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The Dying Cult

In his recent musings, famously successful and provocative bond fund manager Bill Gross claims "the cult of equity is dying." Furthermore he declares a century of stock market returns to be "an historic freak, a mutation likely never to be seen again as far as we mortals are concerned." He then steps off the ledge by likening past returns to a Ponzi scheme.

Well, well, well. Provocative indeed.

Let's start on common ground, the dying cult. The cult of equity peaked 12 and a half years ago, as tech companies went public with little more than fanciful business plans and newly activated websites. Back then, stocks sold for 30 times earnings, one-percent dividend yields, and were grossly over-priced compared to bonds and other assets. Surveys showed naive investors expecting 15 to 20 percent annual returns, ad infinitum. Since that time, equity investors have endured two severe bear markets and a lost decade of returns. If the cult of equity is dying, let's drive a stake through its heart and bury it.

On to the mutation, those freaky returns never to be seen again. Here's where the twisting of numbers turns a bit nonsensical. Mr. Gross cites the past century's 6.6% real equity return as flawed and likely unrepeatable. Perhaps so. We cannot force future performance to reach our arbitrary targets. In reality, equities return what they return, then market historians pick and sort and present the data in whatever context they choose. We need not ask if equities will once again provide a 6.6% real return. Instead we should ask if equities are still among the best choices of investable assets.

Furthermore, the use of real returns injects into the equation an unnecessary variable -- inflation levels -- which only serves to distort any comparative analysis. In reviewing historic results, why not choose nominal returns, and compare these returns to some other objective, nominal measures?

We do just that on the following pages.

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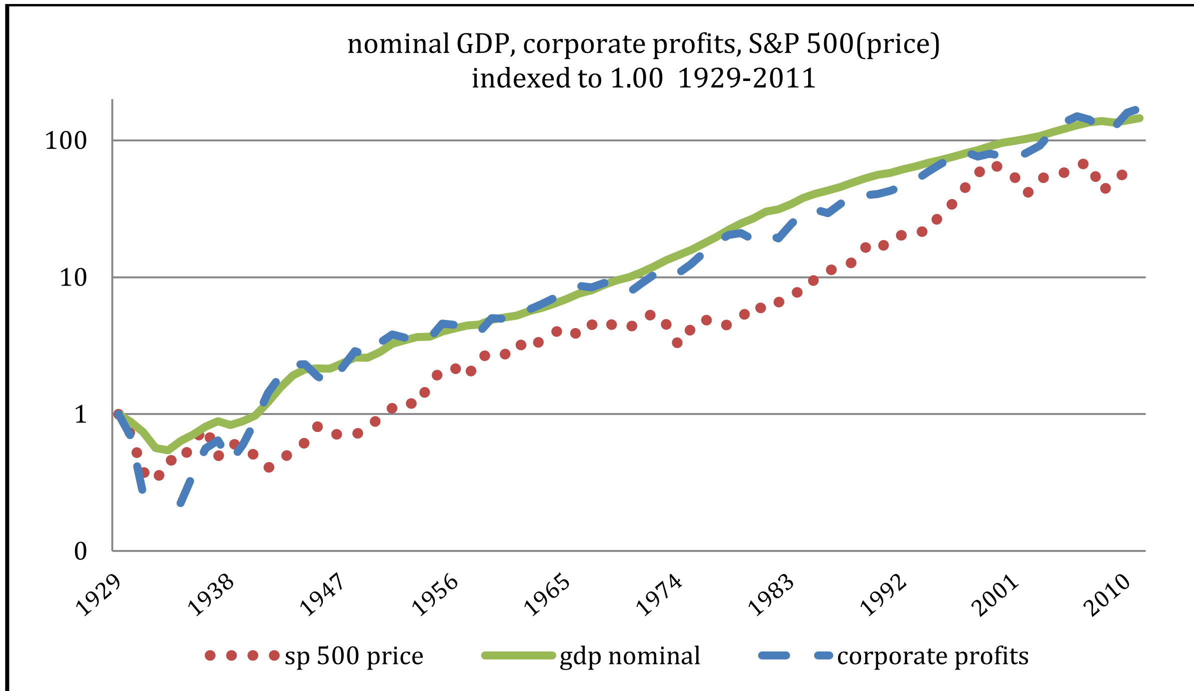
The chart below shows, since 1929, the cumulative growth in the US of nominal GDP, corporate profits, and the price level of the S&P 500. As shown, there is a fairly tight long-term relationship between nominal GDP and corporate profits, whereas stock prices have lagged the two, and with greater variability.

