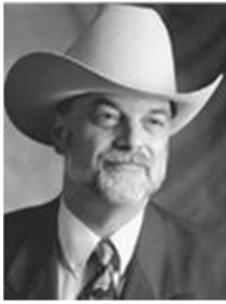

THE PERSONAL WEALTH COACH®

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Market Perspective

A lot has happened since 9/11/2001 and entire books have been written about those changes over the ensuring years. For investors it is probably enough to cite something close to home. At the end of the third quarter of 2001, on September 30, as we digested just how vulnerable we were and how the whole world might come plunging down any time, the S&P 500 Stock Index (S&P 500) closed at 1,040. Today, fourteen years later, again in the midst of pessimism, the S&P 500 closed at 1,961, for an 88% rise in value.

Your initial impression, like mine, was probably something like "Wow! That is a big jump!" In fact, the rise since 9/11 has been one of the slower increases in the history of the Index. Measuring from the beginning of 1871, when the S&P 500's ancestor was first calculated, through the end of 2014, the average annual rate of return for the Index has been 10.77%. But, you may say, "What about inflation?" Yes, today's numbers are indeed inflated by the standards of 1871, but even after subtracting out dollar inflation over the 143 years the Index has been calculated, the average real rate of return still remains about 7% per year.

What then does it mean when the last fourteen years have only averaged 4.63% per year, as they have? There are a couple of ways we could approach this. Obviously, if corporations had become less profitable and less productive, that would explain it, but, in fact, corporations are doing just fine. If anything, corporate earnings are better and their long-term growth better than at any time in that nearly century and a half. So, if the corporations that make up the Index are doing okay, then what does the low average mean?

First, note that there are no guarantees here, but there have been times when the S&P 500 did not do so well, and had long-term returns as low as we are seeing now. What has been consistent though is that over about a thirty year period, any thirty year period, the real price appreciation of the S&P 500 Stock Index has been reasonably consistent. In a practical sense, if history is any guide, then by 2031, about sixteen years from now, that average annual rate of return is likely then to have returned to its long-term average, or as statisticians put it, "returned to the mean."

Here is where things get interesting. If the real (after inflation) rate of appreciation of the S&P 500 Stock Index catches up to the "norm" over the next sixteen years, then it will need to have an average annual *real* rate of return of 8.16% to just reach average. Add in our estimate of future inflation (2.25%) and the nominal return of the U.S. stock market will be around 10.41%. It could be that is just coincidence, but what we are looking at then is a return over the next 16 years that is very, very close to that very long term average of 10.77%. That would put the S&P 500 Stock Index, which closed today at 1,961, up to about 9,563. If the Dow Jones Industrial Average (the Dow) had the same long-term return (which it tends to do) as the S&P 500, then we would be looking at the Dow at 80,000.

The Dow Jones Industrial Average at 80,000 sounds so wild that I would not blame anyone for thinking me a little out of bounds, but wait…

In October of 1987, with the Dow at about 1,350, John Templeton, live on Wall Street Week with Louis Rukeyser, predicted the Dow Jones Industrial Average would be at 10,000 by the end of 1999. As it happened, he was slightly off. It was actually around 12,000, and had overshot its mark. The Dow had risen by a factor of nearly 9 times in twelve years. Yes, as we now know, it was ahead of itself, but it happened. I do not believe the Dow would be ahead of itself if it rose by a factor of about 4.9 over the next sixteen years. That is all it would take to reach that 80,000 mark from where it was at the close of the market today when it hit 16,433.

This still may sound wildly optimistic, but based on actual historic returns, the numbers I have cited here are actually quite conservative and even a bit pessimistic.

Information contained herein has been obtained from sources believed to be reliable but is not warranted as to accuracy or completeness. Past performance is no guarantee of future returns. For tax or legal issues consult with a qualified tax advisor or attorney.

This Week & the Economy

This week the S&P 500 Stock Index rose to 1,961 from its opening on Monday at 1,948, which is a numerical way of saying that not much happened. Note that during the week the Chinese economy did not suddenly stabilize, nor did any suggestion of stability in the Eurozone emerge. The Federal Reserve did not send any signals other than those of uncertainty. In short, the bad news did not go away. On the other hand, the good news of the recovery here in the United States did not go away either.

What did happen is that the construction industry is reportedly facing a shortage of skilled workers and is straining to train new ones. The average debt load carried by Americans continued to shrink, and the Chinese Yuan, which has fallen 1.5% against the dollar, was propped up by the Chinese government, lest it fall further, and job openings in the United States rose to an all-time record high of 5.76 million in July. All of those numbers suggest that wages may soon start to rise and more people will be working in the future than today. Meanwhile the U.S. economy is now on a long-term trend of employing around a quarter of a million new workers each month.

The reported consensus in the markets as to the problem that is holding things back remains that there is uncertainty as to how the markets will react if the Federal Reserve raises rates to 0.25% next month or doesn't. Yes, that is the big issue; traders are reacting to a fear of how traders will react to something that is virtually certain to come in the next several months. Combine that with the fact that the big decision makers at the stock trading firms are still on vacation and you get the picture.

Oh yeah… One more bit of news. We use a measure of market valuation called the "forward price-to-earnings ratio" (forward P/E). We take the current price of the S&P 500 and then divide it by the earnings estimate for the end of next year (2016), That is an awkward way of saying we base the measure of value for stocks on the earnings yield over the next year. As of today, the S&P 500 has a forward P/E of 14.8, meaning that the value of a "share" of the S&P 500 is about 14.8 times next year's estimated profits. Its average P/E over the last forty years or so has been about 20. That means the S&P 500 is below its long term average by about 25%.

Actually that is not a bad thing at all. It does mean that the chances of it getting a lot lower are remote. It also means that we can reasonably expect to see above average growth at some point in the future as it catches up to its long term average. Once it gets above that long-term average, then there will be reason to be cautious. Of course, if history is any guide, by then optimism will have gripped the media and the markets and we will not have to argue against pessimism. In the year 2000, for example, the P/E ratio was 45! I have a great deal of faith it will get there again eventually, and then we will be counseling restraint, but that is for another day.

Radio, Radio, Radio

Jake and I will once again be out of pocket for this Saturday and next as I once again venture into the desert in an attempt to capture images from deep space, but if you missed previous sessions of our broadcast wit and foolishness, you are welcome to listen to KTEM 1400 AM tomorrow from 10:00 to 12:00. Of course if you tune in and it sounds like a bit of déjà vu, then we have other examples of outdated commentary that may sound amazingly like current news on our website at http://www.tpwc.com/radio-program.html.

Until next week,

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