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2019 2nd Quarter Stock Market Commentary

FISHER'S FALLACY

"But a pin lies in wait for every bubble. And when the two eventually meet, a new wave of investors learns some very old lessons: First, many in Wall Street – a community in which quality control is not prized – will sell investors anything they will buy. Second, speculation is most dangerous when it looks easiest."
– Warren Buffett
2000 Berkshire Annual Report

Most people are familiar with Fat Tuesday, the English translation of the French phrase Mardi Gras. It derives from the tradition of finishing the Carnival celebration with a meal of rich, fatty foods before enduring the ritual fasting of Lent. Much less well known (since I made it up) is Fat Wednesday, June 17,1988. That's the day when 25 million Americans became fat, without gaining a single pound from the prior day. This occurred when the National Institutes of Health published revised guidelines for who should be considered obese. The changes were necessitated by a series of studies linking extra weight to health problems.

Dietary guidelines change with distressing frequency. One day coffee is good for you, the next day it's bad. One day you are encouraged to eat eggs because they are rich in protein, the next to skip them because they are high in cholesterol, then back to good again when new studies show dietary cholesterol is not closely correlated with cholesterol in the blood. New data results in new rules of thumb.

The investment world is replete with guidelines, too, but unlike the fields of health and nutrition, they are rarely modified to reflect new information. Consider as one example the "4% Rule." The rule states that a retiree should withdraw no more than 4% from a retirement account every year to maintain the principal during his/her lifetime assuming a blended portfolio of stocks and bonds. This rule was based on a 50-year study of stock and bond returns from 1926-1976. The study's author, William Bengen, found that this rule would have always insured the availability of retirement income for a period of at least 33 years. The study assumed an investor started out with a 50%-50% mix of stocks and bonds and rebalanced annually, although Bengen advised risk tolerant investors to clients to allocate as much as 75% to stocks.

But there are some problems with this recommendation. For starters, the long-term return on equities has been approximately 9% per year. Over the past decade, though, stocks have

averaged a much higher 14.5% per year. Generally speaking, periods of high returns are followed by periods of low ones, in order to produce the 9% average. More importantly, though, bond yields are at an all-time low. During the study period bonds returned an average of 2.5% above the inflation rate. Currently, bond yields are only 0.5%-1% above the inflation rate. Finally, life expectancy today is considerably longer than it was when this study was done. In 1940, life expectancy in the United States was only 66 years. A person retiring at 65 had little chance of outliving their money. Today, life expectancy is more than 84 years for someone who makes it to age 65. Today's retirees should more likely plan to withdraw only 2.5-3% per year if they don't want to risk outliving their money. A different investment environment requires a re-thinking of an old rule of thumb.

For investors, one of the central problems is deciding whether the stock market is "cheap," or whether it is "expensive." In the first case, investors should be buyers, while in the second they would be wise to lighten up on equities. The most commonly used benchmark, or rule of thumb, is the trailing price-to-earnings ratio (or P/E). Trailing earnings are used because forward earnings are guesstimates, often based upon wishful thinking. Since 1870, the trailing twelve-month P/E for the market has been 16.8. Currently, the consensus forecast for 2019 earnings is $176, which implies a P/E of about 16.5 if the earnings come in as predicted. With half the year already completed, it seems likely that the market's P/E is in line with historical values.

Unfortunately, there are numerous examples of times when the P/E ratio on trailing earnings loses its predictive power. This occurs most often at market turning points. One example occurred during the financial crisis of 2009. The stock market troughed in March of that year, at a time when the trailing P/E was nearly 124. It was the ideal time to be a buyer, as the market has more than tripled since then, despite the fact that the market looked expensive using the traditional measure. Earnings fell much faster than the price of the stocks. The trailing P/E in 1929 was in single digits, suggesting a buying opportunity. Noted economist and Yale University Professor Irving Fisher was widely quoted for opining that "Stocks have reached a permanently high plateau." They collapsed soon after at the start of the Great Depression, and produced no return for more than two decades.

The frequent failure of the trailing P/E to serve as a good measuring-stick for cheapness of stocks led Benjamin Graham, the intellectual father of value investing at Columbia University, to suggest that it would be better to divide current stock prices by the average of earnings over a longer time period. In his famous book *Security Analysis*, co-authored with David Dodd, he suggested using 5, 7 or 10 years. More recently, Yale Professor and Nobel prize winner Robert Shiller, has popularized this idea using ten-year inflation adjusted earnings as the denominator. Shiller calls this the Cyclically Adjusted Price Earnings Ratio, usually referred to as CAPE. It is often simply called PE10, which is a lot easier to remember.

