

2020 Hindsight

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To clarify the title, we will give our U.S. stock market outlook from the vantage point at the end of year 2020 looking back a decade. In short, to summarize our belief, we firmly believe that investors will be pleased with what we foresee.

The past decade has been a horror. The stock market (Standard & Poor's 500 stock index) peaked in March, 2000 and was followed by the collapse of what was known as the dot.com bubble. This, of course, was compounded by the events of 9/11 in 2001. After the market recovered from these debacles it was soon hit with the collapse of the housing bubble. We are still working our way out of this problem. View our attached Chart 1. In this chart, the solid blue band simply traces the high/low of the S&P 500 stock index each year since 1940. Notice how the stock market essentially went sideways from the late 1960's up through approximately 1979. Why was the market flat over this time period?

The goal herein is to present our thoughts in a very simple form. From the end of 1968 through 1979 the S&P 500 earnings grew at a rate of 9.0% per year while the stock market was essentially flat. From Chart 2 (which is three cumulative indices), we see that over the long term the S&P 500 price (i.e., principal) index ultimately goes where earnings go. However, along the way, the price index line and the earnings index line sometimes cross each other. These crossings represent the rise and fall of the S&P 500 price to earnings (PE) ratio. Note that when the inflation index line inflects upward the stock principal line goes below the earnings line (this is PE contraction) and as inflation inflects downward the stock principal line goes above the earnings line (this is PE expansion).

Still, why would the S&P 500 index spend 11 years (end of 1968 through 1979) ignoring the earnings growth? The answer lies in the trends of the PE ratio. Historically, Wall Street has assumed that PE's are largely a function of interest rates. In other words, if you consider that fixed income investments are competition for investing in stocks, then higher interest rates would cause demand for stocks to be lower resulting in lower PE's and lower interest rates would cause demand for stocks to be higher resulting in higher PE's. We do not subscribe to this relationship between interest rates and PE's.

Chart 3 displays well over 100 years of the relationship between interest rates (20 year corporate bonds and 90 day Treasury Bills), consumer price inflation and the PE on the S&P 500 index (actually, we use the Cowles Commission All Stocks Index for years prior to the creation of the S&P 500 in 1926). All series are running 10 year averages in order to remove most of the short-term noise in the data so we can

observe trends. Consider the time period 1950 to 1980. Here, there is seemingly no relationship between interest rates and PE. However, the inverse relationship, with a slight lag, between inflation and PE is striking. The slight lag of PE allows for investors to stop “fighting the last war” and accept the trend change in inflation. That is, the slight lag gives investors time to react appropriately. Why might inflation be a key factor in determining PE? When you purchase a common stock you are buying the discounted present value of all future earnings. When inflation is higher the present value of the future earnings is lower and vice versa.

Let us go back to the time period from the end of 1968 through 1979. Over this time period we had inflation averaging 7.3% per year. Coming out of the 1960’s the U.S. was building the Great Society, we had the Vietnam War, we were putting a man on the moon, the dollar was freed from the gold standard and we were about to have OPEC dramatically increase the price of oil. In fact, there were two major spikes in the price of oil in the 1970’s. Inflation was off and running upward. PE’s trended down in a dramatic fashion causing the stock market to have a major collapse ending in the fall of 1974. In short, the growth rate in earnings from the end of 1968 through 1979 was cancelled out by the negative change in the PE ratio resulting in a decade of a flat stock market. Investors were shell shocked by inflation until into the 1980’s. Even though inflation slowed markedly as we entered the 1980’s, it took until the mid-1980’s before investors accepted that it had been tamed for the time being and they started investing accordingly.

Let us return to Chart 1. Chart 1 is titled “Fair Value Channel”. The open band in the chart is based on a proprietary Eads & Heald Investment Counsel computer model that uses only two inputs to determine Fair Value for the S&P 500 index. The two inputs are the earnings growth rate for the S&P 500 and consumer price inflation. We are keying off of the apparent mathematical relationship between inflation and PE. Up to the present, the model is fed actual historical earnings growth rates and actual inflation figures. For the future, the model is given an estimate for the earnings growth rate and inflation. The model is never manipulated so that the actual blue band of the S&P 500 hovers close to the calculated Fair Value Channel. The constant model has 70 years of keeping the same formula mathematics and using actual earnings growth rates and actual inflation numbers. The Fair Value Channel is not a magic formula for riches. It does allow market forecasting to focus on only two variables: earnings growth rate and inflation. The validity of the model could implode at any moment. This would be caused by stock prices ceasing to follow the trend in earnings growth (unlikely) and/or PE’s ceasing to have a dramatic inverse relationship with inflation (also, we believe, unlikely).

In this view of the model looking out to the end of year 2020, we assume that the S&P 500 earnings grow at 6% per year and inflation is 3% per year. From the S&P 500 closing price on September 30, 2010 (1141.2) to the model’s predicted high (4096.21) and low (2457.73) at the end of 2020 the return range is between 15.8% per year and 10.3% per year after we have added on a 2.5% dividend yield for each

year. The lower return of 10.3% per year would approximate the historic long term average return for the S&P 500 index. Consider our forecast range for return as making up for the last decade. The 6% per year estimated earnings growth rate is slightly below the long term average and the 3% inflation estimated approximates long term average inflation.

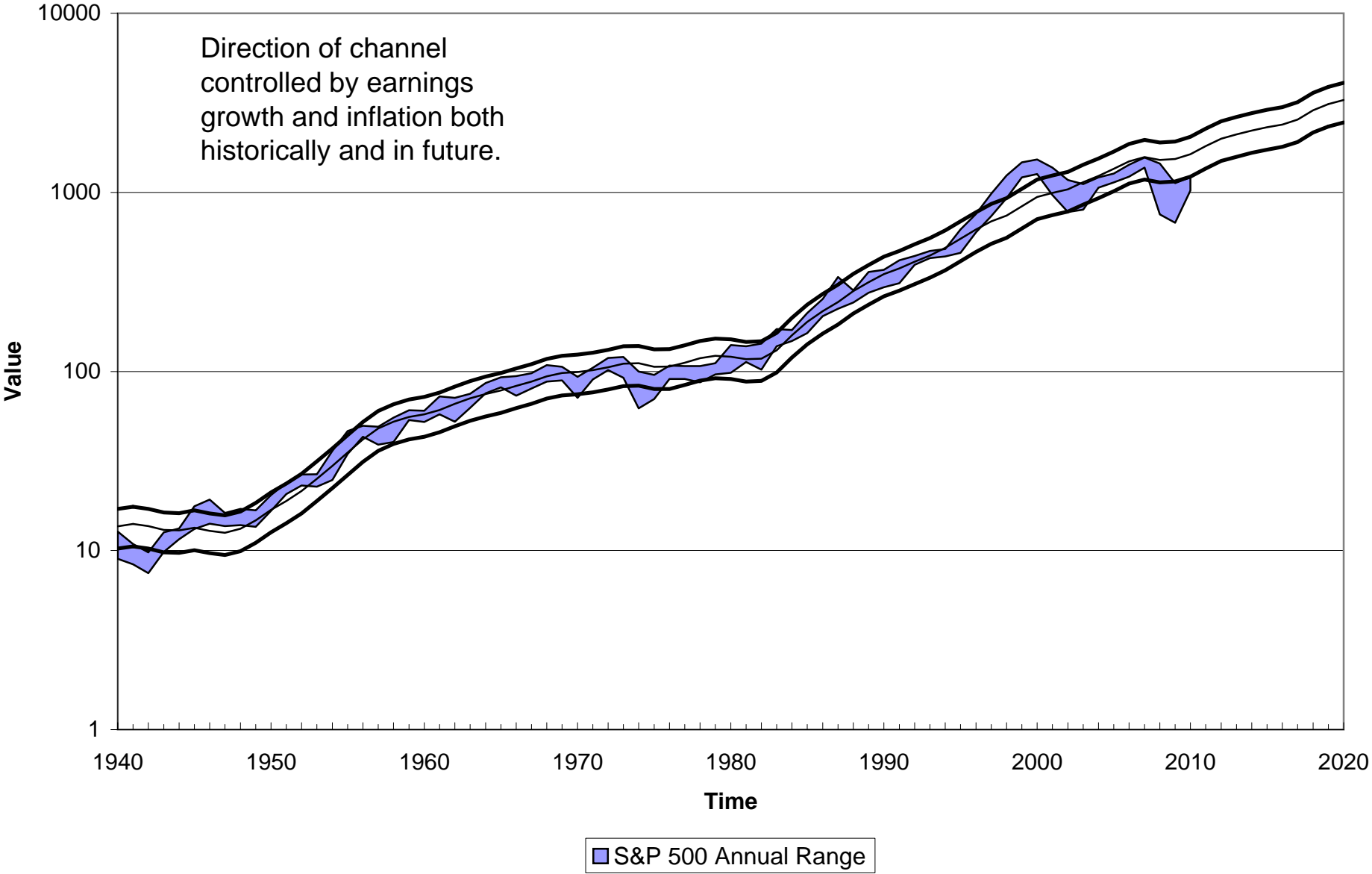
But, how can this “good” come out of the current economic situation? After 41 years in the investment business one starts to learn some simple truths. One is that the stock market and economic conditions always want to sway you to do the exact wrong thing at the wrong time. Euphoria invites you to participate in the party as investment clients clamor to get in on the action. Despair works the opposite way as clients tend to want to withdraw funds from stocks. For as bad as this current economic situation is with high unemployment, housing foreclosures and all, it will not likely leave long term scars like the Great Depression. Many of those Depression individuals were frugal for the rest of their lives. In the current situation, people will likely be back to their old ways not long after the storm clouds lift.

Corporations will regain their earnings power as this economic situation improves. Plus, we are not talking about instant gratification from stocks. The point is that we believe that on December 31, 2020 looking back on the decade just passed stock investors will be glad they invested. What we have in mind is investing in a very broadly diversified portfolio of many high quality stocks and not investing based on hot tips and/or in penny stocks. Also, we are not saying that the next few years could not remain quite troublesome. Our conviction is out through 2020. Why not simply wait until things improve and then invest? I believe we may have already partially addressed this question. Tell me when the good times have returned and then tell me how much the stock market has already risen when you have your positive convictions back. Timing the stock market is a loser’s game.

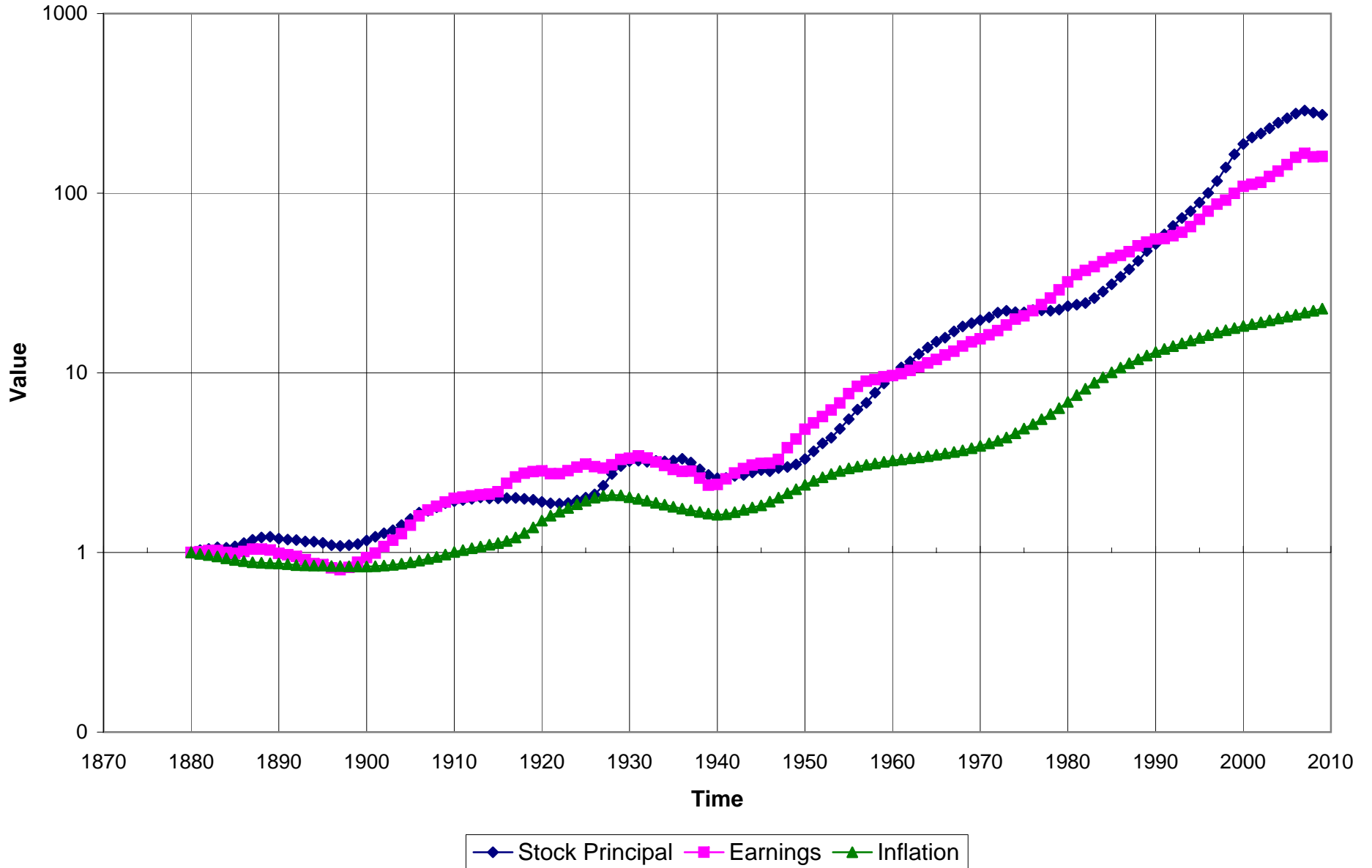
Currently, the political spectrum is filled with venom and some outright hate. There is the situation with Japan having languished for 20 years. How can the U.S. work its way through the current economic situation? Unless we overturn the Constitution, thwart the election process and marginalize free enterprise, the U.S. system is designed to self-check against any straying from our way of governing and capitalism. We believe that the system will prevail and our 2020 hindsight will turn out to be a pleasing and profitable picture.

Disclosure: Past returns are no guarantee of future performance. Some statements herein are forward-looking and predictive in nature. No guarantees of investor returns or market performance are implied. Investing involves risk, and capital losses are possible.

Fair Value Channel



Wealth Indices - 10 Year Moving Average



10 Year Average Annual Interest Rates, Inflation, PE

Chart 3

