MuhlenkampMethods
For the Intelligent Investor
Answers to questions you may not even know you have.

Where to from Here?

Adapted from a presentation at the Muhlenkamp & Company Seminar in November 2006.
2006 was a volatile year in the stock market, and it had many investors concerned. In this essay, Ron addresses those concerns by focusing on two fundamental questions: in terms of the economy and the markets, "Where are we now?" and "Where to from Here?"

It's surprising how many people try to predict the direction of where the economy and the markets without understanding where we are today. If you don't understand what's going on today, how can you possibly predict what's going to happen next? To understand today's investing markets, you need to understand what's led up to them. Therefore, this essay will look at today's economy and the markets by considering them in three contexts: the long-term picture of the last 80 years; the intermediate picture and the economic business cycle; and short-term fluctuations. Then we can address the question, "Where to from Here?"

The Big Picture: Back to Normal (circa 1960)

First, let's consider the big picture: What is the current investment climate? We think the investment climate is back to normal, but it is a normal that we haven't seen since the 1960s. So let's review what a "normal" investment climate is by looking at inflation and interest rates.

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Figure 9.1 Stocks, Bonds, Bills, and Inflation, 1926-2006

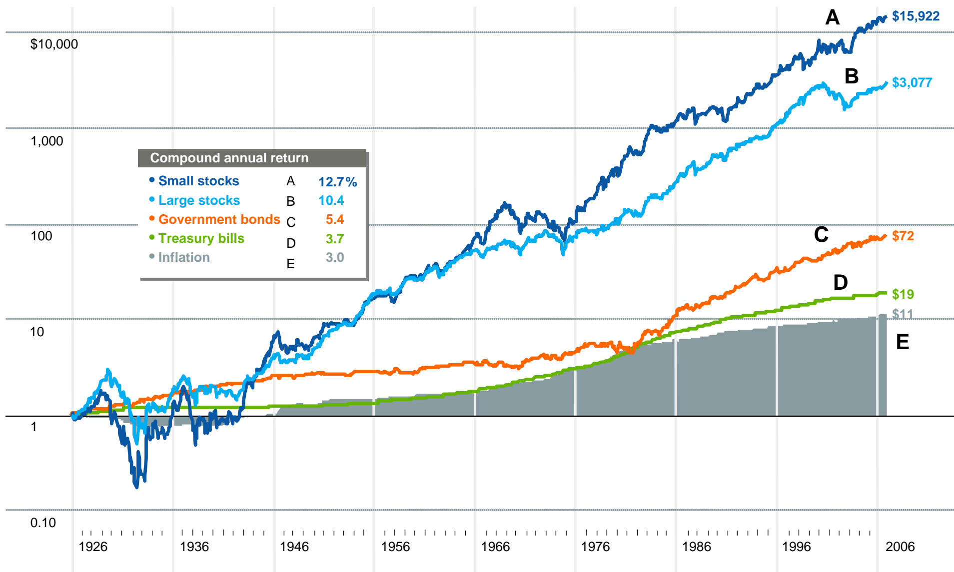

Figure 9.1 is a plot of stocks, bonds, T-Bills and inflation since 1926. It shows that over the last 80 years, the inflation rate has averaged about 3%; short-term rates have averaged about 1% over inflation; and long-term rates have averaged about 2½% over inflation. While average and normal aren't necessarily the same thing, in this case we think the averages are fairly close to normal.

Now take another look at inflation in Figure 9.1 (and remember that on this plot, inflation rate is the slope of the line). First, notice the effects of the Great Depression and the deflation that came with it. Then, notice the period of high inflation that ended around 1980. Can you find the Vietnam War? If the Vietnam War didn't have an impact on the long-term economy, what impact will the war in Iraq have? There is no question that these conflicts are important, but in the long-term picture of the economy and of the markets, they simply don't have much impact. It is important in investing to know what parts of the daily news to pay attention to and what not to. There is always something that's a current problem, but the question is, "Will it influence the economy and how much companies are worth?" In 2005, somebody asked me what it would take to turn me bearish; I said that I would turn bearish if I could think of something to worry about that people weren't already worried about. When people are worried about something, they act. The time to worry is when nobody else is—simply *because* nobody else is. The

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rise and fall of the dotcoms is a classic example. In 1999, everybody seemed convinced that dotcom stocks only went straight up. *Then* I was worried. When the dotcoms fell, many investors were caught unprepared, and the drop in the stock market was exacerbated because of it. It's the things that no one is worried about that surprise us. But (as Figure 9.1 shows) most of the things that people worry about get washed out in the long-term picture.

Inflation has been the defining factor in determining the investment climate over the last 60 years. So let's look at inflation more closely. Figure 9.2 shows the Consumer Price Index from 1952 to 2006. Inflation has been stable between 2% and 3% for the last nine years. It ticked up in '99 and the Fed raised short-term rates and caused a recession to be sure it didn't go any farther. It ticked up a bit in 2006 and the Fed again raised short-term interest rates to contain it. Our government is determined not to let inflation get out of hand, and inflation is, in fact, under control. The last time we had low and stable inflation was in the '60s, and it was actually less stable than it is today. In this respect, we are "back to normal," but it is a normal we haven't seen since the 1960s.

