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The long national economic nightmare is finally ending in Japan. After a decade of denying reality, of bad policies being followed by worse changes, the Japanese economic pulse is starting to be heard. … At long last, the Government is doing everything it can to stimulate the economy with fiscal and monetary policy. Steps are being taken to recapitalize banks and alleviate the credit crunch. Japanese corporations are restructuring in ways that will make them more efficient. The number of new corporate bankruptcies has fallen sharply.

It is not certain that Japan's banks will succeed in putting their bad loans behind them, or that they will be willing to lend to businesses without the government guarantees now being used to stimulate lending. … But consider what will happen if the pessimists are wrong. Just as Japan's falling yen and the retreat of Japanese banks helped cause the Asian collapse, the reversal of those trends could assure that tentative recoveries in South Korea and Thailand continue. A growing Japan would help to stem deflationary forces in the world, helping manufacturers and commodity producers.

Only months after many were worrying that a global recession, or worse, was at hand, there are signs that the sickest of the big economies is off the critical list and on the way to recovery.

Floyd Norris
At Last, It's Time to Bet on Japan's Recovery
(*The New York Times*, 8 March 1999)

Japan's resurrection has become the most important story of the year for Asia, and it is therefore also central for Australia, both economically and strategically. … There is not much that Japan can't do, once its most important interest groups are aligned. Today, those pieces appear to be falling into place, with even the farmers no longer capable of holding back overdue change. This hasn't happened in the past 20 years. The country came close under Junichiro Koizumi, but in the end his refreshingly candid rule ended up as a false dawn.

But Japan's sun really does appear to be rising now under Koizumi's follower Shinzo Abe, 58, who learned a lot from his failure first time around as prime minister from 2006-07. He shot the Asian Development Bank's chief Haruhiko Kuroda into the governorship of the Bank of Japan with a mission to fire the yen down through massive printing, doubling the money supply in two years through "quantitative easing." That has largely worked, boosting domestic industry, tourism, and confidence all round, especially among consumers. … [Australian] policymakers and businesses need to get on board before [Japan's train] leaves the station.

Rowan Callick
No False Dawn Under Abe: Japan's Sun Rising Again
(*The Australian*, 23 May 2013)

Neither in Pamplona nor in Stock Markets Do We Run with Bulls

The end of one financial year and the beginning of the next is an appropriate time to reflect upon the outgoing year's events, twists and turns, triumphs, trials and tribulations. It is also a time to place them into a broader context, consider their causes and consequences, learn one's lessons and set one's course for the next financial year. It's time, in other words, to confront one's actions and expectations with cold logic and hard evidence. For a summary of our actions' results since 1999, click here.

What about the expectations that underlay these actions? I disclaim any ability to foresee short-term changes of business conditions, the level and direction of financial markets or the prices of securities. I possess no crystal ball and ignore – but often succumb to the temptation to mock – those who imply that they do. Neither I nor anybody else can *time* the short-term movements of markets and securities with any reliable degree of accuracy; over the long term, however, investors worthy of the name can roughly *value* them. For more than a decade, cautious assumptions and careful reasoning have yielded the same conclusion: the prices of most financial assets in Australia have been excessively high; accordingly, the people who've bought them resemble speculators more than investors.

From this reasoning follow several additional conclusions. The policies which ignited the boom of 2003-2007, like those which unleashed previous booms, were dangerously misconceived. They were misguided because – like their predecessors – they sow the seeds of bust. The false upswing doesn't just precede the genuine downswing: it causes it. Alas, since 2007 governments around the world have not abandoned their harmful policies. Quite the contrary: in a futile effort to reignite the boom, they have intensified them into an unprecedented frenzy of interventionism. They are oblivious to the fact that "stimulus" dispenses no honey and much poison: it simply intensifies the eventual bust.

In March 2007, I wrote to Leithner & Co.'s shareholders: "… the bulls do not understand the shaky ground upon which rests the mania of 2003-2007 (if that is how it will be regarded in retrospect)." In October 2009, I elaborated:

> The bulls [remain] oblivious of the potential house of cards that the China, mining, fiscal and monetary booms constitute. … In 2003-2007, the bulls applauded but didn't comprehend the deeply damaging policies that fuelled the artificial boom; today, they continue to applaud but still don't understand these very same policies – hurriedly rebadged as "stimulus." Like a predictable film, the increasingly frenzied interventions by politicians and central bankers, which reprise the blunders committed during the 1930s, will eventually beget the same result they did then – namely make a bad situation even worse. Contrarians we have been for a decade, and today we remain:
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> 1. In 2003-2007 we accepted neither the bulls' "reasoning" (often it was simply babble and blind faith) nor their conclusions.
> 2. During the panic phase of the GFC (late in 2008 and early in 2009), we rejected the belated-bears' prognoses of an imminent revisitation of the Great Depression of the 1930s.

3. Today, those who were Chicken Littles in 2008-2009 all declare that the "worst has passed," recession has been averted and boom is nigh (or at least "recovery" has commenced). I reject all of these premises.

In September 2012, at the Festival of Dangerous Ideas in Sydney (Today's Banks Are Inherently Bankrupt: Let Them Fail Because They Inevitably Will Fail), I stated:

> Since 2007, it's become obvious to the American and European man in the street that the "stability" of the past few decades was – like the "strength" of the Soviet Union – apparent rather than real. The bitter truth is that the long Australian boom since the early 1990s has not reflected the success of the mainstream's interventionist policies. The ructions since 2007 have, however, revealed the artificiality of the conditions that these policies created. Australians, in short, should not use the phrase "Global Financial Crisis" in the past tense; rather, it makes more sense to use it in the current and future tense – as something that's ongoing and will return.
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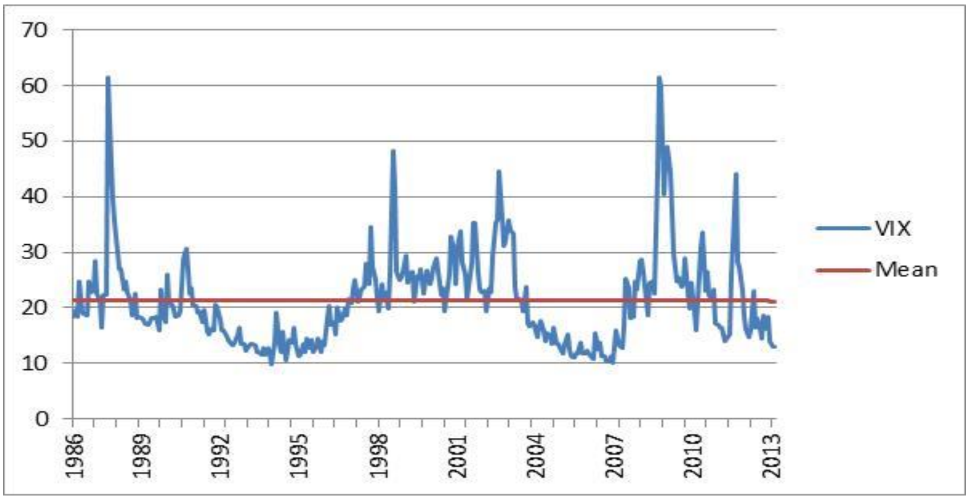
> … [We're] in a position not unlike that of a seismologist or vulcanologist. Alas, these scientists cannot predict with any useful degree of accuracy WHEN the earth will shake or the volcano will erupt; but they can show reasonably precisely WHERE the major fault lines and pressure points lie and WHY the earth will shake. … The Achilles heel of the Australian economy, one that will eventually cause us great grief, just like it has in Europe and the U.S., is fractional reserve and central banking.

Hardly anybody in Australia agrees. "There go the people," allegedly said Alexandre Auguste Ledru-Rolin, a French jurist and politician of the 19th century. "I must follow them, for I am their leader." Investment strategists – the "market leaders" who sport $200 haircuts, wear $2,000 suits and pontificate ceaselessly to the mainstream financial media – echo the current conventional wisdom. They merely parrot in an apparently authoritative guise what is presently exciting (or alarming, etc.) the herd. Their parades to the media mainstream don't influence the crowd's expectations; still less do they create them; instead, they simply follow and reflect them. What are these "leaders" been babbling since mid-2012? According to one, quoted in *The Weekend Australian* (9-10 March 2013),

> A record-breaking week on Wall Street [during which the DJIA surpassed the all-time record high it achieved in mid-2007; in the following week it recorded its longest streak of consecutive daily rises, ten, since November 1996] has turbocharged retail investor interest in the Australian share market, after five years of bad news for equities. … It's now showing that serious retail interest is taking off in selected stocks in our share market. … So we're not in a boom yet, but it's clear that after five years of exchanging horror stories at dinner parties, retail investors are finally wading back into the local equity market. … There's room for our share prices to go up … Anecdotal evidence from around the dealing rooms has it that they are busier than they have been for five years, partly due to the fact that many investors [sic] felt that they'd missed a market move and wanted to get a piece of the action.

The sharply lower (since mid-2012) and presently very subdued reading of the Chicago Board of Trade's Volatility Index ("VIX," see Figure 1) measures the extent to which confidence – or is it complacency or even delusion? – has become rampant. VIX, which measures the expected ups and downs of the Standard & Poor's 500 Index, is popularly known as the "fear index." The lower is the implied volatility as measured by the VIX, the greater is market participants' confidence. Conversely, a high reading reflects their urgent need to change their underpants. That, at any rate, is the assumption.

Figure 1: Chicago Board of Trade's Volatility Index ("VIX")
Monthly Readings, January 1986-February 2013



Since its inception in 1986, the VIX has averaged 21; so far in 2013, it hasn't exceeded 15. This year's is the longest interval of time below 15 since the first few months of 2007. More generally, 80% of the time since 1986 the VIX has exceeded its present level. In March 2012, VIX hovered around 20; in August-October 2011, when Standard & Poor's stripped its AAA credit rating from the U.S. Government and investors fretted about the Eurozone's dissolution, it spiked to 45; and in September-October 2009, when AIG and others tottered and Lehman Bros. collapsed, it briefly exceeded 80 and averaged 60.

Only during the Crash of 1987 (which occurred in October of that year) did VIX rise as high as it did in September-October 2009. And only in the mid-1990s (when Fed Chairman Alan Greenspan decried the market's "irrational exuberance") and early in 2007 did the fear index fall so low and for so long as it has this year. "I think we're seeing fear fatigue," one strategist told *The Wall Street Journal* on 20 February 2013. "Investors are tired of being scared." "Hopes are high that the problems of the past few years have been averted and a recovery is under way," another told *The Weekend Australian Financial Review* ("Bulls Lead the Way," 16-17 February 2013).

According to Don Stammer, a former member of the RBA's board and an advisor to various financial institutions ("Flow of Easy Money Finally Delivering the Goods as Shock of the GFC Fades," *The Australian*, 19 February 2013),

> In the past 12 months, Australian shares have delivered average returns of 20% … [This] happy outcome mainly reflects the easy settings in monetary

> policy in the big economies. Official cash rates are exceptionally low – at near-zero levels in the U.S. and Japan, and 0.75% in Europe – and have been supplemented by "unconventional" measures. For example, the U.S. central bank is keeping the cash rate at a negligible level for an extended period and is aggressively buying government debt from the public. The accommodating settings in monetary policy haven't restored high rates of economic growth in the U.S., Europe or Japan [indeed, growth in the U.S. is sluggish, in the EU and Japan has disappeared]. But via three key linkages[1] they've boosted investment returns worldwide.

Let's translate Stammer into plain English. Since 2007, central banks have flooded the world with an unparalleled tsunami of fiat – that is to say, counterfeit – currency (see Figure 2 on p.7). This great acceleration of the rate of inflation hasn't caused (because it logically cannot cause) the supply of goods and services to rise relative to individuals' and households' incomes. Inflation cannot, in other words, either create or maintain prosperity. To everybody except central bankers and their shills in the media, universities and financial markets, that's patently obvious. If central banks could print prosperity, Zimbabwe would be the world's richest country; and if governments could borrow it, then the years since 1990 in Japan would have been a golden era rather than lost decades.

The truth, of course, is that by greatly boosting the supply of money relative to the supply of goods, central banks' inflation over the years (and particularly their frenzied inflation since 2007) has necessarily debased the purchasing power of money – that is, placed sharply upward pressure upon the prices of some goods (such as stocks and bonds). As Stammer concedes, "stimulus" hasn't caused debt-hobbled economies to recover their

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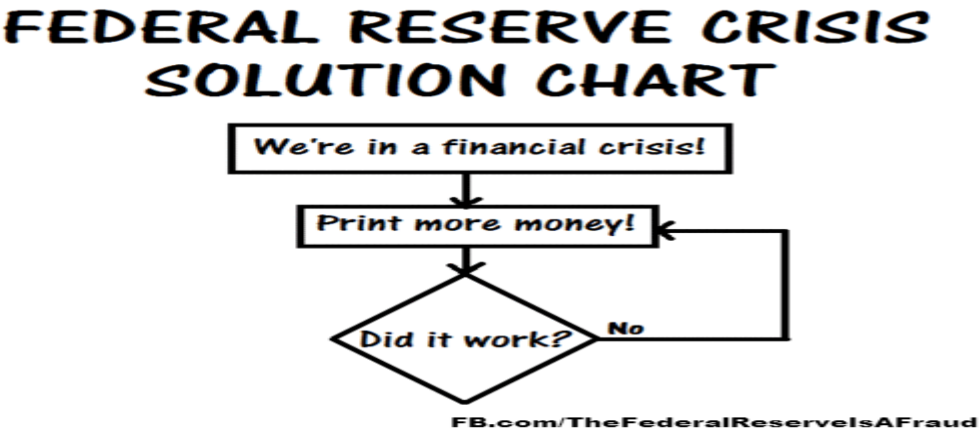
1 The first linkage is central banks' determination (in the words of the head of the European Central Bank, uttered in July 2012) "to do whatever it takes to preserve confidence in the financial system and reduce the risk of renewed global recession." The ECB neglected to add a vital corollary: if "doing whatever it takes" necessitates breaking its own rules as well as the terms of the European Monetary Union, as the ECB's extreme policy does, then (apparently) so be it. Rather ironically, in light of Europe's history during the 20th century, Germany's is the only European government that possesses an even passing interest in keeping its own commitments and respecting the EU's covenants.

