

The Economy is Taking Off: Are You Ready?

In 1975, when the economy was in a funk, consumers were fuming in gas lines and it appeared inflation would never end, the advertising firm of Burson-Marsteller ran a series of advertisements promoting their services. The first ad was entitled, “Why Nobody Loves a Pessimist”. The essence of the copy was that while times were challenging there were positive forces at work as well as adverse ones. History supported the notion that those who focused on the opportunities would be well served. At the time the Dow Jones Industrial Average was around 600.

Fast forward 35 years. The Dow Jones Average is over 10,000. The country has come out of a financial crisis such as seen once every hundred years. Exports are growing, corporate profits are up double digits, inflation is tame and international capital sees the United States again as a safe haven, if only by default. Still, investors are pessimistic about the future. They see a repeat of the downward spiral of late 2008. The banks are shaky, the housing market is in the tank, Europe is coming unglued and deficits are going to consume us all.

Such a focus is off a piece. The firm of DALBAR, Inc. has conducted countless studies of actual investor returns as opposed to market returns. In the most recent time period for which data was available, 1988-2008, the Standard & Poor's returns were 8.35 percent per year. The returns of the investors in the DALBAR study were 1.87 percent per annum.

The difference is simple to explain. Most investors wait until stocks have gone up for some time before committing funds to the market. By doing this they miss the first stage of positive returns. Conversely, investors bail out of stocks when they decline. While such a move does keep their accounts from declining further in the short run, it sets up the investor to being out of the market when it turns around. Add to this trading the effects of taxes on capital gain realization (especially short-term gains) and the almost 6.5 percent per year difference between market and investor returns becomes more understandable.

Nothing gives investors courage like a rising market. The paradox is that to the extent the market is rising faster than its fundamentals (i.e. earnings growth, dividend increases, etc.) later investors are getting less for their money than those who invest before them. Then again, a falling stock market can cause investors to decide to sell out to forego the pain of further declines even if fundamentals support retention of the stock investment.

This is not to say that portfolios should not be rebalanced as one becomes older and circumstances change. An investment in income-producing assets should be evaluated more for the income generated than for the appreciation. Since income is more predictable than appreciation this should be a source of investment stability, properly carried out. However, raising cash by selling investments may eliminate declines but also eliminates gains. Unless one has enough cash to live out the balance of one's life in the accustomed manner, cash cannot be a viable long-term investment strategy.

One of the more fascinating aspects of the rally of the past 15 months is the absence of public investor cash that has participated. Almost all the appreciation generated has come from investment professionals or internal market dynamics. Far more public money has gone into bond funds and annuities than stocks. As a contrary indicator this bodes well for stock market prices in the long run. The average person cannot exist on miniscule money market returns. With returns on Government debt approaching three percent for ten years, there will soon be few viable options for the retail investor other than stocks. When the over \$1 trillion of cash begins to flow back into the market the impact should be fairly dramatic. As usual, those who are first will benefit the most.

The Economy

The economy, contrary to many accounts, has recovered and is progressing in a rather textbook fashion. Like all recoveries, this one will have its own profile. It will be dominated by exports, capital goods and the transfer of production back to the US from other countries. The trend-spotters even have a name for this substitution of domestic goods for imports: in-sourcing.

Under-represented in this economic cycle will be housing, commercial real estate, consumer spending at a rate greater than the overall economy, and government growth. The last item may come as a surprise to some, but there are forces at work that will restrain government spending at both the federal and state level.

While the Index of Leading Indicators was down in April for the first time in over a year, one month does not make a trend. In a similar fashion, data such as unemployment claims tend to bounce around at the beginning of a recovery, sending out “noise” that some people interpret as a second breakdown when it is actually the normal genesis of an economic expansion.

Interest Rates

Interest rates have been taken a notch lower with the crisis in Europe. Given the squabbles in Greece, the talk of the Euro replacing the Dollar as an international currency has been relegated to the back burner. The international flow of capital into the US as a safe haven has knocked over half a point off the ten year US Government bond interest rate.

With housing not a factor in terms of incremental demand, consumer debt is scheduled to continue to contract. At this time the principal payments on mortgages are exceeding the demand for new mortgages. Along with contraction of credit card debt and the like, it does not appear that consumers will be a significant source of credit demand any time soon.

In a similar fashion, corporations are holding more net cash assets than at any time in the past 50 years. This implies that corporate America can fund any growth internally. Only the government sector is a material customer of credit. Given the political trends seen in the primaries this could also change come November. Bottom line: There is no case to be made for higher interest rates in the next 12-18 months.

Inflation

One school of economics argues that money creation leads to inflation. Thus the deficits of the Federal Government will ultimately result in rising prices.

As the previous section demonstrates, government borrowings are about the only source of credit demand in the economy. Furthermore, political forces are at work to reverse these demands through the mid-term elections. It would seem that government credit demands will begin to contract just as the private sector needs begin to expand. If in fact the two offset one another, the low-inflation environment can last for a good deal longer than many people are expecting.

The Stock Market

Stock market volatility has returned to more historically normal levels. However, since we are working with bigger numbers the effects of volatility seem to be exaggerated. This is shaking out of the market many investors who should be staying in.

One overlooked statistic is the estimates of earnings for the Standard & Poor's 500 Index. Current estimates for 2010 range up to \$75 with \$100 in sight for 2011. If these numbers are attained the market at current prices would be selling at about 15 times 2010 earnings and about 12 times 2011 earnings. Both these numbers are below the long-term averages for market valuations.

Add to this the fact that most people are not earning enough from their investments to fund their retirement goals or lifestyle and you have a potent mix of forces that could send the market upwards. Using the 2011 estimate, a more normal ratio of 15 times earnings would propel the index to 1500, about 30 percent higher than current levels.

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