Figure 9.2 Inflation, 1952-2006

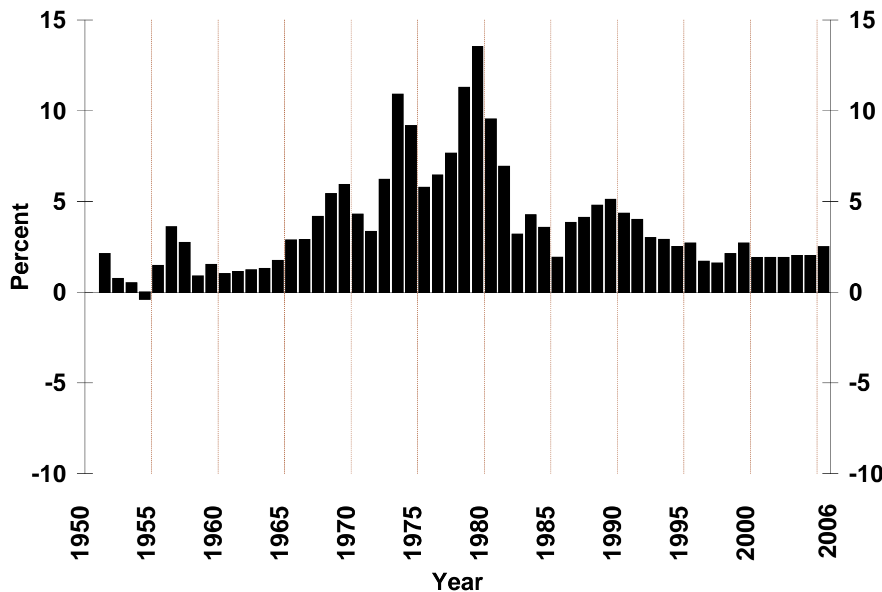

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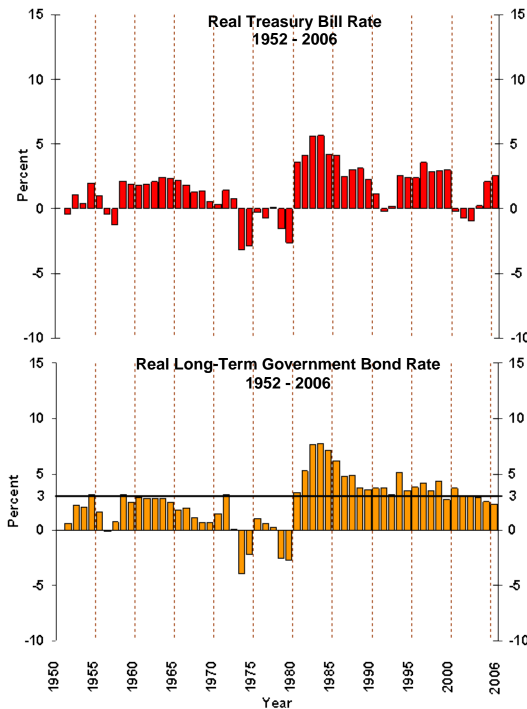
Figure 9.3 Real Treasury Bill Rate and Real Long-Term Government Bond Rate, 1952-2006



Now consider short-term interest rates. The top graph in Figure 9.3 shows real Treasury bill rates (adjusted for inflation) since 1952. Figure 9.1 showed that real short-term rates have averaged 0.7% (above inflation) over the last 80 years. So when rates are much higher than that, they are unusually high. When real rates are much lower than 1%, they are unusually low. In 2003 short-term rates were at 1%; (inflation was around 2%, giving a real rate of -1%). This was an unusually low short-term rate. Subsequently, the Fed raised short-term rates to 2%, then to 3% (for a real rate of 1%). The media was alarmed by the rate increases, but, in fact, all that had happened was the short-term rate returned from an unusually low rate to a rate that was closer to normal. The Fed continued to increase short-term rates so that at the end of 2006, short-term rates were a little above normal at 5¼%.

What about long-term rates? The bottom graph in Figure 9.3 shows long-term government bonds adjusted for inflation (the line at 3% indicates the historic norm). Long-term interest rates have been close to "normal" for four years, and for five out of the last six years. In 2004, people feared long-term rates would move up because short-term rates were climbing. Looking at the historic, inflation-adjusted data, we said that short-term interest rates were rising to get back to normal, but long-term interest rates

