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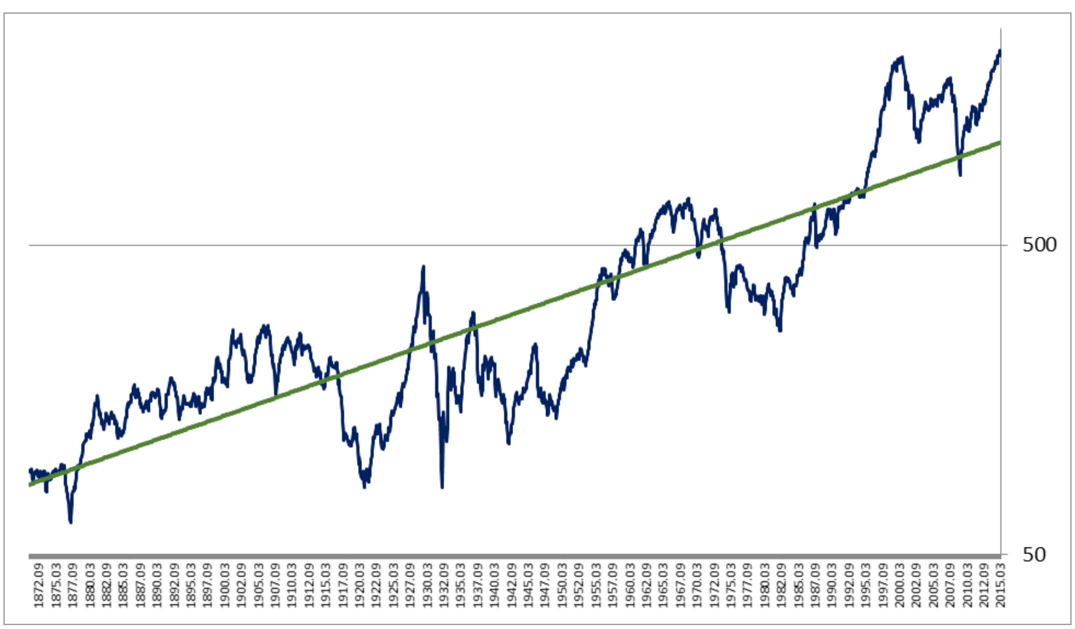
Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Using Hindsight to Look Forward

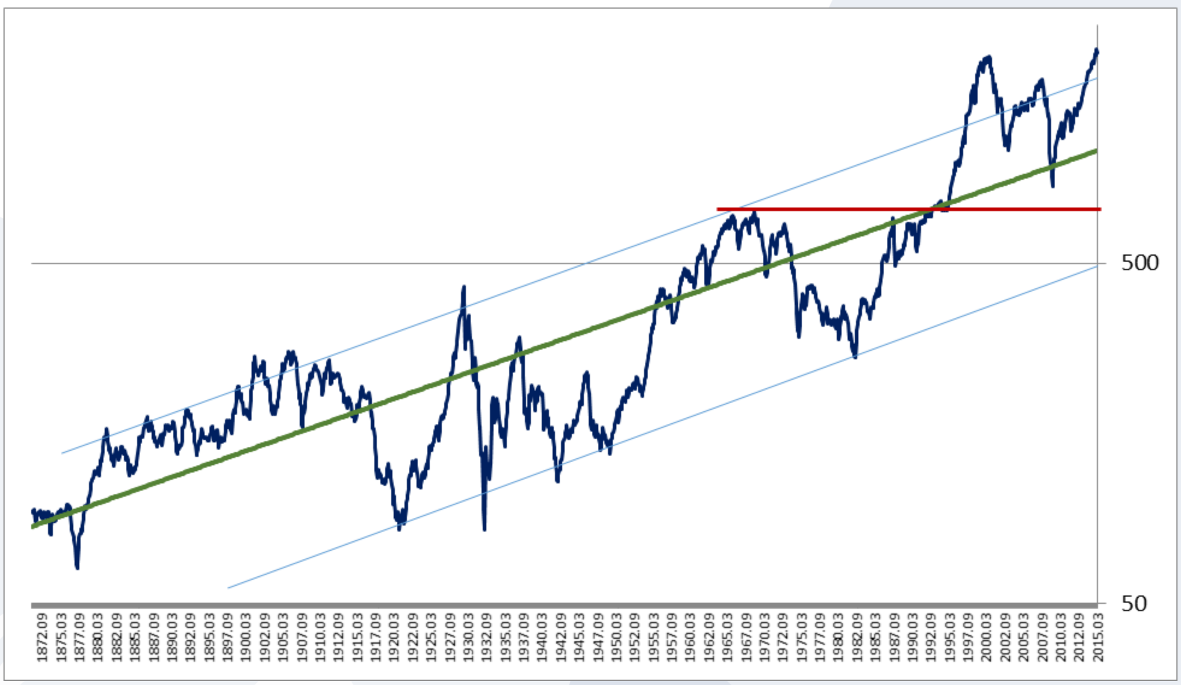
Our January 2014 newsletter included an extensive piece on the value of the S&P 500 corrected for inflation going back to the 1870's. What it showed was a series of peaks and valleys, some of them quite dramatic, with an overall upward trend. The long term average of the upward and downward price moves, here depicted by the green line, is an increase of 1.8% per year above inflation. The inflation-adjusted S&P 500 price is currently nearly 90% above where its long-term average says it should be, and since December of 1994 when the price movement broke above the long-term average, the S&P 500 has averaged 5.4% per year. 5.4% may not sound like a lot because we have subtracted the effects of inflation and dividends which lowers that number, but over the past 20 years the price of the inflation-adjusted S&P 500 has grown at a rate 200% above its long-term average. That's a long time to be that high above average.