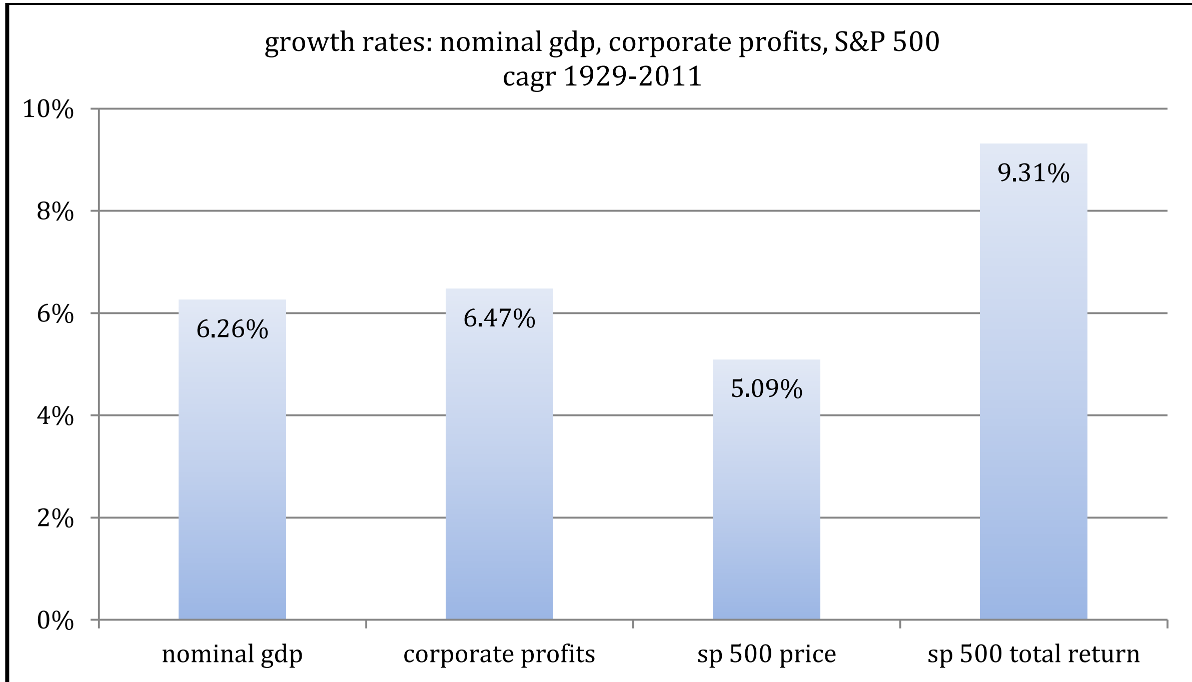


The cause and effect, to the extent it applies, works something like this:
As the overall economy grows, so too grow corporate profits. In time, stock prices reflect the higher level of profits. To some degree, they must; if not, stocks would quickly become "crazy cheap", only to be swooped up by bargain hunters, re-setting the equilibrium.

But changing valuations create much greater volatility in stock prices. Stocks do not conveniently rise at a rate equal to profit growth; we wish it were that simple. The shorter the timeframe, the more variable the move in stocks, the less the relationship described above holds true.

Nevertheless, when considering a near-century of results, the relationships are informative; and the raw numbers are astounding: since 1929, stock prices have grown 58-fold, GDP 145-fold, and profits 170-fold.

The second chart shows the same results in a different format, using compound annual growth rates in place of a cumulative growth line. Also included is the total return on the S&P 500, including dividends.



The introduction of total returns complicates the comparisons. S&P 500 stock prices have lagged the growth of nominal GDP and corporate profits, but when dividends are included total returns jump to a significantly higher level. A critical question is whether the added return from dividends represents the market equivalent of a free lunch.

