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The HeadInvest Quarterly

MarketComment.

There is nothing like a quick, sharp stock market correction to spark both bland reassurances that all is well and dire warnings of a coming collapse. The truth is, no one knows what direction the market is going to take in the next few weeks or months. Nor does a sound long-term investment policy require such clairvoyance. Fundamentally, capitalism provides a framework for millions of people to seek to create wealth. The opportunity to back the efforts of others with our own money—and the ability of innovators to share the risks with others—has been a great boon to wealth creation since the advent of the joint-stock company in the early 17th century. With prudent and diversified stock selections matched to investor risk preferences, we seek to take advantage of a vast human enterprise stacked in our favor.

MARKETS WILL FLUCTUATE

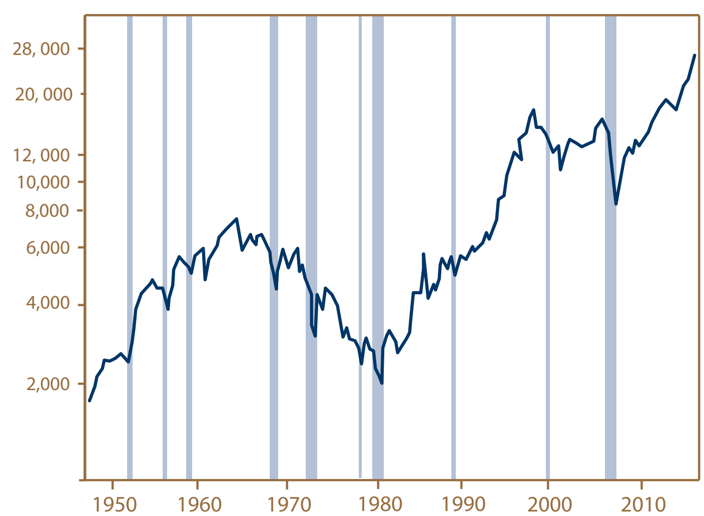
A SMART YOUNG MAN IS SAID TO HAVE APPROACHED JOHN D. ROCKEFELLER WITH THE QUESTION, "MR. ROCKEFELLER, WHAT DO YOU THINK STANDARD OIL STOCKS WILL DO?" AFTER PONDEROUS DELIBERATION, THE REPLY WAS, "YOUNG MAN, I THINK THEY WILL FLUCTUATE."

February's 10% stock market correction, in isolation, means little. On average, there are 10% corrections every year and, on average, it takes about 14 weeks for the decline to complete before the market reverts to its upward course. Corrections are not harbingers of a bear market but they certainly are capable of concentrating the mind on the possibilities.

The chart below shows the Dow Jones Industrial Average in the post-war era. Though the chart runs through February 15, 2018, one struggles to even see the market's latest travails.

As opposed to mere corrections, bear markets are more consequential. Often defined as a 20% or greater decline in stock prices, bear markets happen on average every 3.5 years (according to Ned Davis Research). The consequences for investors can be nasty, particularly if the pain of declining prices—or unforeseen personal circumstances—induces them to sell before stocks recover.

DOW JONES INDUSTRIAL AVERAGE



Source: Macrotrends.net

In the chart, one can make out that large stock price declines are often associated with recessions, denoted by light shading. A recession is a downturn in economic activity characterized by at least two consecutive quarters of decline in a country's gross domestic product.

Unfortunately, we cannot know in advance if a correction is a meaningless fluctuation or, in fact, the beginning of a bear market. One way to assess the probabilities is to study history.

ONE WAY TO ASSESS THE PROBABILITIES IS TO STUDY HISTORY.

There have been eleven recessions in the post-war period. The first one shown on the chart, in 1953, came after an inflationary scare sparked by the Korean war. Once price controls expired, the Federal Reserve, newly independent from the Treasury, asserted its independence by tightening monetary policy. Inflation proved short-lived, as aggregate demand promptly fell, in part the result of lower war spending.

Monetary policy tightening also contributed to the recessions of 1958, 1960-61 and 1969-70, though there were other causes as well. Another decline in military spending during the Eisenhower administration exacerbated the slowdown in 1958, making it by far the most severe of the three.

In 1973-75, the economy slowed in response to a quadrupling of oil prices by OPEC, which was widely seen as retribution to those who supported Israel in the Yom Kippur War. The stock market crash at that time was both a reaction to and a further cause of the recession. President Nixon's resignation in 1974 added to the political disarray of the time. This period gave birth to stagflation, when prices rose despite sluggish economic activity, two things that are normally not associated with each other.