Looking at the entire span of time, 144 years is an impractically long time to talk about long-term returns in the context of what an investor can expect. Even discussing investment markets such as large cap stocks over a ten year period is tricky, given most investors evaluate stock market moves in roughly two year chunks: what have I earned over the last 12 months, and what did I earn the 12 months before? That is about the most investors can process, to their detriment. Thinking that short-term definitely leads to emotional decisions, though we do understand what leads people to think this way.

Some longer term thinking is needed when considering what may happen next with not only the S&P 500, but most equity markets and probably most bond markets too. The S&P 500, and many other asset classes, are about as far above their long-term averages as they have ever been. The money printing, or "quantitative easing", that has occurred to support the appreciation since the financial crisis is unprecedented, and in our opinion unsustainable. This does not mean a major move downward is imminent, necessarily, but it does mean that stocks' ability to continue appreciating the way they have over the past 30 years is getting harder and harder to believe with each passing month. So what might a downward move look like from here?

To gain a little perspective, we'll look at what it would take to get the price of the inflation-adjusted S&P 500 back to its long-term average, what it would take to get back to its last peak in the late 60's, and what it would take to get down to the bottom of the lower channel.



First: Getting back to average. The 3.6% difference between 5.4% growth over 20 years verses 1.8% may seem small at first glance, but compounded over 20 years that difference results in the S&P 500 being nearly 90% above its inflation-adjusted long-term average. Therefore, just to get back to average, the S&P 500 would need to fall around 47% from where it is now. That would take it from its dark blue peak to the green line.

Second: Getting back to the most recent bull market peak. What happens in many corrections is the bottom is not reached until the value of the index reaches a level roughly even with the previous long-term upward move's peak, here denoted by the red line. For the S&P 500 to reach that level, it would need to decline 66% from its price today. The last major downward move below the long-term average, from the end of 1968 to the middle of 1982, the inflation-adjusted value of the index fell by about that much. Some of that move was due to decrease in value, and some was due to an increase in inflation, and this next time around it is reasonable to expect inflation or deflation to also play a part.

Third: Getting back to the long-term lower channel. Our current issue is that we are so far above average that in order for us to get to that lower trend channel line that we have reached and/or exceeded 5 times before (once breaking through it by quite a bit), we'd have to lose about 80% of today's S&P 500 value. The only time this size move has happened was when the stock market crash of 1929 bottomed out in 1932. The downward move from 1906 to 1920 also went from the top trend line to the bottom trend line and represented nearly a 70% downward move, which is obviously quite large, but still not as large as the move that would take the current S&P 500 price to the kind of lows it has found in the past.

