And the Climate Is . . .

This essay was originally published in Muhlenkamp Memorandum *Issue 25, January 1993 as an expansion of the "Investing and Farming: Know the Climate" essay (April 1992). It talks more about the investment climate changes from the 1970s to 1993. Of particular interest is the lag in perception of the changes by the public. In the '70s, people used strategies appropriate in the climate of the 1960s, and lost money. In the 1980s, people used strategies appropriate in the 1970s, and lost money. You don't have to predict climate changes, but you must recognize them when they occur.*

In our essay "Investing and Farming: Know the Climate," we discussed the importance of recognizing the current investment climate. We would like to expand on that theme. Figure 6.1 is the best picture we have been able to construct to display the investment climate. The chart adjusts the nominal interest rates on mortgages for inflation and taxes. Thus, it is a chart of the net real cost of borrowing money. To an investor, it represents the net real return from lending money.

Figure 6.1 Real After-Tax Mortgage Rate, 1952-92

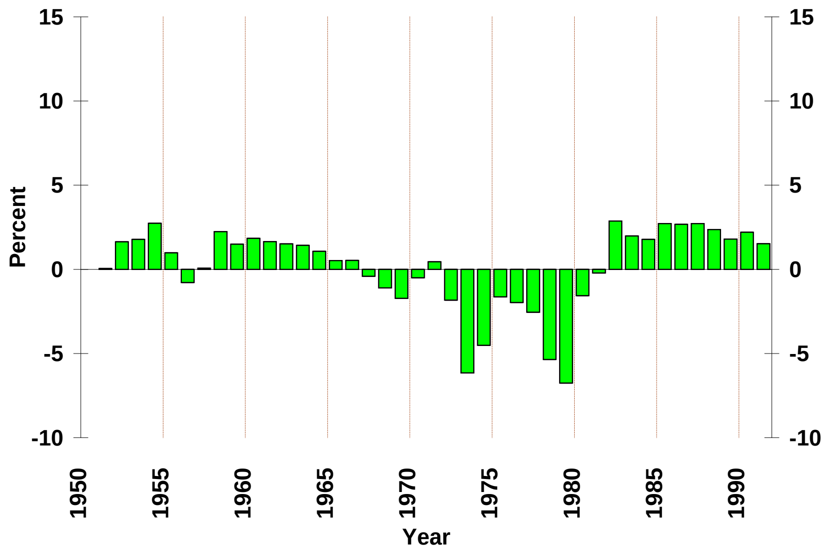


Figure 6.1 makes visible why my father, with a 4% mortgage in the 1950s, strove to pay it off early. This chart also makes visible why, in the 1970s, baby boomers made money buying ever bigger houses with ever bigger mortgages. Their net real cost of borrowing was dramatically negative. Figure 6.1 is why we've been telling clients since 1981 to pre-pay mortgages.

Alternatively, from an investor's perspective, the chart makes visible the 2%–3% real returns on bonds from 1952 to the mid-1960s. It portrays losses suffered by anyone who owned bonds in the 1970s. By 1979, anyone who owned a long bond had a loss. Many bonds sold at 50 cents on the dollar. If, during this period, you avoided the losses of long bonds by keeping your money in passbook savings, you received 5½ % (pretax) while the value of your money shrank by 10% per year due to inflation. The chart also displays the unusually good returns to bondholders in the 1980s.