The second linkage recalls the adage "you can't fight the Fed." By "making cash trash," that is, by supressing rates of interest of savings to derisory levels, which are insufficient to generate a secure stream of income, central banks are coercing investors great and small out of lower-risk investments like term deposits and into higher-risk investments like stocks. Astonishingly (in light of their leading role as instigators of the GFC), central banks continue to think that they know better than the unwashed and can control (or at least influence) the future. Given this hubris, they are effectively forcing investors to forsake actions which investors prefer (namely relatively safe forms of investing) and to undertake actions which central banks prefer (i.e., that "investors" commence riskier forms of investment). Central banks and their inflation have pushed investors out of deposits and into stocks; in so doing, it has inflated the prices of stocks. In Stammer's words, "the hunt for yield has become the dominant theme in investment markets [as] the average prices of shares, property and bonds has been bid up."

The third linkage repeats the second. As Stammer shills, "the liquidity the major central banks are creating is 'spilling over' into asset markets. There's nothing sinister about this. Asset markets are one of the transmission channels through which changes in monetary policy ultimately influence spending … Adjustments in monetary policy usually affect asset markets before their full effects are felt on the real economy." In plain English, investment bankers benefit first and most from central banks' inflation, because they get their hands on the money before anybody else – and at today's prices. Everybody else benefits later – if at all – and at higher prices. Heads, fat-cat investment bankers win; tails, everybody else loses. How's *that* for fairness?

former apparent vigour; it has, however, partly re-inflated the overvalued financial markets (he approvingly calls them "bull markets") that temporarily deflated in 2007-2009. Alas, Stammer overlooks the illogical foundation on which his confidence rests: the cause of the recent sharp rise of stock prices is the very same policy of easy money that caused the problems in the first place!



Stammer reckons that central banks' "unconventional measures" have been relevant and their effects positive. Steve Keen, in contrast, asks: Is QE Quantitatively Irrelevant? He asserts:

> although it dramatically boosts the reserves of private banks, quantitative easing does nothing to directly increase the money supply … QE is colloquially called 'printing money', and the fear that critics have about QE is that it's going to dramatically increase the money supply and cause runaway inflation. But up to this stage in the model, QE has done nothing at all to the money supply.

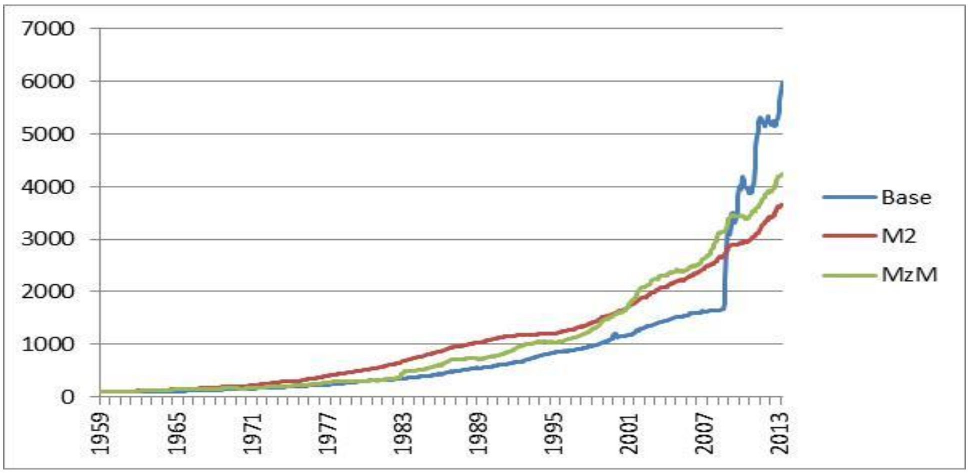
Keen's first sentence is not incorrect (the key word is "direct"), his second is sensible but his last is demonstrably wrong. Since 2007, central banks such as the U.S. Federal Reserve have increased the supply of money more than three-fold (by one definition) and by lesser but still large amounts by other definitions. What will result from their recklessness? "There is no record in the economic history of the whole world, anywhere or at any time," said Gottfried Haberler in *Inflation, Its Causes and Cures* (1960), "of a serious and prolonged [increase of the prices of consumer goods] which has not been [preceded] and made possible, if not directly caused, by a large increase in the quantity of money."

How does the Fed's policy of inflation since 2007 compare to its policy of inflation during previous decades? Figure 2 (p. 7) plots the increases of three definitions of money on a monthly basis (1 January 1959=100; for details, see Chris Casey, Killing the Currency, Mises Daily Article, 27 May 2013). From January 1959 to January 2007, base money increased from 100 to 1630 (i.e., at a compound rate of 6.0% per year); M2 increased from 100 to 2439 (i.e., at 6.9% per year); and MZM increased from 100 to 2613 (i.e., at 7.0% per year). From January 2007 to April 2013, base money zoomed to 5961 (i.e., increased at a compound rate of 24% per year); M2 increased to 3657 (i.e., at 7.0% per year); and MZM increased to 4227 (i.e., at 8.5% per year).

In Casey's words, "three trends are readily apparent from this graph:

1. First, regardless of the definition of money, the money supply has expanded dramatically over time … ;
2. Second, the overall expansion appears to have begun in earnest in 1971 which is, not coincidentally, when President Nixon severed the last links of the U.S. dollar (and effectively all other major currencies), from gold; and
3. Third, the money supply as measured by BASE has exploded since 2008 (up 245% from December 1, 2007 to March 1, 2013) while the money supply from the other two measurements has not followed the same degree of increase (although they too have experienced accelerated growth)."

Figure 2: The Fed's Inflation, Three Definitions, 1959-2013 (1959=100)



Casey concludes: "based on money supply growth – by any measure – since 2008, substantial price inflation is likely." Stammer (and most other strategists), though, is unfazed:

> My guess is we'll hear increasing comment this year that U.S. monetary policy is "gaining traction;" that monetary policy is effective but operates with "long and variable lags." By next year, and led by the U.S., the easy settings of monetary policy in the big economies could be delivering a welcome pick-up in global growth and confidence and strong investment fundamentals for shares and property.

On 5 March 2013 Stammer went further: "as a result of the change in investor sentiment, average price/earnings multiples have increased; most have returned to about their 'normal' levels." (In Figure 8 we'll see that the Australian market's PE has risen well above its average.) "As it appears we're in the early stages of a bull market in global equities, selloffs could present buying opportunities for share investors who expect the fundamentals of the U.S. economy to keep improving." On 2-3 March, *The Weekend Australian* quoted another strategist who repeated Stammer's gist: "it's the early stages of a bull market."[2]

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[2] Stammer agrees. On 21 May 2013 ("Hunt for Yield Spurs Bulls But Till When?" *The Australian*) he was unequivocal: "thanks to the new bull market in shares, most share investors – and particularly those invested in

And on 16 March 2013, AAP ("Investors Ready to Take on World") reported that all's swell. It quoted the chief economist of a Big Four bank:

> The rally in the share market is great and everyone feels better; you can almost feel a collective sigh of relief in this country, let alone the world. Investors for the first time in the post-Lehman world are genuinely looking out five years and saying equities offer value … The world [is] moving towards a genuine recovery … the economy has clearly turned, particularly in China and the U.S.

Nonsense! Although our ranks are quite thin, I'm hardly the only one who doubts that central banks' unprecedented and frenzied interventionism will bear edible fruit. Nor am I the only one who avers the contrary – namely that their crazed policies are toxic. In short, I fear that soft hopes and poor policy rather than hard facts underlie the sharp rise of stock markets since mid-2012 (and, more generally, since early 2009). Surprisingly, views akin to mine have appeared recently in major mainstream media. Even more surprisingly, not only have prominent organs of left-wing opinion published these views: their editors have championed them. In "Bubbles Fast Emerging as the World Plays a Dangerous Game of Monetary-Policy Chicken" (27 February 2013), for example, Francesco Guerrera, the financial editor of *The Wall Street Journal*, wrote:

> In the markets' game of chicken, all investors [the mainstream routinely confuses sober investors and reckless speculators] want to be James Dean in *Rebel Without a Cause*. In that movie's "Chickie Run" scene, Dean's Jim and Corey Allen's Buzz race their cars toward a cliff. Jim manages to get out in time. Buzz doesn't. With parts of the markets overheating, due largely to the "accommodating" policies of central banks around the world, the car race towards the next crisis is on. Speeding on the highways of stock markets feels good, mainly because of the cheap fuel provided by monetary authorities. But, sooner or later, the cliff will appear. … Nobody knows when the road will end … [but] the reality is that the next crisis already has started in some pockets of the financial system. We just don't know where. The question is when, and how, the Fed and its international counterparts will decide to withdraw the massive [props] they have provided to the global economy. … Hold on tight to the wheel and keep an eye on the door.

I accept Guerrera's analogy. (James Grant, a contributor to *The New York Times*, has for years described central banks as demented traffic cops whose suppression of rates to artificially-low levels figuratively removes all speed limits and changes to green the lights at

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US, Japanese or Australian equities – have something to smile about." What makes him think that we're in a bull market? He doesn't directly say so, but his next sentence hints strongly: "key indexes for U.S. shares recently reached record heights and in nominal terms are 130% above their low points of March 2009."

Alas, Stammer conveniently forgets a few inconvenient facts and durable generalisations – most notably, that by historical standards both American and Australian stocks are presently prohibitively expensive. Do bull markets normally proceed from such unattractive valuations? "Never you mind that; she'll be right," he seems to advise: "share valuations in the U.S. are high but not stretched to the levels that usually indicate an end to the bull market," he falsely asserts (see Table 1 on p. 28). And in Australia all's good: "markets could hit a pothole or two before the hunt for yield – and liquidity generation and expectations of increasing earnings – drive the bull market to greater heights."

all major intersections. By these means, central banks make financial and economic crashes – which, as this analogy rightly implies, are not accidents – a simple matter of time). But I reject his recommendation. Rather than succumb to peer pressure and participate in a capital-consuming contest, I'm avoiding the race, the noise and the crowd.

Of Sweet Peas and Intelligent Investing

Sir Francis Galton (1822-1911), a cousin of Charles Darwin, was keenly interested in heredity and not at all in business and finance. Yet his studies of "the average ancestral type" uncovered a statistical regularity that provides a basis for sensible investing. Sir Francis's analysis of the heights of parents and their children found that tall parents tended to bear tall children and that short parents tended to breed short children. He confirmed, in short, that heredity clearly matters. But it matters in a counterintuitive way: on average, the offspring of very tall parents were taller than the average child but not as tall as their parents; and the offspring of very short parents were shorter than the average child but not as short as their parents.

These and other experiments led Sir Francis to describe a principle that has become known as *reversion (or regression) to the mean*. According to Galton, "reversion is the tendency of the ideal mean filial type to depart from the parental type, reverting to what may be roughly and perhaps fairly described as the average ancestral type." If this process did not exist – if, for example, large peas (which Galton also studied) produced ever-larger peas and small peas produced ever-smaller offspring – the world would eventually comprise nought but midgets and giants. With every passing generation, nature would produce fewer average and more extreme specimens.[3]

Regression to the mean doesn't just occur in financial markets: it pervades them.[4] It occurs at both individual and aggregate levels, i.e., with respect to both individual securities and markets as a whole. Using data for the period 1926-1982, Werner De Bondt and Richard Thaler studied the securities of companies whose prices over a three-year interval had either increased or decreased more than the market average. They found that significant movements in the opposite direction subsequently followed these extreme movements of price. If investors are either unduly optimistic or pessimistic about a particular

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3 More generally, "regression to the mean" refers to an inverse correlation among roughly normally distributed observations made repeatedly over time. An extreme observation at one point ("outlier") tends to be followed by a less extreme observation; extremes, in other words, revert or regress over time towards mean or average measurements. For a readable overview, see Peter Bernstein, *Against the Gods: The Remarkable Story of Risk* (John Wiley & Sons, 1996), Chaps. 9-11.