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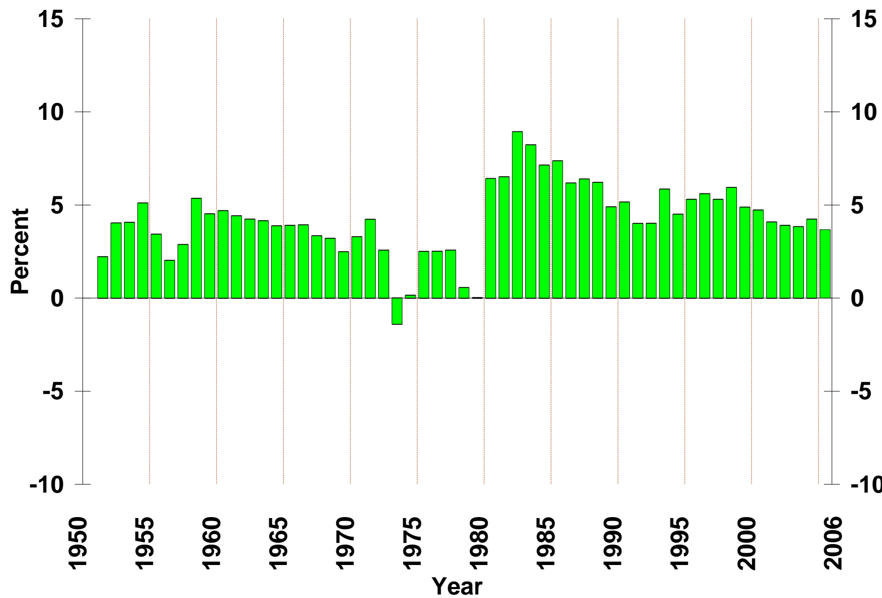
were already there. We did not expect long-term rates to climb. And in fact, as Figure 9.3 shows, long-term rates held steady. Considering the big picture can helped us to better understand what to expect.

Figure 9.4 Real Mortgage Rate, 1952-2006



Mortgage rates have been of particular interest lately, so let's take a moment to look at long-term data for mortgage rates. Figure 9.4 shows real mortgage rates since 1952. Historically, fair value for mortgages has been about 1¼ % above long-term bonds (about 4% above inflation). With long-term bonds currently at 4¾%, a fair mortgage rate ought to be just a little less that 6%. Today, they are about 6.2%. We think that mortgage rates will drop a little bit, but it will be a minor adjustment. (These numbers indicate that the bond market has concluded that inflation is not going to be a problem. The stock market, on the other hand, is trying to figure out if we are going to have a soft landing or a recession. So let's look at the intermediate picture and see if we can determine which it will be.)

The Intermediate Picture and the Economic Business Cycle

In the intermediate picture, the stock market is driven primarily by the economic business cycle. I often compare the business cycle to the seasonal agricultural cycle. When the economy grows, it's

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summer. When the economy peaks, it's harvest-time. When the economy slows down, it's winter. And when the economy is poised to grow again, it's spring. In the 1960s and '70s, most recessions were about four years apart. It was a textbook economic business cycle. In the 1980s, declining inflation and tax rates extended the business cycle, and we went nearly ten years without a recession. In the 1990s, declining inflation, reasonable tax rates, and better management by the Fed allowed us to go ten years without a recession. These economic cycles affect the markets, and can be seen rather clearly in the annual S&P 500 data in Figure 9.5. We think that now we are back to normal (inflation is low and stable) and the business cycle is again the primary driver of the economy and the markets.

Figure 9.5 Yearly Total Return and Three-Year Trailing Average: S&P 500 Index, 1952-2006

