Investment outlook

What should we pay?

In any decision to invest, whether in real estate, venture capital deals, diamonds, bonds, or stocks, price must be a preeminent consideration. Most investors would agree wholeheartedly with that statement. Nevertheless, it seems true that price analysis is really not very important to many investors in their decisions relating to stocks. Instead, most market participants seem inclined to respond mainly to subjective "views" or economic forecasts on the implied assumption that the price will move in the same direction as those views and forecasts. It is true by definition that most people will act in line with human natue. That is, to be bullish when things look good and bearish when conditions are gloomy. But that, alas, is why we so often violate Rule 1 and end up buying high and selling low.

In our opinion, this seemingly trite observation deserves a lot of thought. We have observed from our own experiences in our investment policy group deliberations over the years that it is extremely difficult to think correctly in terms of investment decision making if the analysis is largely subjective or business-cycle-oriented. We became convinced long ago that price is the great equalizer and that the surest route to good investment performance is to be price-sensitive.

But we do not mean price that is based on short-term considerations. Increasingly, we see the merits of the longer view, especially in the light of the theory of rational expectations. The direction of policy movement, for example, might be the proper focus of investment thinking rather than this year's or next year's econometric data. If current considerations had succeeded in putting the market price down, then those investors sensitive to policy movement and price would probably end up buying while the consensus was selling. There is danger in acting on the basis of what could be an oversimplification of today's very complex and dangerous environment, but we believe there is merit to the policy-price approach.

For a long time, we have stressed the movement of economic policy (monetary policy, fiscal policy, and private sector tax incentives). Indeed, we believe, as we stated earlier in prior publications, that the "secular case" has become a consensus view with only the extent of private sector incentives a matter of debate. Yet at the time when the tax outlook looks better to more people, the current environment has worsened because of Iranian upheavals and dislocations feared from very high interest rate levels.

So how do we act under these befuddling conditions? If the circumstances seemed to dictate that only half of pension portfolios should be in stocks—we are there now. If they further dictate that the equity portion should contain a fair amount of "cash"; we are there now. So what do we do? We should depend on price analysis.

Inflation Expectations & Market Return

	Exp. Inflation Rate(a)	S&P 500 Low	Exp. Return On Low	S&P 500 High	Exp. Return On Low
1969	4.3	89	10.13	106	9.57
1970	3.8	69	10.77	93	9.60
1971	4.5	90	10.42	105	9.92
1972	4.4	102	9.96	119	9.50
1973	5.7	92	11.69	120	10.82
1974	6.9	62	14.69	100	12.72
1975	6.8	70	14.66	96	13.11
1976	6.8	91	13.74	108	12.99
1977	6.5	91	13.85	107	13.07
1978	7.0	87	15.00	107	13.89
1979	7.3-8.0	98	14.70	109	14.30

Note: All 1979 figures are estimates of values for the year to date.

(a) Based on the term structure of interest rates at the time.

In the above table (excerpted from Kidder, Peabody's Monthly Valuation Framework and Forecasts, Nov. 12, 1979, by Tony Estep and Nick Hanson), we show the relationships over the past 10 years among expected inflation rates, stack price levels, and expected returns. It is clear that the 1979 expected return (shown at the S & P 500 level of 98) not only greatly exceeds implied returns at most lows of the past 10 years but also rivals the much-higher-than average returns at the lows of the past 5 years.

Surely, however, such rates of return should be high because inflation is now assumed to be much higher than at any time in the period shown. In fact, the 7.3–to–8.0 percent range for 1979 is below our Economics Group's expectation for the 1980's of 8–to–9 percent inflation.

But that is far from the end of the analysis; the 14.7 percent implied rate of return flows from an earnings-growth-rate forecast of 9.0 percent a year, which, in our view, is inconsistent with an 8-to–9 percent inflation assumption. This brings us to one of our favorite subjects, inflation flowthrough. If we assume total flowthrough, then earnings growth is more likely to be on the order of 10 percent or 11 percent a year (and perhaps higher), and expected rates of return would show up in the new high territory of 15 and a ½ to 16 and a ½ percent a year.

As Estep and Hanson point out, however, inflation flowthrough is a tricky subject; it matters greatly whether the flowthrough is full or partial, and if partial, whether large or minimal. Over the past 10 years, in fact, the flowthrough seems to have been only about 82 percent, which, on the basis of an inflation forecast of 8 to 9 percent, would result in a 6.6 to 7.4 percent increment in the corporate earnings growth rate. If we assume 2.5 percent real growth, then the nominal annual growth of profits would be 9.1 to 9.9 percent. Complete flowthrough, of course, would raise the growth rate to 10.5 to 11.5 percent, which would substantially increase expected rates of return from stocks. Examining this from a somewhat different angle, Estep and Hanson focus on real aftertax expected rates of return as the critical item and conclude that current returns might be described as attractive to very attractive.

There is at least one big problem connected with all of the preceding discussion, however. And that is the observation (not subject to proof) that the price-earnings side of the equation seems to adjust to bad inflation news before the corresponding adjustment is made in the earnings stream. Thus delcining P-Es seem to be the "real world" and rising earnings expectations the "theoretical world." Our only consolation is that both increasing use of quantitative methodologies and spreading belief in the theory of rational expectations appear to be closing the gap between the "real world" and the "theoretical world." As we said last month, it seems especially dangerous now to base equity policy (raising cash, for example) on this dilemma since, while it might be correct in the short term, it also might leave one heavily in cash at the market bottom.

For a full text of current recommendations, write to Eric L. Fox, c/o THE PERQUIMANS WEEKLY, P. O. Box 277, Hertford, NC 27944.

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