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We are bullish on US stocks, but we only expect single-digit annual returns.

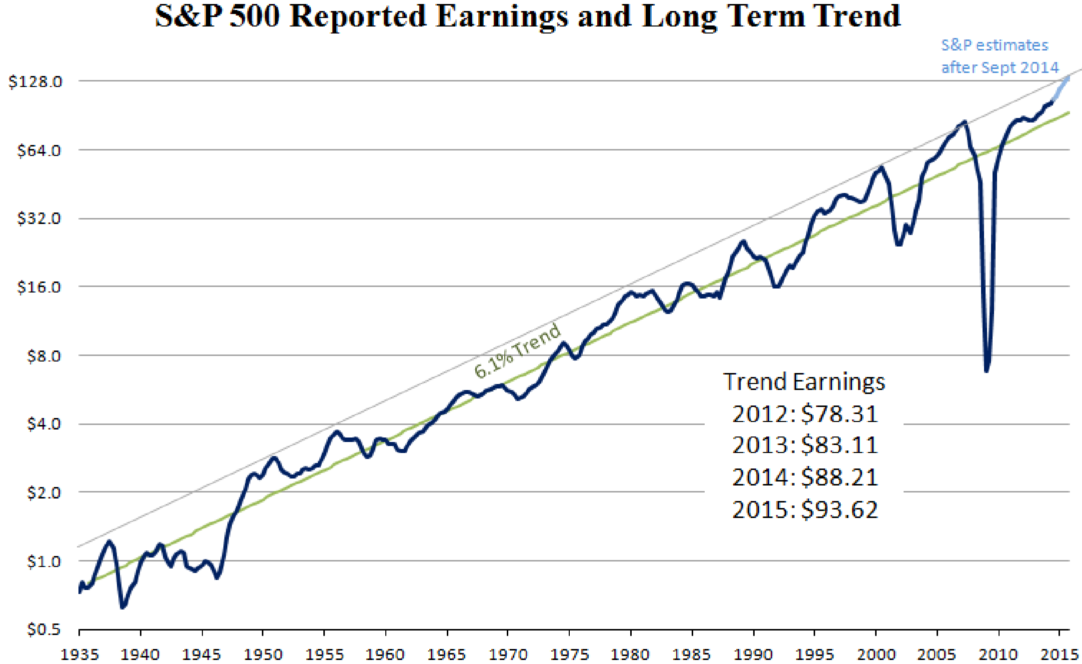
We believe the S&P 500's 6.1% earnings growth trend is sustainable. However, we do not expect earnings growth to be better than its 80-year average, and earnings are currently above trend.

Time to Right-Size Expectations

We are bullish on US stocks, but we only expect single-digit annual returns between now and the next US recession. If recession is many years away, as we expect, then the risk/reward tradeoff for stocks versus bonds or cash remains compelling. We anticipate a prolonged, but slow expansion due to global disinflationary forces (excess supply of labor, capital goods, and some commodities).

A subpar global expansion should keep interest rates lower for longer, but will also suppress earnings growth, especially in countries such as the United States, where margins are near record highs. We believe the S&P 500's 6.1% earnings growth trend is sustainable (see chart below), due to the many globally focused companies in the index and the growth from developing economies —especially China and India. However, we do not expect earnings growth to be better than its 80-year average.

