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The Great Reflation and Stock Prices

ACR has attempted to do one thing well since our founding – earn an *equity-like* return *safely*. *Equity-like* means a mid-single digit return or better over inflation (ACR seeks to beat inflation +6%). *Safely* means investors do not end up after 5-10 years with a loss of purchasing power. The investment team is proud of our record on that score, in part due to difficult market conditions since our founding (full performance record and disclosures at www.acr-invest.com). The stock market has been in an unprecedented period of speculative waves and major declines since 1995. Market highs at various points over this period have produced low or negative *long term* equity market returns. Since ACR's performance inception in April of 2000, the stock market produced a negative 10 year return in over 10% of monthly inception periods, and a 10 year annualized return below 3% in over 30% of monthly inception periods. We believe the risk is particularly high today of such a period occurring again.

Our defensive posture is always implemented one investment at a time. Our discipline is to purchase securities when their prices are sufficiently below their intrinsic values, and to sell securities as their prices rise sufficiently above their intrinsic values. If we build cash in the process, so be it. Discipline is the key. Discipline is difficult when the market is rising faster than your portfolio, yet we believe the reward in the long term is both reduced risk and enhanced return. If discipline was easy, it wouldn't be discipline.

Stock prices in the US today are over 1/3 higher than they were at the previous 2007 stock market peak. The main reasons are straightforward: all-time high corporate profits and all-time low interest rates. The two primary determinants of general stock market prices could not be more favorable today. That is, if you only care about today. Therein lies the problem. Today is important, but in ten years, when that day comes, it will be important too. Myopia seems inherently ingrained in the human psyche. Everyone preaches long term thinking. Few execute on it. One must be willing to look "wrong" for years, not just months. Let us now consider the two primary determinants of general stock market prices – earnings and interest rates – from the perspective of the investor who considers the coming decade compared to the investor fixated on current conditions.

Investors fixated on current conditions oftentimes erroneously value stocks based on a multiple of current earnings. The proper perspective of the stock investor toward earnings is to see them as a continuum of cash flows earned over a few decades. These cash flows have two important properties. First, they constitute the value of the company. Valuing companies based on long term cash flows stands in a subtle but important contrast to valuing companies on a multiple of current earnings. Second, a stream of long term cash flows will rise and fall in the shorter term. That is, earnings can be "lumpy" around a longer term trend. Valuing stocks on a multiple of a large current earnings lump can prove to be a very costly financial mistake. We believe many investors are making that mistake today. The following charts help illustrate our point.

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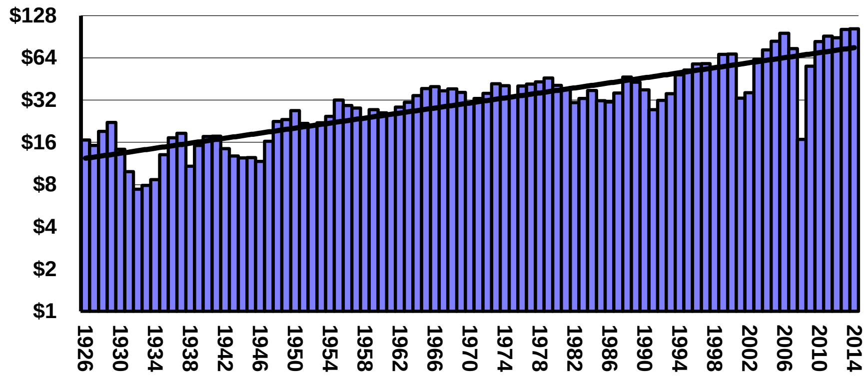
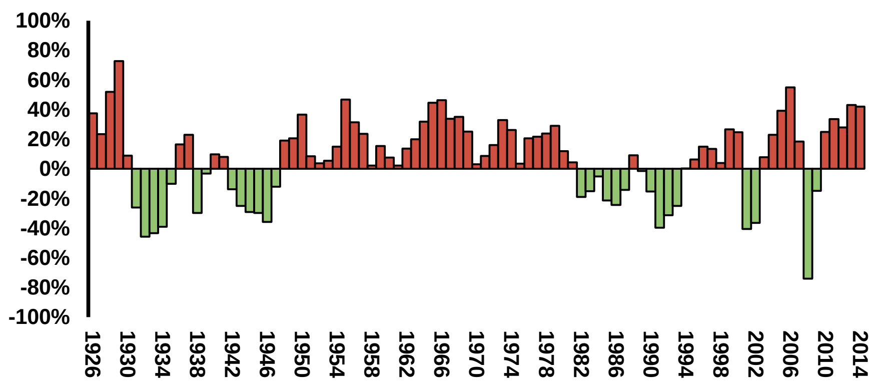
S&P 500 Annual Earnings per Share with Trend-Line 1926-2014
(Adjusted for Inflation)



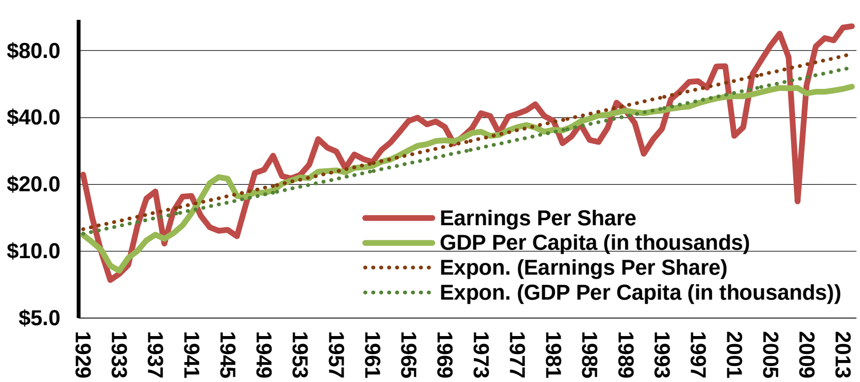
(Sources: S&P Statistical Service; S&P Index Services; Robert Shiller's CAPE Ratio data)