4 It is important to distinguish regression from the mean from something commonly called the "gambler's fallacy." This is the tendency to impute "patterns" from random occurrences. It manifests itself in the mistaken belief that because (say) five tosses of a coin have produced five heads, the next toss is likely (assuming a fair coin) to produce something other than 50:50 odds of a head. Some people will say a tail is "due" and so will expect one on the next toss; others might say the flipper has a "hot hand" and so will expect another head. The laws of probability give us a long-term base rate: if you flip a coin five times and repeat this "experiment" a very large number of times, the average number of heads will regress towards 2.5.

company's securities, and if that company's fundamentals remain unchanged, then after some decent interval their stance was likely to reverse.[5]

Very fashionable stocks and market segments thus become less exalted, and highly unfashionable companies and sectors return to average favour. "Many shall be restored that are now fallen and many Shall fall that are now in honour." This line, from the Roman poet Horace's *Ars Poetica*, appeared opposite the title page of Benjamin Graham's seminal text *Security Analysis* (1934). Graham gave it such a prominent place, I believe, because the crowd's exaggerated reactions occasionally offer tremendous opportunities to investors prepared to stand apart from the crowd. If the price of a sound company's stock is savaged by pessimists such that it falls considerably below a cautious estimate of its value, then – *as long as the company's operations and prospects remain sound* – the price of its securities will tend eventually to recover. Conversely, if a company's shares rise well above a reasonable estimate of value, then – *even when its operations and prospects remain unchanged* – at some point they will fall from their exalted status. As with children and peas in a pod, so too with companies and stock markets as a whole: it cannot be otherwise. If it were, then the economic and financial landscape would comprise companies with colossal and microscopic market capitalisations and virtually no medium-sized enterprises.

This simple and powerful notion underpins many sound decisions. And for good reason: there are few situations in which large things continue without interruption to become infinitely large and small things become infinitesimally small. Trees grow upwards but never reach the heavens; storms rage but eventually dissipate. Accordingly, when we are tempted – as we often are – to extrapolate trends from the recent past into the indefinite future, let's recall Horace's epic and Sir Francis's humble sweet peas.

My guess is that strategists' "model" (they rarely deign to specify it) is simply a one-parameter regression with auto-correlated residuals. More specifically, strategists often talk – with the corollaries I mention below – as if that's their model. That's not a bad thing; indeed, in important respects it's a good thing. But if the phrase "one-parameter regression with negatively-correlated residuals" (and related notions like "regression to the mean") impresses you, then restrain yourself; and if it baffles you, take a deep breath. It's jargon whose plain-English gist is "the higher they rise, the harder they fall" and "Phoenix rises from the ashes." For a diligent student, a better test result is likely to follow an uncharacteristically bad test score. Similarly, for investors a relatively normal (average) result is likely to follow both abnormally good and unusually bad returns.

For owners of a reasonably diverse portfolio of stocks, what's a normal result? On average since 1926 (by then, scholars broadly agree, accounting standards in English-speaking countries had rendered companies' accounts comparable over place and subsequent time), the All Ordinaries Index has increased by 7.3% (not counting dividends) per 12-month period (i.e., January 1925-January 1926, February 1925-February 1926, … and February 2012-February 2013). In the U.S., the S&P 500 has increased, on average, by 7.7% (again, *sans* dividends) per 12-month period. Next time the "performance" of the Australian market arises in conversation, impress your friends and colleagues: "predict"

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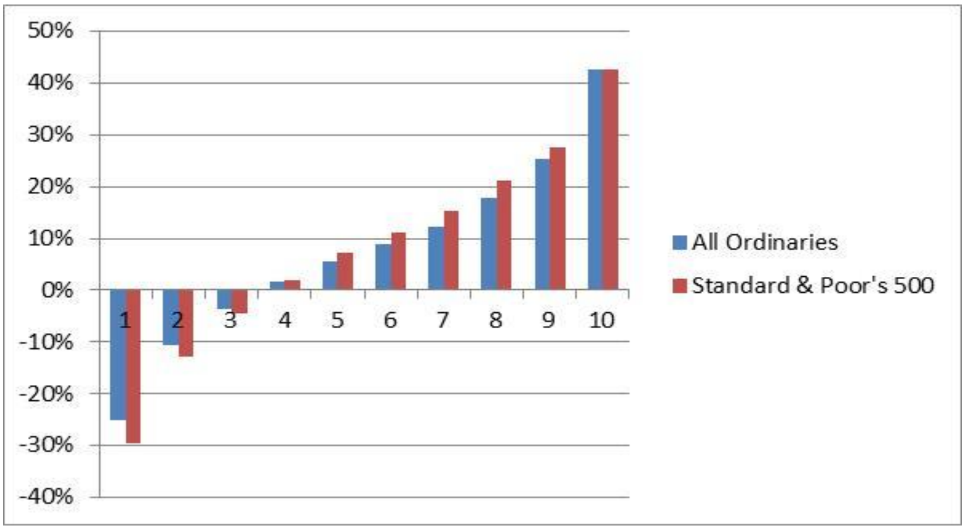
5 Werner DeBondt and Richard Thaler, "Does the Stock Market Overreact?" *Journal of Finance* vol. 40 (1985), pp. 793-805.

that during the next 12 months the All Ordinaries Index will increase 7.3%. If somebody asks the basis of your prediction (unfortunately, people rarely query the basis of strategists' predictions), tell them about your one-parameter regression model; and if they stare blankly at you, tell them that on average since records became valid and reliable, the Australian index has risen by this magnitude every 12 months.

Over long periods, the All Ordinaries Index (as well as the S&P 500, etc.) *consistently* rises. But over relatively short periods of time it doesn't do so *constantly*. In many years it increases, but in almost as many it falls; and in still others it changes little. Indeed, although on average it rises 7.3% per 12-month period, only during 15% of the periods since 1926 has it risen between 5.0% and 10%; the other 85% of the time it has either risen more than 10% or between +5% and -45.7% (its worst-ever 12-month period, by the way, ended in March 2009).

Figure 3 sorts this series of 12-month returns into deciles. It shows that 10% of the time the index's 12-month return has varied between -15.5% and -45.7% (with an average of -25.1%); one tenth of the time its 12-month return has varied between -6.6% and -15.5% (with an average of -10.5%); … and one-tenth of the time its 12-month return has varied between 30.6% and 82.2% (with an average of 42.6%). Its best-ever 12 month period ended just before the Crash of 1987. In roughly one-third of all 12-month periods since 1926, the All Ordinaries has fallen; and roughly 40% of the time, it has risen by more than 10%. For this reason, strategists typically pad their "predictions" with various fluff and fine print (e.g., "upside risks," "downside risks," etc.).

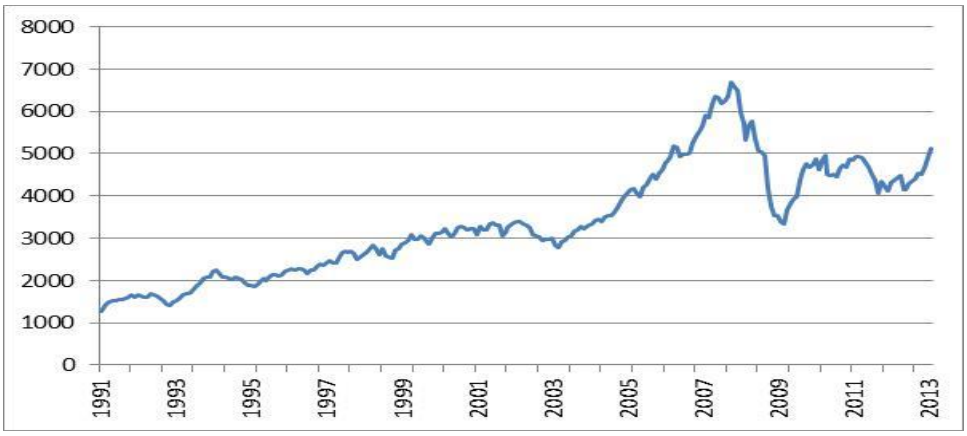
Figure 3: Average 12-month Returns from All Ordinaries and S&P 500 Indexes, Monthly Data, January 1926-February 2013



From January 1980 until December 1999, halcyon decades which strategists of a certain age recall fondly and which seemingly all strategists erroneously regard as "normal" (their end-of-year bonuses are tied not to the accuracy of their forecasts but to the buoyancy of the market), the All Ordinaries increased an average of 12.5% per 12-month period and S&P 500 rose an average of 14.4% per 12-month period. What, then, does today's strategist do? Whenever he's asked (which is often), the average Australian strategist prophesies that, during the next 12 months, the index will rise by ca. (7.3 + 12.5) ÷ 2 = 9.9%, and his American counterpart will on average predict that the S&P 500 will increase by ca. (7.7 + 14.4) = 11.1%. At the end of 2011, for example*, The Australian Financial Review*'s survey showed that, on average, strategists predicted that the S&P/ASX 200 [a relative of the All Ordinaries] would rise by 12.8% to 4,576. Remember that only ca. 15% of the time does the index rise by 7.5-12.5%; typically, then, strategists' forecasts are reliably inaccurate (of which more below).

Australian strategists typically predict that during the next year the index will rise ca. 10%. But their forecasts depend upon context. When the index is rising strongly, as it did from early 2009 until mid-2010, and as it has since mid-2012 (see Figure 4), analysts' forecasts become more optimistic (i.e., they predict gains of 15% or more). When the index is falling, on the other hand, analysts prune their forecasts into single digits and sometimes even attach minus signs to them. *Never forget that strategists reflect rather than mould mass opinion.* During the bogus boom, optimism becomes endemic and the crowd expects – nay, demands – that the string of good results will continue indefinitely; and during the genuine bust, pessimism becomes pervasive and the herd anticipates that losses will never end. The crowd, in other words, tends to do something that financial history demonstrates it shouldn't: *rather than anticipate that today's abnormally good (or bad) result will subsequently regress to the mean, strategists – prompted by the herd – extrapolate the extreme return of the present and immediate past into the indefinite future.* Even worse, the more extreme is the present (by historical standards) the stronger are strategists' and the crowd's tendency to extrapolate this extreme into the indefinite future.

Figure 4: All Ordinaries Index,
Monthly Close, January 1991-February 2013



It's important to emphasise that strategists reflect rather than create the crowd's expectations. On 2 January 2012, for example, the All Ordinaries Index opened at 4,123. During the first half of the calendar year it rose above 4,600, but by the end of June had fallen to 4,136. During the 12 months to 31 December 2012, the index rose 7.9%, and on that date closed at 4,665. By the end of January 2013, it had risen to 4,901; and by the end of February it had risen further, to 5,120. The All Ordinaries rose 24% between 1 June 2012 and 28 February 2013. On 16-17 February, in "Shares Start Their 'Big Bull Year,'" *The Weekend Australian Financial Review* reported: "the past seven weeks represents the best start to a year in more than 30 years and top fund managers believe the rally will continue." How did the index's strong upward trajectory affect strategists' forecasts? On 16-17 February, in "Bulls Lead the Way," *The Weekend AFR* reported:

> Global share markets have had a ripping start to the year as hopes are high that the problems of the past few years have been averted and a recovery is under way. The wave of optimism in offshore markets has led to a switch out of safe haven assets such as government bonds and into riskier investments.[6] [One prominent broker and institutional investor] … hasn't been this confident in the market for four years. "Basically, this rally is still in its infancy. We have a long way to go and 5,550 to 5,600 by December 2013 may be laughable now, but it will be reality later."
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> … "The market will keep trending up, given cash rates are low and going lower and bonds are overvalued," said [one funds manager]. "The market still offers value." … "This year is the big bull year," [another funds manager] said. "We are due a bull market, we are in a bull market and it will extend to the end of [2013], if not into [2014]. … [The rally since mid-2012] is symptomatic of people taking a while to understand the game has changed. Six to nine months ago people were setting valuations in a climate of fear."

Now, this fundie rightly seems to imply, people are "setting valuations" in a climate of greed. He also implies that, because "the game has changed," greed rules. No investor, of course, would ever affirm this view; few speculators, however, would gainsay it.

Why do strategists not just keep their jobs, but prosper? Because their job isn't to predict the future – as we'll discuss in detail below, neither they nor anybody else can do that consistently with reasonable accuracy. Instead, strategists satisfy the crowd's insatiable desire to know the unknowable; they tell people what they want to hear about the future. When the crowd is upbeat and wants to hear that the All Ordinaries will continue to rise,

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[6] Since the fourth quarter of 2012, the mainstream financial media has babbled incessantly about a "rotation out of" bonds and term deposits and "into" stocks (see, for example, "Carnegie's Man Puts Money on 'Tectonic Shift' Back into Equities," *The Australian*, 5 March 2013). This assertion is merely another example of mainstream journalists' intellectual laziness – or perhaps of their financial and economic illiteracy. The plain and very simple fact is that *every* security, once issued, *must* until it is retired be owned by *somebody*. That identity holds for stocks, bonds and cash. Hence in the aggregate, a "Great Rotation" out of bonds and into stocks (or out of cash and into stocks, etc.) is impossible. If you buy stock with cash, you might be "rotating out of cash and into stocks." But the seller is "rotating out of stocks and into cash." Clearly, your rotation perfectly counteracts the seller's opposite rotation; accordingly, the net rotation is zero.

