# Five Scenarios for Stocks

After reaching record highs, stocks may only grind higher from here.

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**KEY TAKEAWAYS**

- The U.S. stock market recently set a record high, and also broke out of its two-year trading range.
- Analyzing possible market environment regimes may offer clues as to where stocks go from here.
- The most plausible scenario is a continuation of the multiyear slow growth, low inflation regime.
- Deglobalization sparked by Brexit or a bond-proxy bubble resulting from the global pursuit for yield are also possibilities.
- An inflation-inspired boom or deflation-induced recession appear to be the least likely scenarios for U.S. stocks during the next 12 months.

After two years of moving sideways within a narrow trading range, the U.S. stock market (as measured by the S&P 500 Index) has recently set record highs. Is this the start of a major new uptrend? A gradual grind higher? Or is it all just a head fake?

To get a sense of what may lie ahead for stocks, it's useful to consider potential market environment scenarios, and to assess their odds of occurring. From my perspective, I see five potential scenarios, or "regimes," that may characterize the future backdrop for stocks. Let's take a look at each of them, ranked in order from what I believe to be the most likely to the least probable scenarios.

**Five potential regimes**

### 1. Secular stagnation (more of the same)

This backdrop would essentially be a continuation of the slow-growth, low-inflation regime that has been in place since the global financial crisis ended. It's the current status quo and remains the default scenario until it's displaced by something worse, better, or different.

The U.S. consumption-based economy (71% of GDP) continues to chug along, as it has for a while now, driven by full unemployment and robust consumption. But aging populations, excessive debt, and stagnant productivity growth have reduced the potential output for the overall global economy. As a result, nominal (non-inflation-adjusted) GDP in the U.S. is only growing at a 2% to 3% clip, while both real GDP and inflation are growing at an annualized rate of 1% to 2%. The U.S. economy is strong enough that the Federal Reserve (Fed) may still tighten monetary policy, but sluggish enough to prevent the Fed from overtightening, which could force the dollar higher and worsen financial conditions.

On a bright note, the global economy has shown recent improvement, as China's economy and financial system have somewhat stabilized. Additionally, in June China was able to conduct another stealth devaluation of its currency (the yuan), but this time without disrupting global financial conditions. It's as if China took advantage of everyone's focus on Brexit (the U.K.'s vote to exit the European Union) and devalued while no one was looking. In any case, the yuan has made more progress toward finding its fair value.

In this regime, interest rates could stay low while earnings growth remains sluggish. This combination suggests that price-to-earnings (P/E) multiples will stay in the high teens, where they have been for some time. This is a regime in which the stock market may grind higher (with the occasional downside shock), but not much more than that.

### 2. Deglobalization

With the advent of Brexit, a deglobalization scenario (broadly defined as a diminished interdependence and integration between the economies of nations) has become more plausible. It essentially would be a reversal of the trend toward labor outsourcing and global capital flows of the past few decades. If Brexit is part of a larger deglobalization trend, we'll likely see less economic growth and somewhat higher inflation than in our current stagnation regime. This outcome would be a negative for corporate earnings because profit margins would get squeezed. In this scenario, companies with pricing power would likely perform the best.

A stagflation regime like this, in which growth remains sluggish while inflation picks up, can be a difficult challenge for central banks. Normally, the Fed's dual mandate would lead it to raise rates if inflation increases, especially against a backdrop of full employment. But with real growth sluggish amid a massive global debt overhang, interest rate hikes may prove difficult. In fact, this is what the Fed has been forced to deal with since it started passively tightening rates in 2013.

If the Fed is unable to raise rates amid a rise in inflation, that by definition would lead to a further decline in real interest rates. Such an outcome would be negative for the dollar, but likely positive for commodities and emerging markets (which benefit from a weaker dollar).