The good news is that this has only happened once before in history, the bad news is that it HAS happened before, and many of the conditions that allowed that to happen exist today, namely historically high prices coinciding with an extraordinary amount of worldwide debt.

How do we survive, and even benefit from a market correction of this magnitude?

Preparing to Buy Low

Rather than look at this circumstance as dire and gloomy, we're viewing it with optimism. Markets move in cycles, which means without the downs, the ups cannot happen. Every sunny stretch of weather ultimately is met with rain. That perfect lawn cannot grow without it. In fact, viewing rain as an inconvenience is short-sighted. Just ask the folks in California how they feel about rain at the moment. Sadly, it can take a disaster to recognize how important a healthy balance in natural cycles can be.

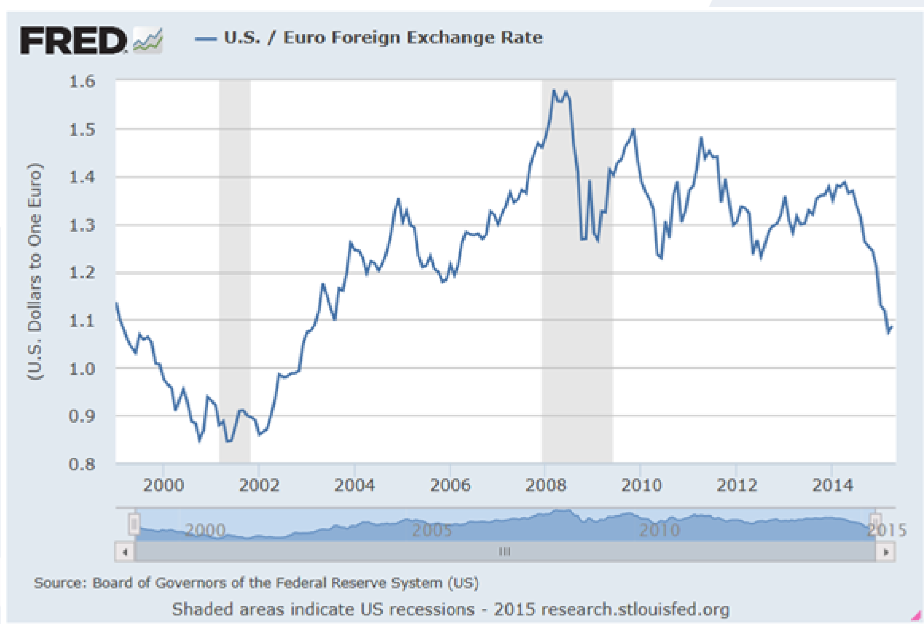
Preparing for the inevitable trip back to normal market returns is very difficult for most because it entails leaving a really fun, high energy party early. All the popular people are there including the Jones', whom most try really hard to keep up with, whether they know it or not. In fact, almost everyone is there, which means if you leave, you'll probably feel like you have nothing to do and that you're missing out. You won't have many other friends to call and pass the time with, because most of them will still be at the party. That's just how these things work. Recognizing that is half the battle. The second half is acting on it and being one of the few wise people to go home before things get out of hand.

Two widely followed models that we use to gauge the sanity of market levels at any point in time are the Schiller CAPE (cyclically-adjusted Price to Earnings) and the Market Cap to GDP models – both of which we've written about before. At present, both models are suggesting that when the other side of the normal market cycle plays out, we'll be sitting between 40% and 65% lower than where stock prices are right now. This isn't opinion, just simple math. It's extremely important to keep in mind that the old buy and hold approach to investing generally only works when markets are mid-cycle or below their long-term averages. When stock prices are above their long term averages, such as they were in the late 1920's, 1960's, and are now, one might have to hold for 20+ years to get back to even after riding out another full market cycle. For younger workers, this can make accumulating wealth for retirement significantly more difficult than it has been the last 30 years. For retirees, it can be outright devastating.

A logical way to benefit from current circumstances is to reduce exposure to stocks in favor of more defensive asset classes, which is something we've already initiated with respect to our client's portfolios. This means a combination of cash, the right types of bonds, and alternative and actively-managed investments. Avoiding major losses as we move back down toward the average means you'll be in a position of strength when the next lasting up-cycle begins. As opposed to nursing losses and hoping that your nest egg recovers in time to preserve your financial goals, you'll be in a position to seize opportunity and build upon your current financial foundation. All it takes is good unbiased information, some tough decision-making, and patience. Keeping up with the Jones' is usually a recipe for disaster and this situation is no different.