In 1980, the economy dipped then recovered before experiencing a larger decline in 1981-82. The Iranian revolution in 1979 had led to another sharp increase in energy prices. Seeking to control the inflation caused by the twin oil price shocks, Fed Chair Paul Volker hiked the federal funds rate target to near 20%. Though Mr. Volker is widely considered a hero for breaking the back of inflation—leading to a 20-year bull market in bonds—the recession he engineered was painful. Unemployment rose to 11% nationally and to 17% in Michigan. This episode is perhaps the poster child for those who view monetary policy as an overly blunt instrument in the arsenal of tools of macroeconomic management.

A lengthy expansion in the 1980s was followed by a mild recession in 1990 (except in New England, which was hit hard). Monetary policy was tightened in response to rising inflation. In addition, tax reform in 1986 sapped the real estate sector of some of its dynamism. Finally, the Iraqi invasion of Kuwait drove a doubling in energy prices. The rapid intervention and quick success of US troops in Operation Desert Storm calmed jitters and helped limit the scope of the downturn.

The next two recessions, in 2001 and in 2007-09, had little to do with restrictive monetary policy. One could argue that these recessions were caused by overly *loose* monetary policy. The bursting of the dot-com and real estate bubbles led to substantial declines in investment and consumer and business confidence. While the early 2000s recession was mild (though the stock market response was not), the collapse in home prices in 2007 had a significant negative impact on the economy, transmitted globally through a weakened financial system.

In the absence of inflationary pressure (except in home prices!), the Federal Reserve adopted a dovish posture about interest rates, keeping them low until well into the housing bubble. In addition, Fed Chair Alan Greenspan also took a hands-off approach to regulation of financial institutions during the boom. He later admitted that perhaps he had been "partially wrong" in this approach. "I have found a flaw," said Greenspan in Congressional testimony in 2008. "Those of us who looked to the self-interest of lending institutions to protect shareholders' equity are in a state of shocked disbelief.. Likely, Mr. Greenspan did not anticipate a comparison with Captain Renault from the film *Casablanca*, "I'm shocked, shocked to find that gambling is going on in here."

REGIME CHANGE

One cannot help but notice from the chart that there were several long phases of stock price movements during the postwar era that were independent of and more important than the impact of business cycles. Rarely are these "regimes" discussed and there is probably too little contemplation of them considering their consequences.

The first of these regimes was characterized by the long run-up in stock prices from the end the World War II until the mid-sixties. Roughly speaking, this was an era during which the US enjoyed unparalleled global prestige and economic supremacy as well as a workable, centrist political consensus. Industrial might, the Marshall Plan, pharmaceutical and materials science innovations, all of this and more fueled economic and market growth until the mid-1960s.

THE US ENJOYED UNPARALLELED GLOBAL PRESTIGE AND ECONOMIC SUPREMACY AS WELL AS A WORKABLE, CENTRIST POLITICAL CONSENSUS

After this, things started to get difficult. President Johnson's "guns and butter" strategy during the Vietnam war, during which both defense and nondefense spending increased dramatically, caused inflation to increase even before the twin oil price shocks. Between 1966 and 1982, inflation averaged 6.8% per year. (When people say that stocks are a good hedge against inflation, it is not because stocks perform well during inflationary periods. Instead, stocks are a hedge because their long-term performance is substantially higher than inflation). Moreover, in retrospect, we realize that it was during this period that the de-industrialization of America began. Competition from Japan and the Asian Tigers helped create the Rust Belt, wage growth began to sputter and income inequality began to rise. Politically, the centrist political consensus began to decline. And the Vietnam War and Watergate crisis—not to mention four recessions and the Iranian hostage crisis—served to undermine American's optimism and faith.

The next regime began when the Carter administration left office. In 1981, Morning in America arrived with the election of Ronald Reagan. During his administration, the country experienced a notable economic expansion as real GDP growth averaged 3.7%. Tax cuts, military expansion, large deficits and the end of the Cold War all contributed. For the stock market, the decline in interest rates from their peak in 1982 provided a robust tailwind. The Plaza Accord in 1985 brought relief to the West by curtailing the rapid appreciation of the dollar, mark, franc and pound against the Japanese yen. A boom in leveraged buyouts and corporate raiders financed with junk bonds mesmerized stock investors, the personal computer era emerged with Microsoft's IPO in 1986 and the internet age began with Netscape's IPO in 1995. The good times continued into the Clinton administration and the market was only temporarily affected by the Clinton impeachment proceedings.