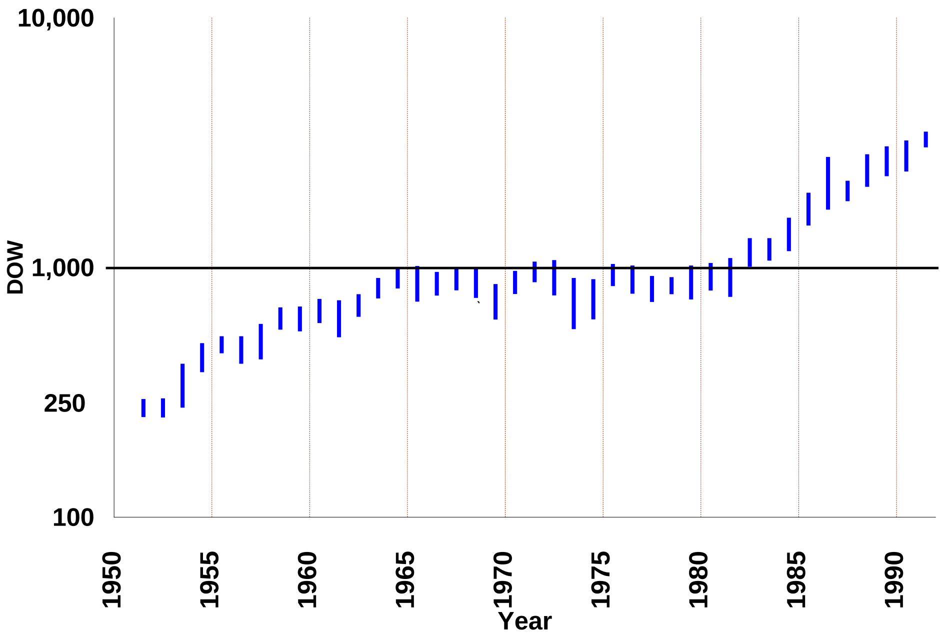
In short, the chart displays a change in the investment climate in 1966 and again in 1982. Each of these changes caught much of the public and many investors by surprise. Through the 1970s, people continued to use strategies appropriate to the climate of the 1960s, until the pain of 10% inflation became unbearable. Savers kept their savings in passbook accounts yielding 5½%. Baby boomers who bought big houses (or farms) with big mortgages were warned by their fathers that they would never be able to pay them off. By the late 1970s, we all knew that we didn't want to pay off the mortgage early. And the savers, typically our parents, flocked to get the 14% rates offered by money market funds.

Meanwhile, the same pain that caused people to move their assets to 14% money market funds caused them to demand lower inflation, resulting in a new Fed chairman and a new occupant of 1600 Pennsylvania Avenue. Yet, while demanding and getting lower inflation, the public continued to follow the strategies appropriate to the 1970s. Our parents kept their money in CDs and money market funds to avoid any loss of principal, and were encouraged to do so by the experts. Baby boomers bought ever bigger houses with ever bigger mortgages, comfortable in the belief that doing so was a good investment and would make them money.

Yet, the chart illustrates the heavy net cost of 11% mortgages in a 4% inflation economy. We've been warning our readers about this cost since 1987, but the public has only taken it to heart in the past two years. We had no influence on the timing of the change, but we believe the recession, exacerbated by the Gulf War, did. Anyway, it has finally happened. The bottom line is that the mortgaged American public has reversed its actions from "trading up on the equity" to "prepaying the mortgage." Folks, this change is a 180-degree turnaround; it is a complete reversal. And since a major segment of this public has gone from 30-year mortgages to 15-year mortgages, this new trend is unlikely to be reversed anytime soon.

Figure 6.2 is a plot of the DJIA over the same time span. We believe the climatic conditions you see in Figure 6.1 drove the prices you see in Figure 6.2, and the perception of the investing public lagged reality, just as the perceptions of the mortgaged public did. It's the same public.

Figure 6.2 Dow Jones Industrial Average, 1952-92



In 1934, Ben Graham co-authored the book *Security Analysis*, which is the definitive work in the field. In the 1951 edition, he said the stock market was overpriced, but (as Figure 6.2 shows) the market went up. In the 1962 edition, he upped his valuation criteria by 50% but still concluded that the market was overpriced. The market rose for another four years. By 1972, the public's confidence in the market had become so strong that a group of us working for an insurance company were nearly fired because we sold half of the stockholdings and went to cash; our criteria told us that, at that time, stocks were overpriced, but our boss did not agree. In 1973–74, reality caught up with the market and stock prices dropped.

Today, (1992), people who compare stock prices to the last decade say the market is too high. Yet our evaluation criteria, which flagged stocks as expensive in 1972, indicate that prices are now fair. After the experience of the last 10 years, we find it fascinating that there's still faith in real estate, but owning stocks is still considered risky.

