USAA Real Estate Company

Can US Stocks Maintain Record Pace?

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The US stock market closed at record highs several times over the last two months. As of August 1, 2016, the S&P 500 and Dow Jones Industrial indices were up more than 40.0% and 33.0% respectively from peak-2007 levels. Given this historical run, it is reasonable to question whether the market's current pace is sustainable.

The continued uptick in equity markets is largely a result of several unique economic conditions. Historically low interest rates have attracted investors to higher-yielding asset classes (such as stocks and real estate) rather than standard fixed income securities. The relatively healthy US economy has created a "flight to quality" from foreign investors who have become increasingly concerned with global economic conditions. The energy sector, which had been a drag on the overall stock market, seems to have stabilized recently with oil prices near $40-$50 per barrel – up significantly from a 13-year low of $26 in February 2016. Prolonged low interest rates, relatively attractive risk-adjusted returns, and a recovery of commodity prices have all contributed to the recent market rally.

The stock market also has several potential risks that warrant caution from investors. The forward rate curve suggests the Federal Reserve will likely increase interest rates in 2017, which could shift investor sentiment away from equities. Stock buybacks have accelerated in recent quarters well above the long run trend, which some critics argue have artificially inflated stock prices at a time when corporate profits have slowed. If the US economy falls into a recession over the next few years, as forecasted by several researchers, stocks would likely experience a sharp decline. Although many investors are aware of these potential issues, it remains difficult to predict exactly if/when they will materialize.

While some may consider the US stock market overextended, famed economist John Maynard Keynes once noted, "The market can stay irrational longer than you can stay solvent." Given this context, cautious investors should exercise patience while also taking steps to mitigate potential downside risks.

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