Four Decades

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Chris provides financial planning, investment planning and full implementation services to about 100 families.

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You may be pleased to know your advisor was able to keep quiet when Zanny Minton Beddoes, Editor in Chief of The Economist, said to a group of us in Dallas recently that the goal of journalism was to 'simplify, exaggerate, and then disturb' the reader. She meant it as a joke, but not really.

One goal of this newsletter, and indeed a good portion of my professional energy, is to give clients the courage to face the daily onslaught of exaggerated negativity that we are bombarded with each day. It is difficult to fathom, it is so one-sided and relentless. As I have said so many times to all of you, news media is utterly useless and in fact counterproductive to intelligent investing[1].

As I write at the end of 2015, we take a look back at the past four decades. Just because it's 2015, we're going to look at decades ending in '5'. And with some delight in offending financial industry lawyers whose favorite expression is something like 'beware the past because the future will be different', today's essay is more along the lines of Harry Truman's adage (admonishment?) that 'The only thing new in the world is the history that you haven't read yet'. It goes like this[2]:

[1] See The Science of News, www.chrishoran.ca
[2] Quoted by permission, Nick Murray, December 2015. Data for US economy, in US$, markets data for S&P500, returns in US$.

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1975

Saigon falls. President Ford escapes two assassination attempts in seventeen days. Margaret Thatcher becomes the first woman to lead Britain's Conservative Party. Saturday Night Live debuts. Three dozen beer and 2 packs of cigarettes, enough to keep your advisor in trouble for a weekend, cost less than C$10. An American and a Soviet spacecraft link up in orbit, and the event is commemorated on a US postage *10 cent stamp*.

Global population: 4.1 billion, *half of whom live in extreme poverty*[3].
US population: 216 million
US GDP: $5.5 trillion
S&P500: Yearend close: 90
Earnings: $7.71
Dividend: $3.73

1985

Gorbachev comes to power in the Soviet Union, and meets with President Reagan (who had survived an assassination attempt 4 years before). The internet domain name system is created. Windows 1.0 is released, and the first successful human heart transplant takes place. In the greatest marketing catastrophe since Ford's Edsel, the Coca Cola Company introduces New Coke. Your advisor graduates business school, marries an undergrad, and a US postage stamp cost 22 cents.

Global population: 4.8 billion
US population: 238 million
US GDP: $7.7 trillion
S&P500: Yearend close: 211
Earnings: $15.68
Dividend: $8.20

1995

The Oklahoma City bombing is the worst domestic terrorist atrocity in American history. OJ Simpson's murder trial begins, and ends 10 months later in his acquittal. Israeli Prime Minister Yitzhak Rabin is assassinated by an Israeli right-wing radical. The Rock and Roll Hall of Fame opens in Cleveland and Jerry Garcia dies. A postage stamp cost 32 cents.

Global population: 5.7 billion
US population: 266 million
US GDP: $10.3 trillion
S&P500: Yearend close: 616
Earnings: $37.70
Dividend: $14.17

[3] World Bank definition income of $1/day.

2005

Hurricane Katrina hits an unprepared New Orleans and devastates an area larger than Great Britain. Saddam Hussein goes on trial for his life. July 7th becomes London's 9/11 as coordinated attacks on the bus and subway system claim 52 lives. Pope John Paul dies. A postage stamp cost 37 cents.

Global population:	6.5 billion		
US population:	296 million		
US GDP:	$14.4 trillion		
S&P500:	Yearend close: 1,248		
		Earnings:	$76.45
		Dividend:	$22.38

2015

A radical Islamist faction, ISIS, casts the Middle East into chaos, and commits atrocities in Paris and elsewhere. China has more high-speed rail than the rest of the world combined, begins construction of a railway through Laos, and Thailand to Singapore, and another one through central Asia to Turkey and Europe. Yogi Berra dies. A postage stamp costs 49 cents.