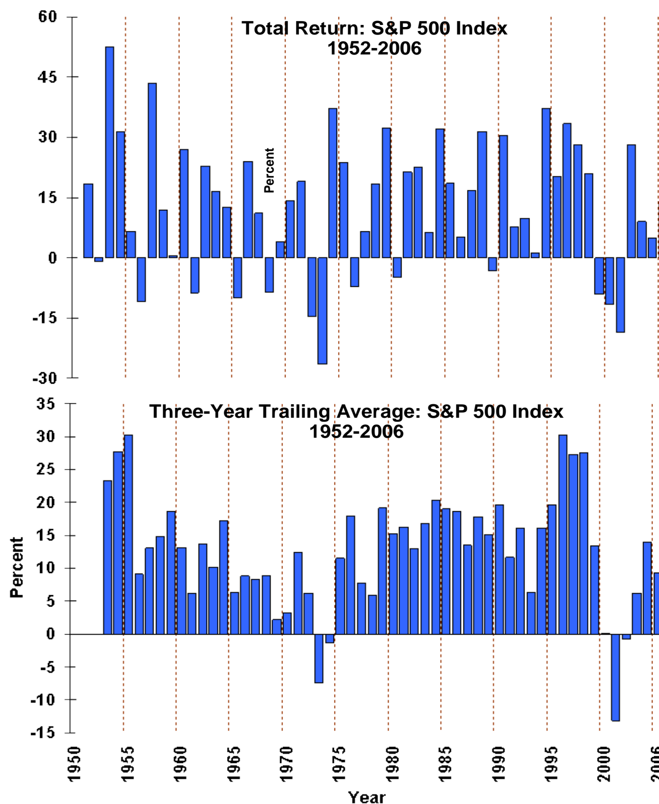

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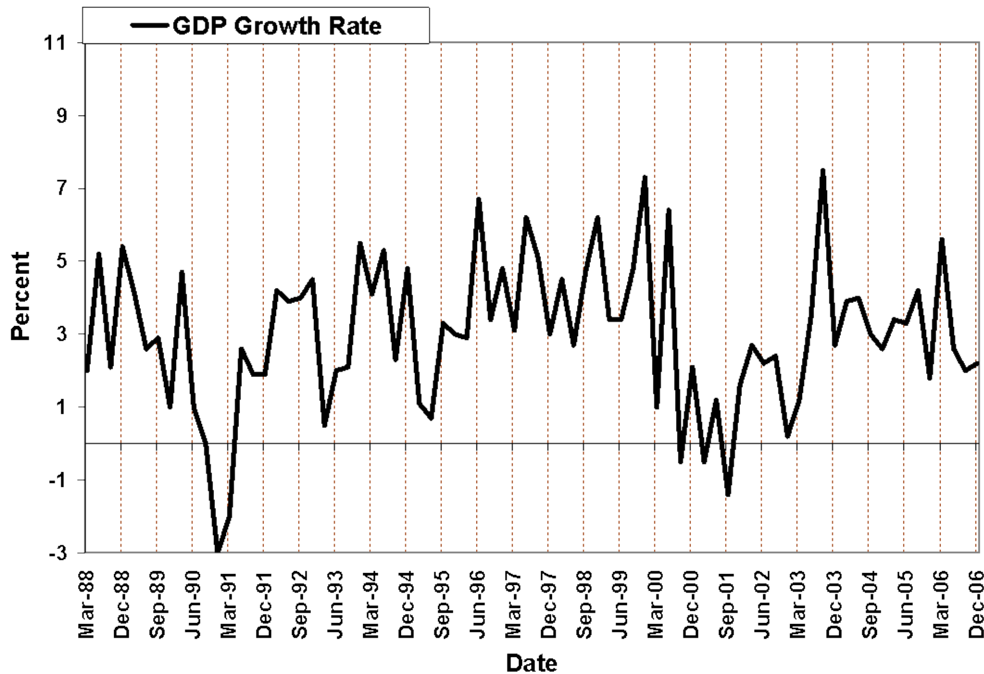
Figure 9.6 GDP Growth Rate, March 1988-December 2006



To better understand how the business cycle drives the markets, let's review the last several cycles. Figure 9.6 shows quarterly GDP growth rate from 1988 through 2006. During this time, the Fed intentionally slowed the economy three times. Two of those slowdowns resulted in recession. One time they managed a soft landing.[1] To understand what happened, we plotted short-term interest rates and inflation data alongside the GDP growth data, as shown in Figure 9.7.

[1] A recession is defined as two consecutive quarters of negative growth. In a soft landing, the economy recovers before a recession occurs.

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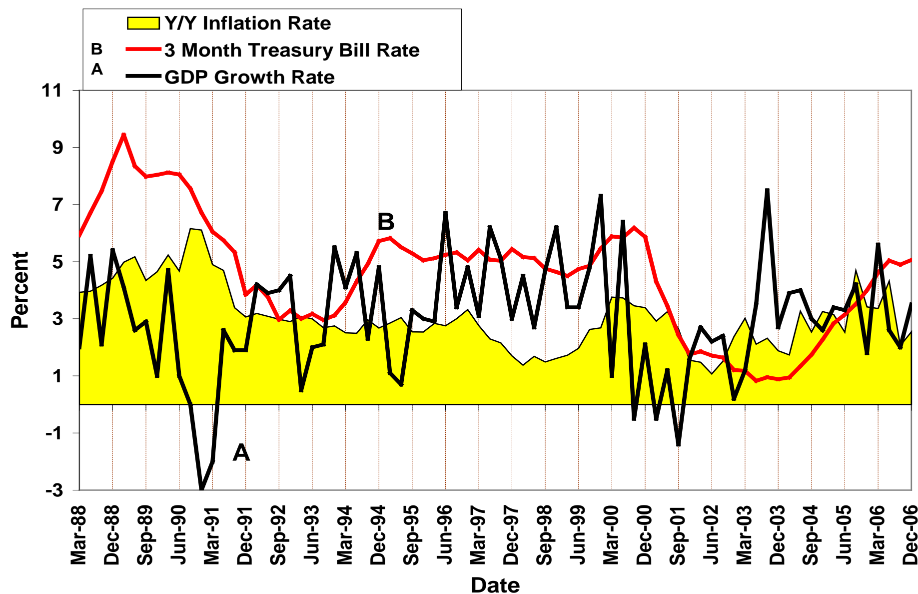
Figure 9.7 Inflation, Growth, and Interest Rates, March 1988-December 2006



In the late 1980s inflation was climbing, ultimately to 6%+, so the Fed raised short-term interest rates up to 9%. This drove GDP growth down and inflation down, but then Saddam Hussein rolled into Kuwait, giving us a recession.[2] In 1994-95, inflation was climbing again, so the Fed raised short-term rates to 6%, and we ended up with a soft landing. In 2000, inflation climbed a bit, so the Fed drove short-term interest rates back up to 6%, bringing inflation back down. But then the attacks of September 11, 2001 drove us into recession. In the aftermath of the September 11attacks, the Fed lowered rates dramatically to stimulate the economy. Short-term rates dropped to an unusually low 1%. Coming out of the recession, we saw growth rates of 3%-4%. The Fed worried that a 3%-4% growth rate might drive inflation up, and they raised short-term rates again to 5¼% (which is a little above normal). We said all along we didn't think a growth rate of 3%-4% could be maintained. After all, at the bottom of the recession, unemployment reached 6½%. Now it's at 4½%. For the economy to continue to grow at that pace, unemployment would have to go to 2½%. We think 2½% unemployment is unlikely. It is more

[2] Note that the Iraqi wars didn't change the long-term climate, but did affect the intermediate term—the business cycle.