Weathering the Cycles

In our weather analogy, while Figure 6.1 shows the investment climate, the seasons correspond to cyclicality in the economy and the markets. Since WWII these seasons have been determined by cyclical patterns in monetary and fiscal policy emanating from Washington, D.C.

In the 1970s, people talked about a four-year cycle in the stock market. Such a cycle is visible in Figure 6.2 from 1954 to 1982. I believe the cycle was determined politically. After being elected, each president from Eisenhower through Ford (with implicit help from the Fed) squeezed the economy to contain inflation and then goosed it to get reelected. Jimmy Carter didn't read the script: he goosed it early. Inflation ran up, and he lacked maneuvering room in his final two years. Responding to popular demand, Reagan and the Fed squeezed the economy to lower inflation but did not goose it later, giving us a good economic decade. My advice to Bill Clinton would be to talk about stimulus but to save any action for 1995–96. We're already set up for good economic numbers for the next couple years. (No, he hasn't asked.)

Finally, just to complete our picture of investment markets and the analogy to weather, daily stock price fluctuations correspond to daily rainfall. Whether stocks run up or down 30 points today is no more important than whether or not we get a half an inch of rain. Today, such fluctuations correspond to human moods and to the passage of weather fronts across the landscape. Such movements give people in the media/entertainment business (and pilots of small planes) something to talk about, but have very little importance.

2005 Update

We continue to find our weather analogies useful in describing the economy and the stock market.

The long-term picture, the investment climate, remains positive as inflation continues at about 2% and the economy continues to grow on a secular basis. Within that climate, the investment seasons continue. Although the economy is now expanding after recovering from only the second recession since 1982, the market has witnessed corrections in 1987, 1990, 1994, 1998, and 2002. So the markets have approximated a four-year cycle even though the economy hasn't. But the most recent years have had some added twists.

In our weather analogy, we sometimes witness daily weather patterns that seem to defy the season. Sometimes the anomaly is temperature; sometimes it's rainfall. We've recently witnessed years when the November-December temperatures were "unseasonably warm." In 2002 we talked about a drought in western Pennsylvania, but it was less a drought than a shift in the timing of the rainfall—more than normal rain in April and May, followed by almost none in June and July. The point is that we can have unusual daily weather without negating the normal seasons or the underlying climate. Similarly, in investing, the psychology (hopes and fears) of the investing public can result in security prices seemingly at odds with the values determined by the investment climate and the business cycle.

In 1999, the Fed raised interest rates to slow the economy. Similar action in the past resulted in declining stock prices. In fact, in 1999 on the New York Stock Exchange, the number of declining stocks exceeded the number of rising stocks. But a group of stocks, including Internet and technology stocks, caught the fancy of a group of investors and set dramatic new highs. For a period of about 18 months, psychology overwhelmed fundamentals for their select group, allowing prices to rise longer and much further than normally expected. Prices of some securities reached absurd levels based purely on hope. Those prices had to come back down to reflect reality. While doing so, investor psychology was pummeled by a litany of fears that sometimes seemed overwhelming, from the terrorist attacks of September 11, 2001, to fears of war in Iraq, to domestic snipers, to crop failure, and so on.

By July 2002, these fears coalesced to the point where many investors "just wanted out"—regardless of price. This psychological reaction was repeated with less intensity (albeit at lower prices) in September-October. We believe that the headlined prices of 1999 and 2002 were driven by the psychological hopes and fears of some investors. We don't believe that these hopes and fears have a major lasting effect on the underlying strength of the American economy, which has since recovered from a normal cyclical recession.

2007 Update

2006 was an interesting year. The prior set-up looked much like 1994. After an economic recovery from a recession four years earlier, the Fed was raising interest rates to slow down economic growth and to contain inflation for reasons spelled out in our essay entitled "Where to from Here?" We judged the odds as favoring a slowdown or soft-landing, rather than a recession. And, economically, that's what we got.

But the psychology of the market added a few wrinkles. People looking for yield(s) drove up the prices of low-rated bonds, utilities (up 30% for the year) and REITS (up 37% for the year), to the extent that they no longer look attractive on a value basis. And the prices of Chinese stocks rose more than 100%.

As often occurs, psychology (short-term weather) can overwhelm the seasonal patterns, for a while.