Quarterly Review and Outlook Using the CAPE Ratio

Q3 2025 – **Robert J. Shiller and Laurence Black**

The Resilience Illusion and the Return of Grand Narratives

This quarter, global financial markets have continued their curious defiance of the geopolitical turmoil swirling around them. The United States economy remains solid on the surface, GDP is growing modestly, the labor market is still showing signs of modest growth, and inflation readings are calm. Yet all this is occurring against a backdrop of rising political uncertainty, global power shifts, and deepening anxieties about trade, taxes, immigration, and regulation.

It is a quarter of cognitive dissonance. The investor narrative seems to rest on the belief that "the economy is strong enough" or at least, strong enough to look past the world's convulsions. But the question that lingers is which force steers the market.

The Federal Reserve finds itself in an awkward dilemma caught between staying the course and anticipating a downturn that has not fully materialized. Price pressures remain subdued, at least for now, while the job market still shows resilience. But for those attuned to narrative history, this quiet may be misleading. As in prior cycles, the perception of stability can give way quickly once stories of rising prices, tightening conditions, or lost jobs begin to spread in earnest. The Fed's hesitance is not weakness; it is a bet that today's tranquility masks tomorrow's challenge. President Trump has taken the opposite position, frequently beseeching Fed Chair Powell to cut rates.

Strongmen and the Spread of Ideas

As discussed last quarter, the return of the "strongman" has become one of the dominant global narratives and this quarter only reinforced that. Today's political stage features forceful figures like Trump, Xi and Putin, evoking historical precedents. The Yalta Conference 1945 springs to mind where Churchill, Roosevelt and Stalin divided up the world into spheres of influence after World War II. In the Depression era, Benito Mussolini pioneered a new form of mass communication: fiery, emotional speeches before huge cheering crowds broadcast live by radio to give the feeling of participation in person in historic moments. The goal was not merely to inform you, it was to shape emotional understanding, to unify people under an identity of grievance and destiny.

That style has evolved but not disappeared. Take Donald Trump, whose name as of June 2025 appears in over 6.6 million English-language news articles indexed by ProQuest. His narrative presence, combative, personalized, unrelenting, is unparalleled. His "You're fired" catchphrase still echoes today, shaping public attitudes toward power, success, and failure. Economic behavior is tied not just to incentives, but to the stories people are telling at the moments of decision. Trump's narrative resonance may help explain why his political return has not been met with market panic, at least not yet.

The Mutating Fear of Technological Displacement

Another powerful narrative gaining traction is that of artificial intelligence and the loss of human capital. This is not a new theme. Stories of machines replacing workers date back at least to the Luddites in 1811 and were rampant during the 1930s. But today's AI narrative feels more vivid. Unlike past eras, where the fear was mechanization of physical labor, today white-collar workers are feeling the anxiety. *Will I be needed at all?* The erosion of work and meaning can unleash not just economic decline, but widespread emotional and social distress. We are seeing people fearful of losing their jobs, which might encourage people to buy stocks related to artificial intelligence, thinking, *If I cannot*

[1] Reuters March 14, 2025: World US consumer sentiment plunges on tariff fears, inflation expectations jump