Global population:	7.3 billion, *less than one in ten of whom live in extreme poverty*[4]		
US population:	322 million		
US GDP:	$16.4 trillion		
S&P500: (Dec 12):	2,086		
		Earnings (est):	$118
		Dividend (est):	$43

To summarize the story:

Equity market rises from 90 to 2086, or 23 *fold*. Company earnings increase 17 *fold*, from $7 to $118. Dividends grow 12-*fold*, from $3.73 to $43. Cost of living, reflected in postage stamps, up 5 *fold.* Turns out postage stamps, beer, or Kraft Dinner are a decent proxy for actual inflation of a little under 4%.

Dividend income from common shares of 500 companies, which a retired person may well want for spending, is up more than 10 fold. Those dividends are paid out of earnings that are up 17 *fold*. And the value of those companies, as reflected in the quoted share prices, is up 23 *fold*.

[4] Population in extreme poverty estimated at 702 million in 2015 under World Bank current definition of $1.90/day down from 1.9 billion people in 1990. World Bank, Guardian, Reuters, Monday October 5, 2015.

Two Main Points

From the story emerge two points. Harry Truman observations if you will:

The obvious conclusion is that the growth in market value, earnings, and dividends from a basket of 500 companies over these horrible four decades blows away the rising cost of living. The real after inflation after tax return from a basket of common shares even blows away Vancouver real estate.[5]

OK, you say, I get the point: growth over 40 years has been pretty good, and I'm supposed to infer that the next 40 years is going to be pretty good too. But four decades is a long time. What about a shorter timeframe?

Let's look at that. The most recent decade includes the financial crisis of 2008/9, when the equity market declined 57%[6] - the worst bear market since the great crash of 1929. Yet at the end of 2015 the US market stands 67% higher than ten years earlier, and 32% above its pre-crisis peak. Thus the crisis is already fading into history, swamped by the progress of the broad US economy, and reflected in company earnings up 55% and dividends up 43%.[7]

(The same point cannot be made of the Canadian equity market, as it remains below its pre-crisis high. The TSX is a two-trick pony, dominated by a bank monopoly and resources, the latter being hammered by long term structural oversupply.)

And the most recent decade is not unusual. The prior decade, 1995 – 2005, also included a bear market decline of about 50% between 2000 and 2003, driven by the 80% collapse in technology stocks.[8] That decline was the biggest since the 45% decline in 73-74.[9] And yet the decade also saw a doubling of the equity market, from 616 to 1248, also powered by earnings up 100% from 1995, and dividends up 45%.

In fact, when you step even further back and look at longer term equity market progress, you see the same messages. The last two decades, the last four, they all blend into the long term trend: the average return of the US market from 1926 is about 10% (Ibbottson, 1926 – 2014). A return of 10% doubles a value in 7 years.

The really remarkable thing, and the first of the two main points of this essay, is that the last two 10-year periods have generated market returns that are perfectly commensurate with the longer term averages, even though the declines within those decades have been among the greatest ever.

Second point: the catastrophists are always wrong.

Global population up from 4 billion to 7 billion, while extreme poverty declines from 50% to 10%. Food is so abundant[10] that we are using corn for motor fuel.

Real GDP per (US) person more than doubles. Hundreds of millions of people, mostly in China, advance towards and into middle class life. China now has 100 million people whose GDP per capita approximates that of the West, making the Chinese middle class as large as its counterpart in the US[11].

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[5] Based very unscientifically on the value of my family home over the period.
[6] S&P500 per Big Charts, calculations by the author
[7] Data per Big Charts and Nick Murray, calculations by the author
[8] Peak to trough decline, S&P500; Technology stocks = Nasdaq index, data per Big Charts, calculations by the author
[9] TSX, source: TPF&C Economic Tables
[10] And the popular understanding of climate science so poor.
[11] 109 million vs 105 million in the US, Credit Suisse Global

In more qualitative terms, the quality of life as reflected in hundreds of things: heart surgery, CT scans, airline crashes, car accidents, cerebrospinal injuries, and even the music that you can carry around in your pocket, all improve ten-*fold*. If not a hundred. The music in your pocket wasn't even dreamt of in 1975.