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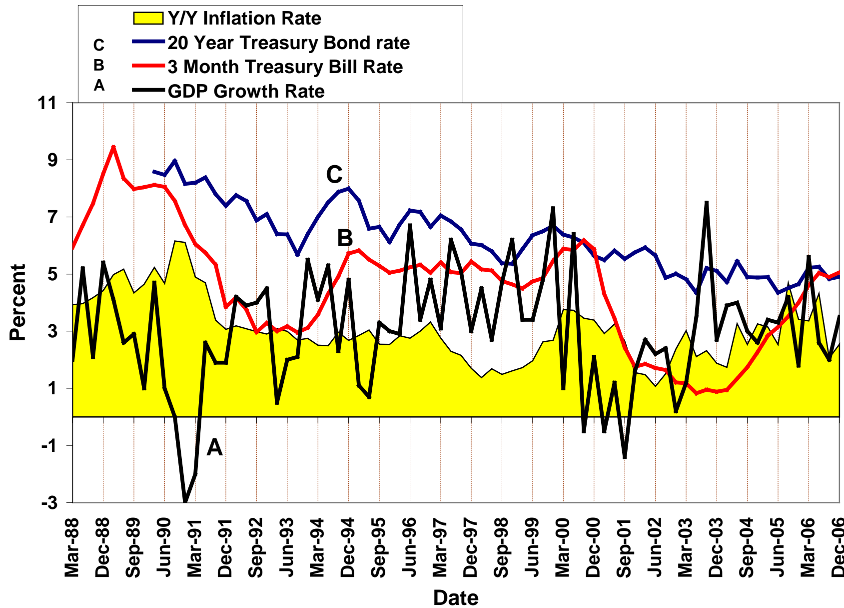
likely for economic growth to slow to about 2½%-3%. In this second half of 2006, as GDP growth and inflation have come down, the Fed has paused, and we suspect the Fed is done raising short-term rates. Therefore, we think that we are at the end of the transition and on our way out of the most recent slowdown.

Figure 9.8 Inflation, Growth, and Interest Rates, March 1988-December 2006



So where are we now? Figure 9.8 adds long-term bond data to the previous plot. On this plot we see that the GDP is slowing down. Inflation is dropping. Short-term rates are up. Long-term rates have fallen back to values less than short-term rates. By the way, when long-term rates are less than short-term rates, this is called an inverted yield curve, and it's got some people worried. Should they be? That depends. If you have an inverted yield curve because the Fed is raising short-term rates above long-term rates, that usually presages a slowdown or a recession. But that's not what happened this year. This year, long rates have fallen below short rates because the bond market has decided that inflation is not going to get out of hand. So the long-term rates are dropping back to normal. Short-term rates just haven't caught up yet. (Incidentally, that's not at all unusual. It happened in 2000, and it happened in 1990.) Short-term rates lag long-term rates because long-term rates are set by the market (which reacts quickly) and short-term rates are somewhat engineered by the Fed (which is slower to react). So in this case, we think

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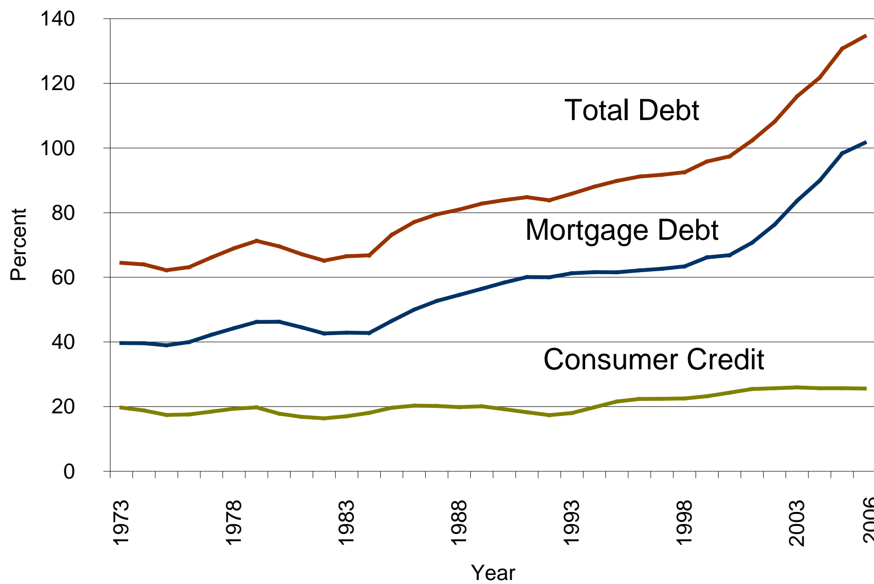
the inverted yield curve does not presage a recession. Rather, we think that we are at the bottom of a soft landing and looking ahead, we expect the economy to grow at a reasonable rate of about 2½%-3%.