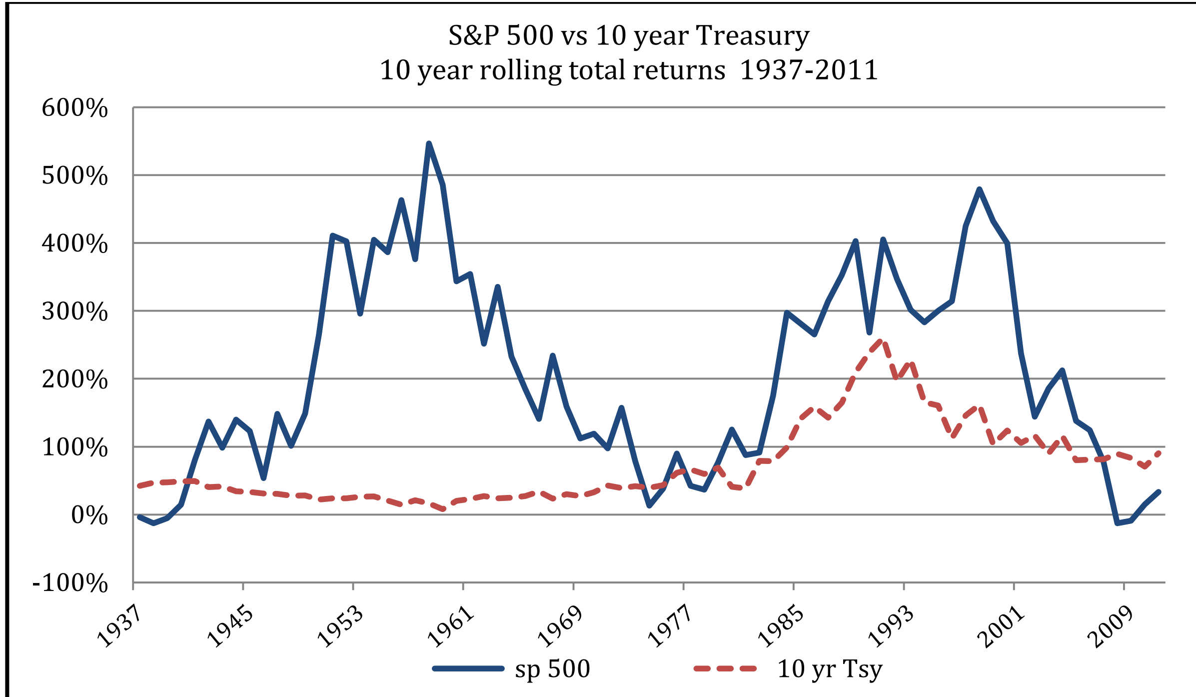
Hypothetically, if 82 years ago stocks sold at low double-digit earnings multiples, and today they sell at similar valuations, we would conclude that stocks are no more expensive than they were in 1930. This is supported by the lagging performance of stock prices. Yet the excessive total returns suggest otherwise. How did stocks compound annual returns at a pace 300 basis points above the growth of both the economy and profits? This is the historic freak.

Let's tweak one condition. If we now assume that valuations have doubled -- that earnings multiples rose from mid single-digits to low double-digits -- this explains one-third of the excess return. That still leaves 200 basis points of annual returns, compounded over 82 years, to account for. This brings us right back to dividends as a key component of total returns. The superior performance of equities is mostly derived from the inclusion of dividends, a shareholder bonus of sorts.

If this is the case, if equities have outperformed not due to soaring valuations, but because stocks offer two components of return -- price gains plus dividends -- then the prospects for future returns are probably not significantly diminished. The freak is explained.

