Investing and Farming: Know the Climate

This essay was originally published in Muhlenkamp Memorandum *Issue 22, April 1992. It reviews changes in the investing climate since the 1970s and illustrates them in terms of the farming climate. It also shows how the people, in aggregate, determine the investing climate. Finally, it continues the farming analogy to demonstrate the transitory nature of short-term swings in the market and the need to stay focused on the long-term climate through such swings.*

The longer I manage money, the more it looks like farming. In mid-February, we had 70° weather in Pittsburgh. While looking at the calendar one day, I started to ponder how a farmer without a calendar would know whether it was February, normally a poor time to plant crops, or April, normally a good time to plant. Of course, this very problem resulted in the invention of the calendar in the first place. It then occurred to me that investing in the stock and bond markets isn't much different from farming—but without the benefit of a calendar.

In either endeavor, the first thing you need to know is the climate in which you live. The climate for farming is determined by temperature and rainfall, and changes are very gradual in a given geographic area. So, in any one lifetime, changes in climate are usually associated with changes in locale. When my parents moved from Coldwater, Ohio, to Albuquerque, New Mexico, they built a house and, like other Midwesterners, planted a lawn. Then they learned that unless they watered the lawn every other day, it soon returned to sand. When they built a second house, they landscaped the yard in sand and rocks. In Albuquerque, brown—not green—is beautiful.

The climate for investing is heavily influenced by the levels of inflation and interest rates, and it can change fairly rapidly. In the 1970s, the investing climate in the United States was determined by inflation levels well above interest rates. You could not offset inflation by lending money. Anyone who had a savings account or bought bonds was a sure loser—and most paid taxes for the privilege. Rather than lending money, the climate favored borrowing money—and buying "hard" assets like gold, oil, and real estate, which held their real value vs. the depreciating (deflating) dollar. By the end of the decade, many people believed that prices of these assets could only go up, so they continued to borrow money to buy them. They borrowed money regardless of the rate, and interest rates climbed.

But, while this was happening, inflation was being brought under control. Inflation fell while interest rates climbed. Since 1981, interest rates have been well above inflation, reversing the investment climate of the 1970s. Other influences (like tax laws) have reinforced this change in climate, so it has paid to lend money. Savings accounts, bonds, and stocks have been big moneymakers. Owning gold or oil or mortgaged real estate has been very expensive—sort of like trying to grow cotton in Ohio or grass in New Mexico.

Anticipating Change

The fundamental difference between farming and investing is that, in the aggregate, we the people determine the climate for investing. Inflation is determined by government action in response to our demands. Interest rates are determined directly by the levels that people are willing to pay or receive. Our unwillingness to pay directly for the Vietnam War (through spending cuts or increased taxes) in the mid-1960s led us to print money, setting off an inflationary spiral (and a change in climate) that lasted until inflation became intolerable to the average voter.

Meanwhile, the public's awareness of inflation lagged the reality; throughout the 1970s, the public accepted interest rates well below inflation. This came to a head in 1979–80, when the voting public insisted on lower inflation (by voting Ronald Reagan into the presidency) and higher interest rates (by moving their money from passbook savings to money market funds)—and changed the economic climate. People who bought gold, oil, or farmland in the late 1970s soon learned that the climate had changed. Those who did so with borrowed money lost on both sides. Their interest costs went up while the market and collateral values went down, and many lost their assets.

Changes in tax laws and the regulatory rules for banks and savings and loans enabled professional lenders to deny the change in climate for a while, building increasingly expensive commercial buildings. By 1986, the excesses became apparent, even to our politicians. Once again they changed the rules—just in time to compound the retrenchment in commercial real estate.

The remaining vestige of the 1970s inflationary climate was the popular belief that a highly mortgaged single-family home would make you money. We've been discussing the fallacy of this belief in our newsletter (*Muhlenkamp Memorandum*) since 1987. In the past year (as of 1992), the belief seems to have died. We cite as proof the public's focus on "paying down their mortgages," which reflects the current climate and is the direct opposite of "trading up on the equity," which was appropriate to the climate of the 1970s.

