The Gazette

A generation of rising stock prices

The Dow Jones Industrial average rose 800 points over the last few days. This is the equivalent of a 7% jump in a few days. You can hear or read in the media many “experts” commenting that this rise might be “artificial”, “unjustified” or even “dangerous”. Shouldn’t they have also asked if it was justified when the Dow dropped some 2000 points earlier this year? The effects of the European crisis on the US have been mild so far. In fact, lately, the US unemployment rate has gone down, not up. So fears of another recession have been – so far – exaggerated. In that line of thought, it would mean that it is not the 800 points rise that is “unjustified” but the preceding drop.

The other fundamental reason why stocks could have dropped may be linked to valuation. When stocks are too expensive, the market tends to find a reason to correct itself. The companies in the Dow are expected to earn 950 points in profits this year. So when it dropped from 12 700 to 10 700, the price to earnings ratio (P/E) fell from 13 times to 11 times. Last week, the P/E jumped from 11x to 12x. Compared with long term interest rates (around 3%), a market P/E of 12x is quite low. In fact, it could be 50% higher (18x) and it would still be a cheaper asset than bonds!

Let’s turn the clock a little further into the past. Let’s go back to 1986 and study what has happened to the S&P 500 - a broader index than the Dow Jones - since then. A generation ago, the S&P 500 was at 250 points. At that time, companies in the index earned total profits of 16 points. So the P/E was 15.5x. On average, in 1986, long term interest rates were around 7.7% (more than twice what they are today). So P/Es of 15-16x were quite justified because they were in line with bond rates. In 25 years, earnings have climbed to around 94 points (this year’s estimate). This is an almost sixfold increase or the equivalent of a 7.3% annualized growth rate. Today, at 1244, the S&P 500 is trading at 13 times earnings, a lower valuation level than in 1986 even though bond rates have gone down from 7.7% to 3.0%. Still, even if undervalued, the S&P 500 is five times the level it was in 1986 (the equivalent of a 6.6% annualized growth rate). If you add dividend to that growth rate in market value, the total return of the S&P 500 is close to 10% per year over the last generation. And if you are a wise investor, you can do even better than the market return. But that’s another story.

How many stock market investors have made 10% a year since 1986? I’m quite certain it’s not a large percentage of investors. My guess is that most of them got scared out of stocks at some point in the last 25 years. In 1986, there were plenty of problems to worry about. The cold war was not over yet (Mikhaïl Gorbachev had been in power for only a year), the US deficit was high and many observers were worried that the Japanese economic “supremacy” would make the US a second rate nation.

In the 25 years since 1986, you had three stock market crashes (1987, 2000-02 and 2008-09), three recessions, two wars in Iraq, a number of once-believed titans of the capitalist worlds collapsed, a huge financial crisis in Asia (1997-98) and the Japanese economy (the second largest in the World) in a recession for two decades. And still, despite all these catastrophes, including dividends, the S&P 500 had a 1000% total return!

That’s how I can buy when most people are afraid and worried about Europe (or whatever other crisis). I just keep a long term perspective on things. Stocks go up for only one reason: because companies are earning more and more money each year, despite of all the problems in the World. Many investors should think about that the next time they have an urge to sell because stocks are going down or even when they are “unjustifiably” going up!