WHAT HAPPENS AFTER A 20% UP YEAR IN THE STOCK MARKET?

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A reader asks:

Sure it's great the S&P 500® Index is up 20% this year but aren't we just pricing in the inevitable Fed rate cuts in 2024? Should we really expect the market to go up again next year after surprising to the upside this year? Color me skeptical. Full disclosure: I'm naturally bearish and take a bit of an anti-Ben stance about the markets.

See, this is what makes a market!

It's fair for anti-Ben to ask if the current run-up in the stock market is pricing in rate cuts for next year. The stock market is forward looking after all.

I love studying historical market returns. Looking at market history is never going to help you predict the future, but it can help you better understand the way the stock market generally functions.

For instance, looking at annual returns in the stock market won't tell you what happens next year, but it can help you prepare for a range of outcomes to set something of a baseline.

One of my all-time favorite market stats is the fact that the U.S. stock market has had more 20% up years than negative years since the 1920s. It's true.

Since 1928, there have been 34 calendar years[1] where the S&P 500 has finished up 20% or more against 26 total down years.[2]

This means the stock market has been up 20% or more 36% of the time and down 27% of all years. That's a pretty good trade-off, especially when you consider the average down year is a loss of ~13%.

The question anti-Ben seems to be asking here is: What happens *after* a 20% gain?

Here are all of the 20% up years along with the following year returns.

Not too bad. More green than red for sure.

Year	Return	Next Year
1954	52.56%	32.60%
1933	49.98%	-1.19%
1935	46.74%	31.94%
1928	43.81%	-8.30%
1958	43.72%	12.06%
1995	37.20%	22.68%
1975	37.00%	23.83%
1945	35.82%	-8.43%
1997	33.10%	28.34%
1955	32.60%	7.44%
2013	32.15%	13.52%
1936	31.94%	-35.34%
1980	31.74%	-4.70%
1989	31.48%	-3.06%
1985	31.24%	18.49%
2019	31.21%	18.02%
1950	30.81%	23.68%

Year	Return	Next Year
1991	30.23%	7.49%
1938	29.28%	-1.10%
2021	28.47%	-18.01%
2003	28.36%	10.74%
1998	28.34%	20.89%
1961	26.64%	-8.81%
2009	25.94%	14.82%
1943	25.06%	19.03%
1976	23.83%	-6.98%
1967	23.80%	10.81%
1951	23.68%	18.15%
1996	22.68%	33.10%
1963	22.61%	16.42%
1983	22.34%	6.15%
2017	21.61%	-4.23%
1999	20.89%	-9.03%
1982	20.42%	22.34%

Past performance is not indicative of future results. Source: NYU.

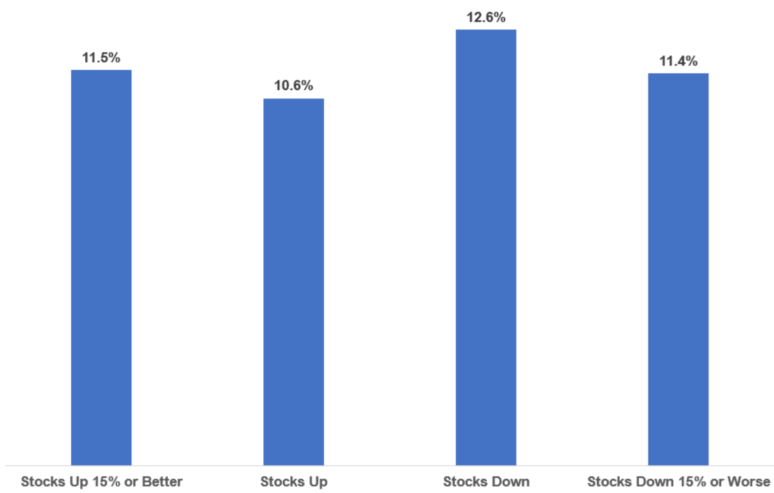
Here are the summary statistics:

- The stock market was up 22 out of the 34 years following a 20% gain (65% of the time).
- The stock market was down 12 out of the 34 years following a 20% gain (35% of the time).
- The average return following a 20% up year was 8.9%.
- The average gain was +18.8% in up years.
- The average loss was -9.1% in down years.
- There were 19 double-digit up years.
- There were just two double-digit down years (1936 and 2022).

This year is teetering on the edge of another 20% up year. We'll see if Santa comes through for us by the end of the year or not, but, so far so good.

It's also important to ask how much returns in one year actually impact returns in the following year. Here's a look at average returns following a big up year, an up year, a down year, and a big down year.

DOES THE STOCK MARKET CARE WHAT HAPPENED LAST YEAR?
S&P 500® Index Average Returns 1928-2022



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So maybe the 20% starting point matters less than one would assume.

I'm sure you could slice and dice the data to offer up some more signal, but there doesn't appear to be much correlation from one year to the next.

Most of the time stocks go up but sometimes they go down is about as good as you're going to get.

It's certainly possible the stock market has been pricing in Fed rate cuts for early next year. The S&P 500 isn't going to wait around for Jerome Powell to spell it out. The inflation rate is falling, interest rates are falling, and wage growth is falling so it makes sense for the Fed to start cutting sometime in the first half of 2024.

But I can't pretend to be smart enough to know how much of that is priced into the stock market or what comes next.

Historical return numbers can help set expectations, but it's also true that things happen in the markets all the time that have never happened before.

I don't know if we're setting up for a new bull market, or a flat market, or a new bear market.

Successful investors understand it's impossible to predict the type of market environment that's coming. The best thing you can do is prepare for a wide range of outcomes to avoid allowing short-term movements in the market to affect your behavior.

[1]Not including 2023…yet.
[2]There have been just six down years of 20% or worse losses.

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