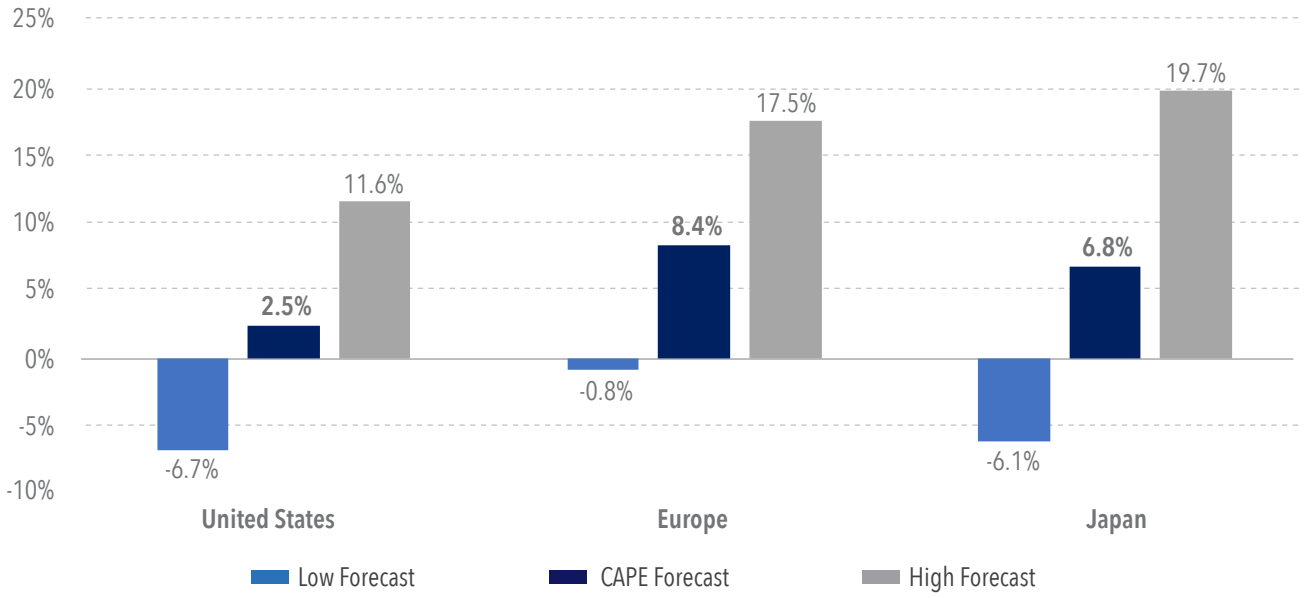
beat them, I will join them. This might be one of the sources of the huge demand and interest in artificial intelligence-related stocks, driving their prices to new highs. Many investors may be overreacting to glamor and gamification of the moment, forgetting that their favorite investments may resemble the dot-com investments of the turn of the millennium. They may lose interest in that there may be beginnings of whispers of discontent with pricing of such glamor that could get bigger as they are incorporated into new narratives.

Markets: Valuation Highs and Cautious Forecasts

Markets, for now, remain elevated. The S&P 500 sits above 6,300. The S&P 500 CAPE ratio is now 37.8 among the highest in history, and our 10-year forward-looking nominal return forecast has dropped to 2.5%. We continue to advocate for diversification across regions and asset classes, and why we believe holding some reserves in cash and some investment in low CAPE sectors, remains not only prudent but wise. Forecasts for Europe and Japan are 8.4% and 6.8%, with CAPE ratios of 21.1 and 23.3 respectively, but with considerable uncertainty.

Key Findings: Our Forecasts based on the CAPE Ratio

Note these forecasts are in local currencies in nominal returns. We show a range for a 95% prediction interval indicating our uncertainty around these forecasts. We use conventional tools to forecast expected returns; however, financial markets are very unpredictable, making forecasting an inherently difficult task. In addition, unforeseen events provide another layer of difficulty and can impact our forecasts in both a positive and a negative manner.



A Note About Forecasting

These are annualized long-term forecasts with a horizon of 10 years. These forecasts are intended to provide a framework and guide investors around strategic equity allocations. They are not intended for those seeking to time markets or obtain short- to medium-term forecasts, as short-term forecasts are unreliable. The forecasts are presented as nominal total annualized returns in local currencies and are presented as a guide only. The forecasts make no attempt to judge the impact of one-of-a-kind factors like COVID-19, political changes, or monetary policy changes, not because these are not potentially important, but because we are not able to quantify them without guesswork. We also show ranges here (95% prediction intervals) to give some indication of the uncertainty around our forecasts. The reader must bear in mind that prediction intervals are hampered by fundamental epistemic uncertainty, which is unquantifiable. For example, some would argue that the upper bound for the 10-year annualized return for Japan in the preceding table is too high, based on their knowledge that the investors in Japan have learned their lesson from the 1980s-1990s and will not overprice markets that much again. It is impossible to be sure one way or the other whether this "knowledge" is correct since it relies on human judgment about people's thinking.