At every point in time, someone must own every stock certificate and bond certificate. Similarly, a security cannot have more buyers than sellers. It is, however, possible that the eagerness of the buyer exceeds the eagerness of the seller, or vice versa. If someone is eager to sell bonds and buy stocks, and that level of eagerness exceeds that of those who buy the bonds and sell the stocks, then the price of stocks vis-à-vis bonds can change. *But after that transaction, there are just as many bonds outstanding, and just as many shares outstanding, as there were previously. Hence there is simply no such thing as money going "into" or "out of" a secondary market.* (In contrast, a primary market transaction – like the issuance of new shares of stock or new debt certificates – represents an exchange of cash for a newly issued security. In a stock issuance, the new cash is presumably used to finance business activities that have some hope of paying a future stream of cash flows to the investor. In a bond issuance, the new cash is presumably used to do the same thing, or possibly to retire maturing debt.)

their "leaders" oblige them; when it's downcast and wants to hear that the Ords will continue to fall, strategists also indulge them.

Why do so few members of the herd remind strategists of their past utterances' woeful inaccuracy? First, doing so reminds the crowd that its opinions are usually erratic, often inconsistent and occasionally plainly irrational.[7] Second, members of the investing public don't, by and large, like to revisit their past mistakes – and these mistakes' financial and psychological costs. Yes, the herd blames its leaders when things go awry; but because the pros merely tell the crowd what the crowd wants to hear, blaming strategists is pointless. Besides, directing the strategist back to his past vomit is, in effect, to question today's conventional wisdom. It thereby distracts attention from the obvious question the crowd never puts to its leaders: "if you're so smart, why aren't you also rich?"

Ignoring strategists' past mistakes obviates another pertinent but uncomfortable question: "given that you were wrong yesterday, why should we attach any credence today to your latest prophesy about tomorrow?" If the crowd ignores its leaders, then it must take its own counsel; whom then can it blame if and when things go awry? On the rare occasions when strategists retrospectively examine their past predictions, their abysmal correspondence to subsequent reality doesn't remotely trouble them: psychologically, it seems that strategists are simply incapable of feeling sheepish. That cognitive attribute tends to limit their supply, and the public's continuous demand for seemingly authoritative predictions ensures their price in the market remains high. Borrowing the famous barb from Winston Churchill's address in December 1941 to the Canadian House of Commons: some price! Some market![8]

Does Economic Growth Boost Investment Returns?

It's natural to infer from the daily torrent of "expert" opinions and projections that the stock market's rate of return depends upon macroeconomic conditions. The higher is the short-term rate of growth of GDP, the lower are interest rates, etc., they routinely allege,

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7 The classical treatment of this point is Charles Mackay, *Extraordinary Popular Delusions and The Madness of Crowds* (1841). On the other hand, and as James Surowiecki shows in *The Wisdom of Crowds* (2005), "under the right circumstances, groups are remarkably intelligent, and are often smarter than the smartest people in them." If four basic conditions are met, a crowd's "collective intelligence" will produce better outcomes than a small group of experts, Surowiecki says, even if members of the crowd don't know all the facts or choose, individually, to act irrationally. "Wise crowds" need (1) diversity of opinion; (2) independence of members from one another; (3) decentralisation; and (4) a good method for aggregating opinions. The diversity brings in different information; independence keeps people from being swayed by a single opinion leader; people's errors balance each other out; and including all opinions guarantees that the results are "smarter" than if a single expert had been in charge.

The vital point – which both Mackay and Surowiecki affirm, and which is so important that it ought to be italicised in the main text rather than obscured in a footnote – is that under most circumstances crowds are more intelligent than "leaders." As one wag put it, he'd rather be governed by 100 people selected at random from the Boston White Pages than by the faculty of the Department of Economics at Harvard University.

8 Churchill said: "on top of all of this came the great French catastrophe [in June 1940] … But [the French] generals misled [the population and civilian leadership]. When I warned them that Britain would fight on alone whatever they did, their generals told their Prime Minister and his divided cabinet: 'in three weeks England will have her neck wrung like a chicken.' Some chicken! Some neck!"

the higher stocks will rise. Market "professionals," journalists and punters alike assume and relentlessly affirm that the prices of stocks tend to rise when market participants perceive that economic conditions are – or will shortly become – strong. The quicker (slower) the pace of economic activity, the more (less) favourable is the investment climate and hence the bigger (smaller) are the gains that investors can expect. Vigorous economic growth, asserts the conventional wisdom, causes strong returns; weak growth underlies tepid returns; and recessions generate investment losses.

To most people this is obvious. Indeed, it's so self-evident that the forecasting industry undertakes a constant, frenetic and expensive search to discover and ever more arcane insights into economic and financial market conditions, the correlation of one to the other – and their course into the "foreseeable future." (How far into the future, by the way, can you foresee?) This industry – not to mention politicians and finance journalists – implicitly and often overtly encourages the crowd to believe that a growing economy underwrites – indeed, virtually guarantees – favourable investing conditions and results. For this reason, and whether in the form of artificially-low rates of interest or untenable magnitudes of government expenditure (including covert subsidies, overt handouts and blatant bailouts) virtually all investment "professionals," journalists and punters – like junkies desperate for ever more powerful "hits" of heroin – constantly demand ever greater quantities of economic "stimulus." And like drug pushers congregating on the seediest street corner, politicians and central bankers move heaven and earth to supply it to them.

I reject the "strong form" of this generalisation (namely that a short-term change of macroeconomic conditions, i.e., measured on a quarterly and even annual basis and in standard ways such as GDP, interest rates and the like, correlates strongly to the short-term returns of stocks). But I acknowledge its "weak form" – namely that healthy economic growth over decades tends to beget robust returns to investors. I also accept a vital corollary: certain sudden (and hence unexpected) changes of economic conditions can influence the returns of stocks. In particular, these returns decline – often drastically – when market participants suddenly anticipate a recession (or belatedly discover that a recession has begun); conversely, they increase when investors abruptly – and whether rightly or wrongly – sense a recovery (or belatedly realise that a recession has ended).

The effects of recessions upon returns, contends Jay Ritter, "are partly due to higher risk aversion … but also due partly to an irrational overreaction" during a recession. Ritter adds that this "irrationality" generates volatility "and mean-reversion over multi-year horizons."[9] In plain English, just as market participants become overly optimistic during booms (and drive the prices of stocks to unreasonably high levels, which deflates long-run returns) they become unreasonably pessimistic during busts – and drive stocks to compellingly cheap levels, which underwrites strong long-run returns.

There's little evidence that supports the "strong form" – and much that contradicts it. Most notably, Elroy Dimson, Paul Marsh and Mike Staunton of the London Business

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9 Jay Ritter, Economic Growth and Equity Returns (Working Paper, University of Florida, 1 November 2004). See also Alan Wood's column in *The Weekend Australian* (17-18 July 2004).

School have, in a series of studies, studied 16 countries' economies and stock markets during the past century.[10] In each country, on an annual or more frequent basis, returns are either unrelated to or inversely related with short-term growth of GDP. The correlation is -0.27 for the period 1900-2000 and -0.03 for 1951-2000. Statistically, the rate of growth of GDP from one year to the next explained only about 7% of the year-to-year fluctuation of stock returns between 1900 and 2000; and this key summary measure of economic conditions explained less than 1% of the short-term variation of returns during the second half of the 20th century.

Other studies, which cover much longer periods of time or analyse particular periods in greater detail, draw similar conclusions. Jeremy Siegel found that between 1970 and 1997 the average correlation between stock returns and growth of GDP (each measured on various short-term bases) was -0.32 in 17 developed countries and -0.03 in 18 emerging markets.[11] Jay Ritter, using the data assembled by Dimson, *et al.*, obtained a correlation of -0.42 for these 16 countries during the twentieth century. If anything, then, the more robust a country's overall rate of economic growth from one year to another, the *lower* its stock market's co-incident or subsequent (i.e., during the next year) rate of return. As a rough rule of thumb, short-term rates of growth explain between at least 1%, always less than 8% and an average of ca. 4% of the short-term variation in stock returns in these countries during the past century. That, frankly, is effectively nothing – and certainly far less than the virtually daily stream of reports in the mainstream media implies.

On 8 March 2013, a single sentence buried on the back page of the business section of *The Australian* let the cat out of the bag: "Lesson Number 1 in explaining the paradox of [today's] booming stock market and struggling economy is: there is no real correlation between the bourse and the economy." On 19 March in *The Australian* ("Best to Follow U.S. Lead on How Shares Fare"), Don Stammer was more explicit: "across the years, many investors have looked for a relationship between Australian economic statistics and the prices of our shares and bonds, but it turns out that the short- and medium-term correlation between our economic conditions and share prices is close to zero."

Why does short-term growth (as opposed to growth extending over decades) typically fail to benefit investors? If anything, why does it *depress* short-run returns? Jeremy Siegel hypothesises that market participants observe today's alleged growth, extrapolate it (or a higher rate) into the future and thereby pay unduly high prices for each dollar of anticipated income. The greater today's outlay relative to tomorrow's stream of income, the lower is the return on the investment. Hence the prescient headlines from *The Wall Street Journal*: "Dow 10,000 Means It's Time to Prepare for the Hangover" (23 March 1999) and "Forget the Party Hats: Why Dow 10,000 Should Be No Cause For Celebration" (10 December 2003). These headlines, by the way, are qualitatively different from those which greeted the Dow's rise, early in March 2013, to an all-time high.

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10 Elroy Dimson, Paul Marsh and Mike Staunton, *The Triumph of the Optimists: 101 Years of Global Investment Returns* (Princeton University Press, 2002).

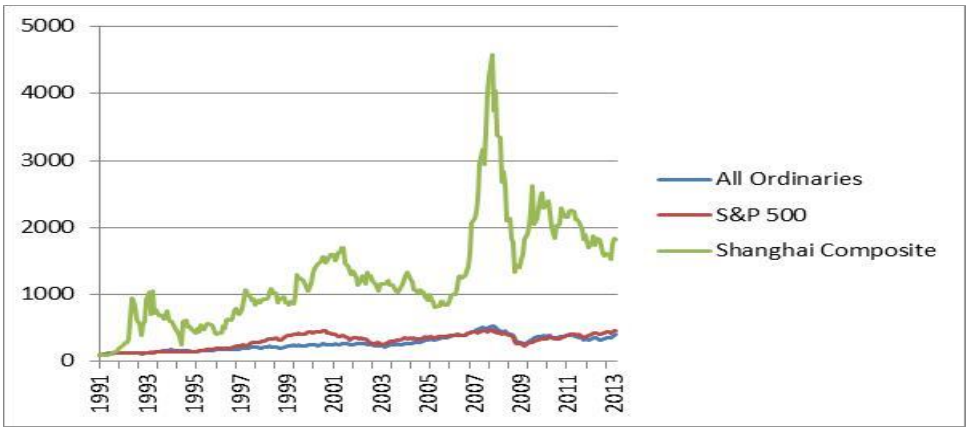
11 Jeremy Siegel, *Stocks for the Long Run: The Definitive Guide to Financial Market Returns and Long-Term Investment Strategies* (McGraw-Hill Trade, 2003).

Here, then, is another pillar of my scepticism about today's optimistic investment climate. *I strongly doubt that the unprecedented (since 2007) fiscal and monetary "stimulus" has laid a firm foundation for a soundly-based economic recovery. But even if it has, that's not good news for investors: in the short-term, it will merely encourage them to bid the prices of stocks to unrealistically high levels – which then regress (reverse) in the long term.* Our model, remember, tells us that returns in financial markets regress to the mean. In short, normal or sub-normal returns tend to follow abnormally good returns – and since early-2009 – returns have been abnormally high.

A Tale of Three Stock Markets and Economies

Economic growth and stock market returns in Australia, China and the U.S. since the early 1990s illustrate these vital points. In the short-term (i.e., during most periods of one year or less and during others of as long as one decade), growth and returns are uncorrelated; over the long term, however – that is, periods of twenty years or more – robust growth boosts returns. Figure 5 plots standardised (January 1991=100) series of the All Ordinaries Index, Standard & Poor's 500 Index and Shanghai Composite Index since January 1991. The All Ordinaries has risen 306% and at a compound rate of 6.6% per year; the S&P 500 has increased 365% and at a compound rate of 7.2% per year; and the Shanghai Composite has skyrocketed 1,720% and at a compound rate of 14.1% per year. Indeed, from January 1991 to October 2007 the Shanghai Composite zoomed an astounding 4,482% – that's a compound rate of 27.0% per year.

Figure 5: Major Stock Market Indices in Australia, China and the U.S., 1991-2013 (January 1991=100)



What underlies the Chinese index's very strong long-run returns, and the modest returns in Australia and the U.S.? Figure 6 plots standardised (Q1-1992=100) series of nominal GDP in these countries. In the U.S., nominal GDP has risen 140% and at a compound rate of 4.6% per year; in Australia, it has increased 240% and at a compound rate of 6.3% per year; and in China, it has skyrocketed 1,820% and at a compound rate of 15.9% per year. Where growth is very strong over the long term, as it's been in China, long-term returns from investment are considerable; conversely, where the pace of growth is much more modest, as it's been in Australia and the U.S., so too are returns. Subject to three caveats,[12] Figures 5 and 6 corroborate the "weak form" of the relationship.

Figure 6: Nominal Gross Domestic Product, Australia, China and the U.S., 1992-2013 (Q1-1992=100)

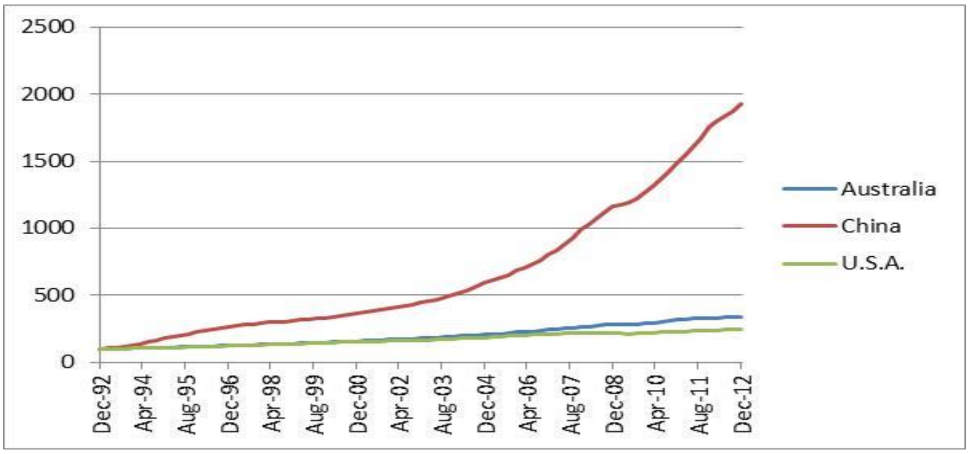


Figure 7 (p. 19) plots market indices in these three countries over the past decade (as opposed to the past two decades in Figure 5). The All Ordinaries has risen 70% and at a compound rate of 5.5% per year; the S&P 500 has increased 68% and at a compound rate of 5.3% per year; and the Shanghai Composite has risen 58% and at a compound rate of 4.7% per year. Yet during the past decade, GDP in China has grown much more quickly than its counterparts in the other countries. Since 2003 (not shown), nominal GDP in China has grown 289% and at a compound rate of 14.6% per year; in Australia it has grown 86% and at a compound rate of 6.4% per year; and nominal GDP in the U.S. has grown 46% and at a compound rate of 3.9% per year. During this decade, the fastest-growing economy has generated the poorest returns to investors.

The linkage over shorter intervals, such as five years, is even more tenuous. In the five years to March 2013, the All Ordinaries has fallen 10% and at a compound rate of -1.8% per year; in the U.S., the S&P 500 has increased 11.6% and at a compound rate of 1.7% per year; and the Shanghai Composite has fallen 46% and at a compound rate of -9.7% per year. Yet since the first quarter of 2008, nominal GDP in China has increased much more rapidly than in Australia and the U.S.: in China, it has grown 79% and at a compound rate of 10.2% per year; in Australia, by 26% and at a compound rate of 4.0% per year; and in the U.S., by 8.9% and at a compound rate of 1.4% per year. In these three countries during the past five years, the more rapid has been the growth of nominal GDP, the worse (more negative) have been the stock market's return. This result, too, disconfirms the "strong form" of the growth-return relationship.

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12 The first caveat is that GDP is a valid measure of growth. It has important and indeed substantial shortcomings, but isn't totally useless. The second caveat is that official Chinese figures validly and reliably measure that country's GDP. I very much doubt that they do; still, I don't doubt that the Chinese economy has grown significantly – and much more quickly than its Western counterparts – during the past twenty years.

The third caveat is that these three countries' growth has been healthy and sustainable. I suspect that much of it hasn't been, i.e., that "malinvestments" riddle their structures of production; that their extent (fomented not least by central banks' artificially low rates of interest) helped to trigger the GFC; and that governments' (and investors') strident refusal to admit and purge them underlies the redoubled interventionism that has followed the GFC – and which must one day be recognised and purged. Still, despite these massive and growing follies of interventionism, each of these countries is sufficiently capitalistic that some of the apparent growth during the past two decades is genuine, healthy and sustainable.

Figure 7: Major Stock Market Indices in Australia, China and the U.S., January 2003-February 2013 (January 2003=100)

For the bulls, these results pose uncomfortable questions. If astronomical (according to the IMF and others, ca. $2-5 trillion) amounts of fiscal and monetary stimulus in China since 2008 hasn't rescued the stock market, and if $4-8 trillion of stimulus in Japan since the recession of the early 1990s has restored neither the economy nor the market to their former glory (the Nikkei reached 38,000 in the late 1980s), why should anybody believe that these policies will generate better results in Europe and the U.S.? Why, for that matter, should anybody believe that they'll subsequently do so in China and Japan?

The Futility of Short-Term Forecasts

Many people rightly admit it, but few really mean it: short-term forecasts of the kind that economists and strategists routinely utter, and which litter the financial and popular press, are utterly worthless. The tragedy is that many people, including journalists and market participants, take these forecasts seriously. In his outstanding book, *The Fortune Sellers: The Big Business of Buying and Selling Predictions* (John Wiley & Sons, 1997), William Sherden reviewed leading research about the accuracy of short-term macro-economic forecasts (that is, of forecasts extending less than 2-3 years into the future) conducted since the 1970s. (More recent analyses haven't significantly altered his conclusions.) Sherden found that

- economists cannot predict turning points in the economy (i.e., when boom turns to bust and vice versa);
- their forecasting skill is, on average, no better than the "naïve forecast" that the near future will continue to be pretty much like the recent past;
- their ability to forecast accurately is, on average, neither better nor worse than guessing;
- increased sophistication (i.e., more powerful computers, more arcane models and ever-growing mountains of data) has not improved the accuracy of their forecasts;
- there is no evidence that forecasters' skill has increased since the 1970s (if anything, their skill, such as it is, has deteriorated over time);
- "consensus" forecasts (i.e., the combination of individual forecasts into a single forecast) are no more accurate than the individual forecasts which comprise them;

- the further into the future they forecast, the less accurate their forecasts become;
- no individual economic forecaster is consistently more accurate than his peers.

The first dot point is perhaps the most important. Even when he gave it the benefit of the doubt and used generous criteria to decide whether a particular prediction was accurate, Sherden found that between 1980 and 1995 the U.S. Federal Reserve – a very large and prestigious organisation, it's hardly necessary to mention, that commands extensive resources and employs many of that country's best-trained mainstream economists – predicted only three of the six major turning points in America's GDP. It predicted neither of the two inflection points in inflation.

The Fed's analysis of others' predictions comes to a similar conclusion.[13] Economists in its Atlanta branch studied macroeconomic forecasts published in *The Wall Street Journal* between 1985 and 2001 and found that forecasters predicted particularly poorly at turning points in the business cycle – exactly, in other words, when sound advice about the future would be most useful and unsound advice most damaging. The accuracy of forecasts was gauged on a scale from 0 to 100 (where 0 denotes least and 100 most accurate). In the middle of an economic expansion, when by definition the near future most closely resembles the recent past, scores tended to hover between 60 and 80. But at turning points they utterly collapsed. At the start of the 1990s recession in July 1990, for example, the score fell to 15. And in January 2001, just before the collapse of the Internet Bubble, it fell to 17.

Sherden's second dot point is perhaps the most disconcerting. The studies he cites show that predictions are so prone to error – particularly of the overly optimistic variety – that they are as worthless as witchcraft. Indeed, if you want to predict the future course of (say) interest rates, take rates for (say) the past decade, measured quarterly, plot them on a piece of paper, draw a "best fitting" line through the scatter of points and extrapolate the line into the next year. A pencil and plain ruler – in effect, a two-parameter regression model – tend to be more accurate than the extremely complex and costly models and methods used by prestigious organisations – including Treasuries and central banks – equipped with Ph.D.s from world-class universities.

The same point generalises to weather ("climate scientists" and politicians, are you listening?), demography and most areas of management. A generation ago, Peter Drucker wrote "forecasting is not a respectable human activity … The future is unpredictable. We can only discredit what we are doing by trying [to foretell] it."[14] The startling fact that child's play can outperform highly schooled (this is not the same as educated or intelligent) professionals across a range of human experience appears to be more than coincidental. That experts and their conclusions, which are routinely accepted with little or no question – and indeed often revered and their critics belittled – are usually no better

[13] See Jon E. Hilsenrath, "Economists' Forecasts Are Worst When They Might Be Most Useful" (*The Wall Street Journal Online* (1 July 2002).

[14] Peter Drucker, *Management: Tasks, Responsibilities, Practices* (Harper & Row, 1974), pp. 123-124. Incidentally, Drucker also wrote (pp. 507-508) "management science has been a disappointment. It has not lived up, so far, to its promise." That point, too, remains valid.

(and sometimes significantly much worse) than flipping a coin guesses implies that the money paid to such experts is an utter and very damaging waste.

Alan Greenspan corroborated this point. "There are several things that we can stipulate with some degree of certainty," Alan Greenspan told the Fed's Open Market Committee on 21 August 1990. "[Most importantly,] those who argue that we are already in a recession … are reasonably certain to be wrong." Unfortunately for Mr Greenspan, the National Bureau of Economic Research, the official arbiter of measurements of the U.S. business cycle, subsequently determined that America entered a two-year recession in July 1990. More recently, virtually all élite economic forecasters – including the International Monetary Fund, Organisation for Economic Cooperation and Development and major international credit ratings agencies – were unable to foresee the Asian economic crisis of 1997; and once it occurred, few if any domestic forecasters accurately predicted its impact upon the Australian economy. And then, of course, there are the recessions of 2002-2003 and 2008-2009: there are plenty of You-Tube videos and no shortage of embarrassing quotations that demonstrate conclusively that the Fed, European Central Bank, Bank of England, Reserve Bank of Australia, International Monetary Fund, Organisation of Economic Co-operation and Development, ratings agencies (Standard & Poor's, Moody's and Fitch), etc. – as well as eminent economists in the world's most prestigious universities – were as attentive as Mister Magoo to the gathering cyclone.

Philip Fisher's conclusion, uttered decades ago, thus remains sound: "I believe that the economics which deals with forecasting business trends may be considered to be about as far along as was the science of chemistry during the Middle Ages … The amount of mental effort the financial community puts into this constant attempt to guess the economic future … makes one wonder what might have been accomplished if only a fraction of such mental effort had been applied to something with a better chance of proving useful."[15] On 3 March 2008, Warren Buffett told CNBC: "I've never made money on economic forecasting. I've made money by staying out of trouble." "We have two classes of forecasters," said the economist John Kenneth Galbraith (one of the very few times he uttered something sensible). "Those who don't know – and those who don't know they don't know." Lao Tzu, the sixth-century BC poet and father of Taoism, uttered the wisest – and perhaps the tartest – words on this subject. "Those who have knowledge don't predict," he said. "And those who predict don't have knowledge."

The Morally and Financially Bankrupt Fed's Dangerous Direction

Short-term forecasting, whether of macroeconomic conditions or of stock markets, and of the kind that central banks and stratgists routinely undertake, is utterly futile. At the same time, let's not lose sight of Jay Ritter's critical insight: certain sudden (and hence short-term and unexpected) changes of economic conditions do influence – indeed, greatly affect – stocks' returns. In particular, these returns decline – often drastically – when market participants suddenly anticipate a recession or belatedly discover that a recession has begun. You're probably sick of hearing from me the inevitability of an eco-

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15 Philip A. Fisher, C*ommon Stocks and Uncommon Profits and Other Writings by Philip A. Fisher* (John Wiley & Sons, 1996), pp. 62-63.

nomic and financial reckoning and the salutary essence of a recession; after all, I've been alert to it for a decade. In Letter 66 (June 2005), for example, I wrote:

> These days, virtually all economists, politicians, bureaucrats, commentators and investors regard recessions as unspeakably horrible things that must be avoided at all costs (people whose sensibilities are too delicate to tolerate this term talk of "slowdowns" and "soft landings" – the word "depression" is utterly taboo). As a result, virtually nobody recognises a recession for what it really is: a healthy tonic, or a salutary restorative, that is necessary in an economic system where central and commercial banks, politicians and herd-like market participants regularly connive to create artificial booms. A recession purges genuine financial excesses that accumulate during sham booms. Like a bushfire that temporarily razes the landscape but also clears the way for healthy long-term growth, a recession destroys poor "investments" and thereby enables a sound allocation of capital to occur. A recession, in short, is a restorative interlude during which some semblance of sanity returns and capital reverts to its rightful owners.
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> Seen from this point of view, the idea that "countercyclical" and "stimulatory" fiscal and monetary policies should be adopted because they will forestall recession – which, in a nutshell, is exactly what central banks and politicians have moved heaven and earth to achieve since 2000 – is clearly absurd. One cannot cure an alcoholic by continuing to ply him with grog. It harms the alcoholic; and doing so long enough and in big enough doses hastens his death.

If pub crawls cannot cure alcoholism, then surely politicians and central bankers cannot treat a widespread addiction to debt by deepening the state's and households' indebtedness. In both cases, the frenzied treatment of symptoms and the emphatic denial of causes generate unanticipated – and negative – consequences.

You're understandably sick of hearing it, so I will desist: instead, you'll hear it from one of the mainstream's most prominent and respected economists. Martin Stuart ("Marty") Feldstein is the George F. Baker Professor of Economics at Harvard University. From 1978 to 2008 he was President and Chief Executive Officer of the National Bureau of Economic Research; and in 1982-1984 he chaired the Council of Economic Advisers. In the latter capacity, he was Ronald Reagan's chief economic advisor – and his "hawkish" views about the budget deficit clashed with the Reagan administration's leftist-Keynesian predilections and policies. According to *Research Papers in Economics*, Feldstein recently (January 2012) ranked among the world's ten most influential economists. In June 2011, *Bloomberg Markets* magazine included him in its "50 Most Influential" ranking. On several occasions, Feldstein has spoken truth to power[16] – a practice that, according to several

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16 According to the Quaker historian H. Larry Ingle, this phrase "goes back to 1955, when the American Friends Service Committee published *Speak Truth to Power*, a pamphlet that proposed a new approach to the Cold War. Its title, which came to Friend Milton Mayer toward the end of the week in summer 1954 when the composing committee finished work on the document, has become almost a cliché; it has become common far beyond Quaker circles, often used by people who have no idea of its origins. (One current example: Anita Hill entitled her memoir of her sensational charges of sexual harassment against Supreme Court nomi-

people in a position to know, prompted George W. Bush in 2005 to snub him and instead appoint Ben S. Bernanke as the Chairman of the Fed's Board of Governors. In 1997, for example, referring to the upcoming European Monetary Union (EMU) and birth of the European Single Currency ("Euro"), Feldstein warned that the "adverse economic effects of a single currency on unemployment and inflation would outweigh any gains from facilitating trade and capital flows;" moreover, although the EMU and Euro were "conceived of as a way of reducing the risk of another intra-European war," they were actually "more likely to have the opposite effect" and "lead to increased conflicts within Europe and between Europe and the United States."[17]

Again speaking truth to power, on 2 January 2013 ("The Fed's Dangerous Direction," *The Wall Street Journal*) Feldstein wrote:

> The Federal Reserve is heading in the wrong direction. What the central bank describes as "unconventional monetary policy" is creating dangerous bubbles in asset markets that will lead to higher future inflation and is supporting the explosive and unsustainable growth of the national debt. … The Fed's recently announced plan to buy $85 billion a month of government bonds and mortgage-backed securities will keep long-term interest rates at historic lows.
>
> The Fed sees its strategy as a way of boosting the prices of equities, real estate and other assets. It has indeed boosted asset prices, although [this] has had very little positive impact on real economic activity. Once the Fed stops buying securities, however, interest rates will rise and asset prices, including stock prices, will fall. This will have serious adverse effects on investors, particularly highly-leveraged institutions and pension funds.

Long-term rates of interest (that is, the yields of bonds whose term is ten years or more) are also likely to rise in the future as a result of the higher inflation – that is, increase of the supply of money – that inheres in the Fed's policy. Given its massive purchases of bonds and mortgage-backed securities, commercial banks currently possess ca. $1.4 trillion more of reserves ("excess reserves") than they are legally required to hold. At the moment they're not using them to create loans, or doing so only spasmodically: banks

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nee Clarence Thomas, *Speaking Truth to Power*. As an older example, David Stockman, one of Ronald Reagan's key economic advisers, gives his memoirs the same name). To speak truth to power sounds so much like an integral part of Quakerism that some modem Friends have simply assumed the phrase goes back to the seventeenth century rather than arriving late in the middle of ours. It reflects what many contemporary Friends would like to believe is the characteristic Quaker stance toward political authority, hallowed in practice if not the exact words. Yet in its origins it was a political statement, entitling an explicitly political document."

17 On the other hand, Feldstein was a board member of AIG, which announced in 2005 that it would restate five years of past financial reports by $2.7 billion. Subsequently, and primarily as a result of the risky bets of its Financial Products Division, AIG's collapse helped to trigger the worldwide economic crisis. The firm was rescued only by multiple infusions of capital and lines of credit (totalling a modest $182.5 billion) by the U.S. Federal Reserve. Although Feldstein was not explicitly linked to these accounting practices and derivatives trades, he had been a Director of AIG since 1988. Further, as a member of the board of AIG Financial Products, he had oversight of the division that contributed most directly to the company's crisis in September 2008. In May 2009, Feldstein announced he would retire as a director of AIG. He is presently a member of the board of the pharmaceuticals giant Eli Lilly and Co., and has been a Director of several other public companies including JPMorgan.

can use these excess reserves to create a vast quantity (roughly $15 trillion) of new loans and deposits. This tsunami of loans, in turn, should it materialise, will greatly increase the demand for – and therefore the prices of – the goods and services borrowers will buy; home buyers, for example, will place upward pressure upon houses, etc. These actions will convert the Fed's "invisible" inflation (which manifests as rises on stock and bond markets) into a form that's readily noticeable in the Consumer Price Index. But I promised to desist, so let's return to Feldstein:

> For now, the banks are content to leave their excess reserves at the Fed in exchange for a low rate of interest. But the day will come when aggregate demand is increasing, companies want to borrow, and the banks are willing to lend aggressively. When the increase in money starts to cause a rapid increase in prices, the Fed will need to limit the banks' credit creation by raising the interest rate it pays for banks to keep their reserves at the central bank. That is the "exit strategy" that Fed Chairman Ben Bernanke and others are counting on to prevent future inflation. Unfortunately, no one knows how high rates will have to go to restrain the commercial banks.
>
> Moreover, because of the large number of very long-term unemployed, unemployment may remain high even as prices climb. And so, just when the Fed should act to tighten the money supply, there will be strong voices in the Federal Open Market Committee emphasizing the Fed's dual mandate to achieve "maximum employment" as well as price stability. Congressional leaders are also likely to warn that raising interest rates while unemployment is still high could cause Congress to punish the Fed with new restrictions. These pressures may cause the FOMC to delay in raising rates, allowing [the rate of increase of CPI] to get out of hand.
>
> … The final problem with the Fed's unconventional policy is perhaps the most obvious. By keeping long-term interest rates low, it removes pressure on Congress and the Obama administration to deal with budget deficits. The deficit has increased to 7% of GDP this year from 1.5% in 2007 [the deficit ballooned to almost 12% of GDP in 2009]. The ratio of debt to GDP has doubled in that time to 73%. Even if the president's original proposed budget was enacted and accomplished all the deficit reduction that the administration claims, the debt-to-GDP ratio would still be above 70% in 2022 and would be expected to rise after that. The Fed, in short, has killed the bond vigilantes before they could have forced Congress to act.

As an aside, the Fed's balance sheet presently contains ca. $3 trillion of total assets and net (of liabilities) assets of ca. $55 billion. That means that the Fed is "leveraged" about 55-to-1 (on the days that they collapsed in September 2009, the leverage of Lehman Bros. and Washington Mutual was less than 20-to-1). *Not only do the Fed's actions resemble those of an aggressive hedge fund: so too do its financial statements. The trouble, of course, is that before long aggressive hedge funds typically hit the wall.* At an average maturity of over 10-years, the duration of the Fed's portfolio of U.S. Government bonds is about 8 years; given these characteristics, an increase of interest rates of 100 basis points (one percentage point) reduces the market value of the Fed's holdings by ca. 8% (i.e., $240 billion). Since July, these rates have increased by about 60 basis points, and have thereby shrunk the market value of the Fed's assets by ca. $144 billion.

But the Fed's net assets (capital) total only $55 billion. *In plain English, these increases of market rates have destroyed the Fed's capital and have thereby rendered the Fed technically insolvent.* Anybody can access this information from the extensive data on the Fed's web site. To my knowledge, no Australian journalist and very few analysts have done so. Why not? To mainstream journalists, central bankers are omniscient, possibly omnipotent and certainly completely dispassionate. More likely, journalists give the Fed the highest passing marks because virtually none of them even dream of speaking truth to power; they simply don't see it as their job. Journalists, in short, are the regime's stenographers and governments merely impose legislation and regulations upon everybody else: politicians and bureaucrats routinely ignore their own rules and the invidious consequences of their actions – and journalists applaud them.

For the moment, at least, the only practical effect of the Fed's technical bankruptcy is that the interest that the public pays on Treasury debt cannot actually be remitted as usual by the Fed (the owner of the debt) back to the Treasury (the agent of the Fed's owner, namely the U.S. Government), but must instead be retained by the Fed in order to recapitalise itself. In effect, the losses in the Fed's bond portfolio are an unlegislated fiscal expenditure. But then again, these days in Washington, *all* fiscal expenditure is unlegislated. Since 2008, Congress hasn't passed a single budget; "continuing resolutions" have been the order of the day. Moreover, assuming an average interest rate on the Fed's holdings of ca. 2.5%, each further increase of 30 basis points of interest rates would destroy portfolio valuation equivalent to a full year of additional interest payments.

Needless to say, very few either know or care. I mention these things simply to underscore how utterly reckless and irresponsible the Fed – like the U.S. Government as a whole – has become. Put bluntly, it is knowingly (and, judging from Ben Bernanke's testimony to Congress, proudly!) trading whilst insolvent. In Australia as well as the U.S., that's an offence that *in extremis* is punishable by imprisonment. But it's London to a brick that Ben Bernanke will neither be charged nor convicted. Never forget that agents of the state merely make the rules and regulations: they certainly don't follow them.

Given That Short-Term Prediction is Futile, What Can Investors Do?

Unlike the crowd and the strategists who follow the herd, investors take history and valid historical data seriously. They also view the present with clear rather than rose-coloured lenses. Most importantly, they abandon the pretence of prescience. Neither I nor anybody else – not even a "strategist"! – can assert, with any reliable degree of prescience: "on the basis of our model, we predict that, during the next three months (or six month or a year, etc.), the All Ordinaries Index will rise (or fall) x%, blah, blah, blah." The investor can, however, say something that strategists/speculators easily could but rarely do: on those past occasions when the index's valuation was similar to its present one, the index subsequently (that is, after five years, etc.) returned a maximum of x%, an average of y% and a minimum of z%. I use a model (namely the same simple one-parameter regression model which most strategists implicitly use). *Unlike strategists, however, I don't use this model to predict a specific future outcome; rather, based upon historical experience, I use it to specify a range of plausible outcomes.*

Strategists stridently deny my conclusion – namely that at present the prices of stocks and bonds in the U.S., Australia and most other countries are significantly and perhaps grossly overvalued, and hence ripe for eventual hefty falls. Of course, I can't foresee when markets will plummet; similarly, nor can seismologists say exactly when California will shake. Alas, logic and evidence lead unavoidably to this unhappy (for the herd) conclusion: no thanks to the recklessness of governments and the central banks that finance them (and which obscure the bankruptcy of both governments and central banks), the risk is that, sooner or later, financial markets – and speculators' returns – will plunge.

How to evaluate, albeit roughly, the extent to which a stock market index such as the All Ordinaries, S&P 500, etc., is undervalued, overvalued or fairly valued? Researchers have found that some measures of valuation possess a reasonable (but hardly an exact or foolproof) ability to forecast long-term (that is, ten years into the future) returns. Over shorter intervals, their ability to predict returns is very limited. Particularly noteworthy as a yardstick of valuation and forecasting is a particular ratio of a market's level to its earnings ("PE ratio"). The ratio's numerator ("price") is well-defined and the subject of little disagreement. Its denominator, on the other hand, is subject to much dispute. One can use "operating" or GAAP earnings, or forecasts ("leading") or actual past ("trailing") earnings; and if one uses trailing earnings, one can use last quarter's, last year's, etc., or even longer periods. Many other adjustments and methods are possible.

I use what's commonly called the "Shiller PE" to value the Australian and American market indexes. Robert Shiller and John Campbell devised it in 1988 (see Stock Prices, Earnings and Expected Dividends) and Shiller popularised it in his book *Irrational Exuberance* (1st edition, Princeton University Press, 2000). It's also called the CAPE (cyclically adjusted price-to-earnings ratio). I use it primarily because its pedigree stems reasonably closely (and closer than any other measure of valuation) from Benjamin Graham and David Dodd, the authors of the value investor's bible *Security Analysis* (McGraw-Hill, 1934). That's probably why it possesses some ability to specify long-term returns. The idea and observation, attributable to Graham, that one-year earnings are highly volatile and mean-reverting, spawned the Shiller PE.[18] When earnings are high and rising, the one-year trailing PE can emit a false signal (namely that stocks are cheap). If earnings are high and rising, "E" tends to rise relative to "P." Under these circumstances the one-year trailing PE tends to be low. But earnings, like the heights of children relative to their parents and Sir Francis Galton's sweet peas, tend to revert to their trend (mean): if they're high and rising, it likely means that they've risen above their trend – and subsequently will likely to regress (fall) back to it. Conversely, when earnings are low and falling, the one-year trailing PE can emit the opposite false signal (namely that stocks are too dear).

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[18] "In former times," noted Benjamin Graham in *The Intelligent Investor* (1949), "analysts and investors paid considerable attention to [a company's] average earnings over a fairly long period in the past – usually from seven to ten years. This 'mean figure' was useful for ironing out the frequent ups and downs of the business cycle, and it was thought to give a better idea of the company's earning power than the results of the latest year alone." This average also smooths the "one off" factors that regularly distort a single year's earnings.

The Shiller PE adjusts for these problems imperfectly but simply and effectively. Instead of one-year trailing earnings, it uses the average of the past 10 years of CPI-adjusted trailing earnings. A decade is, of course, arbitrary: you'd be hard-pressed to find a theoretical argument for 10 rather than, say, eight or 12 years. Still, a decade is reasonable and intuitive. It extends over one or two business cycles without extending too deeply into the distant past. Put simply, the one-year PE represents what an investor pays for this year's earnings (which tends to be a very volatile number). In contrast, the Shiller PE represents what an investor pays for the average of the past 10 years of "real" earnings. This average is usually more stable than one-year trailing earnings; accordingly, it provides a better estimate of long-term earnings – and a better insight into long-term returns.

Figure 8: Ten-Year (Shiller) PE Ratio, Monthly Observations, Standard & Poor's 500 Index, January 1881-February 2013

Figure 8 plots the Shiller PE of the Standard & Poor's 500 Index from 1881 to 2013. Presently, in May 2013, its value (23.2) is two-thirds its height in late 1929 – and one-third above its historical average (16.5). Although it's not near epochal peaks, today's Shiller PE is nonetheless very high: only during the "New Era" of the late-1920s and the Internet bubble of the 1990s-2000s was it much greater than it is today. It's presently higher than it has been 85% of the time since 1881, and 80% of the time since 1926. *In plain English, and putting it mildly, today's high valuations augur poorly for tomorrow's returns. Bluntly, today's not a great time to buy stocks in the U.S., and anybody who asserts otherwise is a damn fool.*

Why should anybody care that the CAPE currently exceeds its historical average? *Because on previous occasions when it's risen to 23.2 or more, the S&P 500 subsequently generates sub-normal ("disappointing") returns.* What does today's CAPE imply about tomorrow's returns? Table 1 sorts the S&P 500's CPI-adjusted returns during every possible rolling decade since January 1926 (i.e., January 1916-January 1926, February 1916-February 1926, … February 2003-February 2013 into deciles ranked according to CAPE at the beginning of the decade. February 2013's CAPE places today's market in the 9th decile (bold font).

As one reads down the columns of Table 1 (p. 28), the S&P 500's subsequent ten-year average CPI-adjusted return falls nearly monotonically (that is, in lock-step). Also, as starting CAPEs increase, the best-case returns weaken and the worst-case returns become even worse. *The ninth (nearly the tenth) decile, the one to which current conditions apply, is ugly: it implies that during the next decade the average "real" (that is, net of CPI) rate of return will average less than 1% per annum.* If so, then he who in mid-2013 invests $100 in a portfolio of American stocks that roughly mirrors the S&P 500, and collects dividends during the decade will, in March 2023, possess (net of CPI) an average of $109.37. The worst case is a rate of return of minus 4.4% real return per annum: at this rate, he who invests $100 today and collects dividends would, after 10 years, have (net of CPI) $63.76.

Table 1: CPI-Adjusted Returns, S&P 500, Ranked Shiller PEs (CAPEs), January 1926-December 2012

Decile	Starting PE		Avg Subseq 10-Yr Return	Worst Subseq 10-Yr Return	Best Subseq 10-Yr Return	Std Dev
	Low	High				
1	5.2	9.6	10.3%	4.8%	17.5%	2.5%
2	9.6	10.8	10.4%	3.8%	17.0%	3.5%
3	10.8	11.9	10.4%	2.8%	15.1%	3.3%
4	11.9	13.8	9.1%	1.2%	14.3%	3.8%
5	13.8	15.7	8.0%	-0.9%	15.1%	4.5%
6	15.7	17.3	5.6%	-2.3%	15.0%	5.1%
7	17.3	18.9	5.3%	-3.9%	13.8%	5.1%
8	18.9	21.1	3.9%	-3.3%	9.9%	3.9%
9	**21.1**	**25.1**	**0.9%**	**-4.4%**	**8.2%**	**3.8%**
10	25.1	46.1	0.5%	-6.1%	6.3%	3.6%

On 6 March 2013, in his column in *Business Spectator*, Alan Kohler referred obliquely to the inescapable reality of the figures in Table 1 – which most of the crowd, particularly bullish strategists, either resolutely ignores or emphatically denies:[19]

> The Dow Jones index's move to a new all-time high [on 5 March] is both historic and depressing – depressing because it means zero capital gain from stocks for 5½ years. In Oz it is even more depressing. The Australian All Ordinaries is still down 26% from its 2007 high … What does all this mean? Well, of course it's a picture of a bear market. Take your pick whether it's a 13-year secular bear, starting with the S&P 500's peak of 1,553 on 24 March 2000 (it's currently 1,541, by the way), or a 5½-year cyclical bear starting with the 2007 peak of 1,550 (17 October).

Note again that my concern about stocks' overvaluation is independent of my disquiet about the parlous state of Western governments' finances, and the artificial state of Western economies. Although the

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[19] Kohler often combines pearls of wisdom with blatant non-sequiturs and utters howlers of illogicality. Consider as an example My Name is Mr Market, and I'm a QE-aholic (27 May 2013). The title is great, and the article states "markets have become addicted to liquidity instead of reality; it could be a painful, volatile, withdrawal … As the second of the 12 steps of Alcoholics Anonymous says: 'a power greater than ourselves could restore us to sanity' (the "power" being economic growth, not the booze of liquidity)."

Not bad – although the "power" is actually liberty and its accompaniments sound money and limited government. Alas, Kohler seems oblivious that these are causes and economic growth is a consequence. Growth, in other words, is a symptom rather than a cause. Perhaps that's the source of his apparent confusion: in the same article Kohler also states – without a shred of evidence – that "low interest rates and money printing [have] worked and produced a sustainable economic recovery …"

correlation between short-term macro-economic and stock market fluctuations is effectively non-existent, the long-term association can be significant. The estimates of prospective 10-year market returns in Table 1 *assume* that during the next decade the nominal rate of economic growth will resume at its historical (that is, since 1926) average, i.e., nominal rate of growth of GDP will average a bit more than 6% per annum. (This might prove overly optimistic: since 2009, it has averaged closer to 2.3%).

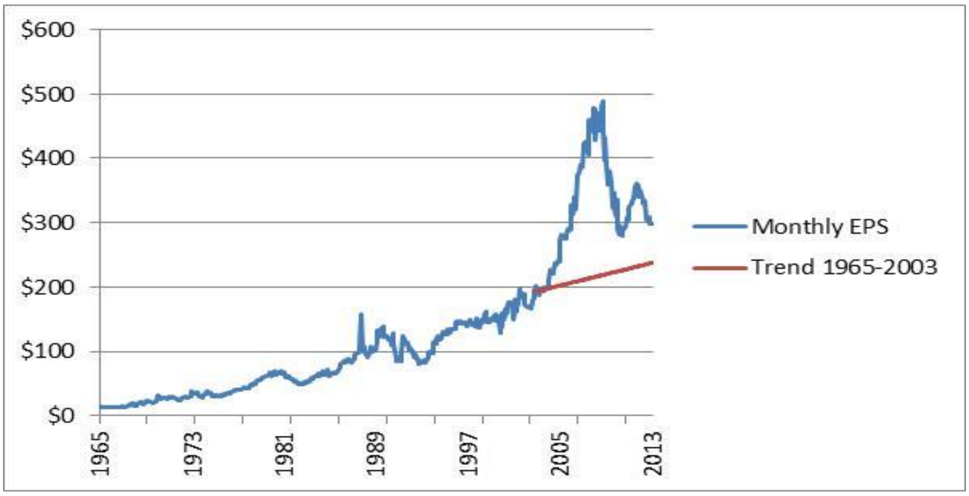
Add to these the current magnitude of public and private debt, the serviceability of these burdens and the strain that further economic weakness (never mind an increase of interest rates) will exert upon that serviceability. My valuations of the S&P 500 and All Ordinaries Index (below) assume that the long-term rate of economic growth will conform to its historical (since 1965) average; but if it falls short, and particularly if recessions or other shocks intrude, then our allegedly dour valuations may actually be unduly rosy. The risk of subsequent economic downside is distinct from today's risk from unduly high current valuations; but each bodes ill for investors' long-term prospective returns (see also Robert Shiller's S&P 500 Forecast for 2020: Is He Overly Optimistic? 3 January 2011).

Figure 9: One-Year PE and 10-Year PE (CAPE), Australia, January 1965-May 2013

At first glance (see Figure 9), and as the mainstream relentlessly and vociferously reiterates, the prices of stocks in Australia do not currently seem drastically overstretched. It's true that one-year "trailing" PE of the All Ordinaries Index is presently (May 2013) 17.2, versus an "historical" (since 1965) average of 14.1. The current one-year multiple, in other words, stands ca. 20% above the historical average. On the other hand, the Australian equivalent of Shiller's PE is presently 15.7 versus an "historical" (since 1974) average of 18.7. The Australian CAPE rose to extreme highs immediately before the crashes of 1987 and 2007, but is currently ca. 15% below its long-term average. So what's the problem? First, as recently as September 2011, the one-year trailing PE was 11.3, and at several more recent points it has fallen below 12.5. Matching these PEs to the All Ordinaries' current EPS ($296) gives an index of 3,550 – a modest 30% below its current level.

Figure 10 summarises the real problem: *bulls' rhetoric resolutely ignores it, but bears' hard data are indisputable: the All Ordinaries Index's earnings are falling*. Thanks mainly to the mining boom, but also to a profligate Commonwealth government, the Ords' EPS zoomed from ca. $200 in 2002 to nearly $500 in 2007. In 2008 they collapsed ca. 40%, i.e., from $485 to $285 in early 2009. They rose to $362 in October 2011, but since then have fallen 20% – and close to their post-GFC low.

Figure 10: Earnings per Share, All Ordinaries Index, January 1965-April 2013



I suspect that earnings will regress to their historical (1965-2003) trend, that is, to the tendency that existed before the mining, government spending and other booms intervened. If earnings regress fully, then they will fall further. Currently, the trend is ca. $238, which is ca. 20% below the market's current EPS. *Trend earnings and an average one-year trailing PE produce a sobering valuation: $238 · 14.1 ≈ 3,350, which is one-third below the All Ords' present level. If you add the possibility of unexpected (to the mainstream) and unpleasant (to everybody) ructions in China (or elsewhere in Asia, particularly Japan), Europe and the U.S., such that earnings fall below trend and the one-year trailing PE ratio falls below its average, then, for example, you have something like $215 • 12 = 2,580. That's roughly one-half of the index's current level.*

The mainstream media in Australia ceaselessly discuss the earnings per share of individual companies. Seldom, however, do they discuss – or even mention – the EPS of the market as a whole, or a reasonable facsimile such as the All Ordinaries Index. Even more rarely have they acknowledged the recent sharp drop of the index's EPS, and the fact that in four of the five years since 2007 the index's EPS has decreased. Moreover, rather than actual and existing (i.e., "hard") data, such as the market's actual EPS, "strategists," journalists and others babble relentlessly about imaginary (i.e., "soft") data – namely strategists' estimates and forecasts of the market's EPS. Twice a year, during "reporting season," John Durie of *The Australian* describes strategists' short-term adjustments of their forecasts. In his column on 9-10 March 2013, he noted without fanfare that before the earnings season that commenced in mid-February, strategists' forecast of EPS growth during 2012-2013 was -6.8%. On the other hand, he drew attention to the fact that, by early March, the estimate had improved to -5.2%. Estimates are now falling a bit less rapidly than they were. This, he had the nerve to assert, constitutes "earnings momentum!"

The assumptions that underlie strategists' forecasts of the All Ords' EPS are seldom explicit; nor do they clarify precisely which sector or scope of the market (i.e., top-20, 100, 200 companies, etc.) is the object of the forecast. Because they (like most financial forecasts) are usually unrealistically optimistic, the media's coverage of EPS is in two respects woeful: it resolutely ignores hard data and languidly obsesses about soft gibberish.

"Reality Check May Spear the Bulls," (*The Australian Financial Review*, 26 February 2013) is an honourable exception. It stated:

> The [recent] rally has delivered huge share price momentum but not equivalent earnings upgrades, triggering fears that stock prices are vulnerable to falls. Perpetual Investments has told clients that markets are experiencing "the most unusual bull market in history" if these gains translate into a prolonged run. "Such extended rallies usually start with low share market valuations and are fuelled by significant cyclical earnings growth. [This one isn't. Accordingly, it] is running on thin air. While price growth can temporarily separate from earnings growth, as it did in 1975, 1982, 1991, 2001, 2009 and 2012, it has never occurred in two consecutive years."

"Shares Look Cheap, in Trend Terms" (*The Weekend Australian Financial Review*, 16-17 February 2013) is much more typical – that is, delusional:

> Cyclically depressed earnings are artificially inflating valuations … Relative to "trend" earnings [which seems to refer to the utterly unsustainable rise from 2003-2007; see Figure 9], the market remains quite cheap. By my estimates [which the journalist neither supplied nor justified], the market's level of forward [i.e., predicted] earnings ended last year about 15% below its trend path.

Let's translate this utterly fantastic sentence: because strategists consistently overestimate earnings, such that actual EPS are presently 15% below the level where strategists predicted a year ago that they would be today, it somehow follows that earnings must rise (i.e., return to the trend of strategists' estimates). In this fantasy world, the strategists' predictions didn't fail: instead, reality fails the analysts! But because the strategists rule supreme, reality will soon conform to their predictions. That's what they predict, anyway. The article concludes: "this implies an attractive five-year [i.e., 2014-2019] annualised total return [sum of capital gains and dividends] for the market of about 14%." We'll see.

Better to Look Like a Fool During a Boom Than a Bust

I believe that stocks in Australia are greatly overvalued, and that at some point they will regress to fair value – which, I estimate, is one-third or more below their present levels. For several years I've incorporated this possibility into Leithner & Co.'s operations (see, for example, Letter 84-86, Letter 90-92, Letter 96-98, Letter 114-116, Letter 124-126 and Letter 148-150). Should unexpected (to the mainstream) economic and financial lightning such – as a recession – strike once again, then markets in Australia and elsewhere could fall 40-50% from their current levels. If that happens, Leithner & Co. is very well prepared: it possesses a huge amount (as a percentage of its total assets) of cash, and also an extensive and well-researched list of investments to buy at depressed prices. The herd, on the other hand, will suffer devastating losses.

Clearly, however, this dour outcome hasn't occurred. What if I'm simply incorrect – that is, stock markets are actually fairly valued or even undervalued, and that for this or some other reason (such as the continuation of central banks' highly inflationary policies) they will subsequently rise further? If so, then for more than a year – indeed, since early 2009 – I've committed "sins of omission." That is, I've not undertaken investments which in retrospect will seem obvious and sensible. Under those conditions, to use the mainstream's jargon, in the short-term Leithner & Co. will "underperform." But peruse our results and accumulation of investors' capital since 1999: not only has Leithner & Co. surpassed by significant margin the All Ordinaries Accumulation Index (which incorporates dividends and distributions); the AOAI must rise considerably from its current level – and Leithner & Co. must lag it – before Leithner & Co. "underperforms" over the long term. Accordingly, a very cautious stance during a bull market costs little compared to the great cost of mistaken bullishness.

Hence I take great comfort from the fact that our portfolio is highly unconventional – that is, far more conservative – than the typical mainstream portfolio. I also rejoice that our thinking and operations are largely but not completely contrarian. Indeed, a few pillars of the establishment reject the crowd's current complacency. In "No, the Banks Are Not Fixed" (*The Weekend Australian Financial Review*, 8-9 September 2012), for example, Kenneth Rogoff, formerly the chief economist at the International Monetary Fund and presently Professor of Economics at Harvard University, declared:

> People often ask if regulators and legislators have fixed the flaws in the financial system that took the world to the brink of a second Great Depression. The short answer is no. Yes, the chances of an immediate repeat of the acute financial meltdown of 2008 are much reduced … But otherwise little has fundamentally changed. Legislation and regulation produced in the wake of the crisis have served mostly as patches to preserve the status quo. Politicians and regulators have neither the political courage nor the intellectual conviction needed to return to a much clearer and more straightforward system.

In October 2012, the IMF warned that "the risks of a serious global recession are alarmingly high," and that "politicians in advanced countries refuse to confront the magnitude of their sovereign debt crises." No kidding! In "The Inconvenient Truth of Real Numbers" (*The Weekend Australian*, 23-24 February 2013), Don Argus, a former Managing Director of NAB and Chairman of BHP-Billiton, emphasised this vital point:

> My conclusion is that if we think we can avoid the fallout from the austerity measures that will be required to stop economic bleeding in developed countries, then we are viewing the world through rose-coloured glasses. … In 2007 it cost $61 to produce a tonne of thermal coal [in Australia], but today it is $176 a tonne compared with $106 a tonne in the rest of the world. If that trend continues then clearly Australia will not be a competitive producer and

> our so-called boom will finish sooner than we think [judging from Figure 10, it already has].
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> In case you have forgotten, our gross national debt – that is, the debt of households, businesses and governments – has doubled since 2005 to about $3 trillion. The only deleveraging that has really occurred in Australia so far has been by businesses. By contrast, government debt continues to rise and household debt has been tracking sideways. … You can plausibly argue that some countries are now technically bankrupt. In other words, they cannot pay their debt obligations without printing money.
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> I am very firmly of the view that … we have become complacent about our public finances. … We can move economic numbers around to get whatever outcome a political system demands, but if we spend more than we earn and if we allocate capital poorly, then we are guaranteed to have troubles ahead.

Another insider, Paul Kelly, is even more forthright. In Rude Awakening After Long Boom (*The Australian* 29 May 2013), he states that "a huge public policy transformation … will be demanded as the resources boom fades." In particular:

> The forces now driving change and assaulting the political culture of Australian complacency will become irresistible and will recast our politics. The questions are: How will Australia manage the decline of the boom that has so effortlessly boosted national income? How serious will be the fall in living standards and real wages? … And will political leaders have the vision and tenacity to terminate the current political culture with its capacity for self-ruin on a grand scale?
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> Australians, raised in tutored ignorance about their own history, are about to relearn one of its classic lessons. It is the curse of [gilded] prosperity. For a decade our national income has been hugely increased by soaring commodity prices while our own productivity stagnated. It is a recipe for short-term gain and long-run pain. The accounting is at hand. The scale of the transition was outlined yesterday by the University of Melbourne's Ross Garnaut, who wants to be optimistic but cannot deny his pessimism. He warns that tolerating "business as usual" policy now means "the decline in average living standards will be large" and the lift in unemployment will be persistent and large.
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> … It needs to be realised that the nation has been betrayed by its leaders on two fronts. They failed to emphasise the temporary nature of the China-driven terms of trade peak and they have failed to tell the proper narrative of what is coming – namely, that the nation faces a difficult transition as the resources boom fades … The public will be shocked because it lives under the delusion that things are tough already when, in fact, much tougher times are coming. A successful transition will need a new reform agenda and that can emerge only from leaders pledged to change the political culture of the past decade. It means an end to the "no losers" mantra, an end to the notion that politics is

> about redistribution, not investment and productivity, and an end to our recent grand deception that progress is achieved by truckloads of social and environmental regulation. These have been the false gods.
>
> If you want to grasp the national challenge post-resources boom, note Garnaut's warning: "Every one of these changes involves some loss of income for some people and some sacrifice of short-term comfort for future gains. Viewed in isolation, each element of reform is politically challenging. Viewed together, at first sight they look impossible." … The test for Australia now is whether the bankruptcy of most of its intellectual class, the weakening of its media, the polarisation of its politics and the rising power of special interests will collectively throttle the impulse for national interest reform now needed.

Argus, Garnaut and Kelly describe an economic and political firmament that's weak and becoming weaker. Does it provide a sound basis for the bear market that Stammer and others proclaim? Alas, here too Stammer's logic traps him. As he acknowledges, short-term improvements of economic conditions do not reliably boost financial markets. Moreover, and as Jay Ritter has emphasised, certain sudden (and hence short-term and unexpected) changes of economic conditions influence – indeed, greatly affect – stocks' returns. In particular, returns usually decline and often plummet when market participants suddenly anticipate a recession, belatedly discover that a recovery is a mirage or that a recession has begun.

A couple of mainstream journalists also question the crowd's current complacent consensus. Adam Creighton, for example ("Animal Spirits Fuelling Global Rush to Optimism," *The Australian*, 7 March 2013), noted:

> The rush of optimism powering global and local equity markets this week appears to rest on little more than "animal spirits." [This phrase, which stems from John Maynard Keynes' *General Theory of Employment, Interest and Money* (1936), is a polite alternative to "sheer delusion" and "naked greed."] Take the U.S., where the key Dow Jones index soared past record highs, while the broader S&P 500 benchmark seems poised to do the same. … Meanwhile, the prospect of a catastrophic U.S. Government default still looms, as the gigantic gap between U.S. Government revenues and expenditures continues to grow with little sign Congress has the power to bridge it. … [In 1995], former Federal Reserve Chairman Alan Greenspan chastised investors for piling into stocks during the dot com boom. [Today,] his successors welcome the latest bout of "irrational exuberance;" indeed, it is a result of their policies.
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> As economists Carmen Reinhart and Kenneth Rogoff pointed out in their book *This Time Is Different: Eight Centuries of Financial Folly* [Princeton University Press, 2010], countries are never forced to default; they choose to [do so]. And the ruthless combination of political and economic logic – crushing debt burdens combined with the voting public's great reluctance to elect governments that will make the sort of spending cuts that make debt repayment possible – are leading them to that choice (see also Alberto Alesina and Francesco

Giavazzi, The Austerity Question: "How" Is as Important as "How Much," 3 April 2012).

Also on 7 March 2013, in another article ("Westpac's Shugg 'Still Smoking'"), Creighton reported:

> Westpac's plain-speaking London-based economist James Shugg remains as gloomy about the global economy as he was over a year ago … Mr Shugg said yesterday he thought the renaissance of economic optimism this year was built on a mirage, a result of "quantitative easing" in the U.S., Europe and Japan, rather than fundamental economic improvements. He suggested that Greece, and potentially other European countries, were likely to default next year.
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> "I stand by every word I said in November 2011," he told *The Australian* from London. At a conference in Queensland in late 2011, Mr Shugg said he had never been so worried about the economic outlook in 25 years. "I've started smoking; I can't get to sleep at night; things are even worse than you're reading about," he reportedly said then. As global stock markets surge to new highs, Mr Shugg said: "There's still so much unjustified optimism out there; the fact is, we're in a sovereign debt crisis that will last for a decade." Westpac's senior London economist, who grew up in Tasmania, said the … transfers required to keep Greece and Italy [and Spain, etc.] in the Eurozone were so great that Germany would be better off leaving the grouping, even though its banks would need to be recapitalised at great cost. … Mr Shugg also suggested Europe was likely to be the trigger of future problems, but said the U.S. was "living on life support."

John Durie ("Problems Have Not Been Solved," *The Australian*, 8 March 2013) aptly summarised the situation: "none of the problems that emerged in 2008 when the global financial crisis hit has actually been repaired; it's just that the high tide is covering the rocks again. The legitimate question from the average punter is: what gives? It doesn't make sense when one of the reasons for the rise in stock prices is the same easy money that caused the problems in the first place."

Indeed, what gives? Given today's (a) self-satisfaction of many market participants, (b) unappealing – that is, implausibly expensive – valuations, (c) bankrupt (in the literal as well as the figurative sense) policies of governments and central banks and (d) parlous condition of the world's major economies, it's comforting to sit upon heaps of cash. The bulls' self-congratulation, their implausible valuations and the economic and financial tremors they deny or ignore – these ingredients do not, I believe, provide sound foundations for healthy investment returns during the next several years. Quite the contrary: they're building blocks of the delusions that eventually trigger crises and bear markets.

John Hussman goes much further. In A Reluctant Bear's Guide to the Universe (4 February 2013) he wrote:

> Present market conditions now match six other instances in history: August 1929 (followed by the 85% market decline of the Great Depression), November 1972 (followed by a market plunge in excess of 50%), August 1987 (followed by a market crash in excess of 30%), March 2000 (followed by a market plunge in excess of 50%), May 2007 (followed by a market plunge in excess of 50%), and January 2011 (followed by a market decline limited to just under 20% as a result of central bank intervention). These conditions represent a syndrome of overvalued, overbought, overbullish, rising yield conditions that has emerged near the most significant market peaks – and preceded the most severe market declines – in history.

In what sense, as Paul Kelly recognises, is the intellectual class in Australia bankrupt? Politicians, bureaucrats (including central bankers and academics), journalists and market strategists vociferously profess morally corrupt, demonstrably false and deeply damaging ideas. Perhaps most notable is the absurd contention that spending (particularly debt-financed expenditure by government) causes prosperity. In A Smart Money Bet Against the Central Banks, 27 May 2013), Bill Bonner ably straightens this warped contention:

> The world's major stock markets, currencies and economies all depend on reckless measures by central banks. In the short run, the central banks can make things appear safe and stable. How? By making lending money at ultra-low rates the norm. It's hard for major players to go broke; they can just re-finance. But in the long run, those same policies can lead to instability, bubbles … and disaster. Too bad, but you can't buy prosperity. You can't print [or] borrow prosperity. … Prosperity comes from hard work, saving and discipline. That is, it comes from responsible policies, not reckless ones (see also Bonner's Health Warning: QE Kills, 4 June 2013).

Whereas since mid-2012 the Australian herd has become increasingly inattentive and mostly content, my doubts and vigilance are waxing. The crowd dreads bear markets and governments move heaven and earth to delay them. Trusting the politicians' extravagant promises and central bankers' extreme policies, the crowd banishes the likelihood of inclement financial and economic conditions; telling the herd what it wants to hear, strategists either anticipate or proclaim a bull market. In contrast, I fear the boom because it causes the bust – but welcome the attractive valuations that the bear's rampages bring.

Compared to many, since mid-2012 I have looked silly. No matter: it's much better that the investor look like a moron during a boom than a bust. Virtually all "strategists" and speculators who mistakenly thought they were investors looked worse than fools in 2007-2009; and they did so precisely because they acted so imprudently in 2003-2007. The problem with false booms is not that sceptics like me morosely commit errors of *omission*. The real problem – which the genuine bust reveals – is that during booms reckless enthusiasts exuberantly commit egregious errors of *commission*. Clearly, the prudent management of risks continues to justify a very conservative, i.e., highly unconventional, investment portfolio.

Chris Leithner