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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Stocks Versus Bonds

If you've been following our monthly newsletters, you're aware that we're six years into the current bull market - one of the longest in history. For an investor feeling this presents a greater risk of loss than she can tolerate, bonds may provide a reasonable alternative to stocks while waiting for the inevitable bear market to arrive. However, this go round presents an interesting dilemma. Stocks aren't the only asset class that's risen appreciably over the last few years. Barring commodities, just about everything has, including good old-fashioned bonds. So in moving from stocks to bonds, one really is taking money from one "expensive" investment and placing it right into another one. A conundrum for sure.

Stocks and Bonds over the Longer Term

There are a couple of ways to view this situation - First from a long-term perspective and then from a shorter-term, more strategic one. In our opinion, the longer term view presents the biggest issue, and by this we mean risk of subpar returns for investors. Our forecast for stocks over the next 7-10 years (looking at average market cap/GDP models and cyclically adjusted price to earnings models) is actually 0%. That's right, 0%. Stock markets can only rise so fast over a longer period of time and given the above average gains over the last six years, we've essentially stolen returns from the future. Our college-aged kids can thank us for that later. Unfortunately, due to the nature of how we've gotten to this point in stocks - extreme and unprecedented central bank intervention - bonds have run up as well and are anything but cheap. This is reflected by the inverse of bond price - interest rates - which are at levels we never thought we'd see in our lifetimes. In fact, less than a decade ago, in observing Japan's ultra-low rates on its government bonds, most pundits wrote them off as a phenomenon that was unique to Japan and its mishandling of their market and economic crises in the early 90's. But with negative interest rates on over 60% of government bonds globally, Japan proved more a warning than a one-off exception.

At some point, rates will rise and bonds will decline in price. When exactly that happens is the million dollar question, but it will happen at some point making bond returns over the long term much less attractive than they have been in the past. The days of 5-8% long term returns from bonds are gone. We'd expect something on the order of 0-3% returns over the next 7-10 years making bonds only slightly better than stocks for the buy and hold investor. If you're feeling cheated, you should. Again, the incredible gains that very few actually participated in fully over the last six years have been taken right out of future investors' pockets.

Stocks and Bonds over the Shorter Term

But don't give up just yet. All hope may not be lost. Although we feel it's all but certain that investment returns for the buy and hold investor going forward the next 10 years will be much less impressive than what we've grown accustomed to regardless of portfolio mix, for the tactical investor the future doesn't necessarily have to look so grim. That's because stocks and bonds won't necessarily take the same path to lower prices. In our estimation it doesn't really matter which bubble pops first, because when they do, investors will be looking for a safe place to put their money. Although central banks have done a stellar job convincing people to take risks they otherwise wouldn't feel comfortable taking, in the heat of the moment when investors are running for the door, stocks will almost always be viewed as riskier than high quality bonds and cash, thus creating flows into the relatively safer categories. In this bubble-burst scenario, not all bonds will be viewed the same way. Lower quality corporate and sovereign bonds will most likely be eschewed in favor of higher quality ones, such as blue chip corporate bonds and those issued by stronger developed countries.

A key variable underpinning this scenario is the current economic weakness across the globe. With China continuing to report very weak economic data (the latest manufacturing report suggesting contracting activity) and inflation failing to pick up materially after six years of monetary steroid therapy, deflation seems to be the natural phenomena at work that we're merely postponing with our meddling. Given the amount of debt in the world at the governmental, corporate, and personal levels, and the fact that we haven't taken any real steps to ameliorate it, this scenario seems plausible. And so when markets inevitably head lower as they've always done and always will, and the positive contributions to the economy from the wealth effect wear off, this deflation that we've seen nipping at our numbers over the months may become very conspicuous to all. This supports lower interest rates. When prices are declining and stocks and real estate are losing propositions, 1.5%, 1%, or even 0% on a bond that's almost certain to return our investment down the road suddenly becomes very reasonable - Especially when the objective has switched from growing wealth as quickly as possible, to preserving wealth at all costs.

Our Most Likely Outcome

Given history as a guide and the variables currently at play, here's how we feel things will most likely play out over time when it comes to stocks and bonds. First, something happens that leads to risk aversion. Whether it's a natural disaster, geopolitical event, financial headline of some sort, or simply fewer buyers showing up to the exchanges than sellers, something will tip the scales away from risk-taking toward risk-aversion. When that happens, we feel stock prices will start their journey lower toward more "normal" valuations. Concurrent to this, cash and the highest quality bonds will most likely be beneficiaries of this money flowing out of stocks, pushing interest rates even lower than they currently are. Depending on how sudden and extreme the stock correction, the economy would most likely feel the effects of the shift away from risk-taking, leading to slowed global growth or even recession. As we discussed earlier, deflation being the path of least resistance at the moment, we'd most likely see consumer prices fall along with asset prices, making lower interest rates more palatable for some period of time.

