

A Caution Signal for the U.S. Equity Market?

Forward-looking U.S. equity valuations are at levels that would suggest future returns may be less robust, as shown in chart.

Average 5-Year Annualized S&P 500 Return by Forward Price-to-Earnings Ratio Since 1985



Source: Thomson Reuters, as of 2/28/18

U.S. equity markets have been on an impressive run during the past five years. The S&P 500 Composite Index returned 15.8% on average annually from 2013 through 2017. Many measures of equity market valuations have risen during this time, including the 12-month forward price-to-earnings ratio, which measures current market price against future earnings expectations. The price-to-earnings ratio at the end of February, which was 17.0, may suggest that future U.S. stock market returns will be modest. Since 1985, when the S&P 500's price has been between 16 and 18 times earnings, annual returns in the following five-year period, on average, were around 4%. Whether this relationship will hold true moving forward is uncertain, but a flexible portfolio may help investors pivot should the investment environment become more difficult to navigate.

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