This progress is factual and undeniable. It is surely the greatest improvement in the welfare of the largest number of people in all of human history.

Yet as some of you are reading this, a little voice will be playing in your head, 'Yes, but what about … ' and your brain will fill in the blank with the apocalypse *du jour* – bombings, income inequality, fiscal cliff, Greece default …. on and on, *ad nauseum*.

All this progress has occurred day by day, year by year, at exactly the same cadence as the news media has bleated that it is all about to end. Yes, it has all been about to end … every day, every month, every year, the entire 40 years, according to the news. Probably the entire 250 years since the Industrial Revolution began.

Yet here we are. In the face of daily disaster, our progress continues, exponentially in fact. The point, and the second major point of the essay, is the relentless progress of humanity. Today we are pulled forward by the emancipation of the Chinese from the dead hand of Communism. (In fact if not in name.) And by the serial technological revolutions springing from the microchip and other technology.

The progress obliterates the pathetic negativity of the news media, the declinists, and the doomsayers.

Paul Erlich, whose 1972 book Limits to Growth, is idolized even today by catastrophists, lost his famous bet with Julian Simon. Erlich's catastrophism has been vaporized by Norman Borlaug's drought-resistant wheat, nutrient-replacement fertilizers, expensive and efficient machines, and enterprising, hardworking farmers.

Looking Forward

So what's my fearless forecast for the next decade? Clients are well aware that I do not pretend to know what the future holds. Economic and investment forecasts aren't worth the paper they are printed on (or the time to scroll them on your phone).

To twist a phrase from Taleb's Black Swan, we could all be turkeys, and this could be the week before Thanksgiving.

But I don't think so. Equity markets today are very close to their long-term valuation norms. Most bear markets start from high valuations, not average. Not only that, but low inflation supports high valuations, because future earnings are not corroded by inflation.

And equity markets are as cheap as they've been in 50 years compared to bonds: today's price/earnings ratio of 17 equates to an earnings yield after tax of about 6%, almost three times the yield on a Canadian 10-year bond, pre-tax. The US consumer is spending normally, up 4% year over year the last 5 years[12].

[12] Nominal growth yr/yr, Financial Times

The US Congress seems inclined to support the Trans Pacific Partnership trade agreement, one of the most positive developments for global prosperity since the North American Free Trade in the mid-1990s. And crude oil under $50 is a huge windfall for consumers around the world. Just think: if the price of crude going from $50 to $140 was so bad – the news media said so – then how can oil falling from $140 to $50 be bad?

The so-called slowdown in China does not mean China is actually slowing; it means the rate of acceleration is slowing from the 10% per year of the last 15 years to a more manageable 6 or 7% per year.[13] Negativists beware: China's slowing growth will double its GDP in only 10 or 12 years. Even 4% over the next decade will increase Chinese GDP by 50%, which would still be awesome.

The centre of gravity of the world economy will continue to shift from mid-Atlantic of the last 100 years to the mid-Pacific … of course there will be bumps – the US had a civil war – but the world economy would still be transformed.

Taking a wild guess, ten years from now the US market is highly likely to have doubled. No heroism there, that's just average.

Equally likely is that one of those 10 years will see a decline of 30% or more. Nothing scary there, that's just average. Whether the decline is in the first year, or the last, or any year in between, is anybody's guess, and totally irrelevant anyway. The point of history is that humanity progresses, in spite of what you see in fear/news/media every day.

We'll look at 2015 in more detail, as well as the outlook for 2016 in the next letter. In the meantime, if you'd like to discuss things in more detail, please email or call. I'd be happy to hear from you.

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[13] Economist 2016 forecast 6.7%, January 2016