S&P 500 Reported Earnings and Long Term Trend



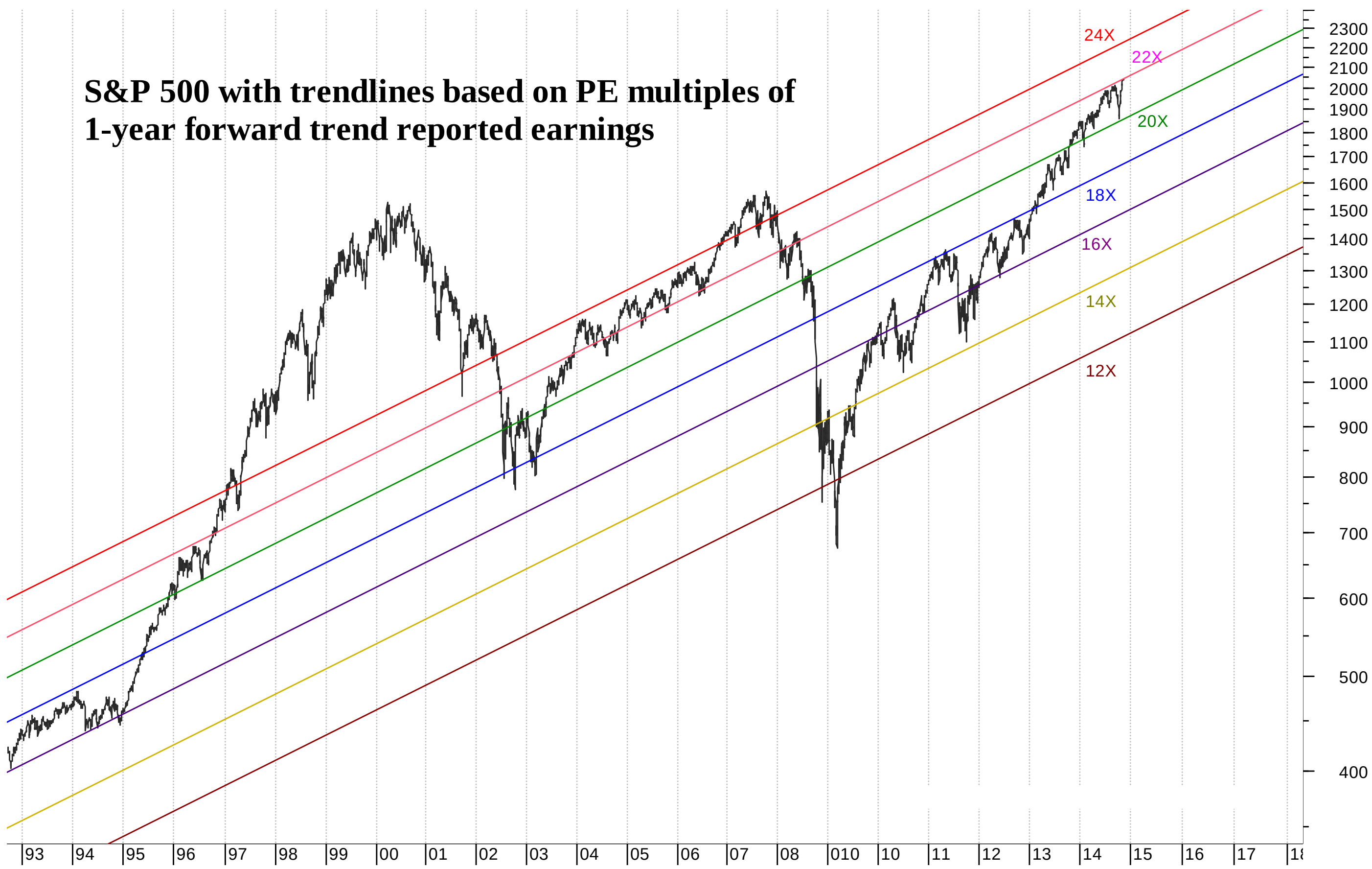
Source: RiverFront Investment Group, Standard & Poor's; Past performance is no guarantee of future results.

Standard & Poor's estimate for the S&P 500's earnings per share (EPS) at the end of 2015 is $135. Trend earnings for the same period is $93.62; thus, expectations are that earnings will be 44% above trend. As the thin grey line above the earnings trend in our chart shows, that would be roughly as far above trend as earnings have been in the last 80 years, which makes the projected price-to-earnings ratio (PE) of 15.1 misleading. Because earnings have persistently returned to trend, we calculate the PE on forward trend earnings to gauge longer-term investor optimism. This is shown in our Weekly Chart. With the long-term earnings trend of 6.1%, we can show how much investors have been willing to pay for one-year forward trend earnings. In the stock bubble of the late 1990s, when actual earnings were well above trend, investors paid $39 for a dollar of trend earnings. By contrast in 2009, when actual earnings were significantly below trend, investors were only willing to pay $10. Such are the swings in investor emotion. Following the S&P 500's significant gains over the last two years, the latest price to forward earnings ratio is 22, a level frequently seen between 2004 and 2006.

Our chart shows that valuation changes significantly through time, making it a blunt and imprecise instrument with which to make forecasts. This is why shorter-term forecasting is challenging: one must not only forecast earnings, but also the multiple of earnings that investors will pay.

Assuming that 20 times trend earnings (the October low) is a floor and 24 times forward trend earnings (the high from 2004 until 2007) is a ceiling, the S&P 500 should trade between 1870 and 2380 next year, compared to the current level of 2040. Our base-case scenario is for stocks to rise approximately in line with trend earnings and remain at current multiples for single-digit returns over the next year.

THE WEEKLY CHART: UPSIDE CONSTRAINED BY VALUATION



Source: RiverFront Investment Group, Standard & Poor's; Past performance is no guarantee of future results.

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