Not everyone agrees with us. A lot of people have pointed out that since World War II we've had ten recessions and we've managed a soft landing only once, in 1994-95. So the odds appear to be 10-to-1 against a soft landing. Nevertheless, we think we will have a soft landing this time around for three reasons: bank balance sheets are in good shape; corporate balance sheets are in good shape; and consumers are in good shape. Nobody disagrees about the bank and corporate balance sheets, but there is a lot of controversy about the condition of the consumer. So let's take a closer look at the consumer.

Figure 9.9 Household Debt as a Percentage of Disposable Personal Income



Many analysts fear the consumer is overextended—too far in debt. They base those fears on charts like Figure 9.9; it shows household debt to disposable personal income from 1973 to 2005. Over that period of time, consumer credit has been pretty stable. Mortgage debt has gone up significantly, as has total debt. However, those trends are debt relative to *income*. We think that if you are going to talk about debt, you should talk about debt relative to *assets*.

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Figure 9.10 Household Balance Sheet Details

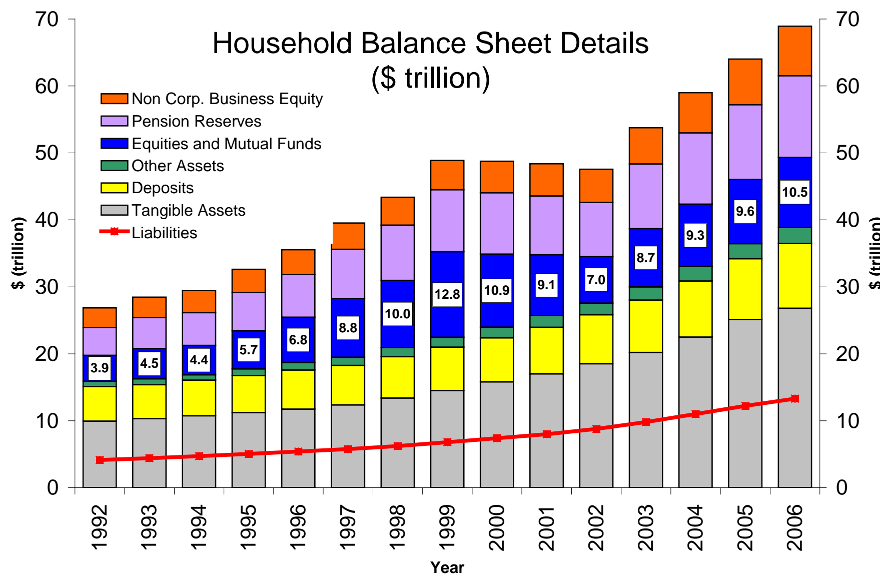

Figure 9.10 shows household debt in an entirely different perspective. It shows debt relative to assets. In 1950, the average household had assets in the order of four-and-a-half times its debt. Today, the average household has assets in the order of five-and-a-half times its debt. So relative to assets, household debt has actually decreased. The average household today has plenty of assets to cover its debt.

Consumer debt is also influenced by the demographics of our population. The American population is getting older. Our baby boomers are approaching retirement. At sixty, an individual's finances look different than they did at thirty. For one thing, a 60-year old has more assets relative to income than a 30-year old. Even though their income may have doubled since they were thirty, their assets went from 'very little' to 'enough to retire on.' After all, they've spent 30 years building assets. So as our population ages, the assets-to-income increases. Taking it one step further, Figure 9.10 indicates that debt and assets tend to track together. If debt and assets track together, as we get older our debt-to-income is likely to increase because we have higher assets to income. Therefore, an increasing debt-to-income ratio may not be a sign that the consumer is overextended. Rather, it may just be a reflection of an aging and more prosperous population.

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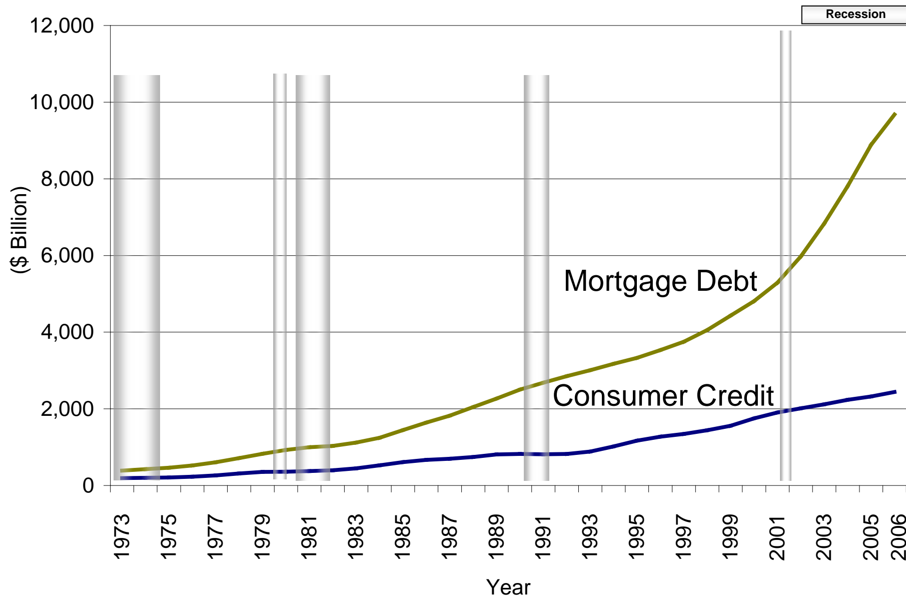
Figure 9.11 Debt



