DIY Market Forecast II - Our Forecast

A week ago we published DIY Market Forecast. This article was unique for us as we did not offer you our opinions and forecasts. Instead, the article provided data and trends but left it to the reader to create their own five-year S&P 500 forecast. This approach appears popular based on the many favorable comments we have received. Of the reader comments, quite a few have asked us what our DIY forecast is. In a nutshell here is our forecast: We selected to use the 3% GDP growth table. While we could have easily opted for the 1% table, we give stronger economic growth the benefit of the doubt. Keep in mind, however, if a recession occurs and growth is minus two or three percent for a year or two, a one percent average growth rate will be the better bet for the next five years. Given the probability of that scenario as this economic cycle ages, consider our range of estimates as a top end of possible outcomes. We then chose a range of profit margins and CAPE valuations that we think are reasonable. In both instances, we believe they will slip from current levels towards longer-term averages. We do consider the possibility that profit margins and CAPE go below average but think the most likely scenario as highlighted in red, is between average and slightly below current levels. We remind that you that current levels in both instances are extreme and unlikely to continue, let alone rise from here. The table below highlights our DIY forecast. The red shaded area is our ?probable? forecast and averages to an S&P 500 forecast of 1707, with a range of 2420 to 1164. The yellow shaded area allows for the two factors to drop slightly below average which historically has been common during market corrections. The average S&P forecast in this scenario is 1172 with a range between 864 and 1512.

3% Annual GDP Growth

		Profit Margin (%)								
		Minimum		Average			Current	Maximum		
CAPE Valuation		4.10%	5.00%	6.37%	7.00%	8.00%	9.50%	10.06%	11.00%	12.00%
Minimum	4.8	213	259	330	363	415	493	522	570	622
	7	310	378	482	529	605	718	761	832	907
	10	443	540	688	756	864	1026	1087	1188	1296
	13	576	702	895	983	1123	1334	1413	1545	1685
	16	709	864	1101	1210	1383	1642	1739	1901	2074
Average	16.9	749	913	1164	1279	1461	1735	1838	2009	2192
	19	842	1026	1307	1437	1642	1950	2065	2258	2463
	22	974	1188	1514	1664	1901	2258	2391	2614	2852
	25	1107	1350	1720	1890	2161	2566	2717	2971	3241
	28	1240	1512	1927	2117	2420	2873	3043	3327	3630
Current	30.5	1351	1647	2099	2306	2636	3130	3315	3624	3954
	33.5	1484	1809	2305	2533	2895	3438	3641	3981	4343
	36.5	1617	1971	2512	2760	3154	3746	3967	4337	4732
	39.5	1749	2134	2718	2987	3414	4054	4293	4694	5120
	42	1860	2269	2890	3176	3630	4310	4564	4991	5444
Maximum	44.2	1958	2387	3042	3342	3820	4536	4803	5252	5730
	45	1993	2431	3097	3403	3889	4618	4890	5347	5833
	48	2126	2593	3303	3630	4148	4926	5216	5704	6222

In prior articles, we have estimated what fair value for the S&P 500 index would be. In general, our estimates tend to converge around 50% of the current level, which would be approximately 1350. Accordingly, the forecast detailed above is in the ballpark and further supports our conviction that investors should not take the possibility of a 50% decline lightly.&#2013266080; These are startling estimates, but considering the extent to which current S&P 500 levels are the product of manufactured liquidity-induced speculation as opposed to healthy organic growth, investors should keep an open mind. If we recall prior occasions in March 2000 and October 2007 when market levels were similarly over-extended, the reaction to a 50% decline projection then was met with equal skepticism. For more on our expectations, please read Why Another 50% Correction Is Possible.