S&P 500 Annual Earnings per Share Above/Below Trend-Line 1926-2014
(Adjusted for Inflation)



(Sources: S&P Statistical Service; S&P Index Services; Robert Shiller's CAPE Ratio data)

Gross Domestic Product per Capita and S&P 500 Earnings per Share 1929-2014
(Adjusted for Inflation)



(Sources: S&P Statistical Service; S&P Index Services; Robert Shiller's CAPE Ratio data; U.S. Bureau of Economic Analysis)

The first chart shows how annual earnings fluctuate around a long term trend, with earnings declines and recessions coinciding. The second chart shows that the divergence between annual earnings and the long term trend can be significant. The third chart helps illustrate that the long term trend is not an arbitrary line, but a tangible economic statistic rising at the same general rate as GDP per Capita. The data in the third chart is supported by two economic facts. First, corporate earnings and GDP are inextricably linked – earnings are a GDP component and interact with other GDP components. Second, earnings are more volatile than GDP due to their inherent operating leverage. The trend therefore represents the long term substance of earnings while eliminating annual earnings "noise" caused by economic cycles. Employing the cyclically adjusted earnings trend, long term investors like ACR consider the stock market to be priced at a historically high P/E of 27.9. Investors fixated on current earnings consider the market to be priced at a misleading low, but still higher than average P/E of 20.5. Bottom-line, stock market prices are high – the historical average P/E of 16.8 is 40% lower than the cyclically adjusted P/E of 27.9. More importantly for ACR investors, since we invest in individual companies rather than the stock market, our valuations include an earnings adjustment which accounts for each company's economic sensitivity.

Let us now transition to interest rates, the second primary determinant of stock market prices. Interest rates have a confusing impact on asset prices, which we believe is often misunderstood by investors and leads to systemic asset mispricing. The confusion begins with the fact that lower interest rates produce higher asset prices. A perpetual annuity paying an annual income of $10 per year is worth $100 at a yield of 10%, whereas the same perpetual annuity is worth $500 at a yield of 2%. The math is indisputable. $10 / $100 = 10%. $10 / $500 = 2%. The Great Reflation refers to the massive increase in asset prices produced by the historically low interest rate policy of every major developed world central bank since the Great Recession.

In our opinion the decline in interest rates is not in itself the problem. The decline can be logically explained by the Classical school of macroeconomics as a result of high saving relative to investment, and can be just as logically explained by the Keynesian school as a deficiency in demand. Either way the outcome is a lower interest rate. Both schools of economics would likely argue that central banks are simply responding to economic conditions by maintaining low short term interest rates with the objective of stimulating investment and demand. The argument of central bank economists, which we do not necessarily dispute, is that low interest rates and the Great Reflation are necessary evils. More open to debate is the impact of central bank buying of long term bonds, a relatively newer phenomenon. While difficult to quantify, long term asset purchases are likely to exacerbate the real problem from an asset pricing perspective.

The real problem is that investors – focused on today rather than the long term – assume the current interest rate will hold over the entire term an asset is held or valued. Investors erroneously pile into longer term assets such as long dated bonds and stocks at higher prices than warranted, just as they erroneously piled out of longer term assets when interest rates were at historical highs in the early 1980s. The result in our opinion is greater long term asset price reflation than warranted. For example, the current 30 year bond yield of 3% implies that interest rates will stay well below 3% in the coming decade and below their historical norm of 5% as far as two decades from today. Possible, but improbable. That is not to say 30 year bond yields will go up from here. The 30 year bond may yield 1% during the next recession for all we know. In this case we would view it as an even riskier speculation. The probability of long term bonds being over-valued due to low interest rates is nevertheless not nearly as high in our opinion as the probability of stocks being over-valued due to low interest rates.

Historically high P/E ratios due to historically low interest rates are highly problematic for two reasons. The first is the same as for long term bonds – the fallacious argument that current historically low interest rates translate into permanently lower stock earnings yields. Specifically, a historically low 30 year bond yield (income/price) should produce a historically low stock yield or E/P (earnings/price), or inversely, a historically high P/E. Stock investors willing to pay high P/Es due to low interest rates are speculating either that interest rates will remain historically low indefinitely or that they are clever enough to sell before rates rise. Claiming that one has the ability to sell before rates rise reminds us of those who claimed they would be able to sell before the tech bubble popped. Good luck.

The second reason is even more concerning. What if interest rates did remain low indefinitely? Long term bonds would most likely turn out to be a profitable investment. But what about stocks? The most likely implication of permanently lower interest rates, as Japan has experienced, is a permanently weak economy. A permanently weak economy produces lower earnings than expected, which is almost certain to be worse for stocks than normalized economic growth and interest rates. The logical conclusion is that under either scenario – normalized economic growth and interest rates, or permanent economic weakness and low interest rates – there is no justification today for a “new normal” of elevated stock P/E ratios.

The duration of this period of elevated, Great Reflation asset prices is unknown, and we believe that speculating on its end could be hazardous to one’s financial health. All we know is that the risk of deflating long term asset prices is a fact, and the realization of the risk for stocks is likely. ACR’s valuation framework will continue to protect our investors from the risk of over-valued Great Reflation asset prices. We will not speculate on perpetually low interest rates or alter the metrics in our valuation inputs. While our strategy may produce some short term pain in the form of market underperformance, we believe that the ultimate reward will be the rare long term pleasure of a satisfactory equity-like return from today’s Great Reflation asset prices.

Nick Tompras
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