end of 2016.