

Why Stocks Are Not Responding To Growth

by Stephen J. Butler

They say the market climbs on a "wall of worry," and most of that worrying comes from the Nattering Nabobs of Negativism out there in the community of economists and short sellers. I spent a morning last week listening to Alan Beaulieu, a widely-respected and historically accurate economist and principal at the Institute for Trend Research. Folded up in my breast pocket was the latest newsletter from Norm Fosback of "Fosback's Fund Forecaster" fame and author of "Stock Market Logic."

Wow. What a divergence of opinion. Every time Alan said something really disturbing, I would have to sneak a peek at Norm's newsletter for some reassurance.

End of recession

The good news from the Trend Research people is that the recession is definitely over and that we are headed into a period of strong economic growth. This is the time to borrow as much money as we can get our hands on with fixed interest rates as low as we will ever see them in our lifetimes. Paradoxically, this strong economic growth will not necessarily be wonderful for the stock market. It will be another seven years before the market reaches its high of October, 2007.

Why wouldn't the stock market be responding more positively to robust economic growth? Because inflation is just around the corner - a lot of it - and rising interest rates will adversely impact corporate profits. Of all factors, interest rates have the most impact on corporate earnings. Stock market values over the next seven years will be climbing a wall of rising interest rates. At least we can console ourselves with the prospect of receiving annual dividends.

Debt concerns

But it gets worse. In twenty years, we will be heading into a worldwide recession which coincides with the famous Kondratiev wave that has capitalism exhibiting 60-year cycles of boom and bust. Alan Beaulieu spells out the coming world-wide conditions (mostly debt) that would contribute to that outcome.

Norm Fosback, by comparison, expects stock prices to rise by 26% over the next twelve months with a total rise of 75% over the next five years. If the Dow Jones average had kept pace with the NASDAQ and the Russell 2000 (smaller companies as a general rule) it would be 2,000 points higher right now. There are plenty of reasons for this stock market logic, not the least of which is the enormous amount of cash held by investors today. At the individual investor level, cash amounts to 25% of portfolios in a remarkable situation where the earnings on that money amount to essentially zero.

Available cash to invest is the engine that raises stock prices. Sooner or later, investors sitting on cash go nuts while watching markets rise and they dollar cost average back in, or at least buy on the dips. It's the mirror image of throwing in the towel when markets are plunging.

For investors struggling with what to do when faced with conflicting ideology, it always boils down to individual circumstances. We won't know until after the fact, which of the above guys will turn out to be right. The question for us is always one of knowing which of the two possible outcomes over the next 5 to 7 years will matter to us one way or the other. It would be nice to see assets almost double over the next five years, but if they only rise about 25% (to get to 2007 levels) in seven years, we might be better off in short term bonds that will benefit from rising interest rates. If you're older, lean toward the latter approach. If you're younger, leave your chips on the table and hope that Norm is right.



Certificate Of Deposit Holders Need New Plan

by Stephen J. Butler

Returns on certificates of deposit are so low as to be laughable if the consequences for retirees were not so disastrous. Last week's column pointing out that the missing money could be as much as \$400 billion a year, prompted a reader to call me and ask what I thought she might do. It goes without saying that we can't wait around for the government or politicians. They're too intimidated by their Wall Street minders to roll us right back to the days of effective regulation. Lobbying, which would be called corruption anywhere else, stands in the way of serious reform.

So, we're alone with our money, and here's what our best course of action could be. For generating income, I have consistently recommended a mix of Vanguard's Short Term Corporate Bond fund, their GNMA fund, and their High Yield Corporate Bond Fund. The returns in the form of monthly dividends deposited into retiree checking accounts have remained relatively constant for the past 10 years, and capital values are about what they were 10 years ago. Investing today at current prices, Short Term pays 2.34 percent, GNMA pays 3.37 percent and High yield is paying 7.05 percent. A three-way even mix would average about 4.5 percent.

What's confusing to investors is that bond prices can rise and fall even if the interest payments remain constant. To illustrate how bonds work, we will buy a five-year bond that sells for \$1,000 and that pays (to keep the arithmetic simple) a 10 percent interest rate. This means that the bond is effectively a loan that will pay the investor \$100 per year and return the original \$1,000 at the end of five years.

The 10 percent rate of return when the bond was brand new was what the going market rate for five-year loans happened to be at the time we purchased the bond. Over the five-year holding period, however, the market rate for new bonds sold to other people fluctuated between 8 percent and 12 percent because of different events taking place in the economy that affected interest rates in general.

Because bonds are priced every day, just like stocks, the price of a previously-issued bond can go down if interest rates in the market go up. Why? Because our old bond (in this example) paying just \$100 per year has to compete with a brand new bond that someone can buy that will pay them \$120 per year. On the open market, the bond's price falls to about \$800 so that our \$100 annual interest payment, (the coupon) would equal a 12 percent return on the \$800 purchase price.

On the other hand, if interest rates in the market had dropped to 8 percent, a brand new bond would only be paying \$80 per year. We have a valuable old bond that pays \$100, so we could actually sell our bond for about \$1,200. Our \$100 annual interest equals about an 8 percent return on \$1,200) and effectively makes us a \$200 profit if we sell at that point. As our bond approaches its maturity - the point at which we get the \$1,000 back - the fluctuation in price goes away regardless of what is happening in the interest rate market. We are too close to the end point to matter.

Bond mutual funds, like those mentioned earlier, need to be purchased carefully right now, because low interest rates have made all the bonds momentarily more valuable. Of the three mentioned above, go mostly with the Short Term Corporate and income average by investing regular amounts over time into the GNMA fund. Go easy on the High Yield Corporate Fund until we see where future interest rates are heading.

