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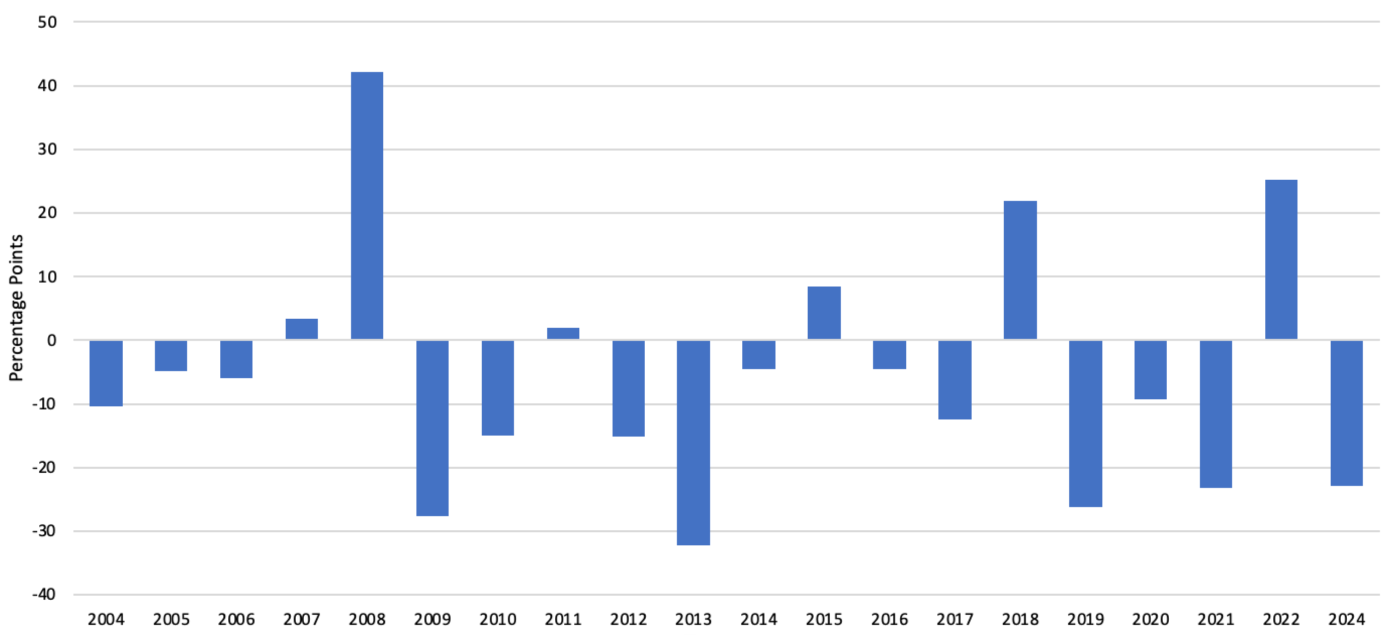
Stock Market Price Targets: Dead Reckoning

- As we near year end, strategists are often asked to predict where the S&P 500 will end the next year.
- If we look at past forecasts from strategists, the record is not encouraging. Over the past 20 years, the average margin of error has been ±16 percentage points. While this might seem poor, it reflects the complexity of the task given the factors involved.
- Setting a price target for the S&P 500 typically involves two key steps: estimating earnings and applying a P/E multiple to those earnings. It sounds easy, but it is not.
- First, what earnings should be used? Many assume it's the upcoming year's earnings, but that's not the case. As we approach the end of 2024, the market is attempting to discount expected earnings for next year, not this year. That means we need to know what strategists think 2026 earnings will be at the end of 2025. We've yet to build a model that can do that.
- Next, assigning a P/E multiple is just as tricky. This requires anticipating investor sentiment at the end of next year. While multiple factors influence the market's P/E, sentiment tends to be the most significant in the short term. A minor miscalculation—off by just 1 P/E point—would skew the price target by 5%. Historically, market multiples tend to fluctuate by more than 2 points within a calendar year.
- Despite the complexity and risk of error, we do formulate price targets—or more accurately, risk and return forecasts —for all the asset classes we track. Rather than relying solely on the traditional earnings and P/E approach, our method resembles dead reckoning. We start with our base case for the economy, financial conditions, risk factors, and valuations. We then use historical patterns to estimate an expected risk and return profile. Currently, we are forecasting a return of 5%-10% for the S&P 500. However, this forecast will likely evolve throughout the year as conditions change.

S&P 500 Index Price Targets: A Reality Check



Source: Bloomberg. Average expected return based on Wall Street strategists' price targets at the beginning of the year less the actual return.

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