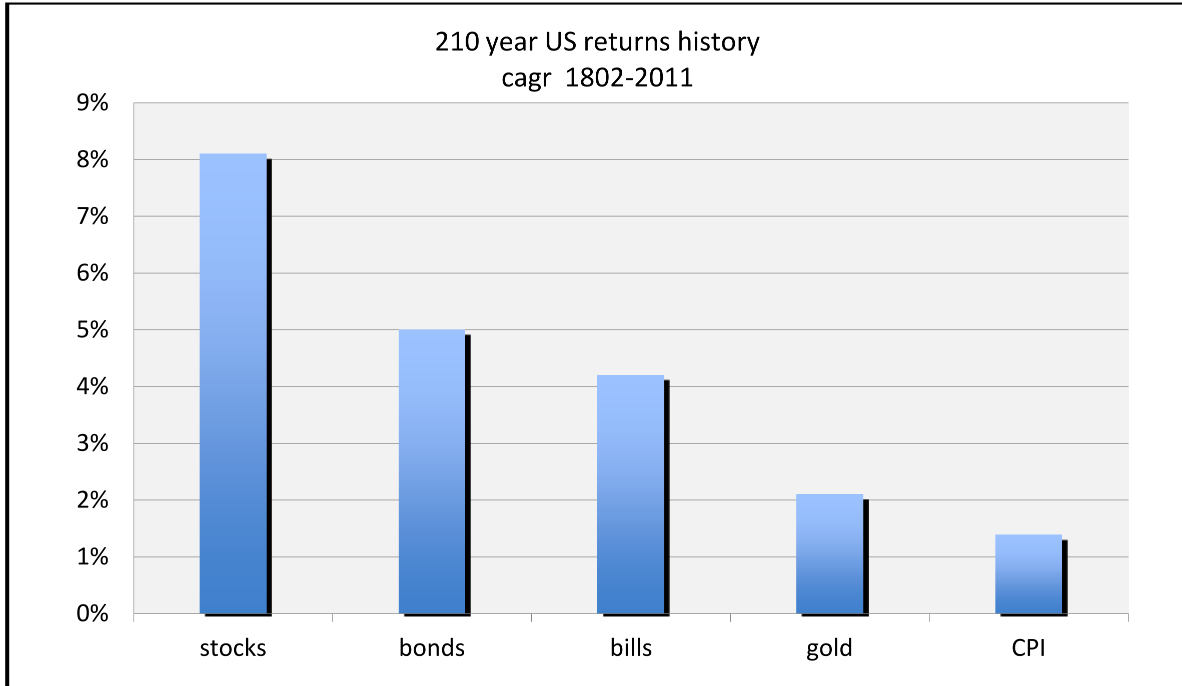
Now they tell us.

History shows that stocks generally outperform bonds, and over a long investment cycle this outperformance is substantial. But no generalizations apply at all times, as shown below. For more than the past decade, bond investors have been nicely-rewarded for taking little risk, nearly doubling their money. Meanwhile stocks have struggled, producing a negative return for the first ten-year stretch since the depression. For anyone to now proclaim that the cult of equity is dying.. well, it is a very strange time to be sounding the alarm.



One final thought..

Freakishly strong equity returns are not a one-century phenomenon; they date back at least two centuries, as shown below. That's no Ponzi scheme. At some point, we all need to concede: backed up by sensible financial theory and empirical results, history wins out. Cult or no cult, so do equities.



The Socialism Referendum

Typically we don't go there. We generally steer clear of political debate; first because it is rarely about policy itself, more about blue-state versus red-state fanaticism; and secondly because all the wisdom in the world amounts to very little if the electorate chooses otherwise.

Nevertheless, here we go.

There is a reason the term "political economy" exists. Even in the US, history's most successful blend of representative government and free markets, there is no escaping the connection between politics and economics. Government sets fiscal policy, deciding how much to spend, tax and borrow at the Federal level. Government sets monetary policy, controlling the supply of money in circulation and the cost of that money. Government enacts laws, writes rules and regulations, provides a framework in which companies and individuals operate. Government levies taxes, seeking a balance between needed revenues and desired incentives. Government, at its worst, attempts to choose economic winners and losers. In all these roles, Government has a profound influence on economic activity, much of it negative. There is no avoiding, and no breaking, the relationship between these two soft sciences -- political and economic.

So here we are, just two months before the Presidential election, and never in the past 32 years has the concept of political economy been so important.

The upcoming election is America's socialism referendum. No President should have a chance at re-election given the condition of the US economy. The Poverty rate is approaching a 50-year high. One in seven Americans is on welfare. Unemployment has sustained a level above 8 percent for the President's entire term, and that level was last seen in 1984. The income gap grows wider and wider, while wages continue to decline as a share of the overall economy. Some 47 percent of wage-earners pay no income tax. The middle class is collapsing into the lower class.