There is another factor to consider in looking at household debt. As Figure 9.11 shows, a large portion of household debt is mortgage debt, and it is increasing. What isn't on this chart is the fact that mortgage rates are half of what they were 20 years ago. You can carry twice as much mortgage at a 6% rate as you could at 13%. So we have bigger, more expensive houses, but not necessarily bigger payments.

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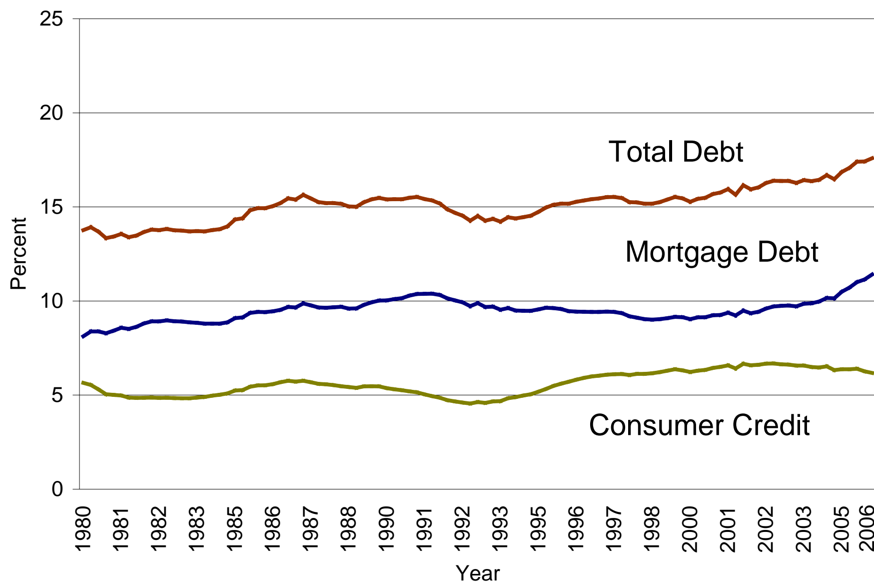
Figure 9.12 Household Debt-Service Burden



So let's calculate our debt another way. Figure 9.12 shows the debt payments of the average household as a percentage of disposable income (called the debt-service burden). When viewed this way, our debt doesn't look so bad. Household debt service has ticked up in the past five years, but it has been between 14% and 18% since 1980. In other words, our debt service-to-income is not much worse than it has been for the last 25 years. The debt has gone up, but because mortgage rates have gone down, the debt burden is pretty steady.

Looking at debt in terms of assets and debt burden, the American consumer is not overextended. The household debt burden has been relatively steady over the last twenty-five years, and the average household has sufficient assets to support the burden.

So in the intermediate picture, we think that with inflation low and stable; the business cycle is going to drive the economy and the markets. The Fed is not currently pushing short-term interest rates higher, so the health of the economy will drive the shape of our rebound. With strong bank and corporate balance sheets and a strong consumer, we think that the economy will see a soft landing, rather than a recession. This is important to the investor because different types of investments are favorable during a recession than during a soft landing. That brings us to the short-term picture. What is happening in the stock market now?

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The Short-Term: Volatility

The economy is currently transitioning from fairly rapid growth to somewhat less rapid growth. And as with all transitions, the change has caused much speculation in the investment field as to the direction of the economy. This speculation has made the market very volatile this year. And that volatility makes great headlines.

What you don't often hear is that for the first part of the year, aggressive stocks led the marketplace—things like commodity stocks, small caps and foreign stocks (which you want to own in an inflationary climate). The fear in March and April was that the economy was growing too fast and we would have inflation. Then in May-June, everything corrected and the stocks that have been leading the market the second half of the year have been defensive stocks like food, utilities and pharmaceuticals (which you should own if you are going into a recession). Which means the fear now, is that the economy is growing too slowly. This is a significant change. However, we think a recession is not imminent. We expect the economy to have a soft landing and the premium on the defensive stocks will dissipate.

In the meantime, while there is fear of recession, the markets may behave as if there *is* a recession, and the markets will be volatile. In time, however, we believe the fears will subside and the market will reflect the economy.

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Where to from Here?

Based on today's interest rates, inflation and investment climate, we think the average long-term investor is looking at the following choices. You can get about 5% on short-term or long-term debt. Adjusting for a 30%-35% tax bracket, you get to keep 3.2%. Adjusting for inflation (which is about 2%) you net 1% on bonds. Or you can invest in stocks. Stocks are currently priced to do about 8%-9%, on average. Taxes for long-term gains are at 15%, leaving you 6.8% after-tax. Adjusting for 2% inflation, you net 4.8%. Over a period of 10 to 20 years, the difference between a 1% annual return and a 5% annual return can be an awful lot of money.