When this natural deflationary cycle is finally allowed to play out – and it only will when central banks either cease their over-reaching or markets finally lose confidence in their ability to save the day – the stage will be set for healthy and lasting growth once again.

At this turning point, stock prices will most likely look much more reasonably priced, while the safer bond categories could look anything but. For an example of this, take a look at Japan a couple years ago – with the stock and real estate bubbles long gone, the only one remaining was and still is in Japanese Government Bonds. This scenario could very well play out right here at home. The big question is how pernicious the deflationary pressures will be and for how long. Ultimately, the bond bubble will pop when these pressures subside and inflation returns along with a more broad-based economic growth or when our government ultimately fails at managing its household finances. We're hoping for the former.

As we all know, a lot can happen to create bumps in the road that either alter the likely outcome completely or make it appear much less likely. Central banks will continue to create these bumps going forward as will political events and other external forces, just as they always have. But it's important to keep a longer-term perspective through all the noise and ours is as we've laid it out here. If we're tactical in terms of when we take risk and when we focus on preserving our capital, we think there's a good chance of salvaging good rates of return going forward even though most investable categories have pretty bleak prospects over the longer term. Being tactical and disciplined has never been more important.

A Brief Look Back at Taxes in America

They say there are only two certainties in life, death and taxes. And unfortunately for us, the tax piece, April 15, is fast approaching. But what did paying taxes look like in America in years gone by?

The first income tax occurred in 1643 when several colonies instituted a "facilities and abilities" tax. Basically, a tax collector would go door to door and ask if you had any income for the year. If you said you did, the collector calculated the tax on the spot and that was your bill. As you can imagine, little revenue was raised this way.

Fast forward 143 years to 1786 in what is now the Commonwealth of Massachusetts and Shay's Rebellion. The Revolutionary War ended in 1783 and European business partners were not extending credit to Massachusetts merchants, who for the most part were located along the developed coastal areas of Massachusetts Bay and along the Connecticut River Valley. The European business partners wanted goods paid for in hard currency – of which there was a continent-wide shortage. In central and western Massachusetts, the economy was based on subsistence agriculture and people bartered with one another for goods and services. The rural farming population was generally unable to meet the new demands for hard currency being placed on them by Massachusetts merchants. People began to lose their land and other possessions when they were unable to fulfill their debt and tax obligations.

At a meeting held by the local commoners at the time, a farmer, Plough Jogger, explained the situation: "I have been greatly abused, have been obliged to do more than my part in the war, been loaded with class rates, province rates, Continental rates, and all rates……been pulled and hauled by sheriffs, constables and collectors, and had my cattle sold for less than they were worth…….The great men are going to get all we have and I think it is time for us to rise up and put a stop to it, and have no more courts, nor sheriffs, nor collectors nor lawyers."

Needless to say, the rebellion was put down, however the legislature elected in 1787 cut taxes and placed a moratorium on debts.

As the Civil War broke out in 1861 and money needed to be raised to help pay for it, the first national income tax was passed into law in 1861. Rates were 3% on income over $600 and under $10,000. Incomes over $10,000 were taxed at 5%

The second national income tax law was passed in 1894 and this was the first peacetime income tax. The rate was 2% on income over $4,000 which effected less than 10% of the households at the time.

Jumping forward almost two decades, we see the beginnings of the first modern income tax law. Up to this point, there were many challenges of the Federal Government's power to set a national tax policy. The new law took effect after the ratification of the Sixteenth Amendment by seventy five percent of the states in 1913.

The 16th amendment says:

The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regards to any census or enumeration.

Now, incomes exceeding $3,000 were taxed at 1% and incomes over $500,000 were taxed at 7%. All prior tax laws were replaced by this one.

Prior to 1935 no one paid any taxes for Social Security or Medicare because those two programs did not exist yet. President Franklin D. Roosevelt signed the Social Security Act into law on August 14, 1935. The maximum amount of earnings on which the Social Security tax was applied was $3,000 at a rate of 2%. Compare that to 2015, where up to $118,500 can be taxed at a rate of 12.4% (6.2% paid by the individual employee and 6.2% paid by the employer)

In 1965, Medicare health care benefits were added to Social Security Act and pay was taxed an additional .7% compared to 2.9% today (again split between employee and employer at 1.45% each)

After all the "improvements" in our country's tax policy over the years, we've finally arrived at the current 73,954 pages of paper required to explain today's US tax code. In case you're wondering, if you chose to print it out yourself, you'd have to dish out around $3,500 in paper and ink costs. Wouldn't it be nice to go back a little over 100 years to 1913 and pay 1% in Federal taxes if you earn less than $500,000. Even paying 7% on over $500,000 of earnings wouldn't be so bad. Tax savings aside, we'd sure be saving a lot of trees!

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