Dream Vacation? Now's The Time!

The recent strength in the US dollar versus the euro over the past year has had quite an economic impact. From corporate earnings to the purchase and sale of goods, a stronger dollar in general means that what we sell to the rest of the world costs more for them now than a year ago. At the same time, on May 6 of last year, something costing one euro would take $1.3925 to buy. Now however, as of today's writing, that same euro would only cost $1.0882 - almost 22% less.



Along with retirement and paying less in taxes, travel is a big goal for a lot of people. If you've always wanted to visit Europe and thought it too expensive – now may be your chance!

Let's take a look at one of Europe's most popular destinations and see how the cost compares to travel in the US.

First of all, you need a place to stay. A quick search on Kayak.com shows that the average cost of a 2 person 3 night stay from May 1 to May 4 in Paris, France is $140/night. The same 3 night stay in New York, New York averages $310 per night. If you are looking to treat yourself to one of the nicest hotels Paris has to offer, the Four Seasons Hotel George V, the real price in terms of dollars has dropped from $1,462.17 a night to "only" $1,142.61 a night. A savings of $319.56 a night compared to a year ago! That's like staying for 3 nights and getting the 4th night free.

Now let's look at popular places to go while in the city. In Paris, you could spend a whole day in one of the main attractions, the Louvre. You can see DaVinci's Mona Lisa plus get access to the permanent collections and temporary exhibitions in both the Louvre and the Musée Eugène Delacroix for just 16 Euros – about $17.41. Compare that to New York where you can head over to the Metropolitan Museum of Art to see Monet's Water Lilies for $25 ($15 if you are 65 and over.)

After spending many hours viewing some of the most beautiful art in the world, you may have worked up quite an appetite. How about brunch? At L'Echappee on the Rue de la Folie Mericourt in Paris you can have the buffet of your choice for 25 euros – about $27.20. At Agave in the West Village in New York you can have an entree and your choice of all you can drink margaritas, bloody marys, mimosas, or sangria for $28.

So what would a hypothetical 3 day trip to Paris cost in 2015 compared to 2014?

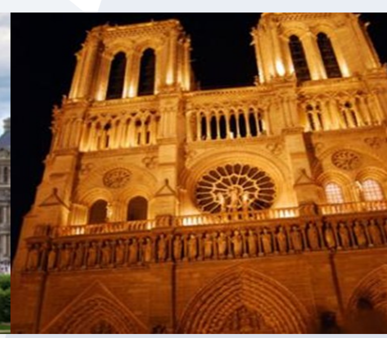
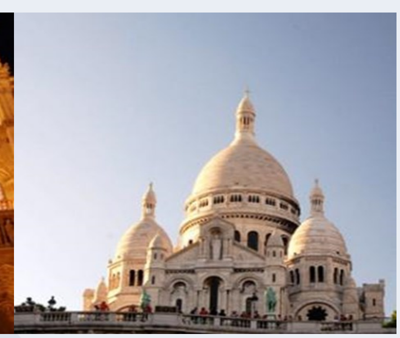
	2014	2015
Hotel	$975	$750
Breakfast	$293	$225
Lunch	$390	$300
Dinner	$780	$600
Miscellaneous	$1,170	$900
Total	**$3607**	**$2,775**

An $832.50 savings this year versus last year!

If travel isn't in your plans this year, don't overlook some online shopping bargains on international goods that may be priced in euros. As an example, we found a finely made Italian jersey costing 75 euros would have set you back $104.44 a year ago. Now, that same 75 euro jersey is just $81.61. Through a little research, you may be able to find some bargains by shopping in Europe online as the global economy continues to expand. Use the stronger dollar to your advantage, but be sure to keep a look out for free shipping to the US!

So as April showers turn to May flowers and you catch that travelling bug – don't overlook the current strength of the US dollar. You may find that travel to countries that seemed too expensive even just a year ago may now be much more affordable.

Bon Voyage!

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