Figure 9.13 Available Returns (%)

	Nominal	After-Tax	Real After-Tax
Short-Term Debt	4.5	2.9	0.9
Long-Term Debt	5	3.2	1.2
Equity	8	6.8	4.8

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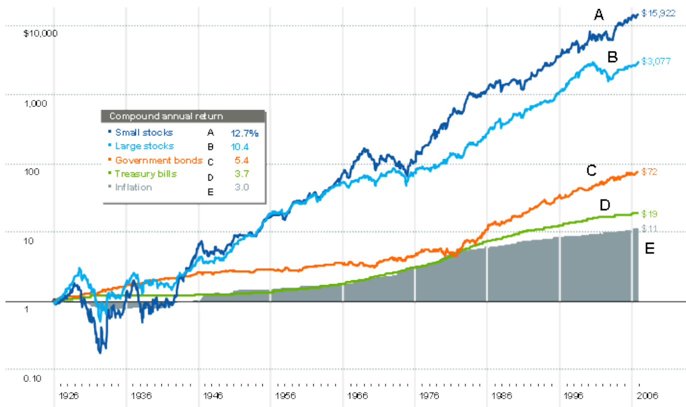
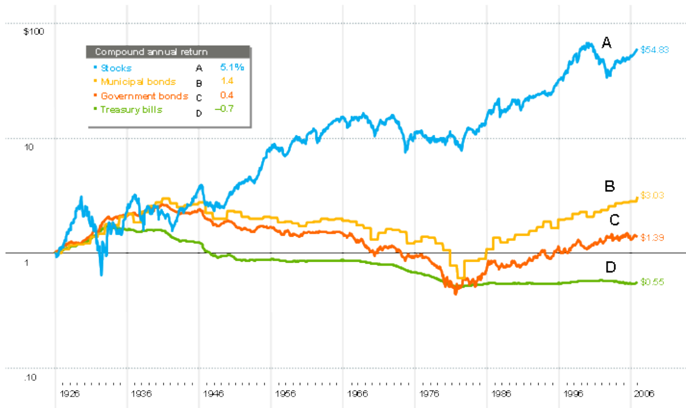
It's interesting at this point to look again at the plot of historical investment returns since 1926 (Figure 9.14). In the last 80 years, bonds have in fact averaged 1% annually (adjusted for inflation and taxes); stocks have averaged 5%. In other words, available long-term investment returns are back to normal.

Figure 9.14 Stocks, Bonds, Bills, and Inflation, 1926-2006; Stocks, Bonds, Bills after Taxes and Inflation, 1926-2006





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Summary

We've covered a lot. So let's take a moment to review some of the highlights.

In the big picture, we think that inflation is under control, bank balance sheets are healthy, corporate balance sheets are healthy, and the consumer is in good shape (much better than reported).

The intermediate picture is driven by the business cycle. We expect a soft landing from the current economic slowdown, and we think that because the Fed is no longer raising short-term rates, the transition period is coming to an end. Long-term interest rates rolled over in May 2006, and they have since declined by ½%. Mortgage rates are following long-term rates downward. Short-term rates are steady at 5¼%. The price of crude oil has declined 15%-20%, allowing the price of gasoline to fall roughly $.50 per gallon. A number of other commodity prices are falling as well. Looking ahead, we expect the economy to grow at a reasonable rate of 2½%-3%. To us, it's starting to look like springtime in the business cycle—a good time to plant investment crops.

In the short term, the market leadership has shifted from inflation beneficiaries (like commodities) to recession leaders (like food and utilities). That means that the investing public no longer expects inflation—they are preparing for recession instead. We don't expect a recession. But in the short term, hype, hope and fear will always have an influence. In the short term, the stock market is going to continue to be volatile.

A volatile stock market is in many ways a test of an investor's convictions. It is a good time to reassess the investing climate, the business cycle, and the merit of concerns that the short-term fluctuations invariably produce. In doing so, keep these things in mind. First, most things that worry people on a day-to-day basis get washed out in the long term. So, the long-term investor should consider them in the context of long-term influence on the economy and corporate values. Second, a volatile stock market is an opportunity for the long-term investor. It means there are quality stocks on sale. The challenge is to find them—and then, to hold them through the fluctuations.

Editor's Note:

Though this essay specifically discusses the economics and the markets in November 2006, it is much more than that. It is an example of how to systematically evaluate the economic and investment situation at any time. It illustrates how an investor must look at the big picture to determine the investment climate, the mid-term data to determine investment season, and the short-term information to understand the daily fluctuations in the market. The data Ron uses is available to everyone. Yet he looks past the popular interpretations of that data, asking

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probing questions about the driving forces behind the numbers. He reminds us that the markets and economics are simply the aggregate results of individuals' decisions. People's decisions drive both the economy and the markets. In the short-term, hype, hope and fear can make those decisions irrational, which makes the markets volatile. But in the long term, emotions level off and the markets behave rationally.

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