December 4, 2008

That manic market!

Roll the tapes back a decade when we were in a period of total exuberance. The Tech Bubble was inflating faster than Kirstie Alley's dress size. Amazon's market-cap surpassed three of the Dow's components combined. Analysts and the investing public hypothesized what had been the reality of the recent past would continue forever, therefore paying 100 times forecasted sales for anything associated with the Internet. With the bubble fully inflated, the estimated revenues of the top ten technology companies would have surpass the entire Gross Domestic Product of the U.S. in just 10 years. How could you go wrong?

Fast forward five years.

The majority of the Tech frenzies spawn had not only failed to meet expectations, but failed entirely as-in out of business. And the ones still standing on average traded at less than 10% of their former high prices, proving once again the human nature of using recent history to project the permanent future is flawed.

The investing public always throws valuation out at market extremes.

Like the top of the Tech Bubble, today's investors are once again using recent experiences to forecast a permanent future. As much as 100 times future sales made no sense a decade ago, today falls at the other extreme, with the Dow's dividend yield surpassing the 30 year Treasury bond and the Price Earnings Ratio of many of today's premiere companies falling below 10.

Earnings fell 25% in 1975, so what happened to the market?

By December of 1974, the investing public had finally become completely educated that things were terrible, facing 12% inflation, short-term interest rates of 12% and an upcoming earnings collapse. Sure, all of it was true, earnings fell by 25% in 1975 and none of the economic news improved, but from December of 1974 the market rallied 80% over the next 18 months.

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Today's market has forecasted the worst recession since the Great Depression.

And it's probably correct, but it won't be permanent. Though the market bottomed in December of 1974, it took years to bring inflation and interest rates down and heal the U.S. economy, but the S&P 500 returned an annual average of 13% over the next decade. The past decade has seen an annual compounded negative return of 3.2% for the S&P 500, even worse than the depression decade of 1929 though 1939. Though it seems hard to believe today, going forward history shows our next decade should show an annual average return in excess of 10%.

So where's is today's bubble?

With the expectations of permanent deflation, the yields on cash assets and treasury bonds have collapsed. Once again we are at an extreme with the 10 year Treasury yielding just 2.7% and the 13 week Treasury bill just .10%. If rates where to move to a more normalized level of say 6%, locking in today's low yields will prove a mistake.

History shows us the sun will come out again.

And as it has in the past, today historically cheap valuations on risk assets will once again have proven to be a great buy. None of us have a crystal ball and can predict when today's asset deflation will end, but as history shows us the sun will come out again.

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