[3] Source: https://www.oecd.org/en/data/indicators/inflation-forecast.html

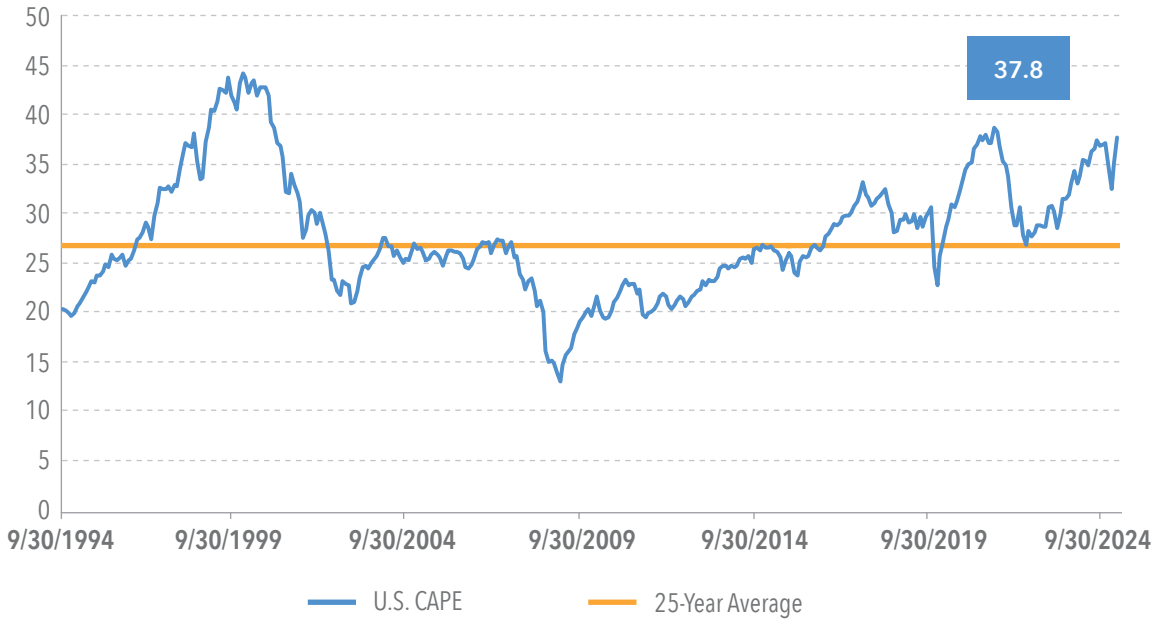
United States – Forecasts Based on the S&P 500 Index

The CAPE Ratio for the United States is 37.8 and the expected 10-year annualized nominal total return is 2.5%. Returns for the S&P 500 Price Return Index are expected to be around 0.5%; here we subtract the average historical dividends of 2%. We also show ranges for U.S. returns. Professor Shiller created a series of value-based indices with Barclays, namely the Shiller Barclays CAPE Family of Indices, which seek to identify undervalued sectors or stocks using the CAPE Ratio. These indices aim to earn a long-term value premium. While past performance is not guaranteed, if an investor purchased a value-based index and held this for the long term, they may generate higher returns than forecast if the value factor performs well.

UNITED STATES FORECAST RETURNS	EXPECTED ANNUALIZED RETURNS
Expected Nominal Total Returns* (S&P 500 Total Return Index)	2.5%
Upper Range of Expected Nominal Total Returns* (95% Confidence Level)	11.6%
Lower Range of Expected Nominal Total Returns* (95% Confidence Level)	-6.7%
Approximate Expected Nominal Price Returns* (S&P 500 Price Return Index)	0.5%