Meanwhile the national debt grows unabated, 100 billion dollars added every month. The two long-term budget busters -- Social Security and Medicare -- are off limits from serious discussion. For Congressmen who broach the issue, counter-attacks strike quickly as sharp partisan rebukes.

Yet come November, the President has a chance, and a decent one at that. Why? In the strangest of twists, bad news is good election politics.

Once we reach a level where the majority of voters are takers, receiving more than they give, the incentive will always exist to take more. This is secured through the ballot. The President has failed to revive the US economy, but has succeeded in creating a dependency class approaching majority status. This class will continue to vote in its own immediate interest -- more government support. Once in place, the majority will be hard to break. Fairness is the guise. Class Warfare is the tactic. Government dependency is the real policy.

We have reached a tipping point. The President winning re-election means America's free market, capitalist system is already lost. The price to be paid will be higher taxes, tighter regulations, larger government, rising debt burdens. This will continue the trend of slow growth, high unemployment and a shrinking middle class. It is a recipe for disaster. Meanwhile the Social Security and Medicare time-bombs will keep ticking. A cynical quip warns that we are turning into France. If not for our own printing press, Greece might be the better comparison.

California Tremors, Part 1

Times are tough out west. Earlier this year Stockton, California became the largest city to file bankruptcy in US history. Within months both Mammoth Lakes and San Bernardino followed suit. Compton is thought to be next in line. Four years ago it was the city of Vallejo starting the California bankruptcy parade.

The state government has its own fiscal problems. Its Legislative Analysts Office recently reported that revenues from capital gains taxes might fall short of projections by hundreds of millions of dollars. The culprit? Facebook and its weak stock. Apparently the budget does not plan for price declines at newly-public companies. Fair enough, but when a state this size needs to highlight a shortfall from a single stock, the problems are much larger than suspected.

Not to be outdone, a week later the California Controller's office served up more budget blues. This time the problem is weaker sales tax receipts. According to the Controller, "July's sales-tax performance is harder to explain as it is unclear whether consumer activity has slowed or if this is an issue of timing," All total, July revenues were ten percent below budget, although only a portion of the shortfall can be blamed on sales taxes. Not to worry, according to the Controller, "the missed amount this month can certainly be made up in the near future."

Sure it can. But here's a guess: The California budget is so bloated that every revenue forecast is pumped up to optimal levels. When there is no room in a budget for a falling stock or a cautious consumer, the problem is not one of revenues, but of spending.

Here's another guess: California politicians will be the last to recognize that fact.

Sources:
Bloomberg
"Stocks For The Long Run" – J. Siegel, 2007, McGraw-Hill Publishing
www.Pimco.com
Wall Street Journal

Tidbits..

Europe, UK, China central banks all move to easier money.

Europe's Airbus chooses Alabama as site of $600 million aircraft manufacturing facility.

Patriot Coal files bankruptcy.
The White House must be thrilled.

Futures broker Peregrine Financial Group goes bust, $200 million gone missing.
Another fraud, another miss by regulators.

Fitch Ratings affirms AAA credit rating of United States.
Who says ratings agencies have no sense of humor?

Short-term rates drop below zero in Germany, Switzerland, Denmark, Finland.
The ultimate flight to safety, when people pay to store their money.

UK's LIBOR rate-setting scandal widens, heads roll, subpoenas fly.
Candidate for most overblown scandal.

US poverty rate projected to reach 50-year high.
For such an advanced society, the saddest of all economic statistics.

Home values post first year over year increase since 2007, Zillow reports.

European Central Bank says Euro is "irreversible", suggests stronger intervention.
This time they really, really mean it.

Knight Capital Group suffers trading glitch, loses $440 million, needs white knight rescue.
A new consideration for trading firms: always one tech snafu away from catastrophe.

Eurozone economy contracts in second quarter as recession deepens.
With debt load already too high, no easy solution.

Congressional Budget Office sees 2013 recession unless fiscal cliff is avoided.

SEC scuttles plan to tighten money market fund regulations.
Industry interests win, sensible regulation loses.

Apple wins patent infringement case against Samsung smart phone design.