This focus on paying down the mortgage, along with the Fed's successful slowing of the economy, has also resulted in short-term interest rates falling from their unusually high levels of the past decade. Since 1989, we have argued that high short-term rates were an anomaly that could only be temporary. These rates have now fallen, and are forcing the savers in this country to face a broader choice of options in an effort to reach their goals.

As investors review these options, they will find the investment climate in the United States remains positive for stocks and bonds. [1]

Weathering the Storms

Even within a given climate, the seasonal and daily weather patterns have great variability. In Ohio, planting that is done in April is less likely to suffer frost than that done in February, but a late frost cannot be ruled out. The hot, humid weather of July and August, which is ideal for growing a corn crop also makes for ideal conditions for hailstorms.

Seasonally speaking, the U.S. economy is now (1992) coming out of a recession, albeit following a couple of false starts. For the past couple of years, our choices of cyclical stocks have focused on those with strong balance sheets. We waited to be sure that the companies we invested in would survive and thrive even if the economic recovery was delayed and some of their competitors failed. Just as any farmer who doesn't allow for a late frost or a hailstorm will soon be wiped out, we expected that the weaker companies in a number of cyclical industries might face extinction. As we see the economy strengthen, we may loosen these balance sheet standards.[2]

[1] The positive climate for bonds ended in late 1993 when long-term interest rates returned to inflation plus 3%. Except for brief periods, bonds have been a poor investment since 1993. Stocks reached fair value in 1998. Since then we've had a split market. In 1999, a "fad" group of stocks skyrocketed while the majority of NYSE stocks went down. After March 2000 these trends reversed.

[2] Reading this paragraph in 2007 is déjà vu.

The emotional swings of the investing public, which affect the daily prices of securities, are at least as variable as the daily weather. These swings are part and parcel of all investing climates. The key is not to confuse the daily changes with seasonal changes or the climate!

I've often compared the October 1987 stock market crash, which dropped prices 25% in two days, to a hailstorm that wiped out one year's crop. But the storm (crash) changed neither the climate nor the fertility of the soil (the strength of the real economy). So the appropriate response was to plant a new crop, and 1988 produced a bumper crop.

The year 1990 was a poor year. The Middle East problem became a war and resulted in both scaring the public (bad weather in our analogy) and postponing the end of the recession (a delayed spring). But it also set the stage for a bumper crop in the following year. We don't expect such a bumper crop this year (1992), but we do expect an average year because the climate remains favorable and spring is here.

2002 Update

This update was written at a time when current events were overriding the normal business cycle. The severity and number of these events made it hard for most people to see that the business cycle was still intact. Therefore, Ron wrote this update to point out that the upswing of the market was only delayed, not dead. 2002 is also an interesting time to consider because it is the same point in the economic cycle as 1992 (when the above essay was originally written).

In 2002 we are once again recovering from a recession, implying springtime in our analogy. But this economic springtime is complicated by an unusually large number of factors with major psychological impact: the hangover from the "fad" stocks of 1999; the impact of the terrorist attacks of September 11, 2001; the threat of war with Iraq; corporate malfeasance; the drought in the U.S. farm belt; the dock strike; etc. The combined effect has been to drive stock prices lower and to delay the expected springtime in the market. In fact, 2002 has been the first time in the 10 recessions since 1945 that the stock market hasn't done well as the economy recovered from recession.

Our best description of the current market is a drought. Just as the two-day drop in 1987 was similar to a hailstorm (short and quick but destroying the year's crop) the decline in 2002 is similar to a drought— a long, drawn-out combination of adverse weather (psychology) that destroys the crop.

As farmers and investors, you and I know that droughts are part of the business—and we're likely to face one sometime in our lifetime. But it's very hard to predict when. Our only recourse is to allow for drought and to make sure we survive it when it comes, but it doesn't change the climate or the seasons. So the proper response is to plant a new crop. The above-listed psychological factors appear to have peaked, and we believe that the combination of economic recovery and current stock prices now favor planting that crop.

Editor's Note

Springtime did in fact come to the stock market. The S&P 500 was up 25% in 2003 and 11% in 2004. Ron believes that after the "transition" year of 2006, when the Fed successfully engineered a slowdown ("soft landing"), but no recession, we are once again in springtime, a good time to plant investment crops.