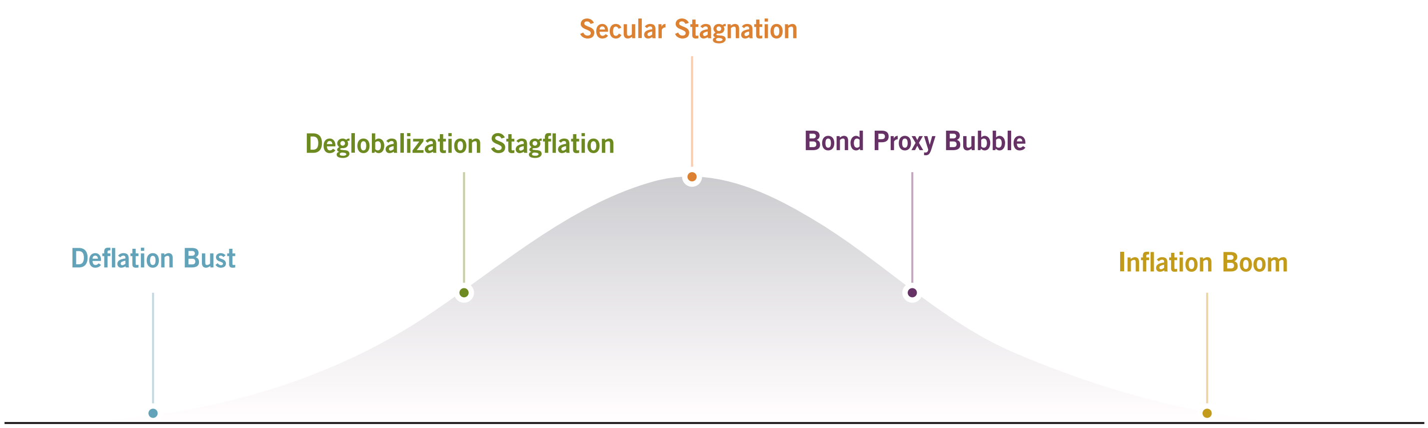
### 3. Bond proxy bubble

The extreme monetary policy actions around the world could have profound unintended consequences on the financial markets. They've already had a great impact on interest rates. And now, one only needs to look around the world to see how low sovereign debt yields have become. It has been a relentless march toward (and even below) zero. In fact, at their recent lows, it was estimated that about a third of all sovereign debt was trading at negative yields.

What if yields continue to decline? What would that do to stocks? The initial impulse is to assume they would fall, because if ever-lower yields are a symptom of a weak defla-

**Exhibit 1** Bell Curve Model of Potential Investment Backdrop Scenarios

The closer it is to the middle, the more likely the potential outcome.




*For illustrative purposes only. Source: Fidelity Investments.*

tionary economy, then the stock market should follow suit. Seems logical.

While that's what has happened in Japan and Europe, it's not what's happened in the U.S. After Brexit, the 10-year Treasury yield fell to a low of 1.3%, in sympathy with the plunge in global yields. That's the key. Fundamentals in the U.S. don't seem to justify such low yields, not with the economy near its potential and the Fed in tightening mode. It seems Treasury yields are only declining due to global capital flows. In other words, they're the product of a global reach for yield.

This has created a dynamic in which Treasury yields are falling and credit spreads are narrowing, which is creating a further reach for yield—but this time *outside* the bond market. This phenomenon has led to very strong fund flows into the so-called "bond proxies," such as low-volatility, high-dividend-paying stocks within the historically defensive consumer staples, utilities, and real estate sectors. Investors seem to be re-valuing these "bond surrogates" less as traditional equities and more like bonds. This is where things could bubble over.

Just take a look at the recent post-Brexit move to new highs. Usually, stock rallies are driven by aggressive growth or cyclical stocks (e.g., technology, consumer discretionary stocks), while defensive sectors lag behind. This time it was exactly the opposite, as defensive plays pulled the broader market out of its two-year trading range. Most unusual.

The move by the bond proxies may or may not be over. It could all depend on whether interest rates move lower from here. If not (and yields have indeed moved a bit higher), then perhaps the move is over. But if bond yields continue to fall, it's possible that the bond proxies will continue to get re-rated. That could push their valuations significantly higher (and many of them are well above their historical norms already).

This would be a fundamentally unsustainable rally if it happens, because the re-valuation would be driven entirely by a decline in interest rates and in the equity risk premium (the excess return of stocks over Treasuries), as opposed to improved earnings growth. It's not what sustained bull markets are made of. For now, with rates up a bit in recent weeks, I will assign a low probability to this regime. But it's not a zero probability, so it's something that should be monitored.

### 4. Deflation bust (recession)

One potential (and extreme) regime that received attention during the past several quarters is the potential for a global and U.S. recession. It was brought to life during the China slowdown in the second half of 2015, and, more recently, during Brexit. In this scenario, corporate earnings would fall significantly in a classic earnings recession, and valuation multiples would follow (probably to the mid-teens). Frankly, this appears to be an unlikely scenario. Yes, Brexit may push the U.K. into recession, but the U.S., Europe, Japan, and China all seem to be doing OK for the moment.

In addition, the earnings cycle appears to be stabilizing (as I discussed in last month's report, "Breakout or Fake Out?"). With the second-quarter earnings season pretty much over, it appears the year-over-year growth rate for Q2 earnings per share (EPS) will be -2.4%. While earnings are still negative, which is bad, the rate of change has improved from Q1, which was down 7% from a year ago. So, after four quarters of negative earnings growth and worsening rates of change, we now have the first quarter where the rate of change is improving. While the quality of earnings remains weak, the improved rate of change suggests we are not heading into a deflationary bust in the near term.

### 5. Inflation boom (global recovery)

Another extreme is the inflation boom scenario, which could be a win-win for equity investors because earnings growth would likely take off while valuations climb into the low 20s. The odds of this happening are small, though. If anything, it probably would already have happened by now, given all the extreme monetary policy attempts that have been made in recent years. With earnings quality poor, aging demographics, and a mountain of debt everywhere you look, the likelihood of an old-fashion boom is probably low.

### Outlook

My base case scenario is a continuation of modest growth and ongoing monetary accommodation by most of the world's central banks, and only limited tightening by the Fed (maybe one or two more rate hikes in the next 12 to 24 months). All in all, I see a market that is supported by slightly better fundamentals but is held back by structural forces. My sense is that the new highs are justified, but that stocks will only grind higher for now, as opposed to an explosive move to the upside.

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*Fidelity Thought Leadership Vice President Matt Bennett provided editorial direction for this article.*



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