*using the CAPE Ratio

Historical U.S. CAPE Ratio Over the Last 30 Years



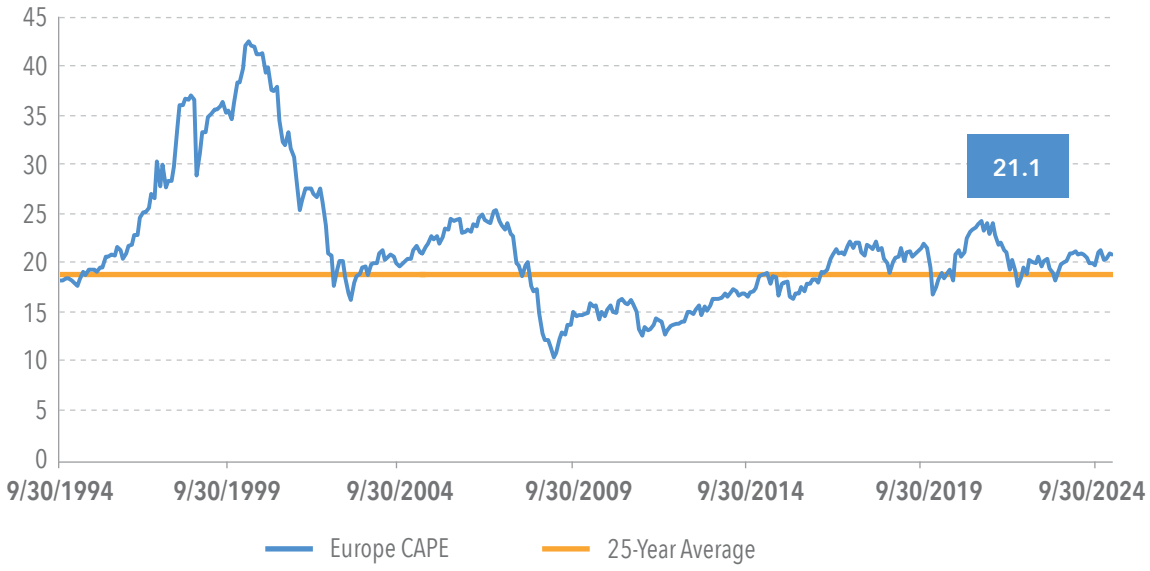
Europe – Forecasts Based on the MSCI Europe Index

The CAPE Ratio for Europe is 21.1 and the expected 10-year annualized nominal total return is 8.4% as of the end of this quarter. Price returns for the MSCI Europe Price Return Index are forecast to be around 5.3%, when we subtract the historical dividend yield and assume this holds true for the next 10 years. We also show ranges for European returns.

EUROPE FORECAST RETURNS	EXPECTED ANNUALIZED RETURNS
Expected Nominal Total Returns* (MSCI Europe Total Return Index)	8.4%
Upper Range of Expected Nominal Total Returns* (95% Confidence Level)	17.5%
Lower Range of Expected Nominal Total Returns* (95% Confidence Level)	-0.8%
Approximate Expected Nominal Price Returns (MSCI Europe Price Return Index)	5.3%

*using the CAPE Ratio

Europe Historical European CAPE Ratio Over the Last 30 Years



Japan – Forecasts Based on the MSCI Japan Index

The CAPE Ratio for Japan is 23.3 and the expected 10-year annualized nominal total return with the CAPE Ratio is 6.8%. Price returns for the MSCI Japan Price Return Index are forecast to be 4.5%; again, we subtract the historical dividend yield from Bloomberg and assume this holds for the next 10 years. We also show ranges for Japanese returns. Note our forecasts include the bubble period in Japan in the 1980s, and this may overstate some of the numbers.

JAPAN FORECAST RETURNS	EXPECTED ANNUALIZED RETURNS
Expected Nominal Total Returns* (MSCI Japan Total Return Index)	6.8%
Upper Range of Expected Nominal Total Returns* (95% Confidence Level)	19.7%
Lower Range of Expected Nominal Total Returns * (95% Confidence Level)	-6.1%
Approximate Expected Nominal Price Returns (MSCI Japan Price Return Index)	4.5%

*using the CAPE Ratio

Japan Historical CAPE Ratio Over the Last 30 Years

Approach to Forecasting

We outline our approach to forecasting in this section. First, we predict the nominal total returns based on the CAPE Ratio, as developed by Robert Shiller and John Campbell in their paper "Stock Prices, Earnings and Expected Dividends." To generate the forecast, we regress 10-year nominal returns on the prevailing CAPE level. We also show ranges for each country's forecasted returns to indicate the uncertainty around our forecasts.

Professor Shiller noted that returns are influenced both by the CAPE and an estimated long-term interest rate in the third edition of Irrational Exuberance. We expect that in years to come the science of narrative economics, with the expansion of our use of digitized text and artificial intelligence to look for specific indicators of public spreading of ideas, will be used to narrow our prediction intervals. They may be able to develop time series of evidence on how the public will be thinking about multiple relevant economic narratives, such as about the intense COVID-19 pandemic narrative with its politicized connection to other narratives, or about the prospects for world war, or about climate change, to improve our forecasts of economic variables. At this juncture, however, we use the CAPE ratio suggesting overpricing or underpricing to help us predict the markets.