The boom continued until the tech wreck in 2000-02. The years 1999-2013 (when at last the Dow's previous peak was regained) saw two recessions, two stock market swoons, the September 11, 2001 terrorist attacks and large-scale follow-on wars. The entry of China into the World Trade Organization in 2001 marked a new, perhaps virulent phase of globalism, at least as viewed from the perspective of displaced workers. Politics seemed to deteriorate further into warring camps with incompatible views of economic and social policy. Children of baby boomers graduated from college with unprecedented levels of debt, retarding household formation and roiling the retail industry.

The election of Donald Trump in 2016 signaled a kind of rejection of the existing order, political and economic, that to some degree mirrors the election of Ronald Reagan. Once again, the new policies include tax cuts, regulatory roll-back and proposed increases in military spending. The political consensus in favor of austerity has evaporated, opening the way once

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again for increases in the federal budget deficit. Markets had been strong and accelerated their gains with Trump's election.

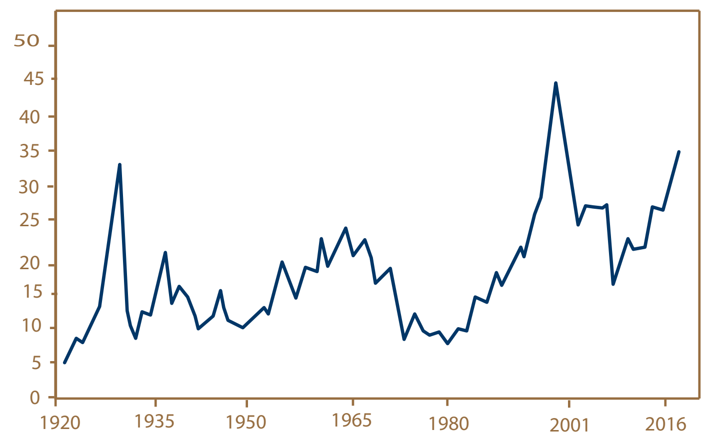
Will the stock market continue to benefit from the economic and social changes at hand? In several important respects, the current period differs markedly from 35-40 years ago. First, there is no prospect of a tailwind from falling interest rates. In fact, monetary policy globally is on the cusp of a major change. Following the decline in US interest rates from nearly 20% in the US to near zero, the Fed has hiked the Fed Funds rate 5 times since December 2016. A poll of Fed governors suggests that three more rate hikes are yet to come this year (though the market is not yet convinced). The Fed has also announced that it will reduce its holdings of Treasury bonds purchased under its policy of quantitative easing by $250 billion this year. With economic activity in Europe rebounding, The European Central Bank is expected to end its QE program later this year and it has already reduced its monthly purchases by half.

The particular risk of rising rates this time around is that overall indebtedness is at very high levels. Federal debt is at 105% of GDP, versus 30% when Reagan was inaugurated. Total nonfinancial debt is at 250% of GDP, its highest ever. Unfortunately, much of the increase in borrowing has occurred since 2008, when interest rates were at or near their lowest levels ever. Rising rates could be the natural expression of economic health, but compounded with larger than usual consequences and the possibility of policy errors, the regime could be quite sobering.

A second major difference is the starting point of stock market valuations. The Shiller Cyclically-Adjusted Price Earnings Ratio ("CAPE"), a measure of stock market valuation in relation to earnings, currently stands at 33 times, compared to 7 times in 1980. The current valuation does not seem as stretched compared to 1965, when the ratio was 23, but it is still as high as it has ever been, except for 1999, when the ratio stood at 44.

This is not to say the market cannot advance, but it seems very unlikely that the Trump era will unleash animal spirits sufficiently to sustain a long boom from current levels. The new regime will likely be characterized by rising interest rates and inflation, coupled with divisive social trends. If this turns out to be the case, these factors may not only reduce earnings growth but reduce the multiple of earnings investors are willing to pay.

S&P 500 SHILLER CAPE RATIO



Source: Robert J. Shiller, Yale University

We value your Comments

We value your thoughts and suggestions. If you would like to receive The HeadInvest Quarterly by email, please contact us at info@headinvest.com