The PE10 is a remarkably good rule of thumb. Since 1881, which is the first year for which a decade of earnings is available, the correlation of this measure with the broad stock market has been remarkably high. A paper published by Advisor Perspectives claims the correlation is a nearly perfect 0.9977. While this seems unlikely to me, the PE10 does have the strongest predictive value of any stock market metric. The long-term value of this PE10 has been 16.9.

Currently, the PE10 for the S&P 500 is 21.7, suggesting stocks are a tad on the expensive side. But a broad coalition of stock strategists have advanced interesting arguments for why the measure may have lost its predictive power and that stocks deserve to be higher.

The primary argument is that stocks deserve higher P/E ratios when interest rates are low. No less a guru than Warren Buffett, speaking in the aftermath of this year's Berkshire Hathaway annual meeting, stated that stocks are a huge bargain if interest rates remain at their low levels. "I think stocks are ridiculously cheap if you believe … that 3% on the 30-year bond makes sense."

The logic behind this statement is sometimes referred to as the Fed Model. The reciprocal of the Price/Earnings ratio is called the earnings yield. It is earnings divided by price. It is the amount that investors could receive in dividend payments if every corporation decided to pay out to shareholders 100% of after-tax earnings. This figure is then compared to ten-year U.S. Treasuries. The larger the gap between the earnings yield and the 10-year treasury yield, the cheaper the market. That gap is currently 3.8%, the widest it has been in three years.

But there is another reason many think that stocks deserve a higher multiple than in the past. The business cycle seems to have gotten less severe. In the period between World War I and World War II, the United States experienced six business cycles. The average recession lasted 18 months and the average expansion 35 months. Since World War II there have been ten business cycles. The average downturn lasted only 10 months, while the average expansion endured for 57 months. Thus, the downturns are shorter even as the expansions lengthen. The current expansion is even more remarkable. This summer marks the tenth year of expansion, the longest such period in U.S. history.

It seems likely that the swings in the economy will remain smaller going forward than in the past. For starters, the U.S. economy is primarily a service economy. Roughly 75% of GDP is currently derived from services, and only 12% from manufacturing. Only fifty years ago manufacturing represented 25% of the total. Services are considerably less volatile, since they do not require costly build-up of inventories.

It also seems that central bankers have become considerably more adept at implementing counter-cyclical policies to avoid downturns. The Australian economy is currently in its 28th year of expansion, causing it to earn the moniker The Land Without Recessions. This economic miracle has certainly benefited by some serendipity. Having the rapidly growing Chinese economy in their backyard to support Australian exports has certainly helped. But so have clever policy decisions. In 1997 there was a financial crisis in Thailand and Indonesia. The currencies of Australia and New Zealand both plummeted. New Zealand raised interest rates to support its falling currency. Australia decided to lower interest rates to spur exports. That decision allowed Australia to avoid the recession that gripped its neighbor.

This example, and others, have taught the Federal Reserve lessons about which policies are most likely to be effective during financial crises, and are no doubt partly responsible for our long run of prosperity.

With less volatility in the business cycle and record low interest rates around the world, it does seem that stocks deserve a somewhat higher multiple than historical benchmarks would suggest. Does this mean investors should adopt the attitude of Professor Irving Fisher that "this time is different?" Are stocks likely to continue rising to new records with little interruption?

I suspect not. While the rules of thumb used to judge over or under-valuation may have changed, human nature has not. We have previously written about risk homeostasis, sometimes called risk compensation. This is a controversial theory which posits that people typically adjust their behavior in response to the perceived level of risk, becoming more careful where they sense greater risk and less careful if they feel more protected. The most well known example is the fact that motorists began driving faster when wearing seatbelts and closer to the vehicle in front when the vehicles were fitted with anti-lock brakes.

If buying stocks that seem historically expensive feels less risky because the market "deserves" a higher multiple, I suspect investors will become somewhat reckless by buying more speculative and overvalued securities. Eventually there will be some external event to trigger a sell-off, but likely from a higher level than in previous market cycles. The business cycle may, in fact, be less cyclical. That does not mean the stock market will be.