US Macroeconomics

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Seven Lean Years

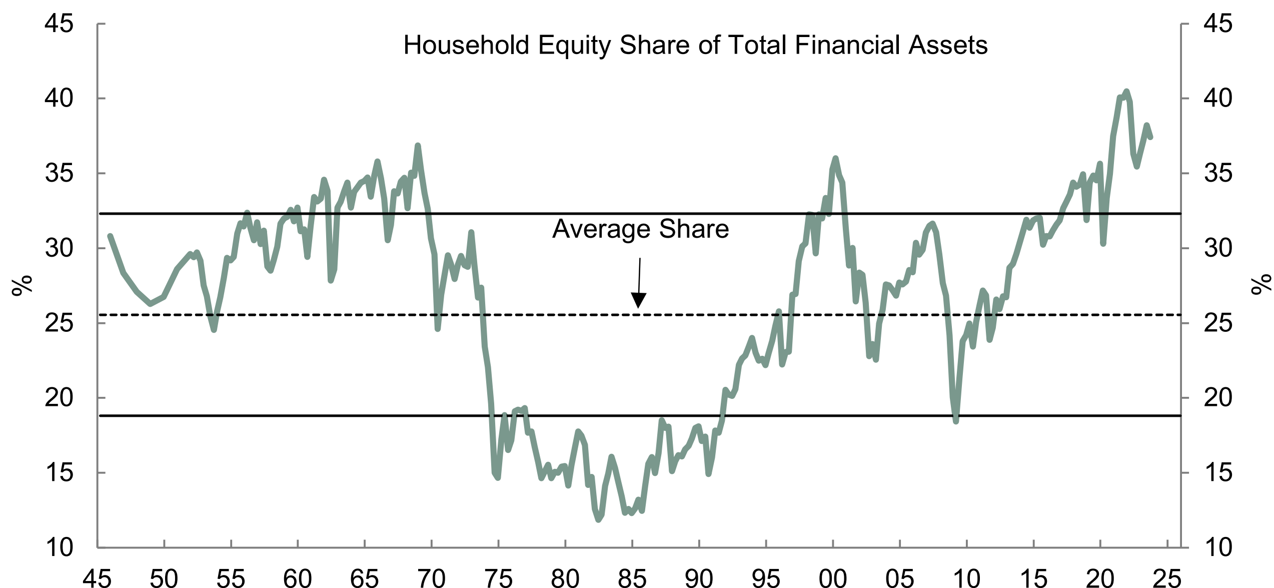
Consumers exposure to the stock market is relatively high. According to the recently released Q3 2023 Flow of Funds accounts, the household equity share of total financial assets is 36.3%. While it is down from an all-time record of 40.5% in Q4 2021, the current reading is still higher than any other period prior to the current business cycle as illustrated in the chart below.

For example, before the onset of the global pandemic, the previous record share was 36.0% set in Q1 2000. This occurred during the height of the internet boom. And prior to the post-pandemic era, the previous all-time peak was 36.9% which was made during the decade's "conglomerate fad."

What are the implications of elevated equity exposure? Historically, **when households own a high percentage of equities in their investment portfolio, future stock returns tend to meaningfully lag historical averages**. Whether household exposure is high or low is determined by one-standard deviation bands around the long-term average. Future returns are based on the stock market's performance over the next seven years because this is broadly consistent with the average length of the post-WWII business cycle.

According to our calculations, the average long-term household equity share of financial assets is 25.6%, shown as a dashed line in the chart. Bands around that average are shown as solid lines. From 1952 to 2016, the long-term total annualized return of the S&P 500 including reinvested dividends is 11.4%. However, when the household share of stock holdings is one standard deviation above its long-term average, stocks return just 4.1% annualized over the proceeding seven years. The opposite is true when the household share of stocks is below its long-term average. Stocks return a large 16.0% annualized over the next seven years.

This year is not yet complete but the market's total return through November is 22.9%. While this is well above the market's long-term annual average, the cumulative annualized return since 2016 is 11.4%, which is identical to the annual returns from 1952 to 2016 period. Incidentally, the ratio stood at 31.9% in Q4 2016. However, if history holds, stock returns over the next seven years should be much lower than the historical average of double-digit gains.



Source: S&P, Haver, SMBC Nikko

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