

Views from the Peak

Timely information for friends and clients

Be fearful when others are greedy and only greedy when others are fearful. –Buffett

The short version

The market is currently priced high when compared to its before tax profits. **While below the 2000 peak on this measure, it is still 60% above where it was in 2008. It hit the 2008 level again in 2015. If the next 10 years plays out like 2000-2010, then expect a flat to negative return. Even though the market has gone up for the last 10 years, we do not know what it will return in the next few years. We should be prepared for an up, down or flat market.**

New Year's Eve, 1999

The **dot.com** rage was in full swing. Companies with little revenue and no profits were valued at obscene levels based on the number of people who visited their website. It is known as the most overvalued market in our history. Let's take a look at things then and now. But first, a few definitions of data kept by the Federal Reserve Bank.

- GDP is the value of all finished goods and services; it provides an economic snapshot of a country.
- Total value of the US stock market is the total value of all of the publicly traded stocks in the US.
- Corporate profits before tax is a measure of the profits of all of corporate businesses in the US.

As of January 2000:

- **US GDP: \$10 trillion.**
- **US Stock Market: \$15.2 trillion**
- **Corporate profits before tax: \$771 billion**

Investors were paying about \$19.77 for every \$1 of corporate profits before tax. The total stock market was valued at about 51% higher than what our economy produced. The market would fall over 50% into 2003.

10 years later

As 2009 came to a close, many of us were wondering if our financial system could survive. Banks were failing and we

had seen the biggest drop in the market since the Great Depression (-60%). The Fed had taken rates to zero and had started the first round of adding liquidity (QE).

As of January 2010: (10 year annual change)

- **US GDP: \$14.7 trillion (+4.25%)**
- **US stock market: \$11.56 trillion (-2%)**
- **Corporate profits before tax: \$1.78 trillion (+9%)**

Investors were paying about \$6.50 for every \$1 of corporate profit before tax. The stock market was priced at 21% below what our economy produced. The market would be up over 150% over the next 10 years.

It's worth noting that in January of 2008, investors were paying about \$10.46 for every \$1 of earnings. The market fell over 50% from that point. Trailing 12 month profits bottomed at \$892B in October 2008 before recovering to the \$1.78 trillion in January 2010.

20 years later

As 2019 came to a close, we had a great recovery from 2018. The market fell almost 20% during 2018. It fully recovered and made new highs in 2019. Almost no one is predicting a bear market. Profits, while above the 2010 level are about 5% below their 2014 peak of about \$2.2 trillion.

As of January 2020 (20 year annual change)

- **US GDP: \$22 Trillion (+4%)**
- **US stock market: \$32.9 trillion. (+4%)**
- **Corporate profits before tax: \$2.1 trillion (+5%)**
- **A rated bonds: (+5.75%)**

Investors are paying about \$15.77 for every \$1 of corporate before tax earnings. That is not quite as bad as in 2000, but well above the January 2008 level. **It has been above the 2008 level since January 2015. It is above its historical averages.**

- Since 1947: \$7.43 (112% higher)
- Since 1980: \$9.33 (70% higher)



Tony Yakos, MBA, CRPC
Financial Advisor

Granite Peak Wealth Management
Of Raymond James®
400 South Walnut St., Suite 100
Muncie, IN 47304

(765) 288-0362 Phone
(888) 797-3707 Toll Free
(765) 288-0380 Fax
tony.yakos@raymondjames.com

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20 year growth rates at various prices per \$1 of profits

- 1980: \$3.77 **15%**
- 1990: \$7.39 **8.5%**
- 2000: \$19.77 **4%**
- 2003: \$9.77 **(TBD)**
- 2008: \$10.48 **(TBD)**
- 2010: \$6.50 **(TBD)**
- 2020: \$16.45 **(TBD)**

We don't know what will happen, but let's look at...

3 potential scenarios for what could happen.

In ten years, the market could be up, down or at the same level. All are probably equally as likely.

Scenario 1: Up

Maybe, the market keeps going until the 2000 valuations are reached. If earnings stayed at about \$2.1 trillion, the market value would need to increase to about \$42 trillion to get to the 2000 level. That is about 28% higher than the January 1 value. If profits increased to \$2.5 trillion, then the market would need to go to \$50 trillion to catch up to the 2000 valuations. **Yes!**

Scenario 2: Stays the same

Profits catch up to the market and we normalize to a previous level. If the market stayed at this level, corporate profits would need to rise to over \$3 trillion to get back to the January 2008 levels. That is a 50% increase.

To get back to the post 2000 average, profits would need to rise to about \$3.5 trillion (75%). To get to the long term average, profits would need to increase to about \$4.4 trillion (110%). **All this and no return!**

Scenario 3: Down

We return to some level of normal valuations. Let's say it returned to the January 2008 level of \$10.46 per \$1 of profits. That would be a 37% loss just to get back to the level that it was prior to the great recession. It would need to go down 43% to get back to its average since 1980 and 55% to get back to its historical average.

Let's say that profits increased to \$2.5 trillion and the market corrected. We would need to fall about 21% to get back to the 2008 level. 30% to get to the average since 1980 and 44% to get back to the historical average since 1947. **These might hurt a little!**

How much of our wealth do we bet in this situation?

What if we are wrong?

Imagine playing a card game. Based on our hand, we have a 75% probability that we will win. We bet all of our money. Our opponent calls. We lay our cards down and lose. Winning was not guaranteed. **There was information that we did not know. We were unlucky.**

In this example, we had a good *process* to identify the odds. **It is not our fault that we lost, but it is our fault that we lost everything.** In investing, the odds are never 100% in any direction. Investors have similar probabilities. The successful ones bet differently. Asset allocation is our bet.

Since 1926, about one out of every 4 years has been negative. 3 out of 4 have been positive. 1.5-2 out of those 3 positive years are spent getting back to even from a down market. If this happened in 4 year increments, then it would be easy.

But it's not

Looking back in 2020, we can see that "A" rated bonds had a similar 20 year return. In hindsight, we should have invested 100% of our money in "A" rated bonds. Looking back 10 years, it would have been stocks. 5 years, stocks.

This is a game that we should not play. A better solution is to allocate our assets to handle both up and down markets using some process to assess our possible outcomes. This decision drives our long-term returns and our ride.

A portfolio of 50% in the total stock market and 50% in the total bond market with an annual rebalance averaged 6.04% since 2000. The total market index's return was about 6.3% with reinvested dividends. The total market index was down about 37% in 2008. The 50/50 was down about 16%. Similar returns for a lot less downside risk.

If we had a year like 2008, our 21 year return on the 100% stock portfolio would be about 1.5% annualized. On the 50/50, it would be about 3% annualized. I may not like either outcome, but I know which one I would prefer